

# Attractive opportunities in recovering U.S. health-care sector

SHIRLEY WON  
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Health care was the second-worst performing sector after energy in the U.S. market last year, but still rose by 20.8 per cent.

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U.S. health-care stocks have been on the mend after ailing last year because of political headwinds and opioid-related litigation.

Although political rhetoric from Democratic Party candidates vying to run in November's U.S. presidential election can still batter stocks, market watchers still see attractive opportunities within this diverse sector.

“I’m certainly more bullish this year because the sector trades at a significant discount to broader market and political headwinds are receding,” says Dean Orrico, president and chief investment officer (CIO) at Middlefield Capital Corp.

Health-care stocks are typically viewed as defensive because consumers will still buy these companies’ products and services during tough economic times, but they can also be sensitive to changes in government regulation.

The sector was hurt last year partly by Democratic Party contenders, including Bernie Sanders and Elizabeth Warren, who champion lower drug prices and a Medicare-for-all program that would eliminate private health coverage.

Health care, which lagged the S&P 500 Total Return index last year, was the second-worst performing sector after energy. Still, health care rose by 20.8 per cent versus 31.49 per cent for the overall index thanks to a rebound that began in October.

Political jitters are likely “going to be much more modest this year even though we are in the election year,” Mr. Orrico says. The sector’s recovery, he notes, coincided with Ms. Warren slipping in the polls and backing away from a full-blown Medicare-for-all plan.

While “continued banter on trying to control drug prices” has hurt the drug makers, hard data indicate they have not been hiking prices. Rather, it’s the middlemen who are capturing a lot of that increase, he says.

The best-performing, health-care segment last year included companies involved in medical equipment, life-science tools and diagnostics because “they’re not in the crosshairs of Democratic [Party] politicians,” Mr. Orrico says.

“Over the past three or four years, we have continued to overweight medical technology,” he says, referring to his firm’s three health-care offerings, including Middlefield Healthcare & Life Sciences ETF (LS-T).

He likes Stryker Corp. (SYK-N), which offers implants for hip and knee replacements; Intuitive Surgical Inc. (ISRG-Q), maker of robotic surgical equipment; and Edwards Lifesciences Corp. (EW-N), which specializes in artificial heart valves.

Acquisition activity should continue as big drug makers look to biotech firms to replenish their pipeline and get exposure to emerging areas such as gene-editing and immuno-oncology [cancer therapy], he says. “In gene-editing, we own CRISPR Therapeutics AG (CRSP-Q), which we think has promise and could be a takeout candidate.”

The health-care sector, which is largely absent in Canada’s stock market, is also attractive over the medium and longer terms, says Paul MacDonald, CIO and portfolio manager at Harvest Portfolios Group Inc.

Tailwinds include an aging population, technological innovation among medical device and drug makers, and potential for growth in developing markets, he says.

“We like the large-cap pharmaceutical sector – particularly companies focused on innovation – and because of [attractive] valuations we see there,” says Mr. MacDonald, who oversees Harvest Healthcare Leaders Income ETF (HHL-T). “We like companies that spend a lot of their revenue on research and development.”

He favours companies like Pfizer Inc. (PFE-N), which has teamed up with Britain-based GlaxoSmithKline PLC to combine their over-the-counter businesses into a joint-venture to focus on higher-margin, prescription medications. He also likes Merck & Co. Inc. (MRK-N), which also plans to spin off some assets into a new company to focus on growth drivers, such as its Keytruda cancer drug.

The medical device and diagnostics areas are also compelling, but investors need to be mindful of the lofty valuations for some stocks, Mr. MacDonald notes. “We like Stryker, Boston Scientific Corp. (BSX-N) and Medtronic Inc. (MDT-N).”

Shares of managed-care companies, which provide medical insurance but also own pharmacy-benefits managers and offer other health-care services, tend to get volatile amid talk of Medicare-for-all, he says. However, he likes UnitedHealth Group Inc. (UNH-N) because it’s well run and should continue to be a dominant player.

“Any volatility driven by political noise are entry points into the sector,” he suggests.

If there’s a Democratic sweep in the U.S. elections this November, “we could have [more] volatility,” but chances for major structural changes in the health-care system are low, Mr.

MacDonald argues. “There is huge divergence in policy perspective, not just between the Democrats and Republicans ... but within each of the parties as well.”

Soo Romanoff, a health-care equity research analyst at Morningstar Inc., remains cautious because of the election and ongoing litigation, but says there are some bright spots.

“I view litigation as probably three-quarters of the way through, but if you look at last year, it was a huge negative factor for a lot of the distributors, some retail pharmacies and a lot of generic manufacturers,” Ms. Romanoff says.

The health-care information technology segment is appealing because it offers “more innovation and growth prospects,” she says.

In this space, Ms. Romanoff likes Cerner Corp. (CERN-Q), a provider of electronic health records. It has a wide moat because hospitals or specialty health-care providers are unlikely to switch to a competitor as they have spent tens to hundreds of millions of dollars to set up their medical-records systems.

Veeva Systems Inc. (VEEV-N), which provides cloud-based software to help drug companies do everything from collecting trial data to managing sales and complying with industry regulations, is also compelling, she adds. Given its high valuation, “we would suggest picking it up opportunistically.”

She sees Israel-based generic drug giant Teva Pharmaceutical Industries Ltd. (TEVA-N) as a contrarian play. Its stock has plunged to the US\$12-a-share range from almost US\$70 in 2015 as it acquired more debt for an acquisition, faced opioid-related lawsuits and struggled with falling generic prices that began stabilizing only recently.

Teva’s new management has been shedding low-margin products and adding more specialty drugs, but smaller, generic companies are valued a lot higher, Ms. Romanoff notes. “Teva trades only at about four times forward earnings.”