Overview

Health Care Growth Drivers - Worldwide health care spending is roughly $7.7 trillion annually, and the U.S. accounts for approximately 40% of that (World Bank). We believe continued growth in the health care sector will be driven by three main factors: favorable demographic trends, growth in emerging markets, and accelerating medical innovation.

Building a Portfolio - We recommend that health care stocks comprise 15% of the equity portion of a portfolio. When adding health care to a portfolio, to better manage risk and potentially increase returns, we recommend buying more than one health care company. For specific recommendations, we point investors to the Edward Jones Stock Focus List.

Investment Risks - Risks exist for health care companies as governments look for ways to curb health care spending growth. Other risks to investing in health care include ongoing health care reform efforts, unexpected product failures and recalls, regulatory action by the FDA, pricing pressure, and the potential for intensifying competition.

Sector Outlook

Health care spending is a large and growing part of the global economy. We believe continued growth in the health care sector will be driven by three main factors: favorable demographic trends, growth in emerging markets, and accelerating medical innovation.

1. Favorable Demographic Trends – The aging of the population and lifestyle choices that result in higher incidence of disease should lead to increased health care spending.

2. Growth in Emerging Markets – As many emerging market countries (such as China and India) become wealthier, they will increasingly look to become healthier, likely spending more on health care products and services.

3. Accelerating Medical Innovation – Given advances in technology, we believe growth in medical innovation will lead to new products and services that better address diseases and support new categories of spending on health care.
1. Favorable Demographic Trends
The U.S. and other developed countries are faced with aging populations. In the U.S., the number of Americans turning age 65 every year is increasing dramatically. While roughly 14% of the U.S. population is aged 65+, that number is expected to grow to over 20% by 2030 (Census Bureau).
And what's so magical about hitting age 65? Given increased medical testing and higher likelihood of disease, we know that health care spending jumps dramatically as people age. For example, those over 84 years old in the U.S. spend roughly $32,000 per person per year on health care expenses compared with people aged 19-64 who spend roughly $7,000 per person (see Figure 1). We believe the aging population should directly contribute to higher health care spending in the years ahead. Further, due to medical advances, people are living longer, and this increased longevity should contribute to higher health care spending.

Figure 1 - Personal Health Care Spending Increases with Age

Another demographic trend is the unhealthy lifestyle choices that many people make by eating poorly and not getting enough exercise. As a result, the percentage of adult Americans that are either overweight or obese is approximately 71% (U.S. Centers for Disease Control). Unhealthy lifestyles have been shown to lead to higher incidence of disease and increased health care spending. For example, more people are likely to need medication for cardiovascular problems such as high blood pressure or high cholesterol; and medical devices for worn-out hips, knees, and joints.

2. Growth in Emerging Markets
While health care spending continues to grow in the U.S., faster growth is occurring in emerging markets. The most notable emerging markets are the BRIC countries of Brazil, Russia, India, and China. Given the emerging nature of these countries, their spending on health care is relatively low. While U.S. health care spending is over $9,400 per person annually, China spends $420 and India $75 (World Bank). In general, as these countries become wealthier, we expect they will increasingly look to become healthier, benefiting many global health care companies.

Figure 2 - Health Care Spending per Person

<table>
<thead>
<tr>
<th>Country</th>
<th>Health Care Spending per Person</th>
<th>Population (Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.</td>
<td>$9,403</td>
<td>321</td>
</tr>
<tr>
<td>China</td>
<td>$420</td>
<td>1,371</td>
</tr>
<tr>
<td>India</td>
<td>$75</td>
<td>1,311</td>
</tr>
</tbody>
</table>

