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The long-term case for health care

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The health care sector has significantly underperformed the broader market over the past two years, delivering an 18% sector return compared to 49% for the MSCI World Index.[1] Excluding health care's own glamour names—an American multinational pharmaceutical company and a leading global health care company headquartered in Denmark—the sector's return drops to just 9%, trailing the MSCI World Index by 40%. With this lagging performance in mind, we believe it is a good time to reiterate what attracts us to the sector as a long-term investment.

Reflections on the sector

Firstly, it's important to reiterate the idiosyncratic demand, supply and funding environment that health care stocks have had to grapple with over the past five years. The onset of COVID-19 was certainly a driving force, particularly for the pharmaceutical companies making the vaccines, the life sciences companies providing testing kits, and the health care equipment companies manufacturing and supplying personal protective equipment (PPE) and other life-sustaining products such as ventilators. The unwinding of this cyclical distortion, however, has been significantly less wonderful for companies' revenues, particularly in bioprocessing where acute overstocking of raw materials and vaccines occurred amid uncertainty over the pandemic's duration. Across the sector more broadly, companies have since faced rapidly rising costs, increasingly fragmented supply chains, a tighter funding environment, and weakness in China[2] due to a lack of government and private funding. Investors' recent preference for mega-cap growth stocks, coupled with political pressures from the U.S. presidential election, have also been further headwinds.

"Health care has delivered the second highest earnings per share growth of any sector in the index over the past 20 years"

[1] Source: FactSet. Data as of 31 October 2024. Cumulative returns.

[2] We are beginning to see signs of stabilisation and we believe the industry is positioned for future growth, given the continuing shift to more complicated drugs and gene therapies.

Despite these recent challenges, in our view, several factors drive a strong long-term outlook for health care:

- **RAPIDLY AGEING GLOBAL POPULATION.** The World Health Organisation projects that by 2050 the number of people over 60 will double to more than 2 billion, while those over 80 will triple to 436 million.[3] Wisdom isn't the only thing that comes with age; health spending typically increases.
- **UNTAPPED MARKET OPPORTUNITIES.** By 2050, two thirds of the world's elderly will reside in low- to middle-income countries, a dramatic shift from current trends in wealthier nations like Japan, where 30% of the population is already over 60.[4] This offers promising opportunities for those companies able to effectively pivot to where the growth is.
- **NON-DISCRETIONARY NATURE OF HEALTH CARE DEMAND.** The products and services the sector offers are essential, regardless of economic conditions, making it more resilient to downturns than most sectors.
- **INNOVATION AND DIGITAL TRANSFORMATION OFFER STRONG POTENTIAL.** Advances in telemedicine, drug discovery, personalised medicine and genomics unlock new opportunities, while technologies like AI, electronic health records and remote monitoring are improving efficiency and patient outcomes.

Quality characteristics

On our two favoured quality metrics, ROOCE (return on operating capital employed) and gross margin, health care ranks among the top sectors. Additionally, it has delivered the second highest earnings per share (EPS) growth of any sector in the index over the past 20 years. Importantly, due to the sector's resilience, this growth has been remarkably steady, with consistent relative earnings outperformance in negative years for the index.[5] The market has recently seemed to place very little value on predictability given the recent benign economic backdrop and the outperformance of cyclical stocks. In our view this is misguided, as predictability often demonstrates its worth just when investors least expect they need it.

Avoiding patent certainty…

As is the case with other sectors, we tend to find high quality compounders in certain sub-sectors and industries. While the health care sector's general lack of cyclicality lends itself to predictability in the short to medium term, we find it challenging to maintain confidence in all sub-sectors over the long term. A sizeable proportion of the health care sector is pharmaceutical and biotech companies, where high returns are primarily a result of patent protection – it is the patents that are the main intangible assets. However, these intangible assets fade away, as when a drug goes off-patent it is exposed to generic competition, which often results in a dramatic decline in sales—often up to 80%[6]—as generic versions undercut the originator on price. A new patented drug is needed to make up for the shortfall in revenues, but this requires a long research and development (R&D) process, which may or may not be profitable and is certainly not predictable. As such, pharmaceutical companies tend to not meet the high quality bar we maintain for our Global portfolios.

…and single product dependency

A key tenet of our investment philosophy is that compounding wealth over time requires a sharp focus on downside risks, which is doubly important when a company is singularly reliant on one product. GLP-1 producers are a prime example, with over 70% of the leading company's sales from GLP-1 medications.[7] While these drugs have enormous potential, our concern is that they too face patent expiry and in time likely extremely aggressive competition—if consensus numbers are anywhere near right about the size of the market. There's also the risk that governments and insurance companies may refuse to pay for patients to receive these drugs, limiting the potential opportunity size. With a price-to-earnings ratio (P/E) approaching 30x the next 12 months projected earnings, the leading company is significantly pricier than the 15x of a typical non-GLP-1 pharma company.[8] This elevated valuation renders the company even more vulnerable to these potential risks, currently making it an unappealing prospect for our quality portfolios.

