

Health care funds have been out of favor. The new Medicare prescription program could be just what the doctor ordered.

# A Good Prognosis

By Susan B. Weiner

## HEALTH CARE FUNDS HAVEN'T BEEN WINNING ANY POPULARITY

contests lately. Only \$150 million flowed into the category in 2005, on the heels of a \$1.45 million outflow in 2004 and a \$100 million inflow in 2003, according to Lipper. But dark horses have been known to come from behind. Should you buck the trend and put your clients' money into funds specializing in this sector?

Despite the lack of popularity, there's a long-term secular case for including health care stocks in your clients' portfolios, plus some near-term factors that could boost profits and expand multiples. These are worth considering even if, like many financial advisors, you don't believe in sector fund investing.

Everybody knows that aging Baby Boomers will raise the demand for health care. That's the first of three positive factors cited by Kris Jenner, manager of the T. Rowe Price Health Sciences fund. Second, the acceleration of scientific discovery will lead to better medicines. And finally, there's the sheer number of diseases for which we lack good therapies, Jenner says.

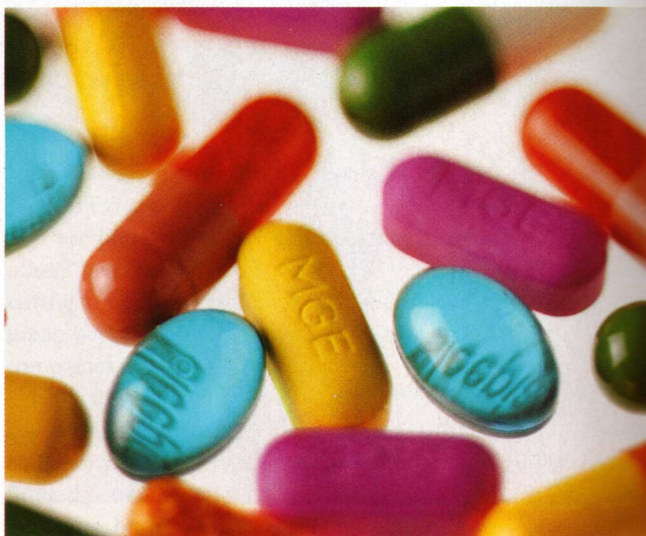
Think about that last point. Usually, increased supply of a product dampens demand. We've seen that so many times. Then, says Jenner, consider what would happen if someone discovered a cure for Alzheimer's disease. Or even just a drug to slow its progress. A new market would be created where none existed previously. Demand would skyrocket.

Valuations also make health care companies attractive, according to J.C. Waller III, portfolio manager of the ICON Healthcare fund. Health care stocks are selling at 22 percent below ICON's estimate of fair value vs. the overall market selling at 15 percent below fair value as of mid-January 2006, says Waller.

The challenge for health care stocks? "Their value isn't recognized by investors yet. I don't know if that will happen in 2006," Waller adds.

Indeed, just because the trend is positive, it doesn't necessarily mean advisors should overweight client portfolios in health care. You need a catalyst for price appreciation. Could the implementation of Medicare's new prescription drug benefit for senior citizens play that role?

The new Medicare drug benefit took effect at the beginning of 2006. Jenner expects it to boost pharmaceutical use by 1 percent to 2 percent annually over the next three to five years. That doesn't sound like much in absolute terms, but usage rose by only 3 percent in 2005. The relative impact of this increase could be great, particularly on generic drug manufacturers, drug distributors and pharmacy benefit managers, says Jenner. That's because they're "more leveraged to an increase in units than to units AND price." Much of the increase in pharmaceutical usage



is expected to be in generic drugs.

Jordan Schreiber, manager of the Merrill Lynch Healthcare fund for more than 20 years, sees the Medicare prescription benefit as a very bullish indicator. He expects it will increase customers for prescriptions by more than 10 million, though he reckons that rise may come at the expense of profit margins over the longer term.

However, investment professionals are looking elsewhere for 2006's catalyst. Mark Gleason, senior financial advisor at Wescap Management Group in Burbank, Calif., is concerned that economic growth will slow this year. "We want companies that are less cyclical and less interest rate-sensitive." Health care fits the bill.

Schreiber agrees that health care companies should benefit. "This group is relatively immune to the economy," he says. Jenner adds that if the economy—or the growth of S&P 500 companies' earnings—slows, the multiples of health care stocks could expand.

