Healthcare Investing: Times of Crisis and Opportunity

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OPTIMA

Introduction

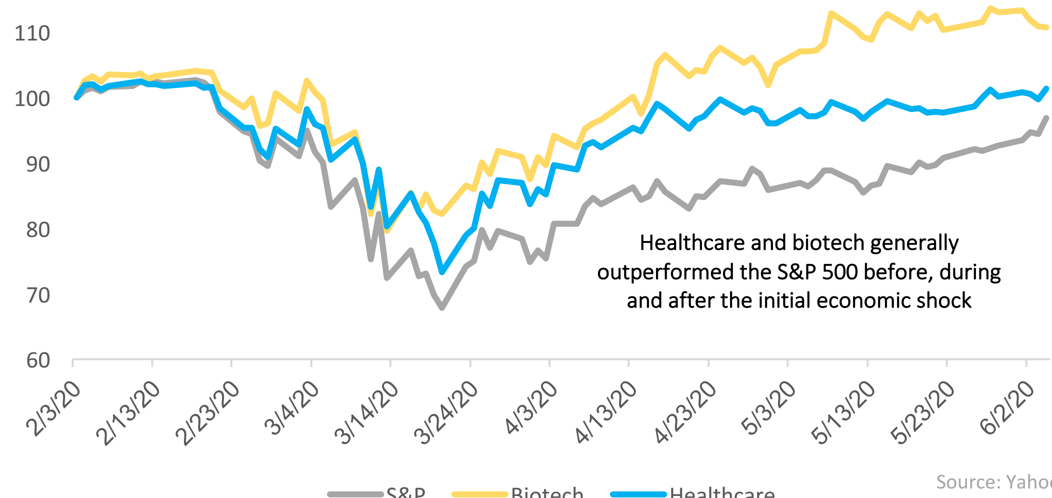
World markets have seen a significant increase in volatility following the outbreak of the coronavirus pandemic. As investors seek to preserve their capital, it would be wise to observe the characteristics of the healthcare sector that have enabled it to weather the recent market downturn with resiliency, while also presenting a variety of discounted opportunities.

The healthcare sector is among the most dynamic and innovative segments of the U.S. and global economies. Given the diversity among healthcare subsectors and increasing innovation, healthcare—and particularly biotech—represents a compelling investment opportunity that can provide investors differentiated performance across market cycles. These dynamics are especially well suited for hedge funds, which can create significant alpha through informed positions on healthcare's binary regulatory framework and other structural factors.

Short Term: A Healthcare Hedge—and Opportunity

Through June 9, 2020, the S&P 500 lost 0.73% for the year, with monetary and fiscal stimulus, alongside surprising unemployment numbers, boosting markets. During this same period, the Healthcare Select Sector SPDR Fund (ticker: XLV) has gained 2.49%, while the iShares Nasdaq Biotechnology ETF (ticker: IBB) actually gained *10.48%*. The healthcare sector's diversification may help explain its recent recession resistance: for every area that saw pandemic-induced losses (e.g. artificial hip producers), there were others producing ventilators, personal protective equipment or potential vaccines that saw stability and even growth.[1]

Healthcare: In Good Times and in Bad



Source: Yahoo Finance

[1] New York Times

Recession Hedge	Recession Opportunity
• Certain subsectors are seeing high growth in this downturn • Growth in these subsectors may level off as markets readjust • High recession demand may highlight inefficiencies/room for eventual growth	• Certain subsectors initially see large losses in economic downturns • Demand for medical treatments *will* return, and losses present opportunities for discount buys

What is notable in the chart above is not only that the healthcare and biotech ETFs saw less downside volatility *during* the initial economic shock, but also that they saw a faster and stronger recovery *after* the market shock. The diversification of the healthcare sector results in a surprising duality: (1) companies that provide protection against the worst of a pandemic-related recession, and (2) battered companies that will quickly rebound due to pent-up demand—meaning that their temporarily depressed prices may be a good investment opportunity. In other words, the healthcare sector can act both in a defensive manner and as a source for opportunistic investment in times of high volatility.

