A differentiated, diversified approach to Health Care investing

This is an edited version of a May 17, 2022, Q&A with Baron Health Care Fund Portfolio Manager Neal Kaufman and Assistant Portfolio Manager Josh Riegelhaupt. To access the video recording, please visit our website.

Executive Summary

- In a period of high inflation and rising interest rates, we're much more focused on companies with pricing power, strong balance sheets, and strong cash flows.
- During the quarter we increased the portfolio's weighting in what we call earnings compounders and decreased the weighting in biotechnology and high-growth companies.
- Like all Baron Funds, we seek to identify and invest in competitively advantaged growth companies for the long term. Unlike most funds in the space, we own fewer stocks, are growth-oriented, and invest in both U.S. and non-U.S. companies.
- Despite challenging macro factors, we still see a lot of long-term positives, including:
    - medical procedure volumes have been recovering
    - the later-stage biotech companies we favor are still able to raise capital
    - M&A activity will likely pick up as large pharma companies replenish pipelines
    - The government remains supportive of scientific research funding
    - the regulatory environment for the Health Care industry is benign

Q&A with Neal Kaufman and Josh Riegelhaupt

Let's start with the Fund's performance.

Neal Kaufman: The first quarter of 2022 was challenging for Baron Health Care Fund. The trends that emerged at the end of 2021 continued, with investors flocking to large-cap value stocks due to the concerns about inflation, interest rates, supply chain disruption, Russia's invasion of Ukraine, and another COVID wave. Investor sold smaller cap growth stocks in tight correlation in the flight to safety, regardless of fundamentals. The Fund declined 10% in the first quarter while the Russell 3000 Health Care Index declined roughly 4.5%.

The best performing sub-industries for the Fund were health care distributors, managed health care, health care services, and health care facilities. These stocks trade at lower valuations and are generally viewed as safer.

Conversely, the worst performing sub-industries were small- and mid-cap stocks in biotech, life sciences tools and services, and health care equipment. In the case of small- and mid-cap biotech, most of these companies are long-duration, meaning their cash flows likely won't start for years and they will have to raise capital before turning profitable. In a rising rate environment, future cash flows are worth less. As for life sciences tools and services, many had performed extremely well during the pandemic because they generated revenue from COVID vaccine production or testing. In some cases, valuations were extended. Many have given up some of those gains as conditions normalize and the stocks are faced with tough comparisons against the artificially heightened results they were generating during the pandemic. Health care equipment companies sold off for similar reasons. We saw a massive rotation out of stocks that had been the stronger performers in prior years.

Which stocks contributed the most to performance, and which detracted?

Neal Kaufman: The top contributors were **McKesson Corporation**, **AstraZeneca PLC, AbbVie Inc.**, **UnitedHealth Group Incorporated**, and **Eli Lilly and Company.** McKesson is a leading distributor of pharmaceuticals and medical supplies. We first bought the stock in the fourth quarter of last year when we saw the company's fundamentals were improving, and we thought it was poised for low double-digit annual earnings growth. The stock benefited during the quarter from valuation expansion. In addition, McKesson reported strong earnings and provided a strong outlook for the upcoming fiscal year. AstraZeneca is a large-cap, European pharma company, whose stock was up because of strong clinical data for its breast cancer drug. AbbVie, a new addition during the quarter, was up because of rotation into lower-multiple, large-cap pharma stocks. Managed care company UnitedHealth Group was up because of strong earnings. And finally, Eli Lilly was up because of investor excitement about its new drug for obesity, which showed a remarkable 22.5% average body weight loss in a recent clinical trial.

The top detractors from performance were **ICON Plc**, **Natera, Inc.**, **Dechra Pharmaceuticals PLC**, **Zoetis Inc.**, and **Bio-Techne Corporation.** Apart from Natera, which we sold during the quarter, all were strong performers last year and we continue to have a high level of conviction in them. Shares of contract research organization ICON was down over concerns about biotech funding levels. Dechra and Zoetis are leading animal health companies whose stocks were down over concerns about slower growth in the companion animal market after a period of exceptional growth during the pandemic. Bio-Techne, a life sciences tools company, was down because of rotation out of 2021's strong performers. Natera, a genomics diagnostics company, was down along with other genomics stocks due to a rotation out of unprofitable companies in the space. We sold the stock because the profit inflection we had originally forecasted will likely take longer to materialize, resulting in heavier cash burn rates.

