Neal Kaufman & Josh Riegelhaupt: Vital Signs Still Strong for Health Care

This is an edited version of a February 15, 2022, Q&A with Baron Health Care Fund Portfolio Manager Neal Kaufman and Assistant Portfolio Manager Josh Riegelhaupt. To access the full recording, please dial (800) 633-8284, passcode #22015482.

Executive Summary

- In the fourth quarter of 2021, concerns about inflation, interest rates, and ongoing supply chain disruptions pushed up a small number of large-cap stocks that were perceived as cheap and safe. That trend has persisted into 2022, with a disproportionate impact on high-growth stocks and unprofitable companies. Our response has been to
  - make more conservative assumptions as we set our price targets,
  - confirm the strength of our companies' balance sheets and cash flows, and
  - monitor their ability to retain pricing power in this inflationary environment.
- The biotech market has been hampered by the risk-off environment, while also experiencing some mean reversion after the subsector's outperformance in 2020. We're keeping an eye on winners with regard to bankruptcies and consolidation. We also look for companies that do something novel. Within that framework, we see ample opportunity.
- Despite the current macro noise, trends in the Healthcare sector remain positive. The funding environment for biotech is strong. The impact of COVID on medical procedure volumes is waning. The pace of innovation continues to accelerate. We are optimistic regarding the outlook for long-term growth in this sector and for our holdings.

Introduction

Baron Health Care Fund is managed by Neal Kaufman, who joined Baron in 2005 and has 21 years of research experience. Assistant Portfolio Manager Josh Riegelhaupt, who has a Ph.D. in Genetics and Molecular Biology fromRockefeller University, joined Baron in 2014 and has 12 years of research experience.

The Fund has attractive risk/return metrics since its April 30, 2018 launch through 12/31/2021. With a 24.12% annualized return, the Fund beat the Morningstar Health Care Category average by 890 basis points while achieving these returns without excessive risk. The Fund's alpha is 5.74% and beta is 1.00, up/down capture is 107.77%/83.01%, and Sharpe ratio is 1.23 for the period since inception.

The Fund has a 5-Star Overall Morningstar Rating as of 1/31/2022.

For the period ended 1/31/2022, Baron Health Care Fund received a 5-Star Overall Morningstar Rating™ and 5-Star 3-Year Rating. The Morningstar Ratings™ were based on the Morningstar Risk-Adjusted Return measures of140 and 140 share classes for the 3-year and Overall periods, respectively. These Morningstar Ratings are for the Institutional share class only; other classes may have different performance characteristics.

Baron Health Care Fund Institutional Share Class is in the Morningstar Health Category. Morningstar calculates the Morningstar Health Category Average performance and rankings using its Fractional Weighting methodology. Morningstar rankings are based on total returns and do not include sales charges. Total returns do account for management, administrative, and 12b-1 fees and other costs automatically deducted from fund assets.

Baron Health Care Fund

Let's start with a snapshot of the health care sector in late 2021/early 2022 environment.

Neal Kaufman: The fourth quarter was challenging. Investors flocked to large-cap index constituents due to concerns about inflation, interest rates, supply chain disruption, and another COVID wave. That pushed up a small number of large-cap stocks that were perceived as cheap and safe, while growth stocks were sold in tight correlation regardless of their fundamental outlooks. While the S&P 500 index ended 2021 up by more than 28%, some areas of health care saw large declines. We've seen these trends persist into early 2022, with inflation driving up market expectations for Fed rate increases. That, in turn, is having a disproportionate impact on high-growth stocks and unprofitable companies.

Have you made any changes in response?

Neal Kaufman: We don't try to predict macro factors like the direction of interest rates or inflation. That said, we certainly don't ignore that data. We're reviewing our models to make more conservative assumptions about discount rates and valuation multiples as we set our price targets. We're constantly confirming the strength of our companies' balance sheets and cash flows. We're monitoring their ability to retain their pricing power despite the inflationary environment. For example, **Mettler Toledo International, Inc.,** a company that sells weighing instruments for the lab, has been able to raise prices a few points every year because customers care more about quality than price. Health insurers like **UnitedHealth Group Incorporated** raise prices by mid-to-high single digits every year. Biotech companies also have pricing power and, even with proposed legislation on pricing, drug companies can set prices upon launch and raise them in line with inflation every year.