Over the next 24-36 months, the healthcare sector will evolve rapidly. Having recently shown both downside resistance and opportunistic buyside pricing, there may be an asymmetric risk/reward dynamic that many investors target. Further, an increase in volatility may grant specialist hedge funds—many of which are generously staffed with MDs and PhDs—an opportunity to outperform, as they can take informed positions in a sector that is relatively inefficient and will likely experience widely divergent outcomes.

Healthcare Near-Term Evolution: Opportunities

Present – 12 Months

High volatility in demand for certain services

- ✓ Payment services
- ✓ Remote clinical services
- ✓ Remote monitoring services

12-18 Months

Strong growth in areas hurt by initial shock

- ✓ Pent-up demand for elective procedures
- ✓ Analytics
- ✓ Home health tech
- ✓ Supply chain

18 Months and Beyond

Transition to new normal

- ✓ Telehealth, mail order pharmacy, remote working models
- ✓ Tech-enabled delivery of care

Source: McKinsey & Company

Medium Term: A New Normal—Powered by Investors

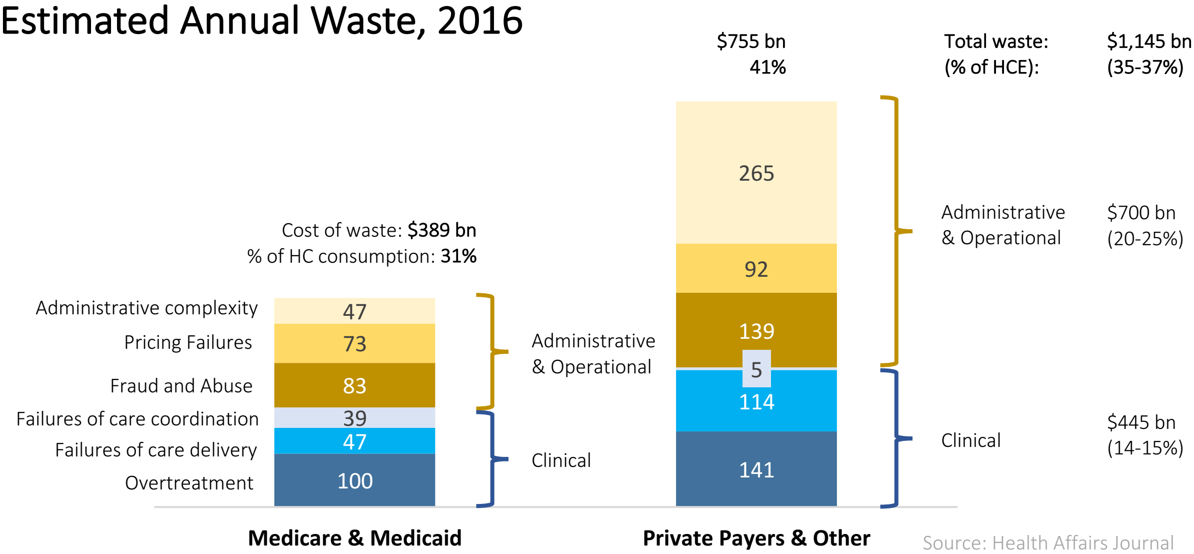
> *"Substantial wastes and inefficiencies in healthcare…could be costing the U.S. $1 trillion…These gaps, failings and their corresponding enormities are an entrepreneur's and investor's dream."*
>
> \- Jeff Greenstein, Pres. of YIS Capital

The ongoing battle against COVID-19 is proving to be a stress test for the U.S. healthcare sector: exposing its inefficiencies, inequities, weaknesses and waste. As healthcare companies return to a new normal over the next 24-36 months, investors will have gained insights into the many areas where they can improve quality while reducing costs.

