WILMINGTON TRUST

INVESTMENT INSIGHTS

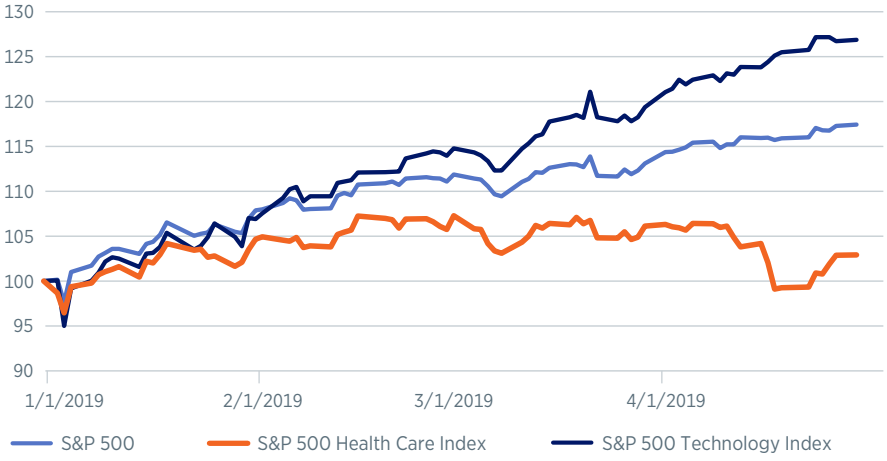
Health Care Stocks: Left for Dead?

Meghan Shue
Senior Investment Strategist

Four months into 2019 and the S&P 500 is up 17% (price return), making it the seventh best start to the year for the index since 1929. One sector is just barely eking out a positive return: health care. The return spread between health care and the best-performing sector—technology—over just the first four months of the year is a staggering 24% (Figure 1).

Figure 1

Health care stocks limping behind the market



As of April 29, 2019. Represents price return indexed to 100 on December 31, 2018.
Past performance cannot guarantee future results. Indices are not available for direct investment.
Sources: Bloomberg, Standard & Poor's.

At a glance:

- **A main reason for health care's anemic pulse is that it is a defensive economic sector, and as such, it tends to do better when equities are underperforming (not the case in 2019)**
- **Policy risk has ramped up dramatically as the 2020 elections near, and all presidential candidates seem to pose a threat to some area of the sector**
- **Three innovation themes are in play involving transitions from sickness treatment to prevention; control of care from doctor to patient; and a focus from treating the ailment to the person**

