

Can You Imagine Life Without The Internet?

We use the Internet to communicate, shop, play games, interact socially, find restaurant menus, buy theater tickets, book travel reservations, and find information about anything and everything. The Internet has expanded beyond the desktop with smartphones, tablets, and other mobile devices. There are more smartphones expected to be sold in 2012 than PCs and notebooks. Moreover, the Internet has become more global, connecting users across borders and boundaries. It is a tool capable of reaching and catalyzing a wide audience. Twitter and Facebook have even been used to spark revolutions. At the same time, the Internet has become increasingly local in providing information about resources and events near you. It has become personal and customizable, providing information that is important to the user while allowing advertisers to target their advertising geographically and demographically.

There are two primary ways for businesses to utilize the Internet: 1) sell or provide goods or services online, otherwise known as e-commerce, and 2) sell advertising.

As we think about the tidal wave of change the Internet brings to our daily lives, what's most staggering is how nascent the industry is: currently only 8% of U.S. commerce is online and only 19% of global advertising spent is online. We think this growth will accelerate as the younger, more technologically astute generations comprise a greater portion of our global population.

SMARTPHONES CHANGE THE DIGITAL LANDSCAPE

Smartphone users today represent 37% of total U.S. handsets, and by the end of 2012 they are expected to represent over 50% of U.S. handsets. Smartphones drive significant data usage and allow consumers to be "always on." These phones permit companies to provide advertising and services that are location sensitive with an immediate impact. For example, if your flight is cancelled, you can use your phone to quickly book an alternative flight or a hotel.

An important aspect of smartphones is how they are used for local searches. A recent Google study found that 95% of smartphone users search for local information, and that 88% of these users take action within a day. The immediacy of consumers' local searches creates several opportunities for companies that can fulfill those requirements utilizing location awareness for greater context. Examples include FourSquare, Google Maps, HotelsToday and Zillow.

However, as consumers view a greater proportion of content on mobile handsets, how content is searched and monetized is impacted. On a smartphone today, consumers are likely to visit fewer sites than they would on a PC, due to the screen size and the lack of a full keyboard. As a result, we think fewer sites stand to benefit from mobile when compared to PC browsing, and the monetization for most sites on mobile will therefore be appropriately lower.

Several financial institutions and credit card companies along with companies like Google, Inc., Apple, Inc., and Paypal have aspirations to be players in the emerging sector of mobile payments. Mobile payments allow you to pay for goods or service from your phone instead of paying with cash, check, or credit cards. Today, these payment mechanisms are restricted to premium SMS, direct carrier billing, website purchases through a mobile browser, and Near Field Communications (NFC). NFC is a set of standards for smartphones and similar devices that allow them to communicate with each other without touching, but by being in close proximity. NFC devices can be used in contactless payment systems, similar to those used in credit cards, to allow mobile payment to replace or supplement existing credit card and debit card type systems. The combined market for all types of mobile payments is expected to reach more than \$600 billion globally by 2013. Google, Inc., a Baron investment, is currently the only company that has a large commercial NFC deployment in the market today. As Google pushes further into local advertising and promotions, it plans to utilize Google Wallet to enhance its relationship with consumers and businesses. Google Wallet is a mobile payment system developed by Google that allows smartphone users to store credit cards, loyalty card, and gift cards on their mobile phones, utilizing NFC for the payment of goods and services. Consumers will be able to redeem promotions or loyalty programs through Google Wallet, enabling stores to enhance their relationships with consumers.

GLOBAL GROWTH OPPORTUNITIES ARE SIGNIFICANT

In 2011, five countries accounted for 46% of global Internet users. These countries include: the U.S. with 240 million online users and 76% online penetration, Brazil with 76 million online

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ASHIM MEHRA
RESEARCH ANALYST

WORLD INTERNET USAGE AND POPULATION STATISTICS

World Regions	Population (2011 Est.)	Internet Users Dec. 31, 2000	Internet Users March 31, 2011	Growth 2000-2011	Penetration (% Population)
Africa	1,037,524,058	4,514,400	118,609,620	2527.40%	11.4%
Asia	3,897,740,877	114,304,000	922,329,554	706.9%	23.8%
Europe	816,426,346	105,096,093	476,213,935	353.1%	58.3%
Middle East	216,258,843	3,284,800	68,553,666	1987.0%	31.7%
North America	347,394,870	108,096,800	272,066,000	151.7%	78.3%
Latin America/ Carib.	597,283,165	18,068,919	215,939,400	1037.4%	36.2%
Oceania/ Australia	35,426,995	7,620,480	21,293,830	179.4%	60.1%
WORLD TOTAL	6,930,055,154	360,985,492	2,095,006,005	480.4%	30.2%

Source: www.internetworldstats.com. Copyright ©2001-2011, Miniwatts Marketing Group. All rights reserved worldwide.

