MarketWatch
May 22, 2023

These stock pickers led the health-fund category over the past 5 years. Here's where they're investing now.

Baron Health Care fund managers find growth potential in Medicare Advantage plans, obesity treatments, advances in cancer screening

By Eleanor Laise

The Baron Health Care Fund's first five years have been exceptional in every sense of the word. Launched in spring 2018, the fund has navigated around the COVID-19 pandemic, a biotech initial public offering market that boomed and fizzled, and D.C. policy makers intent on reining in prescription-drug spending and other healthcare costs.

Despite all that, Baron Health Care is the top-performing health-sector fund over the five years ending May 19, according to investment-research firm Morningstar, with its institutional shares posting a 13.1% annualized total return over that period, versus 6.7% for the category's average fund.

One key to that performance: The fund didn't get distracted by the shiny objects in the sector. Many lower-quality companies that achieved lofty valuations over that period came crashing down. And while some competing funds got caught up in a pandemic-fueled IPO frenzy in the sector, "we weren't spending every Monday morning chasing the next deal," said Joshua Riegelhaupt, assistant portfolio manager.

Neal Kaufman manages the Baron Health Care Fund, the top-performing health-sector fund over the past five years, according to Morningstar. COURTESY OF BARON CAPITAL

"We tried to stick with what we do best," said manager Neal Kaufman, by following the Baron Capital philosophy and "buying and holding companies that we think have competitive advantages and great management teams."

At the same time, Kaufman and Riegelhaupt keep their eyes on some overarching themes in a sector where innovation, regulation and litigation are constantly making and breaking investment opportunities. Longer term trends like advancements in gene therapy, the aging of the population, the growing prevalence of diabetes and obesity and the increased adoption of Medicare Advantage, the private alternative to traditional Medicare, have helped shape their portfolio.

That doesn't mean they hold a little bit of everything. The portfolio tends to be relatively concentrated, with about 40 or 50 stocks, and nearly half of assets were in the top 10 holdings as of late April. The fund's retail share class charges annual fees of 1.1%.

Speaking just after the end of the COVID public health emergency, the managers reflected on some of the positive healthcare transformations highlighted by the pandemic. "There was a vaccine that was created very, very quickly," Riegelhaupt said, underscoring "some of the best of what the industry can do." With the development of the messenger RNA technology used in the COVID shots as well as other types of RNA therapeutics, gene therapy, cell therapy and other advancements, "now we have this toolkit, and every disease needs its own sets of tools," Riegelhaupt said. Focusing on the right tools, he said, "you can make real leaps."

New innovations the managers are watching now include advancements in continuous glucose monitoring, which helps people with diabetes monitor blood sugars. The technology is being adopted by people with diabetes using all types of insulin. And continuous glucose monitoring technology "could have utility among the much larger Type 2 diabetes population, including people who don't use insulin. That's a huge market," Kaufman said. The fund holds DexCom Inc., which late last year got FDA clearance for a continuous glucose monitoring system for people aged two and older with all types of diabetes.

The managers are also tracking developments in blood-based screening for cancer. A new holding in the fund is Exact Sciences Corp., which is developing a test that allows for screening for many types of cancer with a single blood draw.

One of the fund's top holdings, Eli Lilly & Co., is benefiting from a focus on diabetes and obesity treatments — the company last month released strong new results for next-generation obesity drug tirzepatide — as well as new Alzheimer's medications, with Lilly's donanemab slowing disease progression in late-stage trials. "These are two huge categories, and they're a leader in each of those," Kaufman said.

A big question hanging over pharmaceutical companies, however, concerns the impact of the Medicare drug price negotiation required under last year's Inflation Reduction Act, Kaufman said. The initial list of 10 drugs to be negotiated will be published this September, and the first negotiated prices take effect in 2026. Kaufman isn't too worried about that initial list, he said, as "many of those drugs are close to patent expiration anyway, so it won't be all that impactful."

But beyond that initial round of negotiations, there are lots of unknowns, Kaufman said. "After the first year, what do the lists look like in the future? What is the impact on pharma R&D spending?" he asks. Small-molecule drugs can't be selected for price negotiation until they're at least seven years past their FDA approval date, versus 11 years for biologics. "Will there be a big shift away from small molecule drugs and toward biologics?" Kaufman asks. "It does seem like that could happen. And what does that mean for valuations of companies with small molecules?" he said. "There are just a lot of implications here."

Several of the fund's top holdings are dominant players in the Medicare Advantage market, including UnitedHealth Group Inc., Humana Inc. and Elevance Health Inc. Half of all eligible Medicare beneficiaries are now enrolled in these private plans, according to health policy nonprofit KFF, up from 25% in 2010. Policy changes–including less favorable Medicare Advantage reimbursement rates slated for next year–have weighed on some of these holdings this year. But Kaufman is still bullish on the prospects for Medicare Advantage, which can offer some additional benefits, such as vision and dental, not covered under original Medicare. The plans "have the ability to continue to grow nicely, despite some of those rate headwinds," said Kaufman. "We think the long-term growth outlook is positive, and we own the market leaders."

Some of the big insurers also own pharmacy-benefit managers–prescription-drug middlemen who are taking a lot of heat in D.C. this year as the Federal Trade Commission and lawmakers of both parties scrutinize their influence on drug costs and access. That scrutiny was a factor behind the managers' decision earlier this year to sell off the fund's position in Cigna Group, which owns one of the largest PBMs, Express Scripts. But overall, Kaufman said he's "not overly concerned" about the D.C. spotlight on PBMs, because "PBMs in general have the ability to shift their economic models in response to changes that might occur. For the most part, the large managed care companies we own are diversified enough that we don't see a material risk to their businesses."

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Baron Health Care Fund's annualized returns for the Institutional Shares as of 3/31/2023: 1-year, -11.13%; 3-year, 14.72%; Since Inception (4/30/2018), 12.29%.

The **Morningstar Health Category Average** annualized returns as of 3/31/2023: 1-year, -8.73%; 3-year, 9.52%; Since Fund Inception (4/30/2018), 6.98%.

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, 2033, 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.

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 March 31, 2023 for securities mentioned are as follows: Exact Sciences Corporation 1.2%.

Baron Health Care Fund
Top 10 Holdings as of 3/31/2023

Holding	% Holding
UnitedHealth Group Incorporated	8.9
Eli Lilly and Company	6.0
Thermo Fisher Scientific Inc.	5.1
Merck & Co., Inc.	4.0
Intuitive Surgical, Inc.	3.9
Vertex Pharmaceuticals Incorporated	3.6
DexCom, Inc.	2.9
Elevance Health, Inc.	2.9
Mettler-Toledo International, Inc.	2.8
Humana Inc.	2.7
Total	42.7

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

Morningstar calculates the Morningstar Health Category Average performance using its Fractional Weighting methodology. Total returns do account for management, administrative, and 12b-1 fees and other costs automatically deducted from fund assets.

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