



FISHER INVESTMENTS™ on

# HEALTH CARE



- An in-depth look at the global Health Care sector investment universe, including pharma, equipment, biotechnology, managed care, and more
- Tips and tools for security analysis and portfolio management
- A useful guide for investing in any market condition

Foreword by *New York Times* bestselling author Ken Fisher

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# Fisher Investments on Health Care

Fisher Investments Press

with

Michael Kelly and  
Andrew S. Teufel



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Fisher Investments Press brings the research, analysis, and market intelligence of Fisher Investments' research team, headed by CEO and *New York Times* best-selling author Ken Fisher, to all investors. The Press covers a range of investing and market-related topics for a wide audience—from novices to enthusiasts to professionals.

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# ***Foreword***

*Fisher Investments on Health Care* is the eighth in a series of investing guides from Fisher Investments Press—the first-ever imprint from a money manager. While reading the entire series would be a worthwhile endeavor for serious students of capital markets—covering the full breadth of capital market analysis—each book can stand on its own in its area. This book (and the series) presents a usable, top-down strategy for analyzing standard investing sectors (Energy, Materials, Consumer Staples, Industrials, etc.) as well as other investing regions and categories. This book is on Health Care—currently about 8 percent of total world stocks (as measured by the MSCI All Country index).

When folks hear “Health Care,” they probably think pharmaceuticals and insurers. And that’s right—but the sector also covers equipment makers, hospitals, biotechnology, distributors, services, supplies, technology, and life sciences. It may seem stodgy, but there’s massive, non-stop, life-saving innovation going on in drugs and equipment, and also many Health Care sub-industries.

Thanks to major US legislation passed in 2010, Health Care is certain to be a hot and often controversial topic for many years to come. That legislation (and any later legislation to change, repeal, clarify, or what-have-you 2010’s legislation) will impact Health Care firms in ways legislators couldn’t have possibly imagined—and certainly aren’t fully fathomable at this time. But the job of a Health Care analyst isn’t to decide whether legislation is good or bad, or to debate how the sector *should* be regulated. Instead, it is to always rationally assess the existing landscape, whether it’s likely to change, and how that likely impacts demand (and alternatively supply) for Health Care stocks.

Plus, Health Care is no stranger to legislation! Think of all the regulation aimed at pharmaceutical firms, insurers, medical device makers, hospitals, and so on. And Health Care firms are frequently targets for lawsuits. Nothing new about that! Understanding how regulatory and legal matters impact the sector and its industries is vital to making better forecasts. This book shows you how and provides a fundamental framework.

Don't let regulation scare you off. Health Care plays a vital portfolio role—it's a classically defensive sector. When times are tough, folks still take aspirin and need hips replaced. But when times are flush, you generally don't double up on insulin or heart medication. Hence, investors see Health Care as a refuge—it tends to do better than the market during bear markets while lagging in the sizzling times. In an overly simple sense, Health Care can be thought of in just that way—a great thing to own when other forms of defensive stocks beat the market, but not so great when defensive stocks lag in general. But Health Care has certainly had periods when it outperformed during a bull market—as it did in the late 1990s! It is fairly defensive, but innovation can be a tremendous driver too. This book explains the disparate drivers for Health Care's many industries, and how to know if the sector as a whole (and underlying industries) is likely to out- or underperform—no matter the market conditions.

And it's wrong to think Health Care is inherently less risky just because it's overall more defensive than sectors like Consumer Discretionary, Energy, or Materials. Or that Health Care should get better or worse returns over the long term. Over the long term, finance theory says all equity categories should net pretty similar returns when properly accounted for—though traveling drastically different paths over the short to intermediate term. Ultimately, given enough time, newly created supply or the destruction of

existing supply tends to equalize categories. In the nearer term, demand tends to drive stock prices, but longer term (what may seem for most like an eternity but really isn't), supply swamps demand for that category. (For a more detailed discussion on the general process of how supply is almost all powerful in affecting stock prices in the very long term, see my 2007 John Wiley book *The Only Three Questions That Count*, pages 240-250.) That's why a good portfolio is broadly diversified, and why this book (and the entire series) can help you learn to be a better investor.

