Baron Asset Fund
Baron Growth Fund
Baron Small Cap Fund
Baron Opportunity Fund
Baron Partners Fund
Baron Fifth Avenue Growth Fund
Baron Focused Growth Fund
Baron International Growth Fund
Baron Real Estate Fund
Baron Emerging Markets Fund
Baron Energy and Resources Fund
Baron Global Advantage Fund
Baron Discovery Fund

Baron Funds®

December 31, 2015

Quarterly Report

Review and Outlook

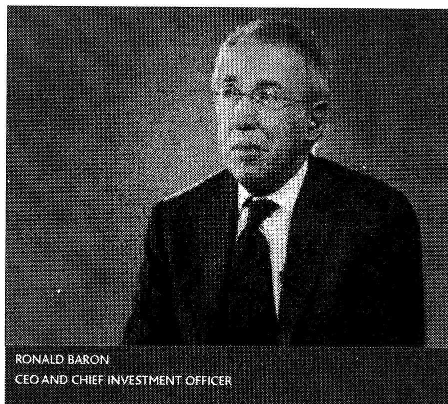
Review.

"The glass is half empty."

On Friday morning, January 15, 2016, the day preceding MLK weekend, Tom Pritzker, Hyatt Hotels' Chairman and principal owner, returned my call from the prior afternoon. He was about to board a plane so our conversation was necessarily brief. Following two weeks of dramatic price declines, U.S. and global stock markets were again falling sharply. Hyatt's share price was again declining even more. "What the heck is going on?" Tom asked. "Why has Hyatt's stock fallen from $50 to $36 in three weeks? Nothing in our business warrants this. I know many analysts are predicting a recession. Maybe. But, there isn't anything in our numbers that indicates recession." He noted that 51% of Hyatt's occupancy relates to business meetings booked significantly in advance. Hyatt's 2016 commercial bookings are stronger than for 2015; those for 2017 are stronger than for 2016.

To give you a sense for how disconnected Hyatt's value had become from its stock price, we estimate Hyatt's "asset light" management business for 137,000 hotel rooms could be worth more than $5 billion. Hyatt's 20,000 owned hotel rooms would be worth an additional $5-6 billion. Hyatt's dramatic share price decline over the past six months despite its continued growth is the result of analysts' recession fears. Hyatt's stock is now valued for just $5 billion! Similar to a 50% off store sale, we suppose. Further, over the next five or six years additional Hyatt management contracts will be converted from backlog to revenue producing assets. If Hyatt's revenue per available room ("RevPAR") on its owned properties increases at its historic 3-4% annual growth rate, the value of this cyclical growth company could reach $18-20 billion...four times its present stock market price!

My conversation with Tom reminded me of a group meeting arranged by J.P. Morgan for about 20 portfolio managers with Marriott's senior executives on November 17, 2015. That was the day after Marriott announced it would acquire Starwood Hotels & Resorts. At that meeting, Marriott's Chairman, Arnie Sorenson, explained the rationale for the acquisition. Most of the portfolio managers were skeptical. Arnie was questioned thoroughly about the transaction and the outlook for Marriott's RevPAR growth which had recently slowed. Arnie said there was nothing in his numbers that suggested Marriott would anytime soon experience declining RevPAR, a measure of hotel businesses' profits outlook. Arnie observed that Wall Street analysts might be able to predict such events. He could not. He believes his responsibility is to consistently grow Marriott's businesses and to take advantage of opportunities when they are presented. He


RONALD BARON
CEO AND CHIEF INVESTMENT OFFICER

explained that Marriott's acquisition, financed principally with equity, would help achieve that goal. Regardless of how attractive Arnie and his team believed the Starwood acquisition, due to analysts' concerns, Marriott's share price has fallen about 25% since November.

"The stock market has predicted 9 of the last 5 recessions." Nobel Prize laureate, MIT Professor Paul A. Samuelson. 1966.

