Dear Baron Small Cap Fund Shareholder:

Performance

Baron Small Cap Fund (the "Fund") was up 4.24% (Institutional Shares) in the fourth quarter of 2022. For the year, the Fund was down 31.05%.

The Fund performed in line with the Russell 2000 Growth Index (the "Index") this quarter (up 4.13%), but underperformed for the year, with the Index losing 26.36%. Since small-cap stocks underperformed larger market caps, the Fund also underperformed the S&P 500 Index for the quarter and the year.

Table I.
Performance†
Annualized for periods ended December 31, 2022

	Baron Small Cap Fund Retail Shares[1,2]	Baron Small Cap Fund Institutional Shares[1,2,3]	Russell 2000 Growth Index[1]	S&P 500 Index[1]
Three Months[4]	4.18%	4.24%	4.13%	7.56%
One Year	(31.22)%	(31.05)%	(26.36)%	(18.11)%
Three Years	3.70%	3.96%	0.65%	7.66%
Five Years	6.79%	7.07%	3.51%	9.42%
Ten Years	9.93%	10.21%	9.20%	12.56%
Fifteen Years	7.57%	7.82%	7.26%	8.81%
Since Inception (September 30, 1997)	9.40%	9.55%	5.65%	7.68%

CLIFF GREENBERG
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Retail Shares: BSCFX
Institutional Shares: BSFIX
R6 Shares: BSCUX

In 2022, U.S. stocks logged their worst performance since 2008. Inflation was much higher than expected, which was combatted by the most aggressive Fed tightening cycle since the Volker era. The Fed raised its target interest rate seven times over that last eight months, and the 10-Year Treasury yield climbed to 3.9% from 1.5% at the beginning of the year. Higher interest rates punished more speculative investments (see the collapse in crypto) and caused stock multiples to contract, which hit growth stocks and small-cap stocks especially hard. The significantly higher interest rate environment coupled with the prospect of further tightening until inflation is tamed presages an increasingly sluggish economy in the upcoming year. The greatest damage to the market was done in the first half of the year, when this cycle of events was put in motion.

Stocks recovered somewhat in the fourth quarter as headline CPI reports improved report after report. Though the economy remained resilient, it was evident from many indicators, such as goods and energy prices, rents, freight…that inflation was clearly cooling. There were signs of an economic slowdown on the horizon, stemming from the aggressive central bank tightening. The market rallied in October and November as interest rates declined and the Federal Reserve chair laid the groundwork to slow the pace of its monetary tightening. However, the market gave back some of the

Performance listed in the above table is net of annual operating expenses. Annual expense ratio for the Retail Shares and Institutional Shares as of September 30, 2022 was 1.30% and 1.04%, respectively. The performance data quoted represents past performance. 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 Fund's 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. For performance information current to the most recent month end, visit www.BaronFunds.com or call 1-800-99BARON.

† The Fund's 3-year historical performance was impacted by gains from IPOs and there is no guarantee that these results can be repeated or that the Fund's level of participation in IPOs will be the same in the future.

1 The **Russell 2000® Growth Index** measures the performance of small-sized U.S. companies that are classified as growth and the **S&P 500 Index** of 500 widely held large cap U.S. companies. All rights in the FTSE Russell Index (the "Index") vest in the relevant LSE Group company which owns the Index. Russell® is a trademark of the relevant LSE Group company and is used by any other LSE Group company under license. Neither LSE Group nor its licensors accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. The indexes and the Fund include reinvestment of dividends, net of withholding taxes, which positively impact the performance results. The indexes are unmanaged. Index performance is not Fund performance; one cannot invest directly into an index.

2 The performance data in the table does not reflect the deduction of taxes that a shareholder would pay on Fund distributions or redemption of Fund shares.

3 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.

4 Not annualized.

gains in December, as the Fed dampened hopes of interest rate cuts in 2023 and remained committed to scorched earth tactics to stamp out the last bastion of inflation until it reaches the Fed's preferred 2.0% target rate from 6.5% as measured in December.