This COVID-19 stress test will accelerate innovation in the healthcare sector, launching some companies and burying others. This dynamic will play to the strengths of hedge funds, especially—savvy investors will identify the innovators likely to succeed, as well as the outmoded actors whose markets are likely to be disrupted. Further, many areas that are ripe for disruption are not technically complicated. There is over $700 billion in waste within administrative and operational activities alone: areas in which investors are well versed.

A global pandemic may have accelerated large-scale shifts in U.S. healthcare, but investors with a focus on efficiency and innovation will drive them forward.

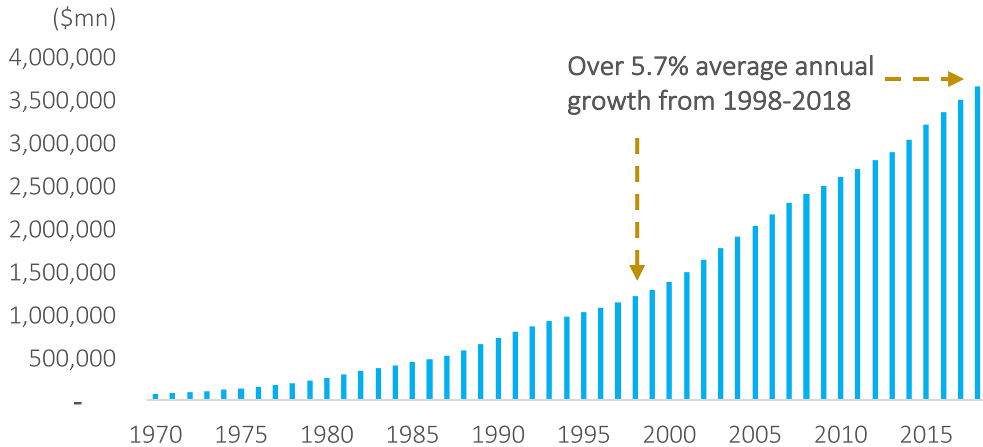
Estimated Annual Waste, 2016



Source: Health Affairs Journal

Long-Term Outlook: A Growing Economic Juggernaut

The Simple Story of U.S. Healthcare Spending: Growth



Source: Center for Medicare and Medicaid Services

The long-term story of the U.S. healthcare sector is at once simple and deeply complex. First, the simple part: growth. The healthcare sector has seen long-term growth in an impressive number of areas: absolute spending, percentage increase of spending, percentage of GDP, percentage weighting in the S&P 500, numbers of new biomedical firms, and FDA approvals for new treatments. While political discourse on “Medicare for All” can rattle healthcare markets from time to time, deep secular trends like an aging population and increasing technological sophistication will facilitate expanding markets and treatment methods.

The world’s aging population is a large driver of healthcare spending growth, as the elderly consume a disproportionate amount of healthcare services. As the Baby Boomer generation in the U.S. move into their 70s and 80s, there will be ever-growing demand for traditional medical services.

Megatrends like the growing role of technology—alongside updated regulations—will open new markets by allowing providers to give care to more people remotely and across jurisdictions. Add to this the growing number of biotech firms and novel devices, and it becomes clear that there will continue to be a great amount of healthcare innovation that is ripe for investment. This innovation will increase the efficiency, quality and types of care available.

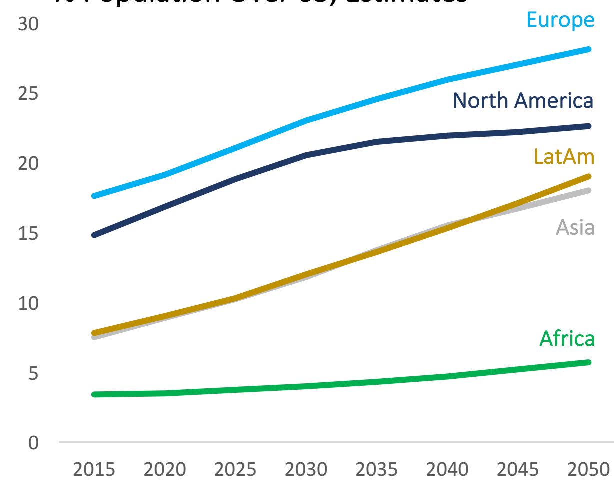
Finally, as discussed above, the COVID-19 pandemic may bring a newly critical eye to the administrative bloat of the healthcare sector, spurring greater and better access to care through modernization and waste reduction.