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users and 39% penetration, Russia with 60 million online users and 42% penetration, China with 384 million online users and 29% online penetration, and India with 61 million users and only 5% online penetration. As the chart below demonstrates, with only 30% of the world's population online there remains considerable room for growth.

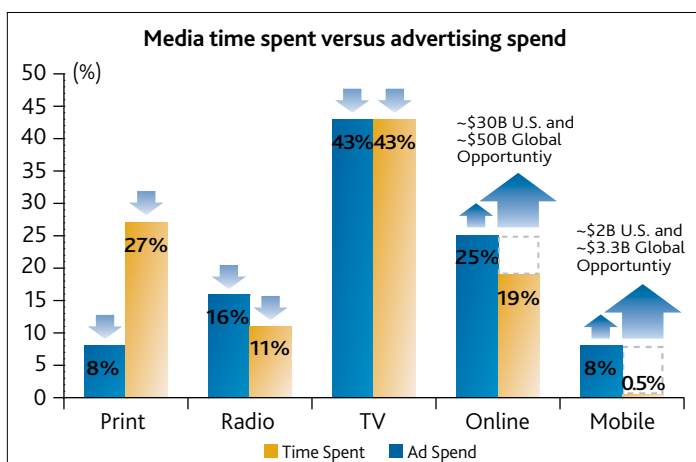
We think the next chapter of Internet growth will be driven by increasing broadband penetration and mobile 3G rollouts globally. Baron invests in the global Internet in two ways: 1) U.S. based Internet companies that have substantial international businesses, and 2) foreign based Internet companies. Several Baron portfolio holdings such as Google, Inc. and priceline.com, Inc. receive 50% or more of their revenues out-

side the U.S., and we think the faster growth of Internet access in emerging economies will be a substantial benefit to these companies. Other Baron portfolio companies such as LinkedIn Corp. and Blue Nile, Inc. are also accelerating their efforts to penetrate international markets in 2012 and beyond.

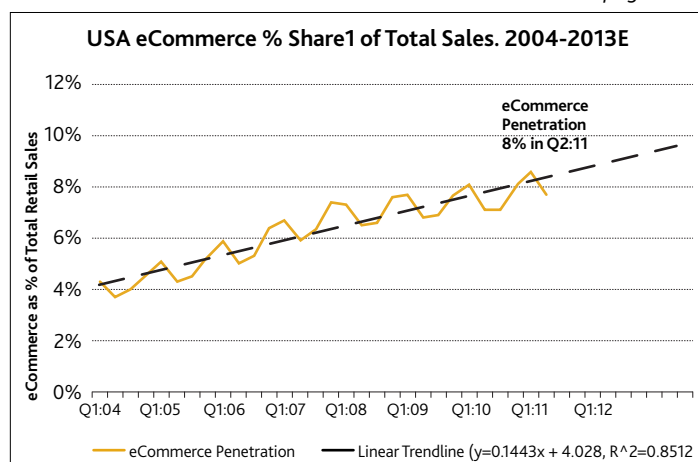
THE SHIFT TO ONLINE SHOPPING AND ADVERTISING REMAINS IN THE EARLY INNINGS

Total Internet advertising revenue is generally expected to increase 17% year-over-year to \$78.5 billion, display is expected to increase 15% year-over-year, paid search is expected to increase 19% year-over-year, and online video an impressive increase 58.5% year-over-year to \$4.7 billion in world-wide revenues. While the industry has focused on the gap between media spent online and the ad dollars spent online (see chart below), for several years, progress has been modest. We think this gap should continue to close over the next several years as mobile Internet and social applications usage grows. Social applications now account for 23% of time spent online by consumers. Advertisers' ability to target consumers continues to improve through richer data profiles of consumers, online measurement tools, and greater sophistication amongst advertisers and technology providers.

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Source: eMarketer 3/11, Goldman Sachs Research estimates



Source: Kleiner Perkins Caufield Byers; U.S. Dept. of Commerce; comScore. 10/18/2011

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We think e-commerce will continue to expand in the U.S. and worldwide as a greater number of transactions are influenced by mobile and online research, superior pricing, broader selection, and greater convenience. We believe e-commerce will benefit the pure-play Internet companies like Amazon.com, Inc. and priceline.com, and traditional retailers will continue to increase their investments into e-commerce in an attempt to compete more strongly for those online shopping dollars. As consumers utilize their mobile phones more frequently to perform in-store price comparisons, the pace of e-commerce and online-influenced commerce broadly should accelerate.