Don't expect to find any "get rich quick" ideas or hot stock tips in this book. Such a thing doesn't exist—someone telling you otherwise is selling you something unhealthy. Rather, this book provides a workable, repeatable framework for increasing the likelihood of finding profitable opportunities in the Health Care sector. And the good news is the investing methodology presented here works for all investing sectors and the broader market. This methodology should serve you not only this year or next, but the whole of your investing career. So good luck and enjoy the journey.

Ken Fisher

CEO of Fisher Investments

*Forbes* Portfolio Strategy Columnist

Author of the *New York Times* Best Sellers, *How to Smell a Rat*, *The Ten Roads to Riches*, and *The Only Three Questions That Count*

# ***Preface***

The *Fisher Investments On* series is designed to provide individual investors, students, and aspiring investment professionals the tools necessary to understand and analyze investment opportunities, primarily for investing in global stocks.

Within the framework of a “top-down” investment method (more on that in Chapter 7), each guide is an easily accessible primer to economic sectors, regions, or other components of the global stock market. While this guide is specifically on Health Care, the basic investment methodology is applicable for analyzing any global sector, regardless of the current macroeconomic environment.

Why a top-down method? Vast evidence shows high-level, or “macro,” investment decisions are ultimately more important portfolio performance drivers than individual stocks. In other words, before picking stocks, investors can benefit greatly by first deciding whether stocks are the best investment relative to other assets (like bonds or cash), and then choosing categories of stocks most likely to perform best on a forward-looking basis.

For example, a Tech sector stock picker in the mid to late 1990s probably saw his picks soar. But in 2000 to 2003, his picks were likely decimated. Was he just smarter in 1998 and 1999? Did his analysis turn bad somehow? Unlikely. What mattered most was stocks in general, and especially Tech stocks, did relatively great in the 1990s, but Tech crashed in 2000, and US stocks overall did lousy in the 2001 to 2002 bear market. In other words, a top-down perspective on the broader economy was key to navigating markets—stock picking just wasn’t as important.

*Fisher Investments on Health Care* will guide you in making top-down investment decisions specifically for the Health Care sector. It shows how to determine better times

to invest in Health Care, what Health Care industries are likelier to do best, and how individual stocks can benefit in various environments. The global Health Care sector is complex, covering many industries and countries with unique characteristics. Using our framework, you will be better-equipped to identify their differences, spot opportunities, and avoid major pitfalls.

This book takes a global approach to Health Care investing. Most US investors typically invest the majority of their assets in domestic securities; they forget America is less than half of the world stock market by weight—over 50 percent of investment opportunities are outside our borders. While a larger proportion of the world's Health Care weight is based in the US, many companies derive a significant portion of profits overseas. Given the vast market landscape and diverse geographic operations, it's vital to have a global perspective when investing in Health Care today.

## **USING YOUR HEALTH CARE GUIDE**

This guide is designed in three parts. Part I, Getting Started in Health Care, discusses vital sector basics including the history of major developments in Health Care. We'll also discuss sector-level drivers that ultimately influence stock prices.

Part II, Next Steps: Health Care Details, walks through the next step of sector analysis. We'll take you through the global Health Care sector investment universe and its diverse components. The Health Care sector itself presents 3 industry groups, 8 industries, and 16 sub-industries. Various firms are driven by enterprise spending, others by consumers, and some by infrastructure build-outs. Many are leveraged to combinations of these, yet others are

leveraged to none. We will take you through the eight industries in detail, how they operate, and what drives profitability—to give you the tools to determine which industry will most likely outperform or underperform looking forward.

Part II also details many of the challenges Health Care firms face, including historical examples of how these challenges have been met and overcome. Moreover, we'll discuss certain products and manufacturing processes used today, as well as how they're advancing through new and emerging technologies.

Part III, *Thinking Like a Portfolio Manager*, delves into a top-down investment methodology and individual security analysis. You'll learn to ask important questions like: What are the most important elements to consider when analyzing semiconductor and PC firms? What are the greatest risks and red flags? This book gives you a five-step process to help differentiate firms so you can identify ones with a greater probability of outperforming. We'll also discuss a few investment strategies to help determine when and how to overweight specific industries within the sector.

