

Long-Term Secular Growth Drivers

Healthcare and Aging Demographics

Scout Investments' Small Cap Strategy Investment Team believes that healthcare and demographic developments play a vital role in driving outsized investment returns. These trends develop over time and help us identify opportunities in the markets that others often miss. From Alexander Fleming's penicillin (the world's first antibiotic discovered in 1928) to organ transplants, antiviral drugs, and stem cell therapy, the last century has produced some of the most important healthcare advancements in recorded history. These innovations have revolutionized our world in many ways, and with the advent of artificial intelligence in the 21st century there are no signs of this evolutionary arc slowing. Due in large part to these innovations, healthcare now comprises over one-third of the small cap growth universe – a trend that makes our research in this space as important as ever. In this paper, we will discuss several healthcare themes that are most pertinent today and explain how the Scout Small Cap investment team seeks to take advantage of these trends in its portfolio.

in the U.S., the Boomers are retiring and driving demand for a variety of leisure goods and services as well as additional healthcare services.

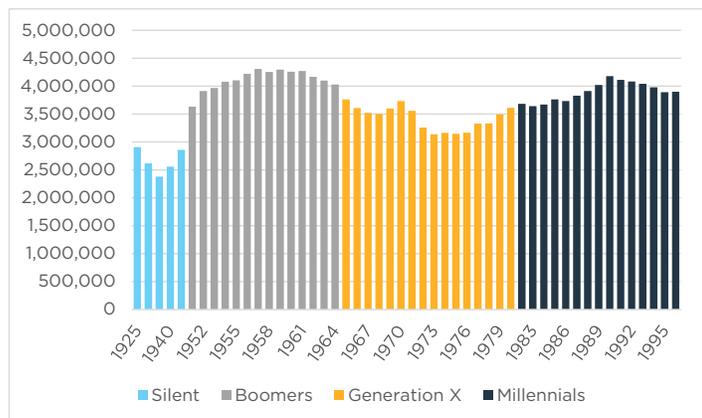
The Millennial generation is now the largest U.S. generation in total population and the most influential in terms of spending power for many categories as members enter their prime earning and spending years. Much discussion and analysis has gone into understanding Millennials' preferences and how they may be similar to or different from other generations. The Millennial generation came of age with the digital experience and the smart phone but also began their working lives in challenging economic conditions. There is a belief that Millennials prefer experiences over things, but as they mature, it appears that some preferences (including the desire to own a home) may be reverting to patterns similar to earlier generations. A large grouping combined with pent-up demand and easy financial conditions create compelling conditions for continued consumption growth.

Demographic Factors

In the U.S. today there are two big generations working their way through the demographic pipeline. The Millennial generation is reaching peak earning years, while the Baby Boom generation is transitioning into retirement.

Scout Small Cap targets high-growth-rate age groups to uncover lasting demographics trends that will drive performance moving forward. Given their size and influence, Baby Boomers and Millennials likely will continue to wield immense power over how companies attempt to win the business of these two cohorts well into the future.

Births Underlying Each Generation



Sources: Department of Health and Human Services, National Center for Health Statistics, web: www.dhhs.gov; Infoplease (<https://www.infoplease.com/us/population/live-births-and-birth-rates-year>)

The growth and maturation of the Baby Boom generation drove an immense transformation of culture as well as demand for goods from housing to cars, clothes, and electronics. After decades as the biggest economic force

Biopharmaceuticals (R&D spending to speed drug development)

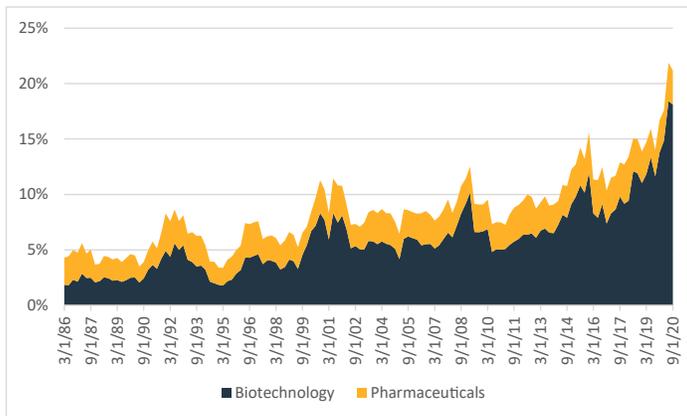
Biotechnology has been changing the way healthcare and pharmaceuticals have been delivered since the launch of the first recombinant insulin in 1982. These biopharmaceuticals are derived from living organisms as opposed to chemical compounds created by traditional pharmaceutical companies, and they use biological methods such as gene therapy and editing, cellular therapy, and RNA therapeutics to treat disease. Therapies now exist to treat everything from rheumatoid arthritis to cancers, while new treatments and vaccines show promise on COVID-19. From those humble beginnings in 1982, the biotech industry has evolved into a nearly \$450 billion market in 2019 and is projected to grow at a nearly 8% compound annual growth rate (CAGR) through 2026 to a nearly \$750 billion behemoth.¹ Moreover, as research and development spending

¹ Source: <https://www.marketwatch.com/press-release/biotechnology-market-size-growing-at-77-cagr-to-hit-usd-7417-billion-by-2026-2020-10-13>

increases to speed drug development, biopharmaceuticals will continue to play a vital role in the ever-evolving healthcare landscape.

