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# Healthcare's hottest stock: Why this top investor backs Eli Lilly

**Leading healthcare fund manager Neal Kaufman is betting big on Eli Lilly as the pharmaceutical giant profits from an explosion in demand for its obesity drug.**

BY **ALGY HALL** IN LONDON

Top-performing fund manager Neal Kaufman is fond of the road less travelled. His career path winds its way from graduating cum laude from Yale with a degree in history, into the legal profession three years later, and then on to equity research and finally portfolio management.

This approach is also reflected in how Kaufman runs the Baron Health Care fund, delivering stellar returns that have earned him his status as an Elite Investor tracked by Citywire Elite Companies.

In a sector where many funds hold well over 100 stocks, Kaufman aims to have 40 to 45 positions. He's also not afraid to place big bets on his favourites. Almost half the value of the portfolio is held in its top 10 stocks and more than a fifth in the top three.

The way the portfolio is diversified is also not on traditional lines. About half of investors' money is allocated to steady growth plays, a quarter to riskier high-growth opportunities and the rest to biotech companies that offer the possibility of spectacular drug discoveries.

This also is not your average pharma fund in performance terms. Adjusted for risk, Kaufman's outperformance of the index over the last four years puts him among the select 3% of the 10,000 global portfolio managers monitored by Citywire that are classed as Elite Investors.

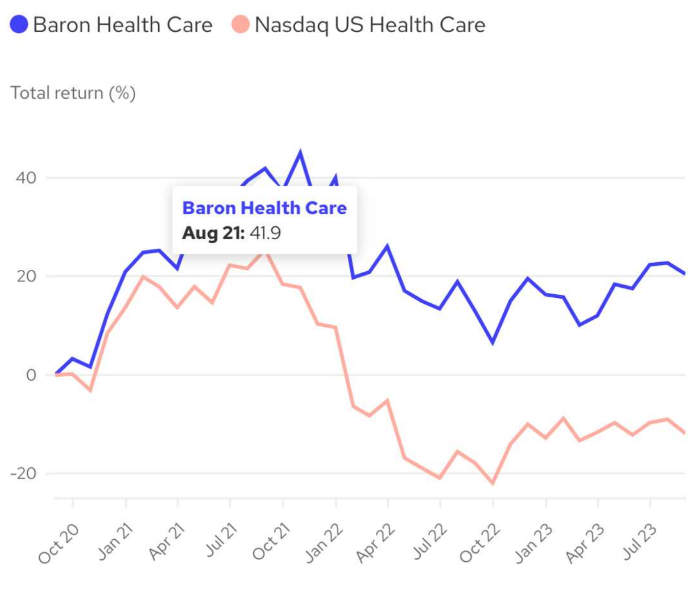
The Baron Health Care fund has returned its backers 20.5% over the three years to the end of August, while the Nasdaq US Healthcare index has lost 11.9%.

### Baron Health Care top 10

| Company | Rating | Size in fund | Conviction rank |
|---|---|---|---|
| UnitedHealth (US:UNH) | AAA | 8.5% | 11/41 |
| Eli Lilly (US:LLY) | AAA | 7.7% | 4/41 |
| Intuitive Surgical (US:ISRG) | AAA | 4.9% | 1/41 |
| Merck (US:MRK) | AA | 4.8% | 27/41 |
| Thermo Fisher Scientific (US:TMO) | A | 4.4% | 19/41 |
| Vertex Pharmaceuticals (US:VRTX) | AAA | 3.8% | 7/41 |
| Dexcom (US:DXCM) | AA | 3.7% | 3/41 |
| Inspire Medical Systems (US:INSP) | AAA | 3.% | 2/41 |
| The Cooper Companies (US:COO) | AAA | 2.9% | 6/41 |
| HCA Healthcare (US:HCA) | AAA | 2.6% | 13/41 |

Sources: Citywire / Morningstar, latest holdings data. Conviction rank is based on overweight versus Citywire selected benchmark.

