HighMark® CAPITAL MANAGEMENT

Economic Insights

AUGUST 2016

HEALTHCARE SECTOR OUTLOOK

As our population ages, the demand for healthcare, including demand for facilities, devices and drugs, increases. Healthcare equities delivered double-digit gains over the period 2011–2014, ranking in the top three best-performing S&P 500 sectors each of those calendar years. However, following a bearish trend in the broader market, the sector began a downward turn in the second half of 2015, which continued into the first quarter of 2016. Healthcare recovered in the second quarter of 2016, and ended July up 5.68% on a year-to-date basis, although it still lagged behind all other sectors other than Consumer Discretionary and Financials.

S&P 500 SECTOR RETURNS: 2011 THROUGH JULY 31, 2016

SECTOR	2011	2012	2013	2014	2015	YTD 7/31/16
Consumer Discretionary	6.08	24.02	43.35	9.71	10.19	5.18
Consumer Staples	14.07	10.42	26.15	16.04	6.33	9.69
Energy	5.16	4.70	25.19	-7.76	-21.22	13.82
Financials	-16.30	29.04	35.31	15.27	-1.48	0.26
Healthcare	**13.19**	**18.12**	**41.35**	**25.46**	**6.89**	**5.68**
Industrials	-0.23	15.03	40.82	9.81	-2.32	9.83
Information Technology	2.59	14.71	28.84	20.35	5.90	7.53
Materials	-9.45	14.95	25.80	7.25	-8.72	12.88
Telecommunication Services	6.14	17.78	12.05	2.30	3.37	26.12
Utilities	19.26	1.61	12.58	28.88	-4.93	22.71

Source: Morningstar, Standard & Poor's

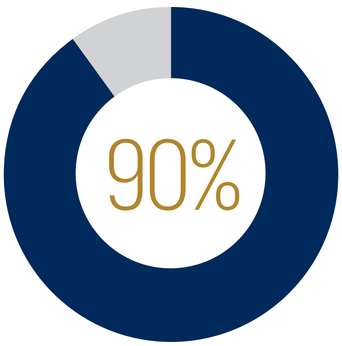
What caused this turn in fortune?

In this review, we would like to address this question by taking a look at how the politics of a presidential election year, drug pricing, and capital for research and development (R&D) are impacting investor appetite for healthcare securities. Despite the 2015 and early 2016 drop in the sector, we believe that significant innovation, particularly within the biopharmaceutical category, offers investors an opportunity to hold businesses with superior innovation, high-returning end-markets (therapeutic areas with high returns on investment), and the prospect of changes in corporate strategy that can unlock value.

The ups and downs of pricing

One of the keys to understanding recent volatility in healthcare stocks is how drug pricing and investment capital can influence the R&D efforts of biopharma firms and the new drugs available to patients worldwide.

Biopharmaceuticals are complex drugs that require advanced and sophisticated R&D. New biopharma drugs are extremely expensive, and almost 90% of candidate drugs fail to produce the desired results—even after, on average, $2.5 billion in costs and at least ten years of development and testing.[1]



The average percentage of candidate drugs that fail to produce the desired results.

To attract investors' interest and capital, healthcare companies large and small pay particular attention to pricing their products at a level that is supportive of their cost structure and strategic plans, but not sufficiently onerous to consumers or likely to attract unwanted political or regulatory scrutiny.

Pricing new drugs is a tricky balance: to encourage the risk-taking needed to develop effective and innovative medicines, our healthcare system allows pharmaceutical "mini monopolies" to form, so-called for their ability to charge extremely high prices during a drug's patent life of around 20 years. While often criticized and misunderstood, this profit motive for companies can lead to remarkable improvements in therapies, medicines, and cures as profits from the monopoly pricing are recycled back into corporate R&D.

Unfortunately, "mini monopolies" can create excesses and bad actors, such as Martin Shkreli of Turing Pharmaceuticals, who gamed the established norms of the system by raising prices without any subsequent reinvestment in innovation and research. As a result, many think tanks, government officials, and the private sector are seeking ways to curtail egregious pricing without stymieing innovation. While think tanks ponder reform, politics now enter the debate: after the Shkreli case, a presidential candidate used social media and political ad campaigns in 2015 to comment on extreme price increases, causing biotech stocks to tumble.

In some cases, negative publicity over sky-high drug prices fails to account for the fact that recently developed biopharma "specialty" drugs for diseases such as cancer total over 30% of spending on drugs but are only used by one or two percent of patients.[2] Sticker-shock "list" prices for drugs can also be misleading, as discounting by large buyers who often demand rebates from drug manufacturers can dramatically reduce the actual cost to consumers.

But whether the pressure on pricing comes from bad actors in front of congressional committees, presidential candidates, the Affordable Care Act, or other exogenous factors, the result is investor concern over holding healthcare—particularly biopharma—stocks in their portfolios. When investors flee healthcare stocks, often due to concerns that pricing pressure will reduce profits and margins, the capital available for R&D shrinks and work on finding new cures slows.

