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.

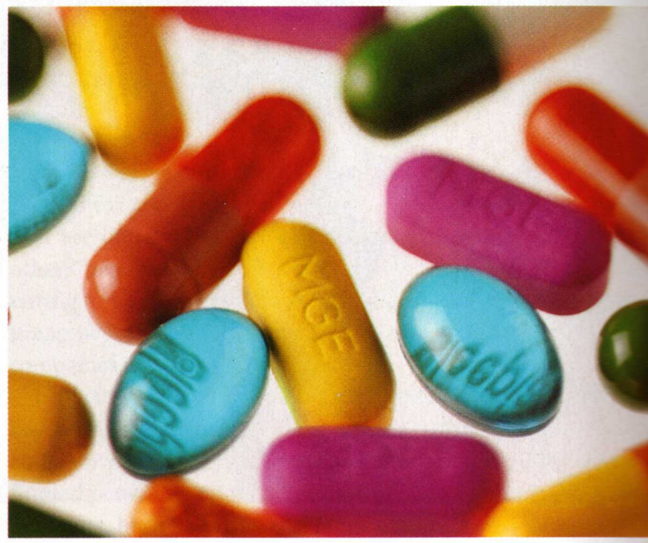
Think about that last point. Usually, increased supply of a product dampens demand. We've seen that so many times. Then, says Jenner, consider what would happen if someone discovered a cure for Alzheimer's disease. Or even just a drug to slow its progress. A new market would be created where none existed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