BARON'S PERSPECTIVE

The Internet sector represents tremendous growth and opportunity for investors. Baron's disciplined investment approach regarding this sector is consistent with its broader investment

process. The importance of leadership and strong teams, valuation discipline, and businesses that are constantly seeking to improve their business are some of the characteristics we look for in potential investments.

Strong leadership teams and CEOs are paramount to a business's success. We look for CEOs who are passionate founders or veteran executives of past Internet companies. Given the competition for engineering talent in Silicon Valley, we also monitor a company's ability to recruit and retain technical personnel.

While many Internet companies today are household names and get a disproportionate amount of financial media publicity, the high growth characteristics and excitement around these types of companies, along with our longer-term investment horizon, require us to apply a more disciplined valuation filter. We scrutinize not only their short-term growth but also the rates at which we think these companies

will be growing years from now.

Kaizen is a Japanese term that means “continuous improvement” and was taken from the context of Japanese auto manufacturers who were focused on making, changing and monitoring results, and then adjusting. Smart executives of Internet companies have adopted the Kaizen philosophy, as they are constantly improving their products and business, technology, and growth initiatives. As investors, we recognize that the most successful companies are able to do this as they grow at above-industry growth rates, while maintaining or improving margins.

As the Internet continues to evolve, we expect the Internet sector to create many more interesting companies in which to invest. We continue to look for these types of companies that represent the leaders of the sector, with talented leadership teams and strong business models, but at valuations that are attractive for long-term investors. ♦

ALEX UMANSKY ARRIVES AT BARON 5TH AVENUE



ALEX UMANSKY
PORTFOLIO MANAGER

Baron Fifth Avenue Growth Fund has a new portfolio manager, Alex Umansky. Alex joins Baron from Morgan Stanley, where he worked since 1993. Alex was an analyst and co-portfolio manager of a number of strategies, including large cap.

Alex Umansky shares Baron's philosophy that value-added investment results can be achieved more consistently through bottom-up analysis and judgment than top-down forecasting.

Under Alex's leadership, higher conviction investments will represent a larger part of the Fund's holdings. Where the top 10 holdings had represented about 25% to 35% of the Fund in the past, Alex expects that to climb to 35% to 45%, believing that these companies will be the strongest contributors to the Fund's return over time. ♦

INTRODUCING BARON ENERGY AND RESOURCES FUND



JAMIE STONE
PORTFOLIO MANAGER

Baron Funds has launched Baron Energy and Resources Fund to take advantage of attractive investment opportunities arising from three key trends:

- Significant technological advances over the next 10 years changing how we find, produce and consume energy and resources;

- Demand for energy and materials rising due to global economic growth, especially in emerging markets; and
- Decades of underinvestment in production capacity for oil and essential resources.

Baron Energy and Resources Fund is managed by Jamie Stone, who joined Baron in 2009 as a research analyst covering energy and resources. He has 23 years of analytical and investing experience, most of it as an energy analyst. ♦

Institutional Sales & Relationship Management

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You should consider the investment objectives, risks, charges, and expenses of any of the Baron Funds carefully before investing. The prospectus contains this and other information about Baron Funds. You may obtain one from its distributor, Baron Capital Inc., by calling 1-800-99-BARON or visiting www.BaronFunds.com/prospectus. Please read it carefully before investing.

The discussion of market trends and companies throughout this report 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 of the publication of this report and are subject to change any time based on market and other conditions, and we have no obligation to update them. Investing in the stock market is always risky.