[3] Source: World Health Organization (WHO) 1 October 2024. Available at www.who.int/news-room/fact-sheets/detail/ageing-and-health
[4] Source: World Health Organization (WHO) 1 October 2024. Available at www.who.int/news-room/fact-sheets/detail/ageing-and-health
[5] Source: FactSet.
[6] Source: "Effect of Patent Expiry on the Performance of Innovator Multinational Pharmaceutical Companies in a Low Middle Income Country", Farrukh Khalil, Joseph Odhiambo Onyango, Frontiers in Medical Technology 2022 April 4. Available at https://pmc.ncbi.nlm.nih.gov/articles/PMC9014174/
[7] Source: Novo Nordisk company reports
[8] Source: FactSet, as of 30 September 2024.

Finding high ROOCE and growth without patent or concentration risk

We look for recurring revenues through consumables or services, where the incentive to change supplier is very low. Examples include "razor-razor blade"[9] business models found in providers of diagnostic tests, or in high quality mission-critical products and services that, for reasons of safety, regulatory compliance or scientific integrity, require a strong competing reason to switch suppliers.

As an example, we hold a leading global provider of infection prevention products and services. The company sells sterilisers and the associated consumables and services required to sterilise surgical instruments. For obvious reasons this is not something that you risk getting wrong to save a few cents, particularly given these products represent a low proportion of its customers' costs. As a result, customers tend to stick with this demonstrated high quality supplier. The company also provides outsourced sterilisation services for medical device producers. Again, a low cost but vitally important activity for its customers that notably is written into regulatory filings, meaning an expensive and time-consuming process to change supplier and an expensive and time-consuming process for those considering entering the market.

Charlie and Luna[10]

We believe global animal health is an attractive non-cyclical market largely without the patent and concentration risks we see in pharmaceuticals and biotech. Pets (like Charlie and Luna) need care, and owners do indeed care about their pets: a good recipe for resilience and growth. The industry was valued at US$304 billion in 2023 and is expected to grow at a compound annual growth rate of 6.8% to 2032.[11] We hold the world's leading diversified animal health company that develops, manufactures and commercialises vaccines, medicines and diagnostics for both pets and livestock. Its direct salesforce is a key barrier to entry, since most competitors are too small to justify having one. Generic drug penetration is very low, payment is out of pocket and customers are extremely fragmented with little incentive to change brands or use generics, particularly as prescriptions are issued by vets.[12] It is a very high quality company, with a return on operating capital more than twice that of the average company in the index at 53%, with pricing that has increased 2%-3% per annum, and supported by positive volume growth.[13] The earnings are resilient, having risen every year over the last decade, as against the MSCI World Index, which has seen two earnings falls in the last 10 years.[14] We consider this an unusual company in the health care sector, with the characteristics we look for to help support steady long-term compounding.

Diversified with a difference: scale and network effects

Our largest health care holding is the biggest U.S. health insurer with 55 million members and a 15% market share.[15] Well diversified, the company also owns a health care services business that includes general practitioner (GP) clinics, data services and a pharmacy benefit manager. Acting as an intermediary in the health system, the company operates between the buyers (employers, government) and the providers (hospitals, clinics, drug manufacturers). Leveraging its considerable membership scale, it achieves discounts from providers, creating a two-sided network with high barriers to entry. Further, the ability to vertically integrate into primary care GPs helps align financial incentives with doctors and generates efficiencies by paying based on quality of outcomes rather than volume of procedures. We believe this is a high quality, non-cyclical business which can compound attractively due to its membership scale and two-sided network effect.

Quality and resilience at a reasonable price

In a concentrated broader market with what we view as generally high valuations on lofty earnings expectations, we feel the risks to the market are appreciably higher than many anticipate. Our health care holdings are anchored by a focus on steady compounding, reasonable valuations and high returns on operating capital. The high quality attributes we prioritise in our health care holdings have historically contributed to consistent performance in difficult economic times, and we believe they are well positioned to continue to do so.

[9] A company using a "razor-razor blade" business model sells a core product (e.g. razors) at a low margin while also selling a related consumable product (e.g. razorblades) at a high margin to drive recurring revenue.

[10] The most popular dog and cat names in the U.S. Source: "The Most Popular Pet Names of 2023 in Each U.S. State" Chris Corlew, Mental Floss, 16 October 2024. https://www.mentalfloss.com/posts/most-popular-pet-names-each-state#:~:text=Instead%20of%20Fido%2C%20the%20top,top%20five%20spots%20for%20boys.

[11] Source: Global Market Insights, June 2024.

[12] Source: International Equity Team research.

[13] Source: International Equity Team research

[14] Source: FactSet.

[15] Source: International Equity Team research.

Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect global franchise companies and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. **Stocks of small- and mid-capitalisation companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed markets. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). Non-diversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **ESG strategies** that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance.

DEFINITIONS

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. It includes all private and public consumption, government outlays, investments and net exports.

Return On Operating Capital Employed (ROOCE) is a ratio indicating the efficiency and profitability of a company's trade working capital. Calculated as: earnings before interest and taxes/property, plant and equipment plus trade working capital (ex-financials and excluding goodwill).

The **MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

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