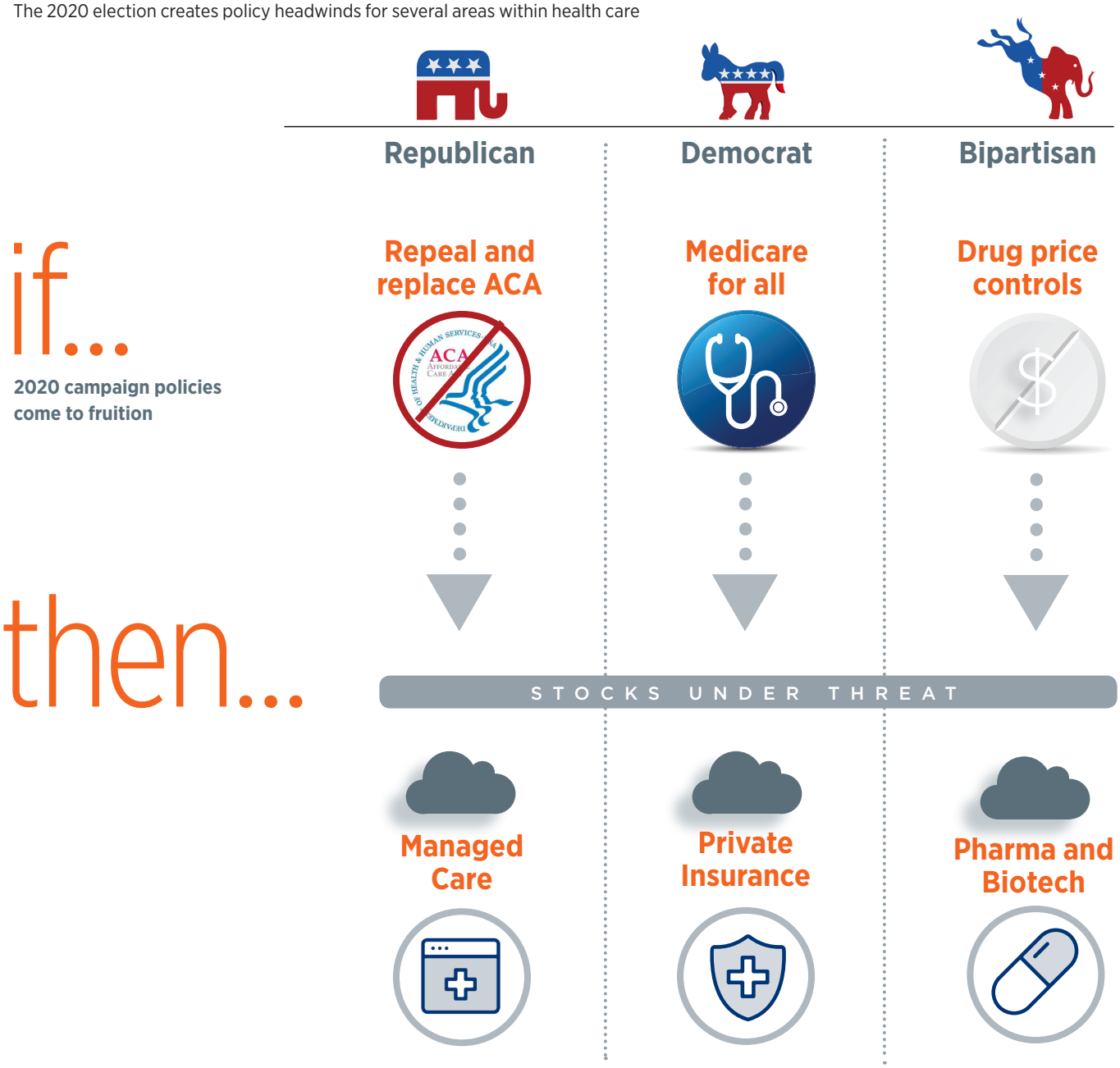
There are two main reasons why the health care sector appears to be on life support. First, health care is one of the more "defensive" sectors of the U.S. equity market and tends to do better in environments where investors are more risk averse. In 2018, a challenging year for equities, the health care sector of the S&P 500 outperformed the broader index by 10.4%. The bounce in the equity market this year has favored those stocks more closely tied to the economic cycle ("cyclical" sectors like technology, industrials, and consumer discretionary). Second, policy risk has ramped up dramatically as the 2020 U.S. presidential election has come into focus. This policy risk is not overstated for some companies, and it is part of the reason we are neutral health care in our equity sector strategy. However, in our view, it is likely that there are at least a few gems among the rubble, leaving some attractive investment opportunities within the health care sector.

Continued

Figure 2

DC to HC: Triple threat

The 2020 election creates policy headwinds for several areas within health care



Health care stocks in the D.C. cross-hairs

It seems that no matter who we listen to on the 2020 campaign trail, their policy vision poses a direct threat to some area of the health care sector (Figure 2).

The Trump administration has backed continued legal challenge to the Affordable Care Act, which could be revisited by the U.S. Supreme Court, and is also contemplating a post-2020 return to Affordable Care Act "repeal and replace" efforts. Repeal of the Affordable Care Act would increase hospitals' "bad debts" as

Continued

While hard to believe, there is also one area of the health care space where Democrats and Republicans share common ground: cracking down on drug pricing.

fewer insured means less demand for health care services, and more people entering hospital emergency rooms without the means to pay the subsequent bills.

Among 2020 Democratic hopefuls is a building chorus of "Medicare for all," and Bernie Sanders is one of the loudest voices. In the general sense, this would mean a single-payer, nationwide, public insurance plan that could lead to lower total cost (netting out higher taxes against lower medical bills) for some but, according to the Mercatus Center at George Mason University, would require an estimated $32.6 trillion increase in federal spending over a 10-year period.[1] Obviously, private insurance companies would feel pain from a move to a public insurance program, but other health care providers could also see a cut to payments relative to private insurance rates. With details scant, there is the potential for ramifications on the entire sector.

