MV Capital Management Weekly Market Flash

Time for a Check-up: Assessing Performance in the Health Care Sector

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The health care sector has done more recently than to supply therapies and cures for mental and physical ailments. It has also showered investors with very healthy portfolio gains. In 2013 the S&P health care sector index returned over 41%, a good 10% more than the broad S&P 500 index. The good times continue to roll; sector gains in 2014 to date are just under 25%, more than double the broader market's total return. This kind of sustained performance logically leads to the question of whether it can last and, if so, for how long?

Follow the Earnings

We have spent some time in recent weeks talking about the importance we place on earnings as a guide to what might happen in equity markets next year. Specifically, with valuation multiples already expensive by long term historical comparisons, we don't see a particularly compelling case for multiple expansion – for stock prices to gain significantly more than the pace of underlying earnings per share (EPS) growth. "Follow the earnings" is as good a mantra as any, in our opinion, for 2015 portfolio choices. With this in mind, let's take a closer look at the internal dynamics of the health care sector as it stands today.

Inclusive Rally

One distinguishing feature of this year's rally in health care stocks is that it is very broad-based. Of the five major industry groups – biotech, equipment & supplies, insurance providers, pharmaceuticals, and life sciences – four are up by more than 20% year to date. And within each industry group the spoils are widely distributed among larger and smaller companies alike. Contrast this dynamic to the state of play in information technology, another outperforming sector year to date. In tech, a disproportionate share of the outperformance is concentrated in the market cap leaders – behemoths Apple, Microsoft, Intel and Facebook are all up by more than 30%. This is an instructive point of comparison. Selection and business model scrutiny is currently happening in technology, and we think it is likely to be a more defining variable in healthcare going forward than it has been to date.

Not All Multiples Are Equal

So if asset selection does become a bigger deal in health care, where are the chips likely to fall? One interesting comparison we see is between biotech and health care providers. At first glance biotech looks prohibitively expensive, with an industry group P/E of around 45x earnings. And the sector is up more than 40% this year. Unsustainable and crazy expensive, right? But a closer look shows the average consensus estimate for S&P 500 biotech EPS growth to be 80%. They may not be cheap, but it is growth, not multiple expansion, leading the way.

By comparison, health insurance providers are up 21% or so year to date, and the P/E is a seemingly more appealing 16x earnings. But 2014 consensus EPS growth for this industry group is a mere 3% - the price performance is largely due to multiple expansion. And 2015 could be a troubled year for providers, which have greatly benefitted from the Affordable Care Act's implementation. The ACA will be in the spotlight next year with a potential Supreme Court ruling that could have an adverse impact on insurance rosters in 36 states. Wall Street hates uncertainty. Uncertainty plus slow growth could make providers a troublesome corner of the market. We still see good fundamentals in healthcare overall, but we believe the rewards may be more stingily bestowed.

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