That could boost large-cap pharmaceutical stocks out of their doldrums. Most of them lagged in 2005, as they experienced the late stages of patent expirations. Moreover, last year there was an unusually small number of drug approvals by the Federal Drug Administration—just 20, down from 36 in 2004, according to the *New York Times*.

Now there's an increase in drugs in the pipeline going through the testing process that precedes FDA approval, says Vern Meyer,

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vice president of the advisory group at The Hartford Mutual Funds, which includes The Hartford Global Health Fund. The abundant R&D of the 1990s is starting to pay off, adds Meyer. Also, some firms have successfully weathered lawsuits.

Large-cap pharmaceuticals might also benefit from having been beaten up so long that it's time for them to come back. "Prospects are often better for such sectors," says Christopher Davis, Morningstar fund analyst.

Jay Furst, principal with AFW Asset Management in Purchase, N.Y., puts it another way. "Everything is cyclical," he says. So these stocks will have their turn again.

ICON's Waller is beginning to buy large-cap pharmaceutical companies. "As Ben Graham said, you want to buy your straw hat in the winter," he says.

Still, there are some negatives for pharmaceuticals. There's bound to be downward pressure on prescription drug prices over the long term, says Morningstar's Davis in a comment echoed by fund managers. Implementation of anything resembling price controls could stifle innovation. Politicians and consumer organizations praise Canada for its low drug prices. But, "how many Canadian companies have come up with breakthrough medicines?" asks T. Rowe's Jenner.

Also, following the withdrawal of Merck's Vioxx, the FDA may

be slower to approve drugs.

Some investors see large-cap pharmaceuticals as yesterday's companies. Innovation has become the domain of biotech and small- to medium-cap pharmaceutical companies, they say. That leaves marketing and distribution to the large companies.

Jenner disagrees. He thinks that innovation is simply more visible at smaller companies, where one new drug can dramatically impact stock price and the bottom line.

Disagreement over the future of large pharmaceutical companies points to another aspect of health care. This is a diverse sector, ranging from large-cap pharmaceuticals, which dominate the sector, to volatile biotech firms pioneering new therapies.

The large-cap pharmaceuticals have strong balance sheets, good cash flows and fairly steady earnings—characteristics that make them defensive plays, according to Schreiber of Merrill Lynch. Medical technology companies have similar attributes, but tend to be smaller. Service companies, such as HMOs, nursing homes and hospitals, are relatively stable because of their role as cost containment vehicles, he adds. Health care information technology is a small, but growing niche. Then there are other medical devices and suppliers and, finally, biotech.

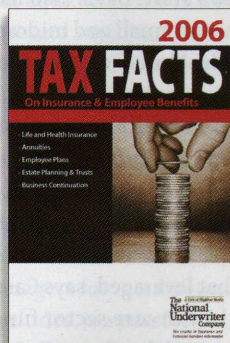
Schreiber sees biotech as the major source of growth in the health care arena. While biotech firms range from profitable large-

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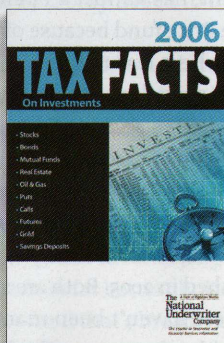
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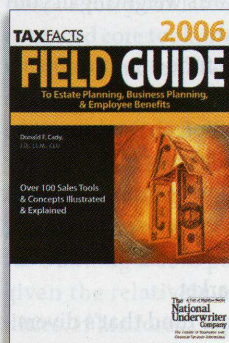
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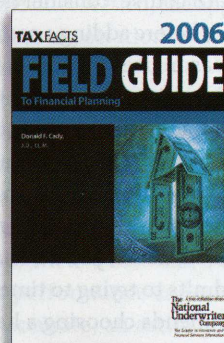
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caps to small-cap developmental companies, they generally lack strong balance sheets. They're the most speculative members of the health care sector because of the long development period before a drug can be launched, says Bryan Beatty of Egan, Berger & Weiner, LLC in Vienna, Va.

Because AFW's Furst sees biotech stocks as speculative, "We don't buy biotech unless our client tells us to." However, biotech does have some offsetting strengths. For example, as Morningstar's Davis points out, biotech drugs are less vulnerable to replication by generic drug manufacturers.