### Kaufman's fund is up 20% in three years
His benchmark has lost 12% over the same period




Source: Morningstar. Returns calculated in USD

Over recent years, one stock in particular has been instrumental in driving performance – AAA-rated drug company Eli Lilly (US:LLY), which accounts for nearly 8% of the portfolio.

## Lilly launch pad

Eli Lilly is to big pharma what Nvidia is to tech: a company at the forefront of the hottest growth story the sector has seen in many years. While Nvidia has artificial intelligence (AI), Eli Lilly has glucagon-like peptide 1 (GLP-1).

The GLP-1 molecule simulates a feeling of fullness in people. It was initially developed to treat diabetes, but it can also be used to help people lose weight. Sales of drugs based on the molecule, such as Eli Lilly's Mounjaro, are soaring on the back of rampant demand linked to both uses.

And that's not all. AAA-rated Danish company Novo Nordisk (DK:NOVO.B), which is the other big global player in the GLP-1 space, has recently reported that clinical trials show the treatment substantially reduces the risk of strokes and heart attacks. As well as potentially providing yet another big market, the data increases the likelihood that GLP-1 drugs will rapidly gain acceptance from US health insurance companies along with other drug buyers around the world.

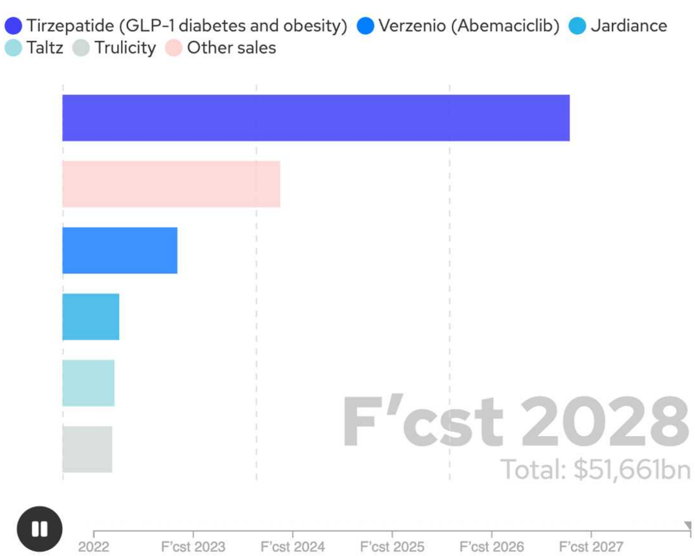
The main issue for Eli Lilly and Novo Nordisk at the moment, though, is not finding buyers, but simply keeping supply up with demand.

Even more use cases could yet emerge. For example, there are hopes the molecule could be used to treat addiction and Alzheimer's disease.

'The GLP-1 category has very significant growth drivers,' says Kaufman. 'We're very bullish.'

Analysts are forecasting the market for GLP-1 drugs could break

### GLP-1 drugs forecast to transform Eli Lilly's sales




Source: FactSet, consensus broker forecasts

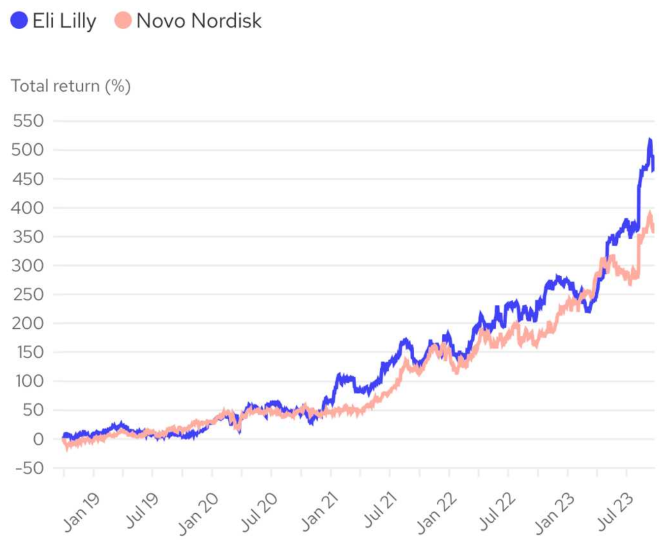
all records at more than $100bn in sales. Eli Lilly's revenue profile could be transformed over the coming five years as a result. Consensus forecasts are for GLP-1 treatments to account for just over half of $52bn of revenue in 2028. That compares with 2% of $23bn last year (see animation below).