While hard to believe, there is also one area of the health care space where Democrats and Republicans share common ground: cracking down on drug pricing. A January 2019 article in the journal *Health Affairs* found that the cost of oral and injectable brand-name drugs increased 9% and 15%, respectively, between 2008 and 2016 (though increases have been more muted in the last couple of years). Price increases for generic oral and injectable equivalents were 4% and 7%, respectively. This compares to the average annual rate of overall inflation of 1.6% over that same period, as measured by the CPI. As an example of what political pressure can do to pharmaceutical stocks, in September 2015, the S&P 500 Pharmaceutical Industry Index fell 24% in a matter of days following a tweet from Hillary Clinton about the exorbitant price increase of a drug called Daraprim. The index has still not recovered.

Innovation driving opportunity

As the road to legislative action on any of these issues is at best incredibly long, winding, and shrouded in fog, we believe it is prudent to proceed with caution. The veil of political uncertainty could weigh on the overall health care sector until or even beyond the 2020 election.

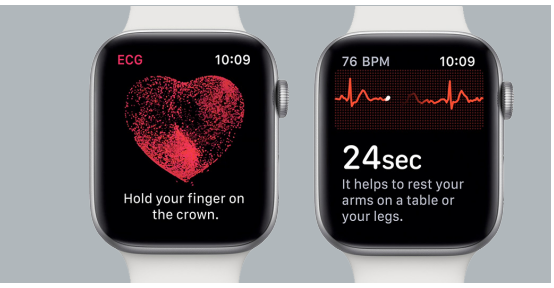
That said, it would be unwise for the long-term investor to write off all health care stocks, as this also happens to be one of the sectors experiencing the most rapid pace of innovation. While politicians are understandably focusing on policy-based solutions to the problem of rising health costs, we expect innovation to be transformational for the industry and drive efficiencies going forward. We highlight three innovation themes that we expect to increase health care productivity, reduce costs, and offer potential investment opportunity:

1) Treating sickness > preventing sickness

One of the most obvious ways to reduce health care costs is to take preventative steps to avoid the expensive treatment of illnesses once they have reached a critical stage. Emergency rooms are notoriously overburdened and understaffed, and they are the most expensive entry point into the health system, but several technologies aim to get ahead of the ambulance ride. Companies like Teladoc

[1] Estimate is based on a July 30, 2018 working paper in response to the Medicare for All Act, or M4A, proposed by Senator Bernie Sanders. The $32.6 trillion increase in federal budget commitments is estimated over the period 2022–2031 and would equal 10.7% of GDP in 2022.

Continued



Apple offers electrocardiogram (ECG) readings on its Apple Watch Series 4, which can provide warning of an irregular heart rhythm or unnaturally high heart rate..., allowing extra time to seek out a doctor.

On-demand, remote medical care through a patient's phone or internet-connected device, removes the often costly and inconvenient physical trip to the doctor.

enable on-demand, **remote medical care** through a patient's phone or internet-connected device, removing the often costly and inconvenient physical trip to the doctor (or multiple doctors). As another example, Apple offers electrocardiogram (ECG) readings on its Apple Watch Series 4, which can provide warning of an irregular heart rhythm or unnaturally high heart rate (when otherwise not moving very much), allowing extra time to seek out a doctor. A somewhat related take on the **wearables** trend is a "smart toilet" (we promise not to get graphic). Researchers at the Rochester Institute of Technology developed a cloud-connected seat containing biometric sensors to measure a person's ECG, blood oxygen levels, and body weight. All of these technologies help solve a major problem in early diagnosis and preventative care: adherence to frequent and regular testing of vitals.

2) Doctor in control > patient in control

Anyone who has switched doctors knows the insanity of transferring your medical records, which often includes a fax—yes, fax—of reams of paper, sometimes at a per-page cost to the patient. In 2016 Google acquired Apigee, a company specializing in open but secure **application programming interfaces** that could transform the traditional closed ecosystem of electronic health records. A future that includes all of a patient's doctors having instant and simultaneous access to the same medical records, and that patient "owning" those records, is one that would be more efficient and less costly.