Were there any notable purchases?

Neal Kaufman: In a period of high inflation and rising interest rates, we're much more focused on companies with pricing power, strong balance sheets, and strong cash flows. During the quarter we increased the portfolio's weighting in what we call earnings compounders and decreased the weighting in biotech and high-growth companies.

One of the names we added is **The Cooper Companies, Inc.**, a leader in the contact lens market, which is benefitting from lens wearers trading up to daily silicone hydrogel lenses. Cooper has an exciting portfolio of myopia management products, including a lens called MiSight, which is the first FDA-approved contact lens indicated to slow the progression of nearsightedness in children between the ages of 8 and 12.

We also bought **Anthem, Inc.**, a large-cap managed health care company. Anthem has multiple growth drivers that would enable the company to grow earnings by 12% to 15% a year. We also added **Novo Nordisk A/S**, a leading biopharma company based in Denmark that dominates the market for diabetes treatments with new drugs for obesity that we think will become blockbusters.

Could you share your perspective on the biotech sector?

Josh Riegelhaupt: Biotech is going through what I characterize as a period of capitulation. Valuations are down 60% from their peak in February 2021, which I believe is largely a result of the industry becoming a victim of its own success.

First, high-risk assets did well in the years leading up to 2022 with government and monetary stimulus as a tailwind. Now we're mean-reverting or correcting, although why the downturn in biotech started earlier than other growth assets isn't particularly clear.

Second, the dilution enabled by free stimulus money spurred a wave of new company formation leading to fierce competition with overlapping modalities and commercial end-markets. This phenomenon unleashed a lot of novel and exciting technologies, which benefits doctors and their patients. But investors are now surveying a tougher landscape, which is somewhat complicated by the fact that many companies were rushing during the free money period, leading, in some cases, to sloppy execution.

Finally, there is a finite number of biotech specialist investors and many more companies. My estimate is that we're outnumbered four-to-one. That makes it tough to support the broader industry.

As for what's next, it's always hard to call macro developments, but no one could deny the industry's progress. When I started looking at biotech stocks 20 years ago, genomics and cell therapies, CRISPR, gene editing, RNA drugs like mRNA or RNAi, immuno-oncology (treating cancers with the immune system) – none of these existed. These are all exponential leaps, and this innovation will continue. The Health Care sector is moving in the right direction. It's arguably as important as any other technology space, be it IT or innovation in energy, automation, or space technology. This is a major tailwind.

As for when shares might turn around, most investors reference large-cap pharma M&A. Very recently, the balance sheets of all large-cap pharma, in total size of cash offers, surpassed the market cap of the entire biotech industry. The public companies are playing close to the vest on what they want to do. Inevitably they will act, in the meantime, I'll call myself a guarded optimist.

With Baron Health Care Fund now over three years old, what do you feel sets your strategy apart?

Neal Kaufman: Like all Baron Funds, our strategy is to identify competitively advantaged growth companies that we can own for years. We think our portfolio is different than other Health Care funds in several key aspects: we own fewer stocks, are a growth-oriented portfolio in an all-cap space, and invest in both U.S. and non-U.S. companies.

To diversify and manage risk, we loosely group the portfolio into three categories: Earnings Compounders, High-Growth companies, and Biotech companies. Earnings Compounders are companies we think can grow revenue 5% to 10% a year and earnings at double-digit rates over the long term. High-Growth stocks are companies we believe can grow revenue at mid-teens or better. They may not be profitable today, but we think they can be highly profitable in the future. We view Biotech as a distinct category. While the portfolio will always invest across all three categories, we have the flexibility to adjust allocations based on our view of the opportunity set and the market environment.

What makes Health Care a good place to invest during periods of high inflation?