Source: World Bank

3. Accelerating Medical Innovation
In our view, we are in the midst of an exciting time in health care innovation. Since the first mapping of the human genome over 15 years ago, medical innovations picked up markedly. Given additional advances in technology, we believe this pace will continue.
Pharmaceutical advancements include extending life in patients with fatal diseases, such as cancer, and turning fatal diseases, such as AIDS, into manageable chronic diseases. Also, genetic testing can help determine if certain drugs will work based upon individual genetic makeups. This should lead to better health outcomes at lower costs. Biopharmaceutical companies are also developing innovative new drugs to treat a variety of diseases including hepatitis C and cancer. Innovations such as these have led to a general increase in FDA drug approvals, as shown in Figure 3.
New innovations utilizing patient data and the Internet also should improve health and lower costs. Pharmacy benefit managers use data to determine what prescriptions patients are taking, potential drug interaction risks, and have programs based on patient-ordering trends to remind patients to take their prescriptions as their doctor recommends. There is an increasing number of medical devices, such as for heart failure, that can remotely communicate a patient's health to caregivers. This should help identify health issues often before the patient realizes there is a problem, potentially saving lives and lowering treatment costs.
Figure 3 - New FDA Drug Approvals

Source: U.S. Food and Drug Administration

How to Build a Health Care Portfolio

We recommend that health care stocks comprise 15% of an investor's equity portfolio. As a defensive sector, health care has traditionally performed better than the broader market in times of heightened uncertainty. Additionally, many stocks within the sector feature attractive dividend yields. Given each subsector's differing exposures to risks and opportunities, we believe it is important for investors to diversify across subsectors. The biopharmaceutical subsector is the largest subsector in health care, and these companies tend to have higher dividend yields and less volatile returns than their health care peers. We suggest gaining a larger exposure in this subsector. Given the size and diverse nature of health care, we recommend diversifying further into the health care services and medical technology & equipment subsectors that typically exhibit more growth, while also tending to exhibit greater stock price fluctuation.

Political Considerations

The U.S. government passed landmark health care reform in 2010. The Affordable Care Act expanded access to health insurance to millions of Americans. It also put in place measures to reduce medical costs, which primarily impacted insurers, hospitals and other health care facilities. In addition, the biopharmaceutical industry agreed to greater rebates for government payers along with paying higher fees. We believe the companies we recommend have managed these changes well, and we believe they will continue to do so in the future. We believe certain areas of health care, such as hospitals, have benefited from the increased volume due to more insured people, while others have experienced a modest to minor impact on product demand.

In our view, government involvement in health care will continue, as those paying for health care look for ways to reduce costs. Particularly, we expect the risk of pricing pressure to continue for medical devices and certain drugs. As a result, we see health care companies, from insurers to biopharmaceutical and device companies, merging with one another to lower costs through increased size and reach. U.S. health care reform remains a controversial topic, and we expect modifications or even a repeal of the law, but we believe large diversified health care companies will navigate through these changes well.

Outlook by Industry

The health care sector is large and diverse, and composed of three main subsectors: Biopharmaceuticals, Medical Technology & Equipment, and Health Care Services (see Figure 4). Over time, stocks in each of these areas have performed differently; thus, we believe diversifying within health care is a good strategy to better manage risk and improve potential returns.

Figure 4 - Breakdown of the S&P 500 Health Care Index

Data as of 8/1/17. The S&P 500 Index is based on the 500 largest companies by market capitalization and are traded on U.S. stock exchanges. The S&P Health Care Index is a capitalization-weighted index comprising 61 health care companies that are found in the S&P 500 Index. An index is unmanaged and is unavailable for direct investment. Past performance is no guarantee of future results.
Biopharmaceuticals – 55% of the S&P Health Care Index

Over the next five years, we expect drug industry revenue growth to be about 4% - 6% on average per year through a combination of demand growth and modest price increases. Demand should be driven by an aging population, innovation across disease areas, and the relative cost-efficiency of drug therapy versus hospital visits and surgery. Overall, the industry is past its major patent cliff and is in the midst of an impressive uptick in innovation. Additionally, the strong financial positions of many of the companies on our coverage list will support acquisitions and the ability to return cash to shareholders. In our view, the primary risk to the industry is pricing pressure, which is likely to intensify due to substantial political pressures and the significant bargaining power of payers.