The decline in Hyatt's share price relative to its value as well as that of Marriott's following its acquision have been among many "glass is half empty" paradigms during the past six months. This has happened to several attractively valued, generally small and mid-sized cyclical growth companies in our portfolios. This has also happened frequently to the rapidly growing businesses that have been so rewarding for us to study and in which we principally invest ...because they have been such profitable investments over the long term.

Stock market prices changed little on average during 2015 despite the unusually strong price appreciation of a small number of technology and health care stocks. This is because more than half of U.S. stock prices <u>fell</u> with a median decline of 22.5%. In fact, 50% of the S&P 500 stocks fell with a median decline in value of 15.93%. 60% of the small cap stocks in the Russell 2000 Growth Index also fell, with a median decline of 23.64%! After about tripling their values per share since March 2009, most Baron mutual funds declined modestly during 2015. This is as you can see from our performance charts and portfolio managers' letters that follow.

When such events take place, there is never a shortage of explanations or commentators to tell us "why?" Low oil prices have potential to bankrupt many energy businesses; resultant distress in "high yield" financial markets of which

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energy businesses are important participants; concern about China's slowing growth, unpredictable economic policies and focus on elimination of corrupt practices; concern that debt-driven economic expansions from 1982 through 2007 have left world economies too indebted; the strong dollar creates deflation; an unusual Presidential election campaign; a significantly changed stock market structure with greater volatility caused by ETFs and high frequency trading that has left us vulnerable to potential "flash crashes;" and slower-than-desired inflation are just a few reasons markets have fallen. Were investors of a different mindset, you might be surprised to learn that it would be as easy to make strong arguments that "the glass is half full" in virtually *all* these instances.

Outlook.

"The glass is half full."

For example, oil companies' profits have fallen 75% in the past two years negatively impacting short term S&P 500 profits. Oil company profits have declined because the price of oil has fallen from $100 per barrel two years ago to $30. Oil prices have declined because fracking technology developed in the United States has allowed the exploitation of America's enormous shale energy reserves that could otherwise not have been economically developed.

While low oil prices mean bankruptcies and defaults for many oil companies, *what's bad for them is good for the rest of us!* There are 97 million barrels of oil produced in the world every day. The United States uses about 20 million barrels per day. Since we now pay about $80 less per barrel, our nation and its citizens are *saving* $1.57 billion per day. Payments to energy producers for oil are the equivalent to a "tax" on our citizens and economy. Just like the taxes we pay on 1099 income to our government. Savings from lower oil prices are the *equivalent of a $570 billion annual tax cut* that should soon help make our economy grow faster! Our nation's government about which politicians often express concern has a projected annual budget deficit of $544 billion!

In contrast to 2007 when banks were highly leveraged, they have since been recapitalized, new regulations prohibit them from engaging in risky principal transactions; counterparty rules have been strengthened; and, banks' exposure to energy loans is modest. Banks will lose money on energy loans for sure, but it is unlikely such writeoffs will cause cataclysmic bank failures that resemble what occurred during 2008-09.

An OpEd by economist Donald Luskin in the January 8, 2016, *The Wall Street Journal,* "The Recession Caused by Low Oil Prices," posits that due to the "technology breakthrough of horizontal drilling and hydraulic fracturing [developed in the United States], consumers worldwide have received a tax cut of $7.8 billion per day"...that should eventually cause an economic boom rather than a bust. It is only because of the speed of this energy price decline that a recession in the short term is a threat. Luskin concludes that low oil prices provide cause for optimism. "The best news is that, thanks to fracking, recessions caused by high oil prices are a thing of the past."