Josh, why have biotech stocks been struggling?

Josh Riegelhaupt: Since the biotech market peaked early last year, we've been in a risk-off environment. The most obvious reason is worries about rising interest rates and how that might affect growth. There has been some mean reversion after biotech's outperformance in 2020.

In a way, biotech has been a victim of its own success. Easy monetary policy, combined with the high-profile nature of the miraculous mRNA vaccines from **BioNTech SE** and **Moderna, Inc**., whet investors' appetite for biotech risk. That led to a surge in new company issuance. About 100 new biotech companies applied to go public last year, surpassing the record 79 companies that went public in 2020. In both of those years, they raised about $14 billion to $15 billion in new capital. To put that in context, historically, even in strong years, the numbers have been 30 to 60 new companies per year, raising maybe $4 billion to $8 billion. So, this has really been a surge. And private markets for the biotech industry are even more robust, with company formation well into the hundreds, many with valuations crossing the $8 billion threshold. That leaves us with a public U.S. mid-cap biotech market of over 700 companies, all chasing the same ROI. This has been dilutive to returns, since the number of investors in the space has remained flat. The existential question is: who is the incremental buyer? The obvious answer is large caps, be it pharma or biotech. They are sitting on billions, arguably trillions, of dollars in dry powder. They share the classic risk to their business model via patent loss on their blockbuster drugs. They need to replenish their pipelines, and now valuations have come in that make mergers and acquisitions more attractive. Just for context, **PFIZER, Inc,** which was heavily involved in both the COVID vaccine and the COVID antiviral, arguably has about $100 billion to deploy.

What is your biggest challenge in this environment?

Josh Riegelhaupt: I'd say it's this deluge of companies and flow. Fortunately, we require companies to have human clinical data. That filter alone eliminates 80%, or more, of the companies that are out there. Then there is the element of natural selection given that the capital markets are no longer permissive, so some companies will struggle with cash raises. So, we're keeping an eye on winners with regard to bankruptcies and consolidation. We're generally protected from this dynamic. The businesses we invest in will have one to three years of cash, and we don't expect the markets to be closed for multiple years at a time, at least not to the quality companies we focus on.

We also look for companies that do something novel. We look for uncrowded spaces. If you remove industry-wide pressures like political or drug pricing risk, it's more accurate to describe the biotech industry as hundreds of markets. Breast cancer is a market. Alzheimer's is a market. Bladder cancer is a market. Rare neurological disorders like ataxia are a market. They each represent independent patients with different epidemiologists, different needs, different drugs that a physician could potentially choose from. So, we look at each of these markets as standalones. We look for winners within that framework, and we see tons of opportunity.

What's interesting about this deluge of new company formation is that there appears to be very little overlap in the science that these companies are pursuing. In the mid-2000s, biotech investors were looking at maybe 10 or 20 big ideas and everyone knew the areas of innovation. Now, there are hundreds of big ideas out there and we're likely to see more Moderna and BioNTech-type breakthroughs. With so many companies and individuals pursuing novel science, the way medicine is delivered and how we live will continue to transform.

You added a new name, McKesson, in the fourth quarter. Take us through the investment thesis.

Neal Kaufman: **McKesson Corporation** is a leading distributor of pharmaceuticals and medical supplies. It delivers roughly 40 million prescriptions per year and is the market leader in U.S. medical surgical alternate site distributions, serving over 50% of U.S. physicians.

The company's competitive advantages include its scale, quality, and diversity of product and service offerings. The management team has streamlined the portfolio recently through the exit of certain businesses and the exit of certain European region businesses, and management is focused on two key growth areas where the company is well-positioned for growth and that is oncology and biopharmaceutical services.

We think McKesson will benefit from higher profit margins on the large pipeline of generic drugs and biosimilars over the coming years. We like the free cash flow characteristics of the business and management's use of free cash flow to enhance shareholder returns.