Value outperformed growth. Larger-cap stocks outperformed smaller ones. The best performing sectors in the quarter were commodity-sensitive and cyclical sectors. Also, defensive sectors such as Consumer Staples, Health Care, and Utilities outperformed, while growth-oriented Information Technology (IT) and Consumer Discretionary stocks remained out of favor.

The Fund's absolute performance in the quarter was driven by strong gains from some of our larger holdings. This was because of strong business performance and outlooks of those companies, as discussed in the next section. Our stock selection, especially in the Health Care sector, was a differentiator and contributed to our returns. Our larger market cap stocks performed better than our smaller ones, which notably did poorly this quarter. On a relative basis, we were hurt by our lack of exposure to Energy stocks, the best performing sector in the Index. We are also underexposed to the Materials and Consumer Staples sectors, which did well this quarter. There were no style factors that played a big role in our relative performance this quarter aside from market cap.

For the year, we had a plethora of stocks that were down 30% or more, which negatively affected our returns. I would bucket those as perceived interest rate sensitive holdings (**SiteOne Landscape Supply, Inc.**, **Floor & Decor Holdings, Inc.**, **Trex Company, Inc.**, **Installed Building Products, Inc.**), technology or employment service providers (**ASGN Incorporated**, **Endava plc**, **Grid Dynamics Holdings, Inc.**, **First Advantage Corporation**), and companies that posted earnings shortfalls (**Vertiv Holdings, LLC**, **Clarivate Plc**, **Holley Inc.**, **Bright Horizons Family Solutions, Inc.**, **Repay Holdings Corporation**, **Nuvei Corporation**). In the first two groupings, the stocks fell primarily because of multiple contraction or fear of a recession impacting their businesses. However, for the most part, results have been strong and as expected. The third grouping is of companies that missed expectations during the year, but the issues were either modest or behind them in our opinion. We believe that these stocks, and some others that were hard hit in 2022, offer some of our best potential returns.

Table II.

Top contributors to performance for the quarter ended December 31, 2022

	Percent Impact
Gartner, Inc.	1.17%
Vertiv Holdings, LLC	0.81
DexCom, Inc.	0.56
Planet Fitness, Inc.	0.49
Inspire Medical Systems, Inc.	0.48

Shares of **Gartner, Inc.**, a leading provider of syndicated research that delivers actionable insights to corporate executives, was again the top contributor. The company reported excellent results for the third quarter. Reported revenues from the core research business grew 15% or 20% on a constant currency basis. Contract value, an indicator of future growth, grew 14%. Conferences were strong, and the flagship events had exceptional attendance and interest from both presenters and attendees. Margins were better than expected, even as the company ramped up hiring of sales associates. The company increased guidance for EBITDA despite tougher currency headwinds. The company repurchased over $1 billion in shares during the year, retiring 11% of the outstanding shares. Tremendous performance and trends bode well for continued double-digit growth in free-cash-flow per share, the operable metric on which we value the business.

Vertiv Holdings, LLC, a leading provider of critical infrastructure solutions for data centers and communications networks, rose significantly in the quarter, after the company reported strong sales and much improved margins. The company demonstrated that it was able to price its products in excess of inflationary cost headwinds, which had led to disappointing earnings earlier in the year. The company expects margins to continue to improve going forward, as its price/cost ratio is now in balance and free-cash-flow is stronger. Management characterized demand as "robust," which we expect will drive strong organic growth. We increased our position early in the year believing that management could get on the right side of the pricing equation, which has played out, and the stock has rebounded nicely. We still see good upside in the stock based on our expectation of continued growth and a higher trading multiple.

DexCom, Inc. is a leading provider of continuous glucose monitoring (CGM) devices for people with diabetes. The stock rose in response to strong results in the third quarter and positive developments in reimbursement and product approvals. Revenues rose 20% on an organic basis in the quarter, and EBITDA margins approached 30%, both ahead of expectations. Medicare approved coverage of CGM for non-intensive Type 2 diabetes. Commercial insurance plans are expected to follow along. In December, the FDA granted clearance for the company's new and improved version of its product called G7. This unit is the smallest, most accurate, and most user-friendly device to be offered, and we believe it is an exciting update. We see a continued long runway of growth for DexCom.