Neal Kaufman: The short answer is pricing power. One example is **Mettler-Toledo International, Inc.**, which sells weighing instruments for laboratories. It can raise prices a few points every year because its products have low average selling prices and its customers care about quality over price. Health Insurance companies like UnitedHealthcare can raise prices by mid-to-high single digits every year. Pharma and biotech companies, even with the prospect of legislation to curtail drug pricing, can set prices upon launch and raise them in line with inflation every year. As an example, **argenx SE**, one of our larger holdings, just launched a novel drug for a disease called myasthenia gravis with attractive pricing.

Argenx has been a top position since the Fund's inception, and a standout performer. Why do you continue to like the stock?

Josh Riegelhaupt: This company is a leader in antibody development. Most of the investment case is hinged on a drug called VYVGART, which controls autoantibody diseases – antibodies that attack a person's own tissue. The many diseases caused by autoantibodies combined with the fact that argenx has a drug for a treatment considered very elusive in the biotech industry makes for a very promising opportunity. It means that one drug can potentially treat multiple diseases, with new disease indications becoming the pipeline itself. What was once a 50,000-patient end-market becomes 100,000 patients, then 200,000, and so on. This can create tremendous efficiencies and profitability and is why argenx is in such a coveted spot. Commercial sales for argenx just started this year, with the first quarter a blowout, beating consensus by almost three times. It's marching its way toward what we think will be a greater than $10 billion peak drug. We think there's a lot to look forward to.

Any final thoughts?

Neal Kaufman: Despite the macro headwinds, there are a lot of positives as well. Even though COVID continues to resurface, medical procedure volumes have been recovering. Inflation, supply chain issues, and foreign currency headwinds are manageable for many of our holdings, which benefit from pricing power, solid balance sheets, and competitive advantages. While the capital markets for early-stage biotech companies has become extremely challenging, the later-stage companies we favor are still able to raise capital. We think M&A activity is likely to pick up given the large amount of cash sitting on the balance sheets of large-cap biopharma companies that need to replenish their pipelines. The government remains supportive of scientific research funding, which bodes well for life sciences tools companies. Drug pricing provisions and the Build Back Better law may resurface, but we think overall we're in a benign regulatory political environment for the Health Care industry. For example, Medicare Advantage companies are set to receive the highest rate increase in decades for fiscal year 2023, which bodes well for the managed care companies we own. Overall, despite near term headwinds, our long-term outlook for the Health Care sector remains optimistic.

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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 March 31, 2022: 1-year, 3.62%; 3-year, 21.98%; Since Inception (4/30/2018), 19.20%. Annual expense ratio for the Institutional Shares as of December 31, 2021, was 0.89%, 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 March 31, 2022: 1-year, 10.83%; 3-year, 14.92%; Since Fund Inception (4/30/2018), 15.01%.

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 March 31, 2022, for securities mentioned are as follows: McKesson Corporation – 2.8%; **AbbVie Inc.** – 2.3%; **UnitedHealth Group Incorporated** – 8.6%; **Bio-Techne Corporation** – 5.2%; **AstraZeneca Plc** – 3.9%; **Mettler-Toledo International, Inc.** – 2.0%; **Eli Lilly and Company** – 4.3%; **ICON plc** – 2.6%; **Dechra Pharmaceuticals PLC** – 3.3%; **Zoetis, Inc.,** -- 2.5%; **argenx SE** – 2.8%; **The Cooper Companies Inc.** – 2.2%; **Anthem, Inc.** – 2.2%; **Novo Nordisk A/S** – 1.4%.

Baron Health Care Fund owned no shares on **Natera, Inc.** as of March 31, 2022.

Top 10 holdings as of March 31, 2022

Holding	% Assets
UnitedHealth Group Incorporated	8.6
Thermo Fisher Scientific Inc.	5.2
Bio-Techne Corporation	5.2
Eli Lilly and Company	4.3
AstraZeneca Plc	3.9
Dechra Pharmaceuticals PLC	3.3
McKesson Corporation	2.8
argenx SE	2.8
Edwards Lifesciences Corp.	2.6
ICON Plc	2.6
Total	41.3

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.

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