

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®

## Quarterly Report

September 30, 2016

**"We're living here in Allentown and they're closing all the factories down...and it's getting very hard to stay." Billy Joel. "Allentown." 1982.**

Soon after the 1980-82 recession, Billy Joel and another legendary, working class hero, Bruce Springsteen, sang about the plight of factory workers who were losing their jobs. "They're closing down the textile mill across the railroad tracks, foreman says these jobs are going, boys, and they ain't coming back," was Bruce's gravelly voiced refrain in "My Hometown." That was a decade before third-party Presidential candidate Ross Perot predicted a "giant sucking sound" caused by factory jobs lost to Mexico when the North American Free Trade Agreement was implemented in 1994. Perot's warning was more than two decades before Donald Trump's plaint that, "We're losing jobs to Mexico, China and other places at a higher rate than ever."

In 1970, at the start of my career, investors were concerned that America's trade deficit would cause an imminent decline in factory jobs. I thought those anxieties were overstated since our economy had become less dependent upon manufacturing, more diversified and services, knowledge and technology oriented. Contrary to expectations, for the next 30 years, most of the time, America's factory jobs remained between 17 and 18 million. Further, from 1989-2000, technology and innovation increased worker productivity 4.1% per year while factory output gained 3.7% per year; increasing almost 50% during this period. However, in the wake of the 2008-09 recession and resultant cyclical decline in output, only 12.3 million American factory jobs remain. In 1989, factory jobs represented 17% of our workers. Those jobs are now just 9% of our workforce. Many attribute lost factory jobs to uncompetitive wages in America, stringent environmental and worker safety regulations, currency manipulation by trading partners, and higher income taxes than competitor nations. However, since American factory workers are competitively disadvantaged



RONALD BARON  
 CEO AND CHIEF INVESTMENT OFFICER

because they earn \$79,000 per year including benefits, compared to \$8,000-\$9,000 or less in many countries, we think the "Boss" had it right when he sang, "those jobs are going, boys, and they ain't coming back"...unless, of course, we want to pay \$60,000 for Toyota Corollas and a lot more for steel and other manufactured products than we do now!

We believe a Technology Revolution comprising plant automation, artificial intelligence, and robotics is the most significant reason factory jobs did not increase from 1970 through 2000 while output more than doubled. We also believe additional plant automation investments coupled with the 2008-09 recession are principally responsible for the recent meaningful decline in American factory jobs, even though factory output is only 4% less than its pre-recession peak.

Were it not for productivity gains and factory output increases since 1970, there would be perhaps three-to-four times as many factory jobs in America as today! However, prices for goods and services in America would likely be much, much higher than they are today...and our standard of living much, much lower.

The Technology Revolution now impacting our factories is akin to the Industrial Revolution two hundred years ago. At the dawn of the Industrial Revolution, Luddite workers in London rioted and destroyed textile machinery they believed threatened their jobs. Today's Technology Revolution, met with protests and anger in America's Rust Belt factories, is in its early innings and, we think, is irreversible. When our analysts and I travel America visiting companies and factories as we research businesses, one thing is apparent: robots have taken the jobs of many workers...and bigger, smarter, faster, more specialized robots are taking the jobs of general purpose robots! The societal benefit is better,

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## Letter from Ron

cheaper products and an improved standard of living for all of us...including displaced workers. We just need a stronger safety net for those displaced. Blue collar workers also need the ability to educate their children with next generation skills without incurring unmanageable debt. This to make certain they, too, can benefit from the growth of our economy in the midst of our Technology Revolution.

Do not lose hope. Whoever becomes our next President is likely to significantly increase infrastructure investments, which will create jobs and strengthen our nation. The vibrancy of our nation and its economy is becoming increasingly visible in what we used to call America's Rust Belt. Our nation's Midwestern cities may instead already deserve the name, "startup cities." Millennials, whom we regard as the 21st century's "immigrants," and whom we think will boost America's growth, are resettling in those post-industrial cities. Generous incentives from those cities that are leveraging their universities are causing redevelopment of their downtown urban centers. Pittsburgh has attracted Uber in part because its Carnegie Mellon Technology Center is undergoing meaningful expansion. Pittsburgh's downtown population increased 20% during the past 10 years, Cincinnati's downtown population doubled over the same period, St Louis' population also doubled, Kansas City's downtown nearly quadrupled, and Cleveland's increased 50%. Detroit, alone among the top 10 Midwestern cities, has not increased its downtown urban population, but things are now looking better there too. Just as they are in Tribeca, Hudson Yards, Silicon Alley in the Flatiron District in New York City; The Brooklyn Navy Yard, New York; South Beach in Miami and too many other places to list.