## No Novo though

While the Baron Health Care fund has owned Novo Nordisk shares in the past, its focus today is only on Eli Lilly. That has proved a smart move since the fund took its current position in the stock in June 2021.

### Eli Lilly vs Novo Nordisk

Eli Lilly has outperformed since Kaufman invested




Source: FactSet

Novo's complex corporate structure is one reason Kaufman is less keen on the company as a way to target this exciting space. Another key reason is the number of potential opportunities Eli Lilly has beyond GLP-1.

'We like their pipeline, it's very attractive,' says Kaufman. 'We're more comfortable with the diversity. [Novo] is more dependent on the one molecule.'

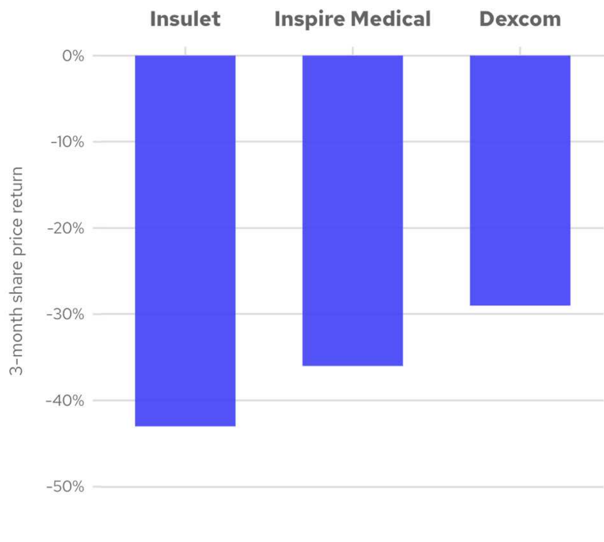
Other areas with significant potential for Eli Lilly include treatments for Alzheimer's disease, cancers and immunology drugs. Meanwhile, the oral version of its GLP-1 treatment looks like it could prove much easier for patients to take compared with Novo's rival pill, although Novo is at a more advanced stage of development.

## A painful flipside

What Eli Lilly has given to investors in the Baron Health Care fund with one hand, it has taken away, at least partly, with the other.

Some of the fund's big bets on medical devices companies focus on diabetes and sleep apnea. These have had their share prices pummelled due to the view that the success of GLP-1 will massively reduce the size of their markets.

**GLP-1 side effects**
Shares of medical devices companies hit




Source: FactSet

Kaufman is still assessing whether prices have moved too far, and an opportunity now exists. 'It's a very complex question,' says Kaufman. 'The market has quickly assumed very rapid adoption [of GLP-1]… the assumption is dramatic.'

Among Kaufman's holdings to have been hit is AA-rated Dexcom (US:DXCM), which accounts for 3.7% of the portfolio. It makes glucose-measuring devices that have the potential to become a new standard for diagnosing and monitoring diabetics.

A-rated Insulet (US:PODD), is the worst-hit stock exposed to the issue in the portfolio but accounts for a relatively modest 1.3% of the fund. It makes insulin-delivery systems for diabetics.

AAA-rated Inspire Medical (US:INSP), a 3% holding, has also slumped. Inspire's devices reduce the risk of sleep apnea, when a person's breathing temporarily pauses during sleep. This potentially life-threatening disorder is often associated with obesity, although Inspire's products are not focused predominantly on that part of the market.

The severity of these share price falls over the past three months suggests the possibility of an overreaction, more so because trading is currently strong and all the worries that have hit the shares relate to a hard-to-predict future.

Taking the example of Dexcon, Josh Riegelhaupt, assistant portfolio manager on the fund, points out that 'its market could be impacted, but it's not going to be impacted from a medical perspective.'

