Rising Health Care Costs Appear Unsustainable

Growth in health care spending is outpacing economic growth in most developed nations due to medical advances and demographics, among other factors. In the U.S., health care spending is expected to increase from $3 trillion in 2014 to $4.5 trillion by 2021. Given this growth, we believe the current trajectory of health care spending is unsustainable.

Increasing Government Involvement Creates Uncertainty

Due to the need to control health care costs, we believe that the U.S. government will increase its involvement in the health care industry over time. Despite the passage of the Affordable Care Act (ACA), controlling costs has been challenging. With a new administration and Republican-controlled Congress looking to repeal and replace the law, we believe that uncertainty will persist in the sector.

Focus on Innovative and Diversified Companies

While it is difficult to predict what impact new regulation or legislation will have on the health care sector, we believe companies with a diverse geographic presence, product portfolio or payer mix are better positioned to navigate any potential changes. Additionally, we believe companies that are highly innovative, with new products that improve quality of life or lower overall health care costs, will be rewarded over time. We recommend 15% of an investor’s equity portfolio be invested in health care.

Figure 1

Growth in National Health Expenditures Outpaces Inflation and Economic Activity

Source: CMS, CBO and Federal Reserve

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Unsustainable Health Care Costs

As seen in Figure 1, the rise in health care costs has significantly outpaced inflation over time. Spending on health care in the U.S. is projected to total $4.5 trillion, or 20% of GDP by 2021, up from $1.4 trillion and 12% of GDP in 2000. While health care costs tend to outpace inflation by a wide margin in most developed economies, the U.S. spends the highest amount per person on health care.

Figure 2

Source: World Bank

Health care costs are increasing in the U.S. due to medical advances, high expectations of care, a greater number of procedures, complex regulations that lead to high administrative costs, demographics (aging population and unhealthy lifestyle choices), a lack of cost-controlling incentives, and a lack of pricing transparency. We believe that the current trajectory of health care spending is unsustainable.

The U.S. Government's Involvement in Health Care

Given the significant changes that will likely have to be made in the U.S. health care industry, we believe that the government will become increasingly involved in health care over the long term. It is difficult to predict what changes could occur, and this creates uncertainty in the industry.

Diagnosing health care reform and its impact on the sector - The Affordable Care Act (ACA, or more commonly known as Obamacare) was signed into law in 2010. The scope of the ACA is vast, but significant features of the law include the creation of public insurance marketplaces, an individual mandate requiring individuals have health insurance, a reduction in drug expenses for seniors, no lifetime health insurance spending caps for individuals, prevention of an insurance company denying coverage to people with pre-existing conditions, and increased regulations on health care companies and increased taxes on higher-income individuals.

Although the Affordable Care Act (ACA) was signed into law more than six years ago, controlling health care costs has proved challenging. In addition to costs, we believe more will have to be done to improve access and quality in the health care system. Going forward, we believe that there will be a greater focus on preventative care to help address some of these issues.

While we believe the health care sector as a whole is benefiting from more people having access to care, some areas of health care have been more impacted than others by the ACA. These include certain facilities and health insurance companies. The expanded insured population has helped hospitals, but this may be offset by lower reimbursement rates. In addition, the biopharmaceutical and medical device subsectors have seen pricing pressure due to increased competition and the desire to lower costs. The areas that have been impacted the least include the dental, laboratory equipment and animal health companies, as these rely less on government payments. Going forward, our expectations of increased government involvement will impact most areas of health care, though to varying degrees.

Political uncertainty persists - We believe we are entering into a period of increased uncertainty for health care reform in this country given the potential for the new administration to repeal and replace health care reform or make modifications to the existing law. While notable changes could occur to the health care landscape in the United States in the upcoming year or two, we cannot say with any certainty what those changes might be. However, with a closely divided Congress, we also think that substantial political compromises will be made. Regardless of what occurs, we believe our Buy-rated companies are well-positioned to navigate through the new landscapes profitably.

Health insurers will likely continue to be affected - We believe any health care reform changes will continue to have far-reaching impacts on health insurance companies. While these companies benefited from more people being insured, we believe this has been offset by increased regulation. For example, the ACA limits the profitability of health insurers by setting the percentage of an insurance company’s sales that must be spent on medical care for members. In addition, the newly insured have been sicker and more costly than expected. As a result, many companies are exiting public health exchanges due to monetary losses. While we believe a new presidential administration may
propose changes to health care reform, over the long term, we think government involvement in paying for health care will increase, creating uncertainty for the foreseeable future.

**Increased focus on drug prices** - Areas that we believe could face greater pricing pressure risks going forward are drug companies and, in turn, the health care service companies, such as distributors, that are involved in the drug supply chain. News items related to prescription drug prices have increased notably over the last year. While only about 10% of total health care costs are spent on prescription drugs, drug prices have become more visible as out-of-pocket costs on drug have risen. While the Republican sweep of the presidency and congress makes it less likely that the government will be focused on drug prices in the near term, we continue to believe that pricing pressure will be a long-term risk for the industry. The consolidation of payors and pharmacy benefit managers has created increased purchasing power that we believe will continue to be used to help lower costs. Going forward, we believe the drug industry will also play a role in lowering prices through increased self-regulation. As a result, we believe biopharmaceutical companies will be less likely to take annual double-digit price increases. While we believe companies will continue to be rewarded for innovation, pricing pressure will be a continuous concern for investors and a long-term risk for the industry.

**Actions to Take**

While it is difficult to predict what changes could occur in the health care industry over the long term, we believe some companies are better positioned than others. For investors looking for ideas in the health care sector, we recommend focusing on companies with a diverse geographic presence, product portfolio, or payer mix, and companies that are highly innovative, with products in development that improve quality of life or that lower overall health care costs.

- **Geographic diversification** - Most large health care companies have considerable international sales, which reduce the impact of any risks associated with changes to health care in the U.S.
- **Product diversification** - A diversified product portfolio minimizes the impact of increased competition or pricing pressure on a specific product or product category.
- **Payer diversification** - Companies with higher sales exposure to non-government payers (such as private insurance and cash pay) have more pricing power and less reliance on government reimbursement.

**Highly innovative** - In our view, companies with differentiated products, particularly for unmet medical needs that improve quality of life, or lower overall health care costs will continue to get paid for innovation.

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<tr>
<th>Company</th>
<th>Med. Devices</th>
<th>Biopharma</th>
<th>One product doesn’t make up more than 10% of sales</th>
<th>Diversified payer mix</th>
<th>Highly Innovative</th>
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Source: Edward Jones Estimates, Company Reports

The table above shows which of our Buy-rated names share these characteristics.

**Building a health care portfolio** - Health care in the U.S. has undergone a considerable transformation since 2010. Despite the changes, the health care companies we recommend have largely done a good job navigating the new landscape profitably, and we believe these companies will continue to do so. While uncertainty related to health care reform is ever-present in the sector, we believe long-term growth will be driven by positive demographic trends, growth in emerging markets, and accelerating medical innovation. We believe that our Buy-rated health care stocks will benefit from these trends and are attractively valued. We recommend 15% of an investor's equity portfolio be invested in health care.

**Additional Risks**

Other than political risks, general risks to consider when investing in health care include pricing pressure, product failures and liabilities, and regulatory risk.

**Valuation**

In valuing health care companies, we use various methods, including price-to-earnings ratios, dividend yields, discounted cash flow estimates, and return-on-investment calculations. For stocks recommended in this report, please see the individual company research opinions for specific company information, including valuation and risks.

1. Centers for Medicare & Medicaid Services (CMS)
2. Congressional Budget Office (CBO)
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