Shares of **Planet Fitness, Inc.**, the leading franchiser and operator of low-cost fitness centers, rose after reporting strong results. The company reported system-wide same-store sales increased 8.2%, raised estimates for growth in net income, and authorized another large share repurchase. Membership grew to an all-time record, now fully recovered from the pandemic lows. New gym openings are somewhat constrained by availability of HVAC units, but we envision the pace of growth will accelerate and that the base of gyms can still double over time from 2,000 to 4,000. We believe that EBITDA can grow at a mid-teens rate long term on a declining share count and that the trading multiple can modestly expand, which will drive continued good stock performance.

Inspire Medical Systems, Inc. sells an implantable device that treats sleep apnea. Revenues grew an astounding 77% in the quarter, way ahead of expectations, and the stock popped. We believe Inspire sells a unique product that has great advantages to CPAP devices, the dominant therapy, and is gaining significant market share. Management is executing on all fronts-driving awareness through effective advertising, increasing procedures at existing centers, and adding new centers. They are also continuing to innovate. This quarter a new Bluetooth remote control device was introduced. The next generation device will come out in mid-2023, and we expect approval of new indications, which will expand the available market. We expect revenues to continue to grow rapidly, with sales potential well over $2 billion, which is five-fold higher than current revenue. We believe the company will be profitable in 2023 and margins will be high over time.

Other stocks that rose 20% or more in the quarter but contributed less to the Fund's performance this quarter were **Red Rock Resorts, Inc.**, **Madison Square Garden Sports Corp.**, **Mettler-Toledo International, Inc.**, **WEX Inc.**, and **IDEXX Laboratories, Inc.**

Table III.
Top detractors from performance for the quarter ended December 31, 2022

	Percent Impact
Chart Industries, Inc.	–0.50%
Grid Dynamics Holdings, Inc.	–0.48
European Wax Center, Inc.	–0.38
ASGN Incorporated	–0.35
The Trade Desk	–0.28

Chart Industries, Inc. is a leading global manufacturer of highly engineered equipment servicing multiple applications in the clean energy and industrial gas markets. The company announced a large and transformational acquisition of Howden, a company of similar size to Chart, but the market hated the deal and the stock got hammered. The concerns were that Chart would have to take on lots of debt to do the deal, the acquired business is of lower quality, and the synergy estimates seemed aggressive. Our view, after much work and consideration, is that Howden is a fine business that fits very well with Chart, increasing its end-markets, expanding the geographic reach, and doubling the "nexus of clean" opportunities to address. We believe that the synergies are identified and significant, and that the deal will be accretive. We also believe that leverage will decline quickly from the free-cash-flow and asset dispositions we expect. Chart did a large equity raise near the end of the year at a depressed price, which we participated in and more than doubled our position in the stock. We believe Chart is a best-in-class industrial compounder focused on growing clean energy end-markets.

Shares of **Grid Dynamics Holdings, Inc.**, a fast-growing provider of digital transformation services, fell this quarter as the company trimmed its earnings guidance and shares of technology service companies declined in general, continuing the wild ride for the stock over 2022. With many of its engineers located in Ukraine, the stock got crushed when war broke out and concerns emerged as to whether Grid would be able to meet demand in the short term and maintain its clientele longer term. Well, management did an incredible job protecting and supporting its employees. We expect revenues to grow 40% organically in 2022, which is remarkable. However, this quarter demand for digital transformation services has softened along with a global macro slowdown in technology spending. This resulted in the company projecting slower growth in the near term. Also, the company sold stock during the quarter to have the capital to make acquisitions and expand its engineering base to new geographies, but it passed on some of the deals on the table after further diligence. We believe that Grid has strong technical capabilities, great management, and operates in a segment with great tailwinds. We buy into their goal of strong growth and becoming a $1 billion-plus revenue company, a three-fold increase from current levels.

