ClearBridge Investments

Assessing the Health Care Selloff

April 30, 2019

Key Takeaways

- Recent political rhetoric over potentially sweeping changes to Medicare and ongoing scrutiny of prescription drug prices have led to a correction in the health care sector.
- We believe the selling pressure has been sentiment driven and that strong fundamentals remain intact across most subsectors.
- We see the best opportunities in biotechnology and pharmaceuticals. We are more cautious to add to positions in managed care, although we believe it will outperform over the longer term.

Medicare for All Push Pressures Managed Care Stocks

Health care stocks normally react to political rhetoric, but the speed and magnitude of the recent correction in the sector has been surprising. Despite bipartisan clamoring for broad changes to the health care system and the Trump administration's push to lower prescription drug prices, we have not seen a material change in near-term fundamentals. The whole move has been sentiment driven, resulting in changes in the long-term or terminal value of companies across health care that could present selective opportunities.

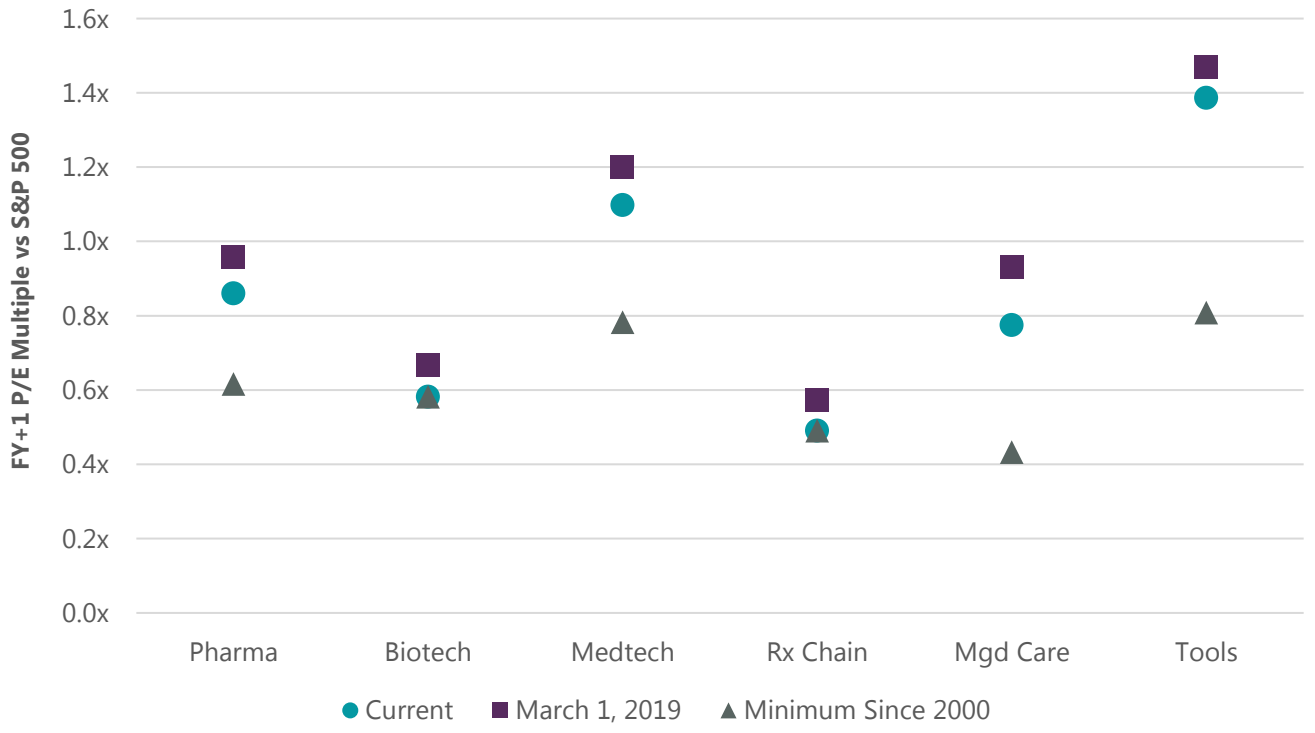
The broad health care sector has underperformed the S&P 500 by about 700 basis points over the last month, but we are probably not at a bottom for most subsectors. Concerns will likely remain elevated through the 2020 election cycle, and possibly longer (if Democrats sweep with a more extreme candidate.) At this point, most subsectors are still 30 to 40% from trough valuations reached in the 2008-2010 downturn (Exhibit 1). Relative to that period, industry fundamentals and growth are healthier, so valuations may not bottom as low as in the past.

Managed care stocks have seen the largest correction thus far, impacted by the growing "Medicare for All" clamor from progressive Democrats on Capitol Hill. True "Medicare for All," i.e. single payor, is an existential risk but one we think is improbable. Federal and state governments likely need managed care to bend the cost curve of expensive Medicaid and Medicare Advantage programs. Managed care suffered through a similar dynamic from 2008-10 but persevered, with companies like UnitedHealth Group rebounding to all-time highs over time. The prescription drug value chain, which includes pharmacy benefit managers and other distributors, meanwhile, faces real near-term business challenges and regulatory risks. These include recently announced government plans to reform rebates in Medicare Part D and drug payments in Medicare Part B. As a result, there is low visibility into earnings for these companies.

Biopharmaceutical companies also face risks from the proposed changes to Medicare Parts D and B. We believe these risks are manageable, however players in more competitive treatment markets will likely face worse risks than others. Management and Wall Street forecasts already reflect a tougher U.S. pricing environment and we remain constructive about idiosyncratic opportunities in current product pipelines.

Two areas of health care, medical technology and tools companies, have held up better than the overall sector. Medical technology stocks have rerated due to better growth prospects and are perceived as being more insulated politically than drug makers and distributors. We also see some potential for greater utilization pressure under a single payor system. Health care tools stocks, meanwhile, have minimal exposure to "Medicare for All" and drug pricing. The multi-year outperformance of the group has also been driven by strong market conditions. The key question here is how long above-average growth rates will persist before normalizing.

Exhibit 1: Health Care Valuations vs S&P 500



As of April 18, 2019. Source: ClearBridge Investments. Pharma consists of price-to-earnings ratios (P/Es) for 11 large cap pharmaceutical companies; Biotech consists of P/Es for four large cap biotechnology companies; Medtech for 13 medical technology and device companies; Rx Chain for five pharmacy benefit manager and drug distribution companies; Mgd Care for seven managed care companies; Tools for eight medical tools companies.

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