For example, since fiscal year 2019, the company has reduced outstanding shares by 24% through share repurchases, while reducing debt at the same time. The stock trades at a low valuation because of historical issues with generic price deflations, opioid litigation, and the perceived threat from Amazon. We believe that, as these issues fade, the stock will rerate and trade at a higher multiple of earnings such that management can deliver on its 12% to 14% long-term EPS growth objectives.

Josh, tell us why you like AstraZeneca, another new position.

Josh Riegelhaupt: We've followed **AstraZeneca PLC** for a long time. It is a large-cap biopharmaceutical company based in the U.K. It is generally considered to be the highest grower, depending on your view, in the Alzheimer's market. We are excited that it doesn't have one of the major risks that plague many other large cap pharma companies -- it doesn't have a blockbuster drug coming off patent, creating a large revenue and earnings hole to fill. It's positioned to organically grow through this decade.

I'd highlight one product called Enhertu. This is an antibody-drug conjugate, which is a chemotherapy drug that is chemically linked to a monoclonal antibody, allowing for a targeted therapy for treating cancer. It's co-developed with a Japanese company, Daiichi Sankyo. And it is approved in patients who have HER2-positive metastatic breast cancer. We think this drug will become the standard of care. The results for second-line treatment (after the initial frontline treatment has failed) were better than those for currently approved drugs for frontline treatment given for breast cancer. We will see if doctors start to use Enhertu in frontline treatment, even without the data, and, obviously, the company can't speak to that. But we're now underwriting a product that industry experts anticipate will be used for frontline treatment.

In addition, we expect to have a lot of data this year that Enhertu is an effective treatment for patients who don't express the biomarker for the antibody. We have some initial data that suggests that this approach can work. If the additional data looks promising, we expect the trial to inflect upwards. We'd also expect a lot of the biotechnology industry to start following this approach, which would open a whole new world of cancer treatments where you no longer need the antibody to target cancer cells. We're excited that Astrazeneca is doing novel science. Without discernible patent cliffs, we expect Astrazeneca to be a double-digit grower both on top and bottom line through the next few years.

What's another holding you find especially compelling?

Neal Kaufman: I think **Bio-Techne Corporation**, one of the Fund's top holdings, is a good example of what we look for in an investment. This is a lifetime tool company, sort of a picks-and-shovel company, that generates good, stable organic growth. It has high margins and the ability to compound earnings over the long term. Its core business is selling biotech reagents to academic labs and biotech companies for research use. This is a high-margin consumable revenue stream that's growing mid-to-high-single digits.

Bio-Techne has other growth drivers, including a platform technology that uses exosomes to detect changes in the blood such as cancer. It has a diagnostic test using this platform to allow men with an ambiguous PSA test to decide whether to get a biopsy for prostate cancer. This platform also drives a pipeline of additional diagnostic tests, including a kidney transplant reject test, and a bladder cancer test, both of which are in the works.

The company recently built a manufacturing facility for products that will be used to manufacture cell and gene therapies. This new facility could expand the revenue for this product category from roughly $50 million in fiscal 2021 to $300 million over time. In addition, Bio-Techne has a protein analysis business that sells various instruments such as an automated western blot device, which can give a rapid sample to answer in a period of hours as opposed to the days it takes for the standard manual process.

Management's fiscal 2026 financial goals include mid-teens organic revenue growth from around $930 million in fiscal 2021 to $2 billion, with at least 40% EBIT margins. We project the company can achieve the $2 billion revenue mark, with roughly $850 million of EBITDA, in fiscal 2026.

We also think the business is worth a high valuation given its stable recurring revenue, high margins, and low capital intensity. Thermo Fisher, a large consolidator in the space, just paid around 40x EBITDA for a lower quality competitor. If we assume a 35x EBITDA multiple on our fiscal 2026 estimate, we think the stock can increase to $872 in the next five years, with additional upside from M&A, where it has $4 billion in potential firepower for acquisitions. Ultimately, we see this company as a potentially valuable asset for consolidators in the life sciences tool space.

Neal, what sets Baron Health Care Fund apart from other funds in the Healthcare sector?

Neal Kaufman: First, we own fewer stocks, roughly 50 to 60. Our top 10 holdings will typically represent over 40% of our assets. It's a growth-oriented portfolio. It's all-cap and can invest in both U.S. and non-U.S. companies.