European Wax Center, Inc. is a fast-growing franchisor and operator of out-of-home waxing services. The stock fell after the company reported that same-store-sales growth was slightly below estimates. Management explained that they saw customers slightly increased their average time between visits, which they attribute to a slowing economy. Makes sense, but not a big deal in our eyes. We like the franchise business model, which generates mid-30s EBITDA margins and requires little capital. We think management is terrific and capable of overseeing the growth of units from 950 to over 3,000 in time, especially with the high-quality franchisees the company is attracting. The stock has been a darling since its IPO on excitement over the business model and growth prospects. As it now trades at a more reasonable multiple, we think we can make strong compounding returns from these levels.

ASGN Incorporated is large staffing company providing IT workers and professional services to Fortune 500 companies. Shares fell this quarter over concerns about demand for future hirings in a slowing economy. The company had a strong third quarter, growing revenues 11.6% and EBITDA 9%. Its consulting segment, a relatively new venture, grew revenues 43% in the quarter and now is about a quarter of overall revenues. The government services segment was flat, but we expect growth going forward as bookings have been strong. The company announced a nice acquisition of a consulting business that will enhance its cyber capabilities. Its customers' technology initiatives are mission critical, so we expect business to be resilient even if the economy slows. We believe the stock is really cheap for this high-quality, fast-growing business, trading at under 12 times our estimate for 2023 earnings.

The Trade Desk is the leading demand side platform enabling advertising agencies to efficiently purchase digital advertising. The stock fell this quarter over concerns about the outlook for advertising spending. Trade Desk beat third quarter estimates, growing revenues 31% and posting 41% EBITDA margins. Connected TV was the fastest growing and largest channel and should continue to benefit from the new advertising inventory that is expected to enter the market, including Disney+ and the new Netflix free tier of service. The company continues to make progress on its UID 2 initiative, which, as adopted, would help grow the market opportunity for Trade Desk. We remain positive on Trade Desk as we believe the programmatic segment of advertising will grow significantly over time and that Trade Desk will remain the leading player with the best technology and solution. The pace of the economy and advertising spending will affect short-term results, but we still view this as a great long-term opportunity, so we plan to hold our position through current volatility.

Other stocks we own that fell 20% or more this quarter but had less effect on our performance were **The Beauty Health Company**, **Holley Inc.**, **Guardant Health, Inc.**, **DraftKings Inc.**, and **Membership Collective Group Inc.**

Portfolio Structure & Recent Activity

As of December 31, 2022, the Fund had $3.9 billion under management and held 66 stocks. The top 10 positions made up 32.6% of the Fund. The number of stocks held is down a bit from prior periods. We made fewer new investments in the period as we like what we own and there were many fewer companies coming public through IPOs or SPAC mergers. We also culled the portfolio more actively throughout the year, selling mostly smaller positions that we had less confidence in.

The top 10 holdings will be familiar to long-term investors or followers of the Fund. On a weighted average basis, we have held the stocks for eight years. All have been successful investments. As a group, they have appreciated 5.9 times since purchase, also on a weighted average basis. We have great experience and confidence in this group and believe there is significant opportunity for strong profit growth and stock returns in the future.

Baron Small Cap Fund

Table IV.
Top 10 holdings as of December 31, 2022

	Year Acquired	Quarter End Investment Value (millions)	Percent of Net Assets
Gartner, Inc.	2007	$252.1	6.4%
ASGN Incorporated	2012	142.6	3.6
ICON Plc	2013	136.0	3.5
Kinsale Capital Group, Inc.	2019	130.8	3.3
SiteOne Landscape Supply, Inc.	2016	123.2	3.1
Red Rock Resorts, Inc.	2016	110.0	2.8
Installed Building Products, Inc.	2017	106.9	2.7
Vertiv Holdings, LLC	2019	104.5	2.7
Floor & Decor Holdings, Inc.	2017	97.5	2.5
Planet Fitness, Inc.	2018	78.8	2.0

At the end of the quarter, the Fund was most heavily invested in four sectors…. Industrials (27.1% of net assets), IT (22.0%), Consumer Discretionary (15.0%), and Health Care (13.8%). Compared to the Russell 2000 Growth Index, we were overweight in Industrials, Consumer Discretionary, and IT, and underweight in Health Care. We have no exposure to Energy or Utilities and are underweight in Materials and Consumer Staples, which hurt our relative performance, as those sectors outperformed in 2022. Our sector weightings are a by-product of our investment process, which focuses on identifying and investing in a diversified group of high-quality, unique, well-managed growth companies across different industry groups. It is not driven by a top-down view on how the market will perform over the short term.