Where are the jobs in those urban centers? They are in services and technology. Not so much in blue collar manufacturing. Analytics, coding, software engineering, marketing, alternative energy, logistics in the new technology corridors, cyber defense, entertainment, leisure, media, health care and traditional defense. Israel has an "Iron Dome" to protect against missile attacks from its enemies. Of course, America will also soon develop a shield, whether from space with lasers or terrestrial, to protect our nation the same way. Some of this work will be done in America's post-industrial cities. We think the dark cloud of the 2008-09 recession and the loss of blue collar manufacturing jobs is the proximate cause of this development.

Warren Buffett recently remarked that, "The luckiest person born in history is the baby being born in the United States today." He continued that although a compound rate of 2% may not sound like a lot, over his 86 year lifespan, that means real wage growth per capita (inflation adjusted) has increased nearly sixfold since 1930. He believes the lifestyle of our citizens will continue to improve at least as rapidly as it has during his lifetime. For example, life expectancy for Americans in 1900 was 45 years. It is now 80 and increasing by three months every year!

One more thing. According to Richard W. Rahn, a senior fellow at the Cato Institute and Chairman of the Institute for Global Economic Growth, the average low income American today lives better than the French King Louis XIV, the Sun King, more than 300 years ago. "The average low-income American lives in a home with air conditioning, a flat screen TV and a dishwasher; and owns an automobile. Louis XIV lived in constant fear of dying from small pox and many other diseases that are now cured quickly by antibiotics. His palace at Versailles had 700 rooms but no bathrooms and no central heating or air conditioning. One hundred years ago, John D. Rockefeller was the richest man in the world. He had bathrooms but no air conditioning and was in constant danger of dying from ailments that are now quickly treatable." We are convinced that our grandchildren's grandchildren will think about our lives the way we think about the lives of Louis XIV and John D. Rockefeller.

One of the lessons I learned in law school was the phrase, "Res ipsa loquitur." It means "the thing speaks for itself." That is how I think about the greatness of our country and its economy. It of course can improve...which I am certain it will. As an architect might say, the "bones" are there.

**"No matter how great the talent or efforts, some things just take time. You can't produce a baby in one month by getting nine women pregnant." Warren Buffett. 2013.**

Baron Funds invest in growth businesses for considerably longer time periods than most mutual funds. This is because we attempt to materially outperform benchmark indexes over the long term by investing in companies that could grow much faster than passive indexes over the long term. For example, Baron Growth Fund's holding period for its investments is over 12 years! Most actively managed mutual funds attempt to compete against their benchmark indexes over the short term and turn over their

entire portfolios every 1.3 years. This means they purchase and hold stocks on average for 16 months before selling them.

Baron Growth Fund has outperformed its benchmark over nearly 22 years by on average more than 526 basis points per year. This is despite several periods when this and the performance of other Baron Funds has been only average. A significant portion of Baron Funds' assets under management have investment holding periods that average in excess of six years and have also outperformed their indexes over the long term. See Table 1. We believe few active managers employing short-term trading strategies have outperformed over the long term. This is since the research such investors perform is focused on news not fundamentals.

In order to significantly outperform passive indexes and other active managers, our Firm's 36 investment professionals research businesses with compelling growth opportunities that "just take time" to realize. To provide us with confidence to hold such investments when those companies' share prices do not outperform in the short term, we try to imagine and score the likelihood of many favorable and unfavorable scenarios. We especially focus on whether competitive advantages of businesses in which we invest are durable. We also carefully study events that can create or forestall business growth. To invest with conviction for years in businesses with compelling growth opportunities, we also need to carefully assess management and its vision.