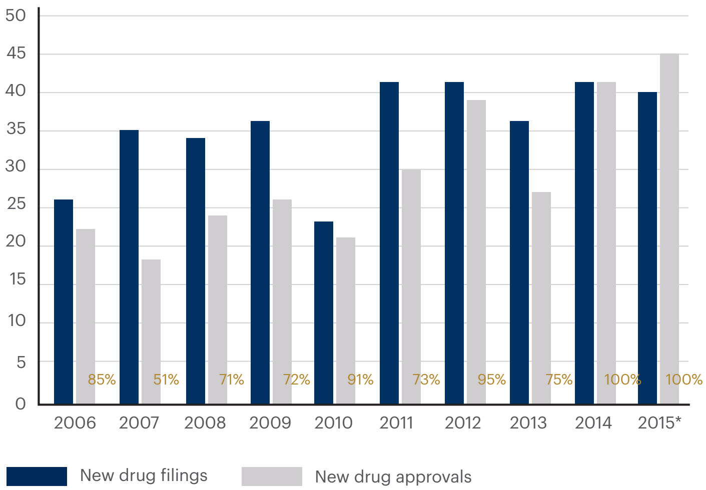
Good R&D and bad R&D

Biopharma spends more on R&D than any other business sector in the U.S. According to the Pharmaceutical Research and Manufacturers of America (PhRMA), biopharma's share of U.S. R&D is twice that of software firms and five times greater than the auto sector's share. Unlike new cars and cellphone apps, however, the majority of new drugs never make it to market because they either fail to be effective in testing or are not approved by Food and Drug Administration (FDA) regulators.

R&D productivity for the healthcare industry is often measured by the relationship between FDA filings and approvals. In the late 1990s, a series of successful drug filings led investors to pour money into biopharma firms which, unfortunately, led to excesses and poor capital allocations. We believe that a maxim which applies to many sectors—and the healthcare industry in particular—is that "capital in search of ideas is truly inefficient." By the mid-2000s, approvals had declined and reached a low of just over 50% in 2007 according to the FDA. Investors responded by allocating capital to less risky opportunities, and this lack of capital disproportionately affected vulnerable, early-stage companies.

1 Source: Pharmaceutical Research and Manufacturers of America (PhRMA)
2 Source: FiercePharma

FDA NEW DRUG FILINGS AND APPROVALS, 2006 – 2015



** The 2015 approval number is higher than filing number since an application may be filed in one year, and approved in another.*

SOURCE: U.S. Food & Drug Administration.

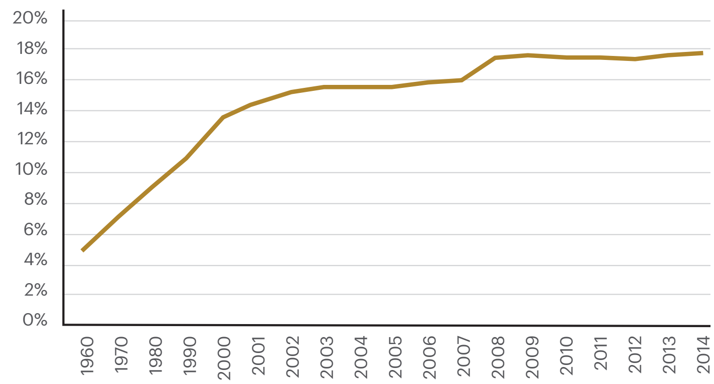
Faced with declining R&D budgets but continued expectations for successful new drugs, many drug companies were forced to adapt. They tightened R&D budgets and reallocated investment capital to therapeutic areas with higher returns on investment, such as oncology drugs vs. Alzheimer's drugs, as well as more targeted therapies to increase their odds of success. The belt-tightening exercise appears to have worked: for the first time in decades, R&D productivity has actually increased over the past few years. FDA approvals as a percentage of filings have averaged nearly 90% since 2011 and healthcare stocks responded in kind, outperforming the market for five consecutive years until the volatility of the summer of 2015.

> "Despite the politics, headlines and stock price volatility, healthcare is a great business with solid growth that outlasts recessions or periods of stock market turbulence."

What investors need to know

It is important to remember that despite the politics, headlines, and stock price volatility, healthcare is a great business with solid growth that outlasts recessions or periods of stock market turbulence. Healthcare spending as a percentage of gross domestic product, as shown in the following chart, was only around 5% in 1960 and has gradually increased over time to around 18% today. Similarly, consumer spending on drugs continues to grow as life expectancies increase both in the U.S. and globally.

U.S. HEALTHCARE SPENDING
(as a percentage of GDP, 1960–2014)



SOURCE: Centers for Medicare & Medicaid Services, Office of the Actuary, National Health Statistics Group; U.S. Department of Commerce, Bureau of Economic Analysis; and U.S. Bureau of the Census.

Proceed with caution

While the future appears bright for healthcare, investors need to exercise caution when selecting stocks in the sector and, particularly, in the biopharma industry. When considering an investment, one of the key considerations we review is whether the company is making efficient use of its R&D budget and is focused on areas of innovation that will help patients and be rewarded by U.S. regulators, healthcare providers, and stock markets. We avoid investing in speculative companies with suspect practices and we steer clear of trying to pick the next drug trial success. By investing in focused businesses that feature superior innovation, concentrate on high-returning end-markets, and offer the potential for strategic change, we believe that we can weather existing and emerging headwinds in the ever-evolving healthcare sector.

Healthcare Sector Outlook

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