We are long-term investors and believe we are investing in businesses that will be much larger and much more valuable in time. At the end of the year, 27.4% of our assets were in stocks we have held 10 years or more. 26.9% of the Fund has been held 5 to 10 years, and 41.6% was in stocks held under 5 years. We held cash of 4.1% at year end. The Fund is laden with "big winners," stocks that have doubled or more since their initial purchase.

At the end of the year, 24.3% of the Fund's holdings have appreciated five times or more. Another 36.5% of the Fund's holdings have risen two to five times. So over 60% of the Fund is in stocks that have more than doubled. The annualized returns of our long held and "big winners" has been over 22% a year on a weighted average basis, which we believe is a proof point that our approach to investing when executed well yields strong long-term results.

The three-year average portfolio turnover of our Fund is around 15%, which is an outgrowth of our long-term investing. This is considerably lower than most other small-cap growth funds. We don't need to reinvent the wheel each year by finding new stocks to replace the ones we own in search of short-term performance. We believe if we invest early in great, special companies they can grow their businesses and profits at strong compounding rates for a long time, and their stocks can perform for years. The key is to identify the right companies to invest in, to monitor their progress by being in close contact with the leadership, and to have a keen understanding of industry trends and developments enabling us to buy in at reasonable valuations. We seek to find a handful of new investments each year that meet our high standards, and to be decisive in selling out of investments that are not achieving or we are concerned won't achieve the outcomes we were expecting or selling stocks that have appreciated so much that there isn't sufficient growth in the stock anymore to justify holding it.

After declining in the most in the recent downturn (peak to trough), small caps, as an asset class, appear cheap relative to their historical average and relative to large caps, especially growth stocks. Relative valuations suggest now may be a good time to own small caps. Yet, the segment has become more speculative, with over a quarter of the small-cap stocks expected to lose money. We think successfully investing in small caps requires skilled active management.

Our new investments are only in small-cap companies. We do add to positions that have appreciated somewhat if we believe the position sizes are underweight the opportunity we see in those equities. We trim our larger market cap holdings to fund new small-cap investments and to regulate the overall market cap of the Fund. We seek to balance being true to our small-cap mandate and achieving the highest returns for our investors based on our long-term approach. Over the last few years, we have been successful in reducing the market cap of the Fund (lowering the "size score" of the Fund). The weighted geometric average market cap of the Fund is now $6.1 billion, and at one point during the year it hit $5.4 billion, representing a nearly 37% decline from peak levels. Unfortunately, some of the decline was from the large drawdown in stocks in the first half of the year. The market cap is now approaching levels it was at in 2018. It's nice to have a range of market caps and maturities of holdings in the Fund. Our smaller-cap holdings and newer investments performed worse last year, but we believe they offer the outsized upside from here.

Table V.
Top net purchases for the quarter ended December 31, 2022

	Year Acquired	Quarter End Market Cap (billions)	Amount Purchased (millions)
Chart Industries, Inc.	2022	$4.9	$49.8
Neogen Corp.	2022	3.3	31.6
European Wax Center, Inc.	2021	0.8	6.7
Grid Dynamics Holdings, Inc.	2019	0.8	5.4
Sprout Social, Inc.	2022	3.1	5.4

We re-initiated a position in **Neogen Corp.**, a leading pure-play food security company with solutions across food safety, animal safety, and genomics. The company offers a wide array of products including indicator testing (Petrifilm), diagnostic test kits to detect dangerous or unintended substances in food, genetic testing, rodenticides, disinfectants, vaccines, veterinary instruments, laboratory services, and data analytics.