The biopharmaceutical subsector has performed well over the last few years, which we believe has been driven by successful new product development. While stock prices have generally increased, the industry’s valuation is near historical averages. We believe attractive opportunities remain in companies that have strong fundamentals and the opportunity for accelerating growth driven by innovation. That have strong fundamentals and the opportunity for accelerating growth driven by innovation. Johnson & Johnson (JNJ), Merck (MRK), Novartis (NVS) and Pfizer (PFE) are on the Edward Jones Stock Focus List. We also recommend Allergan (AGN) and Bristol-Myers Squibb (BMY).

Medical Technology and Equipment – 25% of the S&P Health Care Index

Like biopharmaceutical companies, we also expect medical technology and equipment product companies to grow sales 4% - 6% on average over the next 10 years. Our forecast is based on new innovative products and further expansion into emerging markets.

New innovative products include devices that not only treat diseases, but also have the ability to use a patient's smartphone or tablet to download data from a medical device, such as a pacemaker, and transmit it to their doctor to help diagnose issues. This may allow doctors to make timely treatment decisions sometimes even before a patient realizes he or she has a problem. With other new devices that treat heart failure, brain disorders, and minimally invasive heart valve replacement products, we feel the medical device industry is well-positioned to show sustained sales growth for the long term. Emerging markets should also drive demand. As these markets grow and develop, their medical infrastructure becomes more established and sophisticated. This often leads to increased purchases of diagnostic products, drug discovery tools, and devices.

While valuations tend to be higher in this area compared with pharmaceuticals, we think this industry is attractive given the long-term growth opportunities noted above. We believe the major risks with medical device companies are pricing pressure and product recalls (although these are relatively rare). Given these risks, we prefer companies with diversified product lines in attractive growth markets as well as a solid history of sustained innovation over time. Abbott Labs (ABT), Medtronic (MDT) and Thermo Fisher (TMO) are on the Edward Jones Stock Focus List.

Health Care Services – 19% of the S&P Health Care Index

Health care services encompasses a broad array of industries involved in the distribution and administration of health care products. Pharmacy benefit managers, managed care companies, health care distributors, laboratories and hospitals are all considered health care service firms. In screening for investment ideas, we look for health care services firms that add value by containing costs or improving health care outcomes.

We believe that pharmacy benefit managers (or PBMs) play an important role in both cost containment and better health outcomes. PBMs negotiate lower drug prices, encourage the use of low-cost generic drugs, and help ensure that members take the drugs that they are prescribed. We recommend Cerner (CERN), a health care IT company that develops software used by hospitals and doctors.

We also believe that managed care companies play an important role in cost containment and better health outcomes as they negotiate discounts from physicians, hospitals, labs, and clinics, and provide disease management programs to members. While the rising cost of insurance has made it difficult for insurance companies to grow their commercial (or employer-based) membership, these companies have been realizing growth through providing Medicare Advantage and Medicare prescription drug plans to seniors, and also through increased outsourcing of state Medicaid services. However, given U.S. health care reform legislation, the industry faces more political headwinds and uncertainty, and we believe the taxes and market structure changes imposed on managed care may pressure future profit growth.
Valuation
In valuing health care companies, we use various methods including price-to-earnings ratios (P/E), dividend yields, discounted cash flow estimates, and return on investment calculations.

Risks
• Due to the highly regulated nature of the sector, political and regulatory risk is always present. Health care companies are subject to risks related to health care reform and government reimbursement policies. Additionally, regulatory risk related to the FDA is present, as the FDA has become increasingly focused on safety, which could cause a delay in new products being approved and brought to market.
• Research & development (R&D) is typically one of the largest expenses of pharmaceutical and medical device firms, and the hit-or-miss nature of R&D creates the risk that a significant amount of money could be invested in a product that fails to reach the market.
• Health care companies make products that can save lives, but sometimes these products have side effects or unintended consequences. As a result, unexpected product failures or liabilities could impact these companies.
• Intense competition for market share among health care services firms could lead to significant pressure on earnings.
• Pressure is likely to rise for product manufacturers to limit price increases. If more drastic measures are taken, such as price controls, earnings and stock prices could be hurt.

For stocks recommended in this report, please see the individual company research opinions for specific company information, including valuation and risks.

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