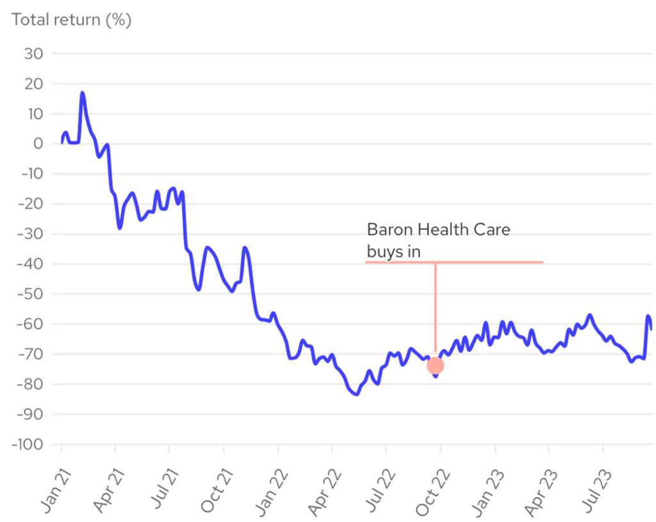
## Will they Rocket?

Depending on their analysis, Kaufman and Riegelhaupt have previously seized upon stocks that have received a drubbing by the market. The fallout from last year's selloff for growth stocks is a case in point.

Gene therapy companies were caught up in both the frenetic, futurist euphoria that engulfed markets during 2021 and the subsequent bursting of that bubble.

Baron Health Care used this as an opportunity to take a stake in A-rated Rocket Pharmaceuticals (US:RCKT), which is one of the few listed companies looking to pioneer gene therapy treatments outside the world of cancers.

**Rocket falls back to earth**
Baron Health Care's bargain shopping




Source: FactSet

The company, which accounts for 2.1% of Baron Health Care's portfolio, already has a treatment for a heart condition called Danon disease that has been fast tracked for approval by the Food and Drug Administration (FDA). Meanwhile, Riegelhaupt hopes health insurance firms will be more inclined to pay for patients to get the new and novel types of medicines it is developing due to the life-or-death nature of the conditions Rocket seeks to treat.

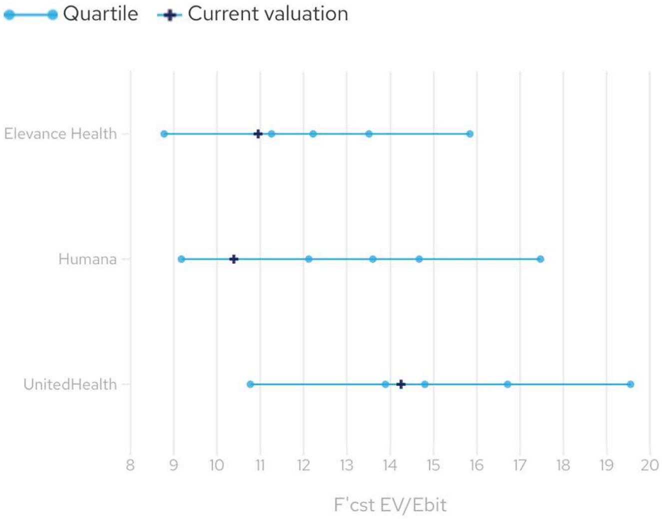
## Value opportunities

While medical device plays could, like Rocket, offer a contrarian opportunity based on extreme swings in sentiment, more straightforward value opportunities exist in the portfolio among the big US-managed health companies it holds. These include the fund's largest holding, UnitedHealth (US:UNH), which accounts for 8.5% of the portfolio, along with AAA-rated Humana (US:HUM) and AAA-rated Elevance (US:ANTM).

These companies have faced multiple headwinds in 2023. The regulatory backdrop has become tougher as clawbacks have been sought by government on alleged overpayment. Meanwhile, worries have mounted about downward pressure on rates paid to these companies through the Medicare Advantage programme. Medicare Advantage involves health insurers being paid by the government to take responsibility for over-65s who elect to use private provision. Both United Health and Humana are major providers.