We have long admired Neogen, having been shareholders in the past, as recently as 2020. Our interest in the stock reignited with its recently completed merger with 3M Food Safety and valuation reset in 2022. The 3M Food Safety deal is transformational and creates a scaled global leader in the food security industry with a broader product portfolio and increased resources to invest in innovation and manufacturing efficiency. 3M Food Safety is a high-margin, consumables business that has grown sales at a 9% CAGR historically. With less than 35% customer overlap, Neogen expects to accelerate growth via cross-selling, especially in Petrifilm, 3M Food Safety's leading indicator testing brand. On valuation, the stock pulled back meaningfully in 2022 due to a combination of broader macro-related weakness for small-cap growth companies and technical pressure in the stock related to the merger.

We believe the company is recession-resistant, well positioned to drive mid to high single-digit organic revenue growth through a combination of pricing and volume increases (especially in emerging markets). In fact, Neogen has failed to grow in only 6 quarters over the past 32 years! The market for food and animal safety solutions, and Neogen as a market leader, stand to benefit from several long-term secular trends around increasing food allergies, more incidents of food contamination, pathogen awareness, more health-conscious consumers, and an increasing focus from regulators. Beyond organic growth, the company has a long track record of completing successful acquisitions, which we expect to continue going forward.

Neogen's competitive advantage is derived from its pure-play focus on the food and animal safety markets, the breadth of their product portfolio, deep customer relationships, and efficient manufacturing processes that enable attractive price points and delivery times. The company has strong customer retention rates, as its products often become deeply embedded in daily workflows and around 95% of revenue comes from consumable products, which are recurring in nature. The 3M Food Safety merger integration process will somewhat distort near-term profitability but adjusted EBITDA margins should approach 30% over the next few years, with strong free-cash-flow generation. Once the merger integration is complete, we believe that Neogen will be well positioned to capitalize on resilient end-markets and leverage complementary capabilities to deliver compounding earnings and solid returns for the stock over a multi-year period.

We added to our position in **Chart Industries, Inc.** during the quarter. Chart is a leader in cryogenic technology, process, and storage equipment sold into industrial gas and clean and traditional energy end-markets. We took advantage of a significant drop in share price when the company announced a $4.4 billion merger with private company Howden, a global leader in compressors and blowers, that approximately doubles Chart's revenue and EBITDA. The stock sold off as the unexpected deal is the largest in the company's history, which added integration risk, increased leverage at a time of elevated rates, and required the company to issue equity, all in the face of heightened macroeconomic uncertainty heading into 2023.

We like the acquisition and believe the combination makes the company even more attractive longer term by expanding Chart's equipment portfolio and process technology offering for multiple molecules and applications across high-growth areas such as hydrogen, carbon capture and storage, and decarbonization. The transaction strategically makes Chart's business higher margin and more economically resilient by adding new capabilities in small-scale gas compression, increasing its aftermarket capabilities, and expanding its global footprint.

The company completed the required financing for the transaction in December, which removed a key area of uncertainty, and the company has several levers to bring leverage down quickly, including divestitures of non-core assets. Additionally, while not fully underwritten in our estimates, we believe management can realize a large portion of cost and revenue synergies leading to at least 500 basis points of margin improvement in the coming years. The more diverse manufacturing footprint gives Chart access to geographies it previously had trouble penetrating, and the combined companies expanded number of products increases content opportunities per project. Once the integration is complete, Chart will be a more resilient, globally balanced, industrial business with exposure to relatively higher-growth end-markets and top-tier margins and cash flow. With results that we believe will come in better than current expectations, the stock should be up multi-fold, even using a conservative multiple of EBITDA.

Table VI.
Top net sales for the quarter ended December 31, 2022

	Year Acquired	Market Cap When Acquired (billions)	Quarter End Market Cap or Market Cap When Sold (billions)	Amount Sold (millions)
Gartner, Inc.	2007	$2.2	$26.6	$33.7
Americold Realty Trust	2018	2.4	7.6	16.2
DexCom, Inc.	2012	1.0	43.7	14.3
Progyny, Inc.	2022	3.9	2.9	13.5
Installed Building Products, Inc.	2017	2.4	2.4	12.7

As part of our process, we reduced position sizes in higher market cap companies **Gartner, Inc.** and **DexCom, Inc.** to fund purchases of smaller-cap companies. We lowered our weightings in **Americold Realty Trust**, **Progyny, Inc.**, and **Installed Building Products, Inc.** for company and stock-specific reasons.