Given the positives of the health care sector, perhaps you're ready to consider using one of these funds in your client portfolios. So, when are they appropriate?

Even their purveyors don't recommend health care sector funds

Some financial advisors seek such selectivity. "I wouldn't want to be too broadly invested in health care—you have to be choosy in this sector overall. . . I would want to know where the money is going if I were investing in a health care-based fund or index," says Dallas Horn, president of Christopher Financial Group in Fort Mitchell, Ky.

Indeed, you should look carefully at what your potential health care fund investment holds. They are not monolithic, warns Morningstar's Davis. They run the gamut from value to growth and from well-diversified to concentrated in a single subsector.

Some managers stress that your health care fund should be global, incorporating firms headquartered outside the United States. "That gives you the greatest opportunity set," says The Hartford's Meyer.

And Merrill's Schreiber notes that investing globally allows in-

## **JUST LIKE A BOWL OF CEREAL SHOULD BE ONLY A PART OF A NUTRITIOUS BREAKFAST, SECTOR FUNDS, INCLUDING HEALTH CARE SECTOR FUNDS, SHOULD BE . . . NO MORE THAN A 10 PERCENT ALLOCATION.**

for everyone. "We believe that for the vast majority of investors, especially those just starting out, a diversified fund is more appropriate," says The Hartford's Meyer. "[A health care fund is] not to be used as a core replacement."

ICON's Waller agrees. "A health care fund should be a peripheral holding." It's a good way to overweight the sector when its prospects appear good. Indeed, Beatty of Egan, Berger & Weiner sees investing in health care as a tactical move.

A health care fund shouldn't dominate a client's portfolio. "Just like a bowl of cereal should be only a part of a nutritious breakfast, sector funds, including health care sector funds, should be . . . no more than a 10 percent allocation," says Troy M. Smith, an independent planner in Raleigh, N.C. T. Rowe's Jenner argues for weighting health care at the same percentage that it makes up in world gross domestic product, roughly 13 percent to 15 percent vs. 13 percent of the S&P 500. Of course, consider health care's weighting in your overall portfolio before adding a sector fund.

Wescap's Gleason uses health care sector funds to inject some growth into value-oriented portfolios. "We don't do general growth stocks. No technology. No internet stocks." Biotech tends to make up a small percentage of the health care funds he uses.

Not every investor limits a health care fund to a small piece of their portfolio. There are those who rotate through sectors, trying to pick winners. However, you'd be hard pressed to find a financial advisor who admits to trying to time the market.

Meyer recommends choosing a health care fund that's diversified across subsectors. Waller says he doesn't believe in blindly replicating the subsector weightings of the major benchmarks. "You'll find many funds own large-cap pharmaceuticals because it's such a dominant part of the benchmark. We won't own it if we don't feel conviction about it."

vestors to profit from different health care practices elsewhere. That's more important now that rising global standards of living have made health care accessible around the world. He also says that a global fund can lessen the impact of changes in currency exchange rates on your portfolio.

Consider the riskiness of the funds. "Don't go down the return avenue only," warns Larry Mano, co-manager of the Schwab Health Care fund. His fund uses a multi-factor risk model in addition to screens to identify stocks likely to deliver positive surprises. Other fund managers agree that it's important to balance returns vs. the risk taken to achieve them.

Naturally, expenses are a concern. "This is an expensive category," says Morningstar's Davis. Health care fund expenses average 1.8 percent. That means a fund like Jenner's, with expenses of 0.93 percent, has almost a 1 percent head start. Davis also likes the T. Rowe Price fund because of its focus on small and midcap companies, where less research is available. Moreover, "the fund is less likely to overlap with what you own elsewhere," he adds.

Nine ETFs account for \$8.1 billion in health care fund assets vs. \$51 billion in 57 open-end funds and \$0.8 billion in three closed-end funds, says Don Cassidy, a senior research analyst at Lipper. Two new ETFs, the PowerShares Dynamic Pharmaceuticals Portfolio and the PowerShares Dynamic Biotech & Genome Portfolio, were launched in 2005. Both are somewhat leveraged, says Cassidy.

There haven't been many new health care sector funds introduced lately, nor much client demand for them. But if performance takes off, watch out! That's when new funds are likely to be launched to thunderous acclaim by investors.

**SUSAN B. WEINER, CFA** is a Newton, Mass.-based writer specializing in investment-related topics.