3) Treating the ailment > treating the person

The traditional medical diagnosis process involves conveying symptoms to a physician who prescribes a treatment for the ailment or disease believed to be causing those symptoms. But not everyone reacts to the same treatment in the same way, forcing multiple costly rounds of trial and error until the physician and patient find something that works. Now envision a world where a treatment was prescribed not only based on the ailment but also that patient's **genetic markers**, more quickly zeroing in on what treatment could be most effective for that specific person. That is being made possible through the partnership of 23andMe, the company that sells home DNA kits, with pharmaceutical companies to develop more "personalized" treatment plans through the use of genetic data culled from millions of customers.

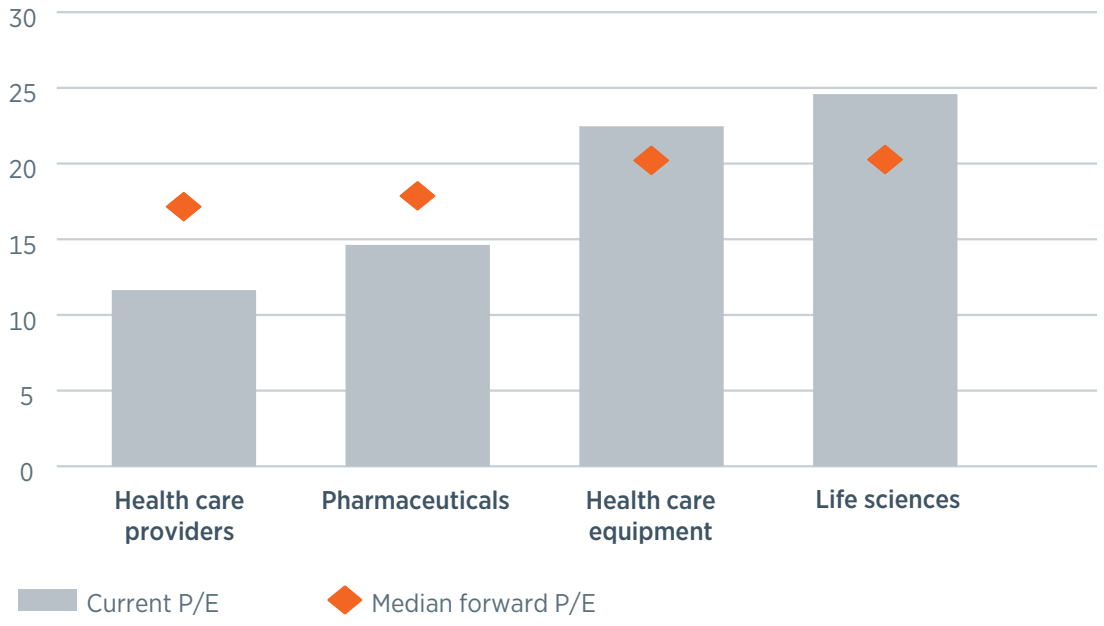
Patience, but diligence, on the road ahead

The road ahead could be rocky for health care investors. It will be increasingly important for investors to balance the political risks with the innovation that we are finding in certain companies, all with an eye toward reasonable valuations.
We are finding opportunities within each industry, but stock selection is key. In general, where the political risks are higher—in managed care, hospitals, and pharmaceuticals—the valuations based on forward-looking earnings estimates are more reasonable and, in some cases, more than compensate for those political tail risks. Those areas seeing innovation but skirting the political spotlight, like medical

Continued

Figure 3

Valuations reflect political risk



As of April 24, 2019.

Represents the price-to-earnings ratio of S&P GICS Level 3 indices based on blended estimates of next–12–months earnings, going back to May 2006.

GICS is a standardized classification system for equities made up of a hierarchy of 11 sectors, 24 industry groups, 69 industries, and 158 sub-industries. Level 1 are the sectors; Level 2, the industry groups; Level 3, the industries; and Level 4, the sub-industries.

Sources: Bloomberg, Standard & Poor's.

The road ahead could be rocky for health care investors. It will be increasingly important for investors to balance the political risks with the innovation that we are finding in certain companies, all with an eye toward reasonable valuations.

devices and life sciences, tend to trade at higher valuations relative to their own history, but appear attractive for a more growth-oriented investor with a long time horizon (Figure 3).

At this time, we are maintaining a neutral allocation to health care stocks, but we think it would be a mistake to shun the sector in its entirety. Instead, taking a more surgical approach to investing in the sector could result in some very innovative investment opportunities.