*Fisher Investments on Health Care* won't give you a "silver bullet" for picking the right Health Care stocks. The fact is the "right" Health Care stocks will be different in different times and situations. Instead, this guide provides a framework for understanding the sector and its industries so that you can be dynamic and find information the market hasn't yet priced in. There won't be any stock recommendations, target prices, political stances, or even a suggestion whether now is a good time to be invested in the Health Care sector. The goal is to provide you with tools to make these decisions for yourself, now and in the future. Ultimately, our aim is to give you the framework for repeated, successful investing. Enjoy.



# ***Acknowledgments***

A number of colleagues and friends deserve tremendous praise and thanks for helping make this book a reality. We would like to extend our tremendous thanks to Ken Fisher for providing the opportunity to write this book. Jeff Silk deserves our thanks for constantly challenging us to improve and presenting new and insightful questions as fast as we can answer them. Our colleagues at Fisher Investments also deserve tremendous thanks for continually sharing their wealth of knowledge, insights, and analysis. Without these people the very concept of this book would never have been possible.

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Michael Kelly would also like to specifically thank his wife Megan and parents Michael and Patti for their constant love and support.

***PART I***

***GETTING STARTED IN HEALTH  
CARE***

# **CHAPTER 1**

## **HEALTH CARE BASICS**

Shane is having dinner with his wife Emily when he notices a strange numbness in his arm keeps him from picking up his fork. He tries to tell Emily, but numbness in his face slurs his speech. Worried, she immediately calls 911, and an ambulance arrives and rushes him to the nearest hospital. Doctors run various tests and determine plaque formation in his carotid artery is preventing adequate blood flow to his brain, causing a stroke. To treat Shane, doctors will perform a procedure called carotid angioplasty and stenting, where a small balloon will open the clogged carotid artery, and a stent (a thin, metal mesh tube) will be inserted to keep the artery open. Shane is moved and placed on a stainless steel table in a sanitized operating room. Doctors wash their hands, put on their scrubs and gloves, and use various tools and equipment to perform the procedure. Shane successfully recovers and heads to the local pharmacy to pick up his newly prescribed medicine. He later receives the bill and works with his insurance company to pay for the services rendered. Shane is thankful Emily recognized the early signs of a stroke.

This is more than a simple anecdote with a happy ending—it’s an illustration of how Health Care products and services impact our lives. Every event, interaction, and item in Shane’s situation used products and services from the Health Care sector. [Table 1.1](#) lists just some of the Health Care products and services he encountered.

**[Table 1.1](#) Health Care Sector Impact**

Interaction With	Health Care Sector Involvement
------------------	--------------------------------

Interaction With	Health Care Sector Involvement
Ambulance	Performed by a Health Care Services company
Hospital	Run by a Health Care Facilities company
Diagnostic machines used to run tests	Made by Life Sciences and Health Care Equipment firms
Lab test	Performed by a Health Care Services company
Balloon and stent	Manufactured by a Health Care Equipment company
Stainless steel table, knives, and gloves	Manufactured by Health Care Equipment and Supplies companies and delivered to hospitals through Health Care Distributors
Prescription drugs	Manufactured by a Pharmaceuticals firm
Health insurance company	Run by a Managed Care provider

This book covers investment opportunities in the Health Care sector, as well as how to better incorporate a Health Care allocation into a broader portfolio. Many of the firms making people’s lives healthier are publicly traded and can be an integral part of your portfolio. Of the 10 standard investing sectors, Health Care arguably plays the most critical role—literally—in daily life. Moreover, in recent years, health care—its availability, cost, and how it should be delivered—are among the most hotly debated topics around the world. After all, it was Mahatma Gandhi who said, “It is health that is the real wealth and not pieces of gold and silver.”

This doesn’t suggest Health Care is inherently superior to other sectors (Energy, Materials, Industrials, Consumer Staples, etc.)—it isn’t. But Health Care, like each sector, has unique attributes leading both to outperformance and underperformance depending upon economic, market, and industry-specific conditions. There will be periods when Health Care performs very well relative to the broader market and periods when it lags.