The promise of these therapies has led to massive investment in biotechnology startups by venture capital and public market investors. These companies are investing tens of billions of dollars in research and development as well. Indeed, with the global coronavirus pandemic as backdrop, 2020 has seen record amounts of both venture capital funding as well as initial public offering fundraising.² While the vast majority of these early stage and small-cap biotech companies are unprofitable, this R&D spending provides opportunities for investment through adjacent businesses such as clinical trial operators, research toolmakers, and companies that provide enabling technologies such as drug delivery methods. Biopharma stocks now comprise well over 20% of the Russell 2000® Growth Index, roughly a three-fold increase over the past decade. These stocks are continuing to become an increasingly important part of the investing landscape as well as companies that the Scout Small Cap investment team researches in an attempt to separate ideal investments from so-called “public science experiments.”

Russell 2000® Growth Weights



Source: Furey Research and FactSet, as of 9/30/20

Rapid Decline of Gene Sequencing Cost

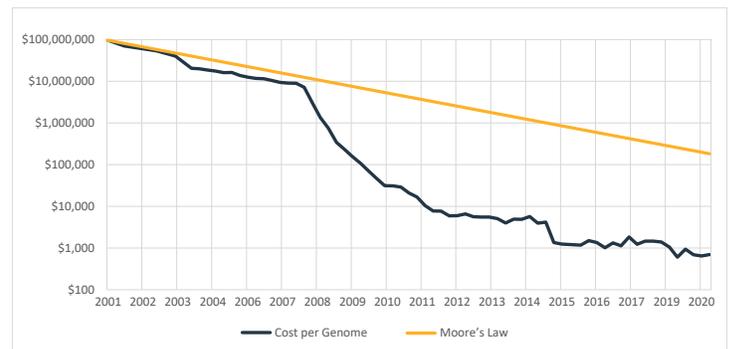
The human genome was sequenced in 2003 at a cost at the time of \$2.7B. It took over 13 years. A dramatic decrease in time and cost took place with the introduction of next generation sequencing techniques, ultimately driving the cost to below \$1000 per human genome. More recently, it only took three days to sequence the genome of COVID-19 (SARS-CoV-2). This provided valuable information that helped researchers develop the foundation of how they could begin taking on this disease

²Source: <https://www.forbes.com/sites/brucebooth/2020/07/15/the-record-breaking-biotech-funding-tsunami-of-1h2020/?sh=20205480c0fe>

and track its various forms as it mutates. The graph in this section illustrates how the sequencing cost per human genome has improved faster than Moore’s Law for semiconductors, which involves the doubling of the number of transistors on a microchip about every two years with the cost of the chip divided in half. As most investors are familiar with this growth trend, if new technology is outpacing Moore’s Law, it is considered a good barometer that makes for a useful comparison.

Cost per Human Genome³

Cost over time to sequence one human genome, compared to Moore’s Law



Source: National Institutes of Health

With this exponential improvement, gene sequencing has moved into clinical settings such as cancer treatments, reproductive health, and rare diseases. This has enabled personalized medicine to incorporate various treatment options that have proven most successful with a patient’s genetic makeup. The clinical market is the fastest growing component of next-generation sequencing. For cancer patients, a genomic test can help doctors determine a patient’s prognosis whether the cancer is aggressive or slow growing, and choose the most effective treatment. Differences in a person’s genome affect the risk of developing diseases and how they respond to different medications.

As expected, with the cost of sequencing dropping, the number of companies participating in the industry has grown as have overall applications using this new technology. For instance, next-generation sequencing (NGS) testing for the reproductive health market is on pace for a compound annual growth rate of roughly 14% through 2022 while the oncology NGS market is on track to grow at a compound annual growth rate of over 37% by 2022.⁴ Demand for NGS testing should continue to grow apace and create opportunities for a wide array of companies – opportunities that the Scout Small Cap investment team will work to discover.

³Wetterstrand KA. DNA Sequencing Costs: Data from the NHGRI Genome Sequencing Program (GSP) Available at: www.genome.gov/sequencingcostsdata. Accessed 11/23/20.

⁴National Institutes of Health: <https://www.ncbi.nlm.nih.gov/pmc/articles/PMC7059995>

Definitions:

The Russell 2000® Growth Index measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values.

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