Themes of Long-Term Healthcare Growth

Aging Population

- In 2018, about 16% of Americans were over the age of 65, and this number is expected to increase to 22% by 2050
- The world population is also aging, and the over-65 population is forecast to increase from 9% currently to 16% in 2050
- People over 65 tend to use much more healthcare services than other demographics

% Population Over 65, Estimates

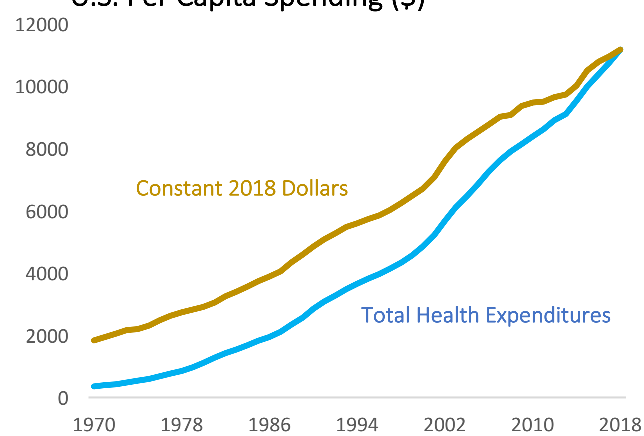


Source: United Nations

Greater Spending

- Overall U.S. healthcare spending increased by over 50% from 2008-2018, with per capita spending increasing 41%
- A growing middle class in lower-income countries is expanding global access to—and spending on—healthcare services, creating massive new markets

U.S. Per Capita Spending ($)

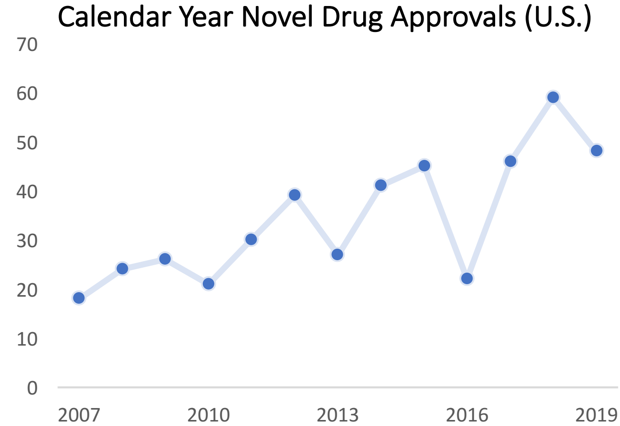


Source: KFF

Technology / Innovation

- Rapid innovation and scientific breakthroughs are creating new therapies, drugs and devices at a quickening pace
- Spurred by the pandemic, new approaches to treatment and healthcare administration—like telemedicine and electronic records, respectively—are bringing efficiency and savings

Calendar Year Novel Drug Approvals (U.S.)



Source: Federal Drug Administration

Spotlight on Biotech

Investors are often wary of the biotech market as its subject matter seems esoteric compared to other areas of the market. However, biotech has experienced stand-out performance during the current pandemic-induced economic crisis—even for the resilient healthcare sector. While the S&P 500 has lost 0.73% and the Healthcare Select ETF gained 2.49%, since the beginning of the year, biotech is up 10.48% through June 9, 2020. And this performance is not simply due to the medical nature of the current economic crisis: over the 2001, 2008-9 and 2020 recessions, biotech averaged a 1% loss compared to 10% in pharmaceuticals and 20% in the S&P 500.[2] This strong performance during recessions is further highlighted by lower P/E multiples of biotech firms (often less than 2x) compared to others in the market.