**Big US health insurers trade at low valuations**

Five-year forecast EV/Ebit range




Source: FactSet, consensus forecasts, data tails removed beyond 2.5 standard deviations from 5yr average. EV/Ebit = enterprise value to earnings before interest and tax

**Thermo Fisher's EPS forecasts slide**


Source: FactSet, consensus broker forecasts

Cost has been another investor concern. Early in the year, comments by UnitedHealth, the sector leader and bellwether, led to worries that expenses were being driven higher by pent-up demand for surgeries that had been delayed by Covid, such as hip and knee replacements. Guidance by Humana also echoed this. Some investors have fretted that companies are having to massage their numbers to meet forecasts.

Meanwhile, there is added cause for nervousness based on the fact that health insurance is something of a political football in the US and an election year beckons.

The result is that these companies now look cheap compared with the valuation range of the last five years (see chart).

Beyond the angst, Kaufman believes there is still much to like about these businesses. They benefit from an ageing population, an ever-larger proportion of which is using Medicare Advantage. Kaufman also sees potential for rates to continue to rise despite current pressures and reckons the companies his fund backs are well positioned to manage costs.

'More recently they've talked about a stabilisation in cost trends,' he says. 'Overall, the outlook is still very good.'

## Long Covid

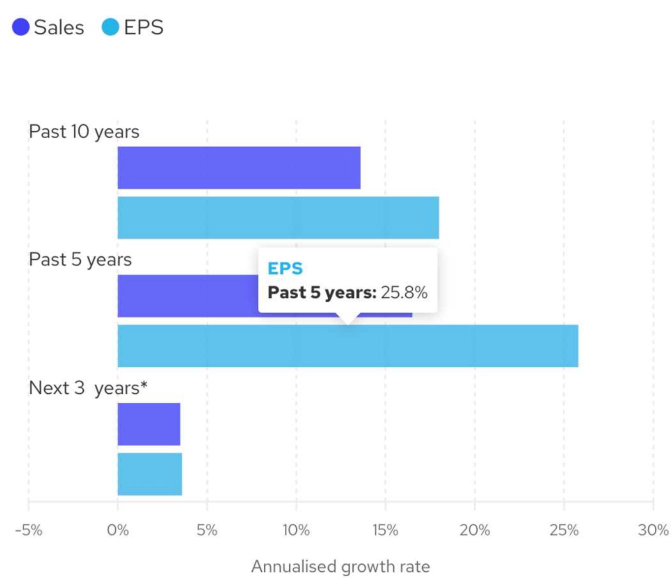
The cost-related post-Covid travails of health insurers are outdone by the hangover faced by life science tools companies. One of these, A-rated Thermo Fisher (US:TMO) accounts for 4.4% of the Baron Health Care fund's portfolio.

A boom in demand for the company's products during the Covid pandemic is now waning, but this is not Thermo Fisher's only problem. The company has also suffered a noteworthy drop in sales to China this year. Furthermore, as monetary policy has tightened around the world and economic uncertainty has increased, life science customers have become more reluctant to embark on big spending projects, which has also dented demand.

Thermo Fisher fits with Kaufman's stable growth theme but has gone through a rare period in which earnings have been the subject of noteworthy downgrades.

Expected annual growth over the next three years now looks anaemic compared with history. However, the company's track record of leadership and innovation in growth markets, coupled with a history of very successful deal-making, underpins confidence this is a bump in the road rather than the end of the line.

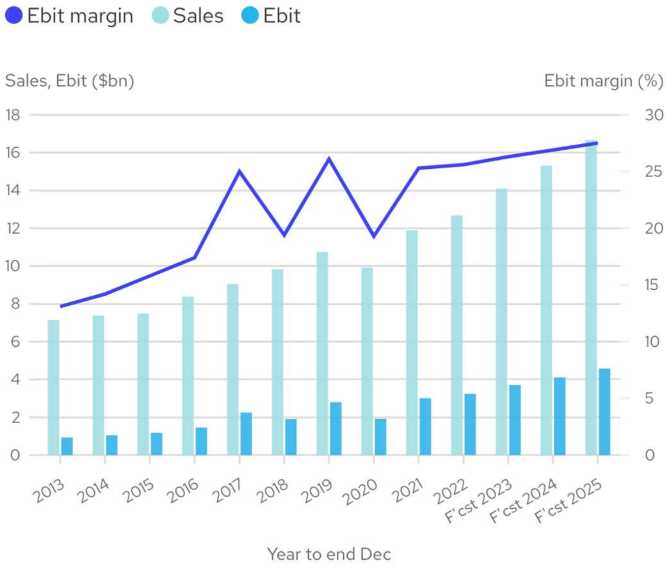
**Thermo Fisher's growth is forecast to slow**