To ensure diversification and help manage risk, we loosely group the portfolio into three categories: 10 earnings compounders; 2) high growth companies; and 3) biotech companies. We define earning compounders as companies that we think can compound earnings at double-digit rates over the long term. Among high-growth stocks, we look for companies that can generate mid-teens or better revenue growth. They may not be profitable today, but we believe they can be highly profitable in the future. And biotech stocks are biotech stocks. Our allocations among these three categories can change depending on upon our view of the opportunity sets in the market environment.

Closing thoughts?

Neal Kaufman: Despite the current macro noise, trends in the Healthcare sector are still very positive. The funding environment for biotech is still strong. The impact of COVID on medical procedure volumes is waning. The pace of innovation continues to accelerate. Our outlook for long-term growth in this sector, and for our holdings, is quite positive.

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.

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 Baron Fund expenses pursuantto a contract expiring on August 29, 2032, 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 www.BaronFunds.com or call 1-800-99BARON.

Baron Health Care Fund's annualized returns for the Institutional Shares as of December 31, 2021: 1-year, 15.72%; 3-year, 32.34%; Since Inception (4/30/2018), 24.12%. Annual expense ratio for the Institutional Shares as of December 31, 2020, was 1.45%, but the net annual expense ratio was 0.85% (net of the Adviser's fee waivers). The **Russell 3000 Health Care Index**'s annualized returns as of

December 31, 2021: 1-year, 18.60%; 3-year, 20.01%; Since Fund Inception (4/30/2018), 17.60%.

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 assetsin 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.

The discussion of market trends is not intended as advice to any person regarding the advisability of investing inany particular security. The views expressed in this document reflect those of the respective writer. Some of ourcomments are based on 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 at any time based on market and other conditions and Baron has no obligation to update them.

Portfolio holdings as a percentage of net assets as of December 31, 2021, for securities mentioned are as follows: Moderna, Inc. – 0.2%, **BioNTech SE** – 0.3%, **UnitedHealth Group Incorporated** – 7.0%, **McKesson Corporation** – 2.0%, **Bio-Techne Corporation** – 4.7%, **AstraZeneca Plc** – 2.2%, **Mettler-Toledo International, Inc.** – 2.1%.

Top 10 holdings as of December 31, 2021

Holding	% Assets
UnitedHealth Group Incorporated	7.0
ICON Plc	5.4
Thermo Fisher Scientific Inc.	4.7
Bio-Techne Corporation	4.7
Natera, Inc.	4.2
Eli Lilly and Company	3.9
argenx SE	3.3
Zoetis Inc.	2.8
Dechra Pharmaceuticals PLC	2.8
Edwards Lifesciences Corp.	2.3
Total	41.1

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

The **Russell 3000® Health Care Index** is an unmanaged index representative of companies involved in medical services or health care in the Russell 3000 Index, which is comprised of the 3,000 largest U.S. companies as determined by total market capitalization. Russell Investment Group is the source and owner of the trademarks,service marks and copyrights related to the Russell Indexes. Russell is a trademark of Russell Investment Group. The **S&P 500 Index** measures the performance of 500 widely held large cap U.S. companies. 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. Non-mutual fund products are available to institutional investors only.

The **Morningstar Rating™** for funds, or "star rating", is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The Morningstar Rating does not include any adjustment for sales loads. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10- year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods.

Alpha measures the difference between a fund’s actual returns and its expected performance, given its level of risk as measured by beta. **Beta** measures a fund’s sensitivity to market movements. The beta of the market is 1.00 by definition. **Upside Capture** explains how well a fund performs in time periods where the benchmark’s returns are greater than zero. **Downside Capture** measures how well a fund performs in time periods where the benchmark’s returns are less than zero. **Sharpe Ratio** is a risk adjusted performance statistic that measures reward per unit of risk. The higher the Sharpe ratio, the better a fund’s risk adjusted performance

BAMCO, Inc. is an investment adviser registered with the U.S. Securities and Exchange Commission (SEC). BaronCapital, Inc. is a broker-dealer registered with the SEC and member of the Financial Industry Regulatory Authority, Inc. (FINRA).