While health care can be a politically touchy subject and can foster great ethical debate, the aim of the book isn’t to support one ideology or another. Rather, the goal is to help you gain a basic understanding of the Health Care sector—its components, drivers, and challenges—and serve as a general guide for better Health Care investing. Wherever

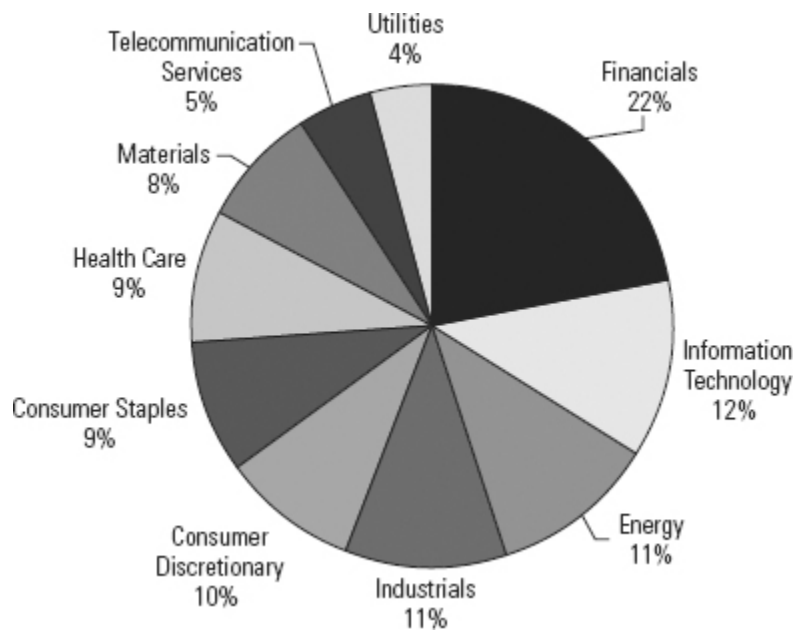
possible, we'll also help you think critically about the sector to generate your own views rather than just dictating rules. Successfully investing in Health Care firms doesn't require an advanced degree in medicine. Instead, you need a firm grasp of the laws of supply and demand and an understanding of what drives the earnings and stock prices of Health Care firms.

## HEALTH CARE BASICS

[Figure 1.1](#) shows how the sector composition of the MSCI All Country World Index (ACWI) is broken down. The ACWI index covers the entire globe, including emerging markets, and is currently the broadest representation of global stocks. The index is capitalization weighted, meaning larger firms have more weight. Health Care currently accounts for 9 percent of the index and is one of the smaller sectors by weight. That doesn't make it unimportant, however. Further, sector weights may differ among various indexes, as you will see in subsequent chapters. And as sectors go in and out of favor, their relative weights can change, sometimes tremendously.

### **[Figure 1.1](#) Breakdown of the MSCI All Country World Index**

*Source:* Thomson Reuters, MSCI Inc.,<sup>1</sup> as of 12/31/2009.



What does the Health Care sector look like from a high level? Not all health-related firms belong in the sector. For example, food, some consumer products, and retail pharmacies belong in the Consumer Staples sector, while some Industrial sector conglomerates, such as General Electric and Siemens, own large Health Care equipment and diagnostic divisions. This isn't a hard and fast rule, but classification as a Health Care firm largely depends upon how much health-related revenues and profits comprise a firm's overall sales and earnings.

Because Health Care has many diverse industries, it's split into two broad groups (as defined by the Global Industry Classification Standard [GICS] classification system):

- Pharmaceuticals, Biotechnology & Life Sciences
- Health Care Equipment & Services

Pharmaceuticals, Biotechnology & Life Sciences, the larger group, includes firms involved in the discovery, development, manufacturing, and distribution of prescription drugs. It also includes firms supporting the drug discovery process, as well as those that serve firms outside the health care business by testing the quality of food, water, air, and metals. There are over 1,600 publicly traded

firms globally in this segment.<sup>2</sup> [Table 1.2](#) lists the largest firms in this industry group.

### **[Table 1.2](#) Largest Firms in the Pharmaceuticals, Biotechnology & Life Sciences Group**

*Source:* Thomson Reuters, as of 12/31/2009.