Outlook

The market is off to a good start in 2023, which is somewhat surprising after a miserable 2022 and a pervasive sense of pessimism. The reasons that the market is acting better are three-fold. First, the economy continues to be healthy, highlighted by low unemployment and stable and solid consumer spending. Second, inflation is declining. The CPI has now declined for six consecutive months, from a peak of 9.1% in June to 6.5% in December. Third, market participants believe that the Federal Reserve is near the end of its rate hiking cycle, with reductions in interest rates expected later in 2023. This is evidenced by the inverted yield curve and the 10-Year bond presently trading around 3.5%.

There is however a persistent headwind caused by the Federal Reserve's strident approach to fighting inflation. They have posited that short-term rates will rise to over 5% and remain there for an extended period. The Fed is focused on reducing "core" inflation, or the pace of wage growth, which will probably be hard to reverse since labor markets are tight. We expect the Fed Chair and Governors to continue to hijack the economic narrative in an effort to convince investors of their commitment to slow down the economy, to induce unemployment, and reduce wage pressure, which they view as necessary. What a perverse situation.

The economy is slowing. Higher interest rates will impact growth. Leading indicators point to a slowdown, and we hear that from the management teams of our investments. However, we do not know if the slowdown (recession?) will be short lived and shallow or longer and more severe. That's the $64,000 question. If it's the latter, we fear that it could be the catalyst for an unfortunate financial accident that may result in more severe economic contractions.

We continuously update our expectations of earnings for our holdings based on our conversations with managements and our take on the macroeconomic environment. Presently, we estimate that about 10% of our investments will have lower earnings in 2023. We believe the remainder of our companies will show nice growth, albeit slower than we would typically expect them to grow. This compares favorably to Street expectations for S&P 500 Index earnings, which assume that a quarter to a third of companies will have negative earnings growth in the next 12 months.

Baron Small Cap Fund

Our stocks trade at cheap multiples against our expectations for earnings. The reset in multiples of growth stocks has been severe. Many of our stocks were down a lot in 2022 without much fundamental change in performance. The multiple compression often felt indiscriminate, meaning that higher-quality businesses (higher margins and returns, better business models, more consistent results, strong and more durable organic growth) were not trading at the premiums at which they usually, and deservedly, trade. If our companies perform as we expect, and growth improves back to prior and expected trend lines go forward, we expect to make good returns from these levels. However, we must admit that the near-term outlook is murky and subject to change. If the economy is weaker than we expect or stays soft longer, than we would expect that the recovery in stock prices will be delayed.

We own a portfolio of well-managed, high-quality companies. They are leaders in their niches, with strong competitive advantages. We believe that they have great growth opportunities based on their positioning in their sectors and well-established business plans. The growth is evidenced by strong historic results. We underwrite significant long-term growth, which we do not believe is reflected in the trading prices of their stocks, as the market is presently focused, seemingly exclusively, on the near term. That will change.

Thank you, our fellow shareholders, for investing with us. We feel humbled but undaunted. We continue to believe in our approach to stay invested in special, high-quality businesses through tougher economic times. We believe that they will do better than most. As shareholders, we believe we will be rewarded with strong returns as we get closer to the next upcycle, as has been the case in the past.

Cliff Greenberg
Portfolio Manager

Investors should consider the investment objectives, risks, and charges and expenses of the investment carefully before investing. The prospectus and summary prospectus 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.

Risks: Specific risks associated with investing in smaller companies include that the securities may be thinly traded and more difficult to sell during market downturns. Even though the Fund is diversified, it may establish significant positions where the Adviser has the greatest conviction. This could increase volatility of the Fund's returns. The Fund may not achieve its objectives. Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.

The discussions of the companies herein are not intended as advice to any person regarding the advisability of investing in any particular security. The views expressed in this report reflect those of the respective portfolio manager only through the end of the period stated in this report. The portfolio manager's views are not intended as recommendations or investment advice to any person reading this report and are subject to change at any time based on market and other conditions and Baron has no obligation to update them.

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Free cash flow (FCF) represents the cash that a company generates after accounting for cash outflows to support operations and maintain its capital assets.

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