We believe opportunities for growth businesses in our nation have never been stronger...perhaps not in mature cyclical businesses like steel, cement, oil, commodities and retail. But in health care, technology, electric cars and autonomous driving vehicles, for example, more jobs are being created than there are individuals trained to fill them! Medicine a century ago was rudimentary compared to today. That is why life expectancies of Americans in 1900 was 47 years while today it is nearly 80. Within the next century it could reach 125 years! Antibiotics were invented during World War II. Vaccinations for the dreaded scourge of polio in the 1950s. As a result of recently developed, inexpensive and rapid gene sequencing, in the next decade most cancers could become chronic disease states, not death sentences. Alzheimer's is probably within 15 to 20 years of successful treatment. Access to "big data" by health care providers on their iPads will soon allow all of us to obtain the "right" care, higher quality, lower cost with better outcomes, regardless of where we present for treatment! Autonomous driving will save lives and trillions of dollars per year. Electric cars are not only safer than cars powered by internal combustion engines...they are better for the environment.

We think inexpensive energy and inexpensive money may persist much longer than most expect. In the short run, oil is cheap because markets are oversupplied. In the long run, if transportation shifts to electric power from internal combustion engines, there will be less demand for oil than most anticipate. Energy is an important cost for our economy. As described by economist Donald Luskin, low cost energy will ultimately help cause an economic boom. Further, as we have been discussing for a long time, our nation and other developed economies are presently heavily indebted. America's debt-to-GDP percentage currently approximates 345%. This is following a 25-year debt-driven economic expansion from 1982 to 2007. Debt increased during this period from about 160% of GDP, near where it had remained since the 1930s. We are now in a secular deleveraging cycle because significantly higher interest rates are unaffordable. It could take 20 years to return to acceptable debt-to-GDP ratios. We think our dollars will then be worth much less...and, our stocks, real estate, art and businesses will be worth much more.

Ronald Baron
January 25, 2016

The discussion of market trends and companies are not intended as advice to any person regarding the advisability of investing in any particular security. Some of our comments are based on current management expectations and are considered "forward-looking statements." Actual future results, however, may prove to be different from our expectations. Our views are a reflection of our best judgment at the time and are subject to change any time based on market and other conditions, and we have no obligation to update them.

Cumulative Performance of Institutional Shares for the Period 3/31/2009 – 12/31/2014

Fund	Performance
Baron Asset Fund	208.34%
Baron Growth Fund	210.44%
Baron Small Cap Fund	198.35%
Baron Opportunity Fund	191.55%
Baron Partners Fund	244.23%
Baron Fifth Avenue Growth Fund	178.23%
Baron Focused Growth Fund	168.29%
Baron International Growth Fund	128.32%

Investors should consider the investment objectives, risks, and charges and expenses of the investment carefully before investing. The prospectus and summary prospectuses contain this and other information about the Funds. You may obtain them from the Funds' distributor, Baron Capital, Inc., by calling 1-800-99BARON or visiting www.BaronFunds.com. Please read them carefully before investing.

Portfolio holdings as a percentage of net assets as of December 31, 2015 for securities mentioned are as follows: **Hyatt Hotels Corp.** – Baron Asset Fund (1.5%), Baron Partners Fund (5.0%*), Baron Focused Growth Fund (7.3%), Baron Real Estate Fund (2.0%); **Marriott Vacations Worldwide Corp.** – Baron Growth Fund (1.3%*).

Portfolio holdings may change over time.

* % of Long Positions

Past performance is no guarantee of future results. The investment return and principal value of an investment will fluctuate; an investor's shares, when redeemed, may be worth more or less than their original cost. The Adviser has reimbursed certain Fund expenses for Baron Opportunity, Fifth Avenue Growth, Focused Growth and International Growth Funds (by contract as long as BAMCO, Inc. is the adviser to the Fund) and all the Funds' transfer agency expenses may be reduced by expense offsets from an unaffiliated transfer agent, without which performance would have been lower. Current performance may be lower or higher than the performance data quoted. Performance for the Institutional Shares prior to May 29, 2009 is based on the performance of the Retail Shares, which have a distribution fee. The Institutional Shares do not have a distribution fee. If the annual returns for the Institutional Shares prior to May 29, 2009 did not reflect this fee, the returns would be higher. For performance information current to the most recent month end, visit www.BaronFunds.com or call 1-800-99BARON.