Biotech's Broad Reach

Technologies

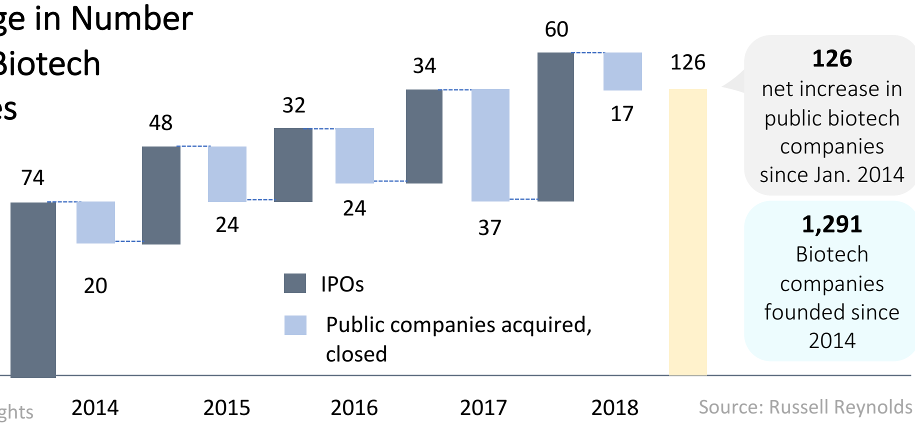
- DNA sequencing
- Nanobiotechnology
- Tissue engineering and regeneration
- Fermentation
- Cell based assay
- PCR technology
- Chromatography
- Others

Applications

- Health
- Food and agriculture
- Natural resources and environment
- Industrial processing
- Bioinformatics
- Others

Biotech's current global market size is about $400 billion and is expected to see a 9.9% compound annual growth rate (CAGR) through 2025, growing to $775 billion.[3] The market is diversifying, and in 2018 there were almost five times as many biotech firms valued from $500 million to $1 billion as in 2008. There is a wide dispersion between these firms in size, positioning and focus, which offers opportunities to add value: both long and short. Finally, the regulatory nature of biotech—with its yes-or-no trials—also presents a high-octane investment opportunity for hedge funds looking for winners and losers.

Net Change in Number of Public Biotech Companies



Source: Russell Reynolds

[2] Barron's
[3] Global Market Insights

Healthcare Sector Prognosis: Positive

In the midst of a public health and economic crisis, the healthcare sector has served as a resilient diversifier for investor capital. The diversification inside the healthcare sector has helped create its dynamism in the short term, as some companies have shown resistance to downside volatility while others provide opportunities to buy at a discount, with pent-up demand on the horizon. As the COVID-19 pandemic puts stress on the U.S. health system, vast inefficiencies in the healthcare sector will help chart the path for new, more efficient companies and processes to disrupt and improve current systems. Deep, long-term trends will also continue to benefit healthcare companies into the future, with aging populations and increasing innovation pushing care to new heights.

The combination of high diversity, resistance to the current recession, opportunity for discounted prices, and long-term tailwinds makes the healthcare sector an attractive investment target.

Biotech presents an especially compelling opportunity, as the breadth of its application—across medicine, agriculture and industry—continues to fuel its growth globally. The biotech market may be especially interesting for hedge funds, with a wide dispersion between firms, downside protection paired with relatively low pricing, and a regulatory structure that starkly chooses winners and losers. In this way, it is broadly similar to the rest of the healthcare sector in character, but with potentially higher upside.

Every crisis brings opportunity, and healthcare and biotech may not only help allow investors to navigate the current crisis, but also to be favorably positioned well into the future.

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