



Quality Companies Within U.S. Health Care Can Endure Near-Term Worries

With a presidential election year looming, talk of U.S. health care reform is weighing on the sector.

July 2019

KEY INSIGHTS

- More than a year out from the U.S. presidential election, health care is already shaping up to be one of the pivotal issues of the 2020 campaign.
- With Republican and Democratic Party presidential candidates favoring very different U.S. health care models, the uncertainty has seen the health care sector notably underperform in 2019.
- While volatility will likely remain a feature of the health care sector in the near term, we believe the fundamental quality of companies will drive long-term performance.



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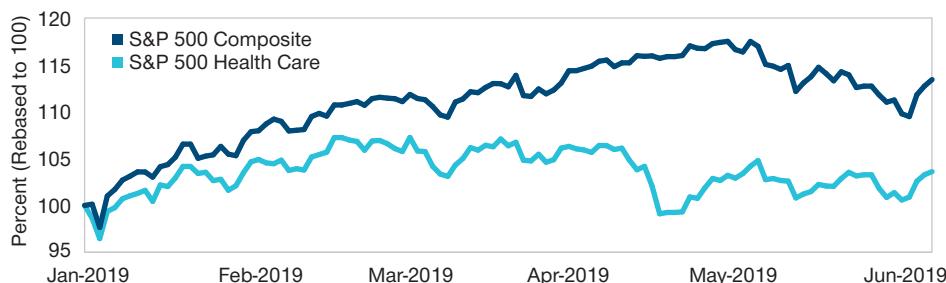
The U.S. health care sector has endured a volatile 2019, in the crosshairs as the U.S. presidential election cycle gathers momentum. With more than a year until the election, health care is

shaping up to be one of the principal issues of the 2020 campaign. But while volatility will likely remain a feature in the near term, we believe the fundamental quality of companies will drive long-term performance.

(Fig. 1) U.S. Health Care Has Notably Underperformed In 2019

The health care sector is once again at the mercy of the U.S. political cycle

As of June 6, 2019



Past Performance is not a reliable indicator of future performance.

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USD 32 trillion¹

Estimated additional health care spending required under a single-payer, Medicare for all model.

What's Driving The Sector's Volatility?

Democratic candidates running for the 2020 election nomination favor a universal coverage system, although views diverge as to how best to achieve it. While some advocate for a single-payer system, others favor a combination of government-run and private health coverage. Republicans generally oppose a single-payer system, preferring a free market approach to health care reform with minimal government intervention. The uncertain political backdrop has hurt the health care sector in 2019 and is likely to continue as the election campaign progresses.

Putting Near-Term Caution Into Perspective

For investors in health care, the biggest concern is the proposed single-payer "Medicare for all" model. Democratic Senator Bernie Sanders has been a particularly vocal advocate. While his sweeping reform plans might be construed as radical, they cannot be ruled out should he ultimately win his way to the White House in November 2020.

While we regard this outcome as a very low-probability event, the mere mention of such significant reforms has clouded the near-term outlook, adding an equity risk premium to the health care sector in general.

However, the long-term outlook should be put into perspective. A challenging chain of events would need to unfold before Bernie Sanders' proposal could become a reality. First, he must win the Democratic nomination to contest the presidential election and, subsequently, go on to win the vote to become the next U.S. president. Once in office, he would need to have majority Democratic Party support in both the Senate and the House of

Representatives in order to have any hope of enacting his radical health care plan. Finally, to fund the plan, he would need the vice president to sign off on roughly USD 32 trillion of additional health care expenditure on a budget-neutral basis, meaning the additional spending would have to be netted off against cuts made elsewhere.

The likelihood of so many stars aligning in this way is low, in our view. Nevertheless, as the political campaigning evolves and gathers pace over the next 12 to 18 months, we anticipate an ongoing degree of risk to be priced into the sector.

Managed Care Companies Bearing The Brunt Of Uncertainty

The successful introduction of any single-payer, universal coverage system would see health management companies most significantly impacted, given that their entire business model would be made redundant. Consequently, the managed care subsector has been particularly volatile in 2019, despite the low probability of the outcome.

Under the current health care system, individual managed care companies negotiate lower health care costs, including cheaper prescription drugs, on behalf of customers. The proposed single-payer Medicare-for-all system would see the federal government negotiate directly on behalf of all Americans. This brings into play a powerful single payer with the potential to exercise its monopolistic buying power to dictate the price at which it buys drugs. The National Health Service in Great Britain demonstrates the potential of such a system—it pays less for prescription drugs than any other developed country. While good news for consumers, it would be bad news for pharmaceutical companies, which would be forced to accept lower prices for their products.

¹Research by the Mercatus Center, George Mason University, as of July 30, 2018.



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In The U.S. Large-Cap Growth Portfolio, Fundamental Quality Matters Most

From an investment perspective, the uncertain near-term environment does not deflect from our fundamental analysis of companies. With this intricate understanding of company quality as a starting point, we apply a probability framework that considers the likelihood of either a Republican or Democratic candidate becoming president and, similarly, the likelihood of the U.S. Senate and the House of Representatives being controlled by either party. We then overlay these scenarios onto the values of individual health care companies to determine if any discounts should be applied to each company and, in turn, which are discounting more, or less, risk than we think is probable.

Fine-tuning our exposure is admittedly more difficult in the current environment. While we have a constructive view of the health care sector over a three- to five-year horizon, it is difficult to anticipate exactly how the landscape might evolve over the next 12 to 18 months, as the election campaign unfolds.

Nevertheless, we can still be proactive in terms of our relative positioning. Through our fundamental analysis of companies, we have a good sense of which companies are being overly discounted and, similarly, which ones are not pricing in enough risk. This helps us to reprioritize the companies we own within the managed health care space on a relative basis—as opposed to trying to pick the best times to sell our exposure and then buy back into the sector at a later stage.

We maintain our conviction in the fundamental quality of certain managed care companies. This is an area where we have a deep insight into growth drivers that are underappreciated

by the market in general. Given this positive longer-term perspective, we are prepared to weather some volatility in the performance of these holdings over the coming 12 to 18 months.

Investing In Beneficiaries Of Long-Term, Secular Trends

Within health care, we look for companies that are major beneficiaries of durable secular trends. Innovation in medical equipment and robotic technology is one such area of focus. Intuitive Surgical, a dominant player in the still relatively nascent robotic surgery market, is a good example. Intuitive's market-leading DaVinci surgical system is leading to vast improvements in clinical outcomes and patient recovery times, given the minimally invasive nature of the robot-assisted surgery—from orthopedic hip replacements, to cardiothoracic surgery, to neurosurgery. Robotics and technological advancement are revolutionizing patient treatment by providing precise, dexterous, and stable assistance to human surgery. We are witnessing a period of great change, and the penetration of robotics in the U.S. general surgery ecosystem is growing rapidly, driving higher revenues and earnings for leaders in this field.

Stryker is another attractive idiosyncratic story within the health care sector—an innovative company specializing in hip and knee replacement surgery. Its leading position in 3D printing of replacement hips and knees, together with its robotic technology, is similarly leading to dramatically better patient outcomes. As a result, Stryker is rapidly taking market share from competitors.

These are highly specialized, high-barrier businesses and, as such, are less exposed to the politically charged uncertainty that is evident in certain other areas in health care currently. Once the robotic equipment

is in place in a hospital, for example, and surgeons become skilled using it, these companies achieve “first mover” advantage because it is neither desirable nor efficient to buy new or upgraded equipment from a different

supplier. In this way, companies like Intuitive and Stryker become incumbent businesses, selling consumables and upgrades to the original piece of technology/equipment.

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