

Stenham Healthcare

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Conclusion

“Valuations for healthcare stocks are currently near historical lows relative to the general market. Prior periods when this was the case have represented an exceptional valuation entry point to invest in the sector”.

Bruce Harington

Overview

The long-term case for investing in the healthcare sector

Since we launched our healthcare fund in January 2013, we have written two whitepapers and in both we recognised a key benefit of investing in healthcare in that it is perhaps the only sector globally that offers both growth and defensive attributes in a recession. Below we revisit some of the key attributes of the sector as well as looking at why it is attractive right now.

Investors can expect long-term growth from the sector due to three powerful secular tailwinds:

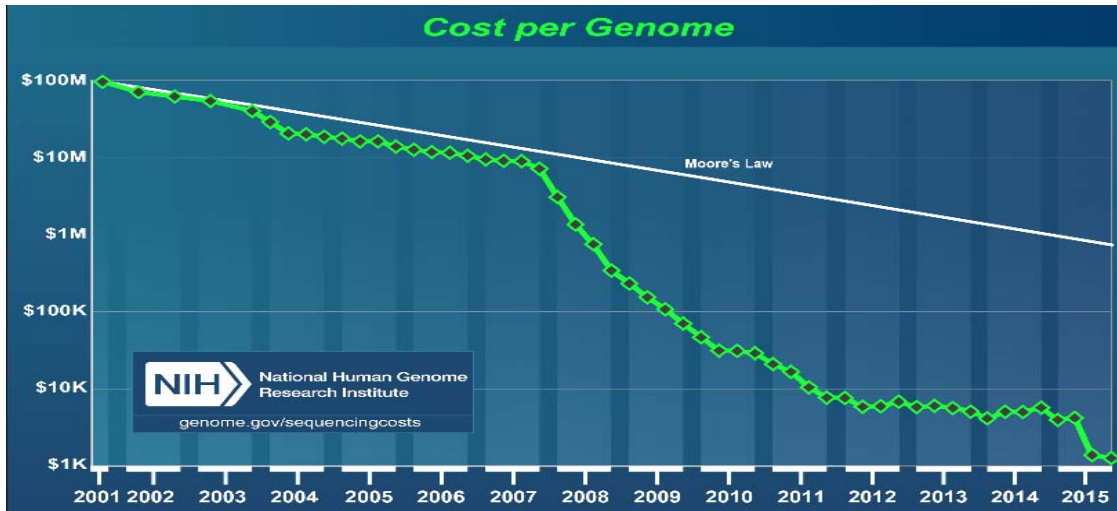
- An aging global population
- Increasing wealth in emerging markets, and
- Innovation addressing the huge number of unsolved medical problems

Healthcare spending increases exponentially with age (particularly beyond age 50) thus an aging global population results in exponential growth in healthcare needs. In emerging markets healthcare spending as a percentage of GDP is significantly below the levels for developed markets. Spending on healthcare in emerging markets is expected to grow at a pace above that of local GDP growth as wealth per capita increases and healthcare spending as a percentage of GDP increases.

With respect to innovation, medical science has made huge advances but many of the largest diseases in the world such as cancer and Alzheimer’s are still inadequately treated. With our increased understanding of genomics and biologics as well as our improved ability to analyse data, innovation in new drug development has never been as strong as it is today. Some of the most exciting new areas of innovation include immuno-oncology, gene therapy, and cellular therapy.

To highlight just one of these, gene therapy, the results that are being demonstrated today are incredible and would have been considered science fiction just 10 years ago. Gene therapy involves the introduction of normal genes to replace missing or defective genes. The first gene therapy treatment, a cure for a form of inherited blindness, was approved by the FDA in December 2017. Gene therapy trials are currently recording phenomenal results across a range of diseases including haemophilia, Duchenne’s muscular dystrophy, and spinal muscular atrophy. We are literally at the start of gene therapy treatments becoming a reality for patients.

Innovation driver – the cost of sequencing the human genome



Source: Ned Davis Research Inc.

Why the sector is particularly attractive now?

Aside from the new wave of innovation and the value that this creates, valuations for healthcare stocks are also currently near historical lows relative to the general market. This is particularly true for biotechnology which is near the cheapest that it has ever traded relative to the market.

The chart below shows the valuation for the healthcare sector relative to the S&P 500:



Source: SSP Capital, MSCI Inc

As can be seen from the chart above the healthcare sector is currently trading at a discount to the valuation for the general market. Historically the sector has traded at a 10% - 15% premium on average to the general market which has been justified by its better earnings growth and defensive characteristics.

There have only been three periods in the last 35 years where the sector has traded at a discount to the general market; 1992 - 1994, 2008 - 2010, and mid-2015 - present. Each of these periods was relatively short-lived and represented an exceptional valuation entry point to invest in the sector.

The Alpha Opportunity

Investing in specialist managers

We have researched over 100 healthcare managers. Our experience has been that, in general those with a specialist focus on healthcare outperform those with a more generalist focus. We have analysed the levels of alpha generated by a range of equity managers and identified that healthcare specialist managers consistently generate by far the highest levels of alpha of any type of manager that we have looked at. In our opinion, there are a few reasons for this:

- The sector is complex. A deep understanding of the medical science is required in order to understand the businesses.
- There are a limited number of investors who have the required combination of medical science knowledge and investment market skill. The pool of capital managed by specialist healthcare managers is very small relative to the total size of the healthcare sector.
- Many generalist managers do not invest in the sector and most completely avoid biotechnology due to the complexity and potential for volatility in stock prices.

The increased level of innovation in the sector has increased the value of specialist medical science knowledge because the science has become increasingly complex and the pace of change more rapid.

Interestingly one of our managers said that when he started his career in the early 2000s he thought that over time the biotechnology sector would become more efficiently analysed as more people with biotech science training entered the investment world. What he has found however, is that the analysis of the sector has actually become less efficient over time. This is because the pace of innovation in new science has been far greater than the pace at which new people with science backgrounds have entered the investment industry.

Conclusion

The healthcare sector offers compelling long-term investment prospects. Valuations are currently attractive relative to historic levels. Innovation in medical science is unprecedented and accelerating, creating new treatment options for patients and significant wealth for businesses. Investing in specialist healthcare managers with strong medical science backgrounds combined with investment experience is an advantage in accessing the unusually high levels of alpha.

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