As of 12/31/2011 the top ten holdings of Funds mentioned as well as any other holdings mentioned in this publication are: **Baron Asset Fund** are: Gartner, Inc. 3.9%, Fastenal Co. 3.7%, IDEXX Laboratories, Inc. 3.7%, Arch Capital Group Ltd. 3.1%, FactSet Research Systems, Inc. 3.0%, C.H. Robinson Worldwide, Inc. 2.9%, Vail Resorts, Inc. 2.9%, SBA Communications Corp., 2.9%, Verisk Analytics, Inc., 2.9%, Equinix, Inc. 2.8%, Priceline.com, Inc. 2.1%, LinkedIn Corp. 0.7%. **Baron Emerging Markets Fund** are: O&G Petroleo e Gás Participações SA 2.3%, TOTVS SA 2.3%, Itaú Unibanco Holdings SA 2.2%, Bank Rakyat Indonesia (Persero) Tbk PT 2.2%, CFR Pharmaceuticals SA 2.2%, Daum Communications Corp. 2.0%, Anhanguera Educacional Participações SA 1.9%, Dah Chong Holdings Ltd. 1.9%, Exillon Energy plc 1.9%, Qualicorp SA 1.9%. **Baron Fifth Avenue Growth Fund** are: Google, Inc. 5.4%, Apple, Inc. 5.2%, Amazon.com, Inc. 4.8%, Visa, Inc. 3.5%, Fastenal Co., 3.0%, Brookfield Asset Management, Inc. 3.0%, MasterCard, Inc. 3.0%, Monsanto Co. 3.0%, YUM! Brands, Inc. 2.9%, Baidu, Inc. 2.8%, Priceline.com, Inc. 2.5%, LinkedIn Corp. 0.5%. **Baron Focused Growth Fund** are: Hyatt Hotels Corp. 6.6%, Genesee & Wyoming, Inc. 5.9%, Verisk Analytics, Inc. 5.6%, Airgas, Inc. 5.1%, Fastenal Co. 4.7%, Choice Hotels International, Inc. 4.6%, MSCI, Inc. 4.3%, Arch Capital Group Ltd. 4.1%, Dick's Sporting Goods, Inc. 4.0%, AMERIGROUP Corp. 3.9%. **Baron Growth Fund** are: Dick's Sporting Goods, Inc. 3.2%, ITC Holdings Corp. 2.9%, Core Laboratories N.V. 2.7%, Arch Capital Group Ltd. 2.7%, Mettler-Toledo International, Inc. 2.5%, FactSet Research Systems, Inc. 2.4%, AMERIGROUP Corp. 2.4%, DeVry, Inc. 2.4%, MSCI, Inc. 2.3%, ANSYS, Inc. 2.2%, Blue Nile, Inc. 0.7%. **Baron International Growth Fund** are: Eurofins Scientific SE 3.1%, bwin.party digital entertainment plc 3.0%, Bridgestone Corp. 2.7%, Julius Baer Group Ltd. 2.6%, Symrise AG 2.5%, Experian plc 2.4%, Opera Software ASA 2.3%, FANUC Corp. 2.3%, Compagnie Financière Richemont SA 2.2%, Kirkland Lake Gold, Inc. 2.2%. **Baron Opportunity Fund** are: Equinix, Inc. 3.9%, SBA Communications Corp. 3.7%, Gartner, Inc. 3.3%, Polypore International, Inc. 3.2%, CARBO Ceramics, Inc. 2.9%, Bankrate, Inc. 2.8%, MSCI, Inc. 2.8%, Discovery Communications, Inc. 2.6%, CoStar Group, Inc. 2.6%, ANSYS, Inc. 2.5%, Priceline.com, Inc. 1.8%, Google, Inc. 1.6%, Blue Nile, Inc. 0.8%, LinkedIn Corp. 0.7%. **Baron Partners Fund** are: Fastenal Co. 12.0%, ITC Holdings Corp. 10.4%, Arch Capital Group Ltd. 10.2%, FactSet Research Systems, Inc. 9.6%, Hyatt Hotels Corp. 8.8%, Dick's Sporting Goods, Inc. 8.1%, Verisk Analytics, Inc. 6.8%, MSCI, Inc. 5.5%, C.H. Robinson Worldwide, Inc. 5.1%, The Charles Schwab Corp. 4.6%. **Baron Real Estate Fund** are: Wyndham Worldwide Corp. 5.9%, Equinix, Inc. 5.1%, Capital Senior Living Corp. 4.9%, American Tower Corp. 3.5%, Golar LNG Partners L.P. 3.4%, Brookdale Senior Living, Inc. 3.1%, Hyatt Hotels Corp. 3.0%, Starwood Hotels & Resorts Worldwide, Inc. 2.9%, LaSalle Hotel Properties 2.9%, Brookfield Infrastructure Partners, L.P. 2.8%. **Baron Small Cap Fund** are: TransDigm Group, Inc. 3.5%, SBA Communications Corp. 3.2%, Penn National Gaming, Inc. 3.2%, Liberty Media Corp. 2.6%, Equinix, Inc. 2.4%, Clean Harbors, Inc. 2.3%, Waste Connections, Inc. 2.2%, Gartner, Inc. 2.1%, Fossil, Inc. 1.9%, Intuitive Surgical, Inc. 1.9%.

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We offer eleven mutual funds* in Retail as well as Institutional Share Classes, Separately Managed Accounts, Sub-Advisory Services* and an Offshore Fund.

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