We began to purchase Vail Resorts in 1997. We made significant investments in Vail through 2006. Our returns on that investment through 2006 were modest. However, from 2006 through 2016, Vail's share price increased nearly sixfold. Based on our estimates for cash flow growth and a modest increase in multiple, Vail shares could double again in five or six years. We invested in Vail since we believed the physical attributes of its ski mountains, what we considered to be Vail's competitive advantage, were better than any other and its growth opportunity was strong. Vail's management then thought the idea of investing mountain cash flow to regentrify Vail Village where there had been virtually no construction since 1970 was not a good one. Management also considered additional investments in \$15 million high speed ski lifts, \$15 million restaurants, more snowmaking and more grooming with questionable returns to be "doubling down" and "too risky." We thought those ideas offered potential to enable Vail to increase daily ski pass

prices from \$44 to \$100 and significantly boost cash flow. Baron became Vail's largest shareholder in 2006; and, Rob Katz, a Board member and we think a spectacular executive then became its CEO. A building boom in Vail ensued; Vail made significant investments in Vail mountain; Vail's annual season pass sales mushroomed; it received the National Park Service's approval to add summer mountain rides that we expect to be an appealing attraction; and Vail acquired other ski mountains, including Park City/Canyons, Whistler, and Perisher. Vail's daily ski ticket cost \$178 last year! Vail's share price was \$27 in 2006. It is now \$156. We think Vail's growth opportunities remain favorable, its competitive advantages are stronger than ever, and its management exceptional.

From 1966 to 1969, I attended George Washington University Law School in the evenings and was a Patent Examiner in the United States Patent Office by day. In the summer of 1969, I read that Manor Care, a nursing home business, planned an initial public offering. I was interested because President Lyndon Johnson four years before persuaded Congress to create Medicare. I thought Medicare legislation would increase demand for Manor Care's services. Medicare provided health insurance to individuals over 65, half of whom had previously been unable to afford medical care.

After studying Manor Care's prospectus, I borrowed \$2,000 from Household Finance, Beneficial Finance, and The United States Patent Office Credit Union enabling me to invest in Manor Care stock. After Manor Care sold 360,000 of its 1.4 million outstanding shares at

\$12 per share, Manor Care's book value was just \$5 million. In the 1970's, I became an institutional securities analyst and recommended our clients purchase Manor Care. Those investments were successful. When we started Baron Capital in 1982, we invested a significant percentage of our initially modest assets under management in Manor Care's stock. By 1998, Baron mutual funds and clients had become one of Manor Care's largest shareholders and remained so until its acquisition by The Carlyle Group in 2007. We invested for all those years because we believed Manor Care's growth prospects were bright, we thought the real estate it owned was undervalued, and we believed its properties were more attractive than others. At least as importantly, we invested because, after spending a lot of time with Stewart Bainum, the company's CEO whose family was Manor Care's largest shareholder, we believed he was unusually talented and would treat shareholders fairly. When the company merged with HCR, fortunately for us, we found its CEO, Paul Ormond, a terrific executive and wonderful person. We were right. HCR ManorCare was sold to Carlyle for \$4.9 billion in 2007! That was 1,000 times its value in 1969! We also received dividends of hotel franchisor Choice Hotels, nursing home pharmacy Vitalink, and hotel owner Sunburst along the way.

Following the 2008-09 worldwide financial panic, Stewart invested for his family to help recapitalize 50 of the 16,000 community banks in small town USA that then existed. Only 6,000 such banks remain. Stewart, not surprisingly to those who know him, earned very strong returns on his family's community bank investments over the past 10 years.

Stewart called recently and asked me if I would meet with Joe Squeri and Tim Peterson, who managed those investments for the Bainums. I have known Joe for a long time. He is the former CFO of Choice Hotels, which Stewart also controls and in which Baron has been a shareholder following the Choice spinout from Manor Care in 1996. Baron Funds has also earned attractive returns and received large special dividends from our Choice Hotels' investment...with still more appreciation to come, we think.

At the end of my two hour, incredibly interesting meeting with Joe and Tim, I asked them what else they were doing that might be of interest for Baron Funds. Joe replied that Stewart had recently asked him the same thing and wanted the two men to find an interesting investment for Stewart's mother. Joe then asked Stewart his mom's age? When Stewart replied, "96," Joe asked what time horizon Stewart had in mind? "Fifteen years," was the reply! I love Stewart. Although my investment horizon is long, I now think Stewart's may be longer.

I could write about Hyatt, Under Armour, Tesla, Arch Capital, Edwards Lifesciences, Schwab, Wynn Resorts and dozens and dozens of our other, successful long-term investments but I won't. One of my friends, who reviews my conference speeches every year and suggests edits, a year or two ago argued to eliminate paragraphs that I thought were required to fully explain a concept. "Ron," he told me. "I have never heard anyone leave a speech regardless of how brilliantly delivered and remark, 'Wow! That was great. I just wish it was five minutes longer.'"