Heartwood
Investment Management

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Investment Insight

Weekly Insight

Are the US healthcare sector's frailties treatable?

The US healthcare sector has been a notable underperformer since the presidential election, saddled by issues around competitive drug pricing and the Affordable Care Act (ACA). Stocks have been under further selling pressure this week as US Congressional discussions begin to repeal and replace the ACA. This political overhang is likely to stay in the short term, but we also think that some of the market's concerns are overdone. Ultimately, our view is that a Republican president and a Republican-controlled Congress will probably provide a more corporate friendly environment - via tax cuts and a desire to reduce the regulatory burden - than perhaps if Hillary Clinton had been elected. Furthermore, the healthcare lobby in Washington is a powerful force, being the largest spender by some margin versus other industries. Its financial clout suggests that any legislative change would be difficult to implement if it were seen to be a negative for the industry.

Longer term, the healthcare sector remains underpinned by the following structural trends:

- **Ageing demographics, rising life expectancy and growing consumerism in healthcare.** According to the United Nations, the proportion of the population aged 60 and over is expected to nearly double between now and 2050. Rising life expectancy, a phenomenon being experienced in both developed and developing nations, implies increasing levels of healthcare spending to treat chronic illnesses, such as heart disease, cancer and diabetes. Global spending on health as a proportion of GDP was 9.9% in 2014, according to the World Health Organisation. Some of the largest spending increases have been seen in emerging market economies as their middle class populations expand, particularly in South East Asia and the Middle East.

- **New discoveries through technological advancements and innovation:** The biotech revolution represents one of the most exciting areas of technical innovation. Since the mapping of the human genome in 2000, the pharmaceutical industry has made enormous strides into developing therapies to treat and prevent disease. Gene therapy, a technique that modifies the genetic code to correct cell irregularities, has been used to develop treatments for a range of conditions, including certain cancers. More recently, scientists have made far-reaching progress in stem cell research, developing innovations in areas such as organ transplants. Advances are also underway in neuro-engineering, where theoretically brain implants could be used to treat conditions such as Alzheimer's and Parkinson's. Outside of therapeutics, progress is being made in diagnostics and imaging technologies, and in the delivery of services - for example, treating patients with long-term conditions remotely.

At present we believe that the healthcare sector is priced at a more attractive entry point, especially if considered relative to the broader US equity market. Moreover, there have been wide divergences between sub-sectors, with biotech seeing the most underperformance. Potentially, this may present opportunities for greater synergies and industry consolidation. In particular, the life cycle of new product launches from conception to market is a multi-year/multi-decade process. Rather than commit significant resources and capital to developing therapeutics, it can be more cost efficient for larger pharmaceuticals to acquire the research and development of smaller, biotech pioneers.

We believe that the long-term risk/reward profile of healthcare represents a compelling opportunity. However, as we have seen in recent months, investors need to be prepared for volatility, particularly lower down the market-cap spectrum.

Clear Thinking

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To find out more about the Heartwood strategies, visit our website or contact your local representative.

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