Name	Ticker	Market Cap (\$Mil)	Country	Industry
Johnson & Johnson	JNJ	\$177,714	US	Pharmaceuticals
Pfizer	PFE	\$146,785	US	Pharmaceuticals
Novartis	NVS	\$144,165	Switzerland	Pharmaceuticals
Roche Holding	RHHBY	\$119,482	Switzerland	Pharmaceuticals
Merck & Co.	MRK	\$111,610	US	Pharmaceuticals

The Health Care Equipment & Services group includes medical equipment makers, health insurance firms (called managed health), pharmacy benefit managers, hospitals, and technology firms. There are over 1,200 globally publicly traded firms in this segment.<sup>3</sup> [Table 1.3](#) lists the largest firms in this group.

### **[Table 1.3](#) Largest Companies in the Health Care Equipment & Services Group**

*Source:* Thomson Reuters, as of 12/31/2009.

Name	Ticker	Market Cap (\$Mil)	Country	Industry
Medtronic	MDT	\$48,583	US	Health Care Equipment
Baxter International	BAX	\$35,376	US	Health Care Equipment
UnitedHealth Group	UNH	\$35,418	US	Managed Health Care
WellPoint	WLP	\$26,717	US	Managed Health Care
Medco Health Solutions	MHS	\$30,470	US	Health Care Services
Covidien	COV	\$24,062	US	Health Care Equipment



# HEALTH CARE CHARACTERISTICS

Although Health Care firms span various industries, firms in this sector tend to share some similar characteristics. Generally, the sector as a whole:

- Is less economically sensitive and less volatile than the broad market.
- Deals with heavy government involvement.
- Has a large, global market.
- Is mostly characterized by big cap, growth companies.
- Is dominated by US firms.

Let's look at each of these characteristics in more detail.

## Less Economically Sensitive

As we'll cover more in depth in Chapter 4, Health Care's drivers can be somewhat independent of pure economic growth. In other words, demand for Health Care goods and services typically holds up well even when the economy sours. In a down economy, consumers might buy fewer Consumer Discretionary goods and firms might delay upgrading computer systems during recession (which isn't great for the Tech sector), but folks are likely to keep taking heart medication and visiting the emergency room. In other words, Health Care firms produce goods and services for which there is typically *inelastic* demand.

Health Care, as a relatively economically insensitive sector, can be a useful part of your portfolio because it can perform relatively well when the economy contracts and broader markets decline. For this reason, the sector is also sometimes described as *defensive*. This doesn't necessarily mean Health Care stocks will post positive returns during a market downturn—instead, those stocks may just perform relatively better than stocks as a whole during those periods. Nor does it mean the sector must underperform in good times. For example, Health Care led at some points as

broader markets rose during the late 1990s. No sector has a single, defining driver, and there can be myriad reasons Health Care (though generally defensive in nature) might lead during broad market advances and lag during declines.

## Elasticity

Elasticity is a measure of one variable's sensitivity to a change in another variable. The term references changes in demand relative to changes in price or income. The concept of elasticity is core to understanding what makes the Health Care sector tick.

Health Care products are generally inelastic because they are necessities purchased regardless of how an individual's personal economic situation shifts over time. Discretionary purchases, like vacations, are just the opposite—elastic—because income or price fluctuations do materially impact demand.

For example, if our friend Shane's income increased, he wouldn't demand more surgery or prescription drugs. And if the price of surgery or drugs increased, he would still need those things to keep him alive. An elastic industry might be the Consumer Discretionary industry. Take the Automobile industry, for example. An increase in either income or the price of cars could substantially alter demand.

Historically, however, Health Care has held up relatively well during bear markets and corrections. [Table 1.4](#) shows the relative performance between the S&P 500 and S&P Pharmaceuticals during bear markets going back to 1929. (Note: We encourage you to always think globally, but when studying history, US markets are a good proxy for the world because we have more and better data going back further on US stocks at this point.) Pharmaceuticals—a majority of the Health Care sector—outperformed the broader market in 14 of 16 bear markets and/or corrections—sometimes by a very wide margin.

### **[Table 1.4](#) Pharmaceuticals Outperformance During US Bear Markets**

*Source:* Global Financial Data, Inc., S&P 500 Price Index, S&P 500 Pharmaceuticals Price Index, from 12/31/1925 to 12/31/2009. Performance based on monthly data.