*based on forecasts for next three financial years

Source: FactSet, consensus forecasts

**Strong growth forecast for Boston Scientific**




Source: FactSet, consensus broker forecasts and adjustments

‘The long-term drivers are still there,’ says Kaufman. ‘It is not a question of if, but when.’

## A new compounder

Thermo Fisher’s growth hiatus contrasts with the prospects for a new stock Kaufman has recently added to his collection of stable growth businesses. A-rated Boston Scientific (US:BSX), a 2% fund holding, is expected to accelerate growth over the coming years.

‘The updated long-range plan is for annual sales growth of 8% to 10% and double-digit [earnings per share] growth,’ says Kaufman. It is the kind of opportunity to compound value that the manager aims to capture in this part of his portfolio.

Having previously owned the stock, Kaufman was drawn back to it this year, disclosing a stake in June, following clinical trial data on its pulsed field ablation technology, which involves using electrical pulses to treat irregular heartbeats. Conversations with doctors helped cement his view this could help spice up long-term growth alongside the group’s stroke-reduction device, Watchman, which represents the other key opportunity for expansion.

## Bold but balanced

The healthcare space has not been an easy area of the stock market since the end of the pandemic. However, Kaufman and Riegelhaupt have done well in combining the heady excitement of big bets on companies like Eli Lilly and investment in innovative biotech plays, alongside holding stable, quality growth businesses.

Meanwhile, challenging conditions in several parts of the market may now have set up some interesting value opportunities for Elite Investors to exploit.

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Baron Health Care Fund's annualized returns for the Institutional Shares as of 6/30/2023: 1-year, 7.85%; 5-year, 12.98%; Since Inception (4/30/2018), 13.58%. The gross annual expense ratio for the Institutional Shares as of December 31, 2022 was 0.90%, but the net expense ratio was 0.85% (net of reimbursements from the adviser).

The NASDAQ US Health Care Index's returns as of 6/30/2023: 1-year, 14.15%; 5-year, 3.13%; Since Fund Inception (4/30/2018), 4.43%.

*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 Adviser reimburses certain Fund expenses pursuant to a contract expiring on August 29, 2034, unless renewed for another 11-year term and 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 baronfunds.com or call 1-800-99-BARON.*

**Risks**: In addition to general market conditions, the value of the Fund will be affected by investments in health care companies which are subject to a number of risks, including the adverse impact of legislative actions and government regulations. The Fund is non-diversified, which means it may have a greater percentage of its assets in a single issuer than a diversified fund. The Fund invests in small and medium sized companies whose securities may be thinly traded and more difficult to sell during market downturns.

Portfolio holdings as a percentage of net assets as of June 30, 2023 for securities mentioned are as follows: **Insulet Corporation** 1.3%; **Inspire Medical Systems, Inc.** 3.0%; **Rocket Pharmaceuticals, Inc.** 2.1%; **Humana Inc.** 2.0%; **Elevance Health, Inc.** 2.0%; **Boston Scientific Corporation** 2.0%.

**Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.**

The **NASDAQ Health Care Index** contains securities of NASDAQ-listed companies classified according to the Industry Classification Benchmark as Health Care. They include health care providers, medical equipment, medical supplies, biotechnology, and pharmaceuticals. The Fund includes reinvestment of dividends, net of foreign withholding taxes, while the NASDAQ Health Care Index includes reinvestment of dividends before taxes. Reinvestment of dividends positively impacts performance results. The index is unmanaged. Index performance is not Fund performance. Investors cannot invest directly in an index.

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