Investment Overview

During every presidential election cycle, lively policy discussions are commonplace among the candidates. These discussions often influence perceptions of health care companies and their stocks, at least in the short term. This election year promises to be no different, and this may be one reason why health care has underperformed the broader market since the beginning of the year. In addition, both parties have very different ideas on which way health care policy should proceed. While periods of heightened political debate can create an environment of uncertainty and volatility, we believe there will be minimal, if any, impact on our long-term outlook.

- Most large health care companies have considerable international sales, which reduces the impact of any risks associated with changes to health care in the U.S.
- Health care in this country has undergone a considerable transformation over the past six years. Despite the changes, health care companies largely have done a good job in navigating the new landscape profitably, in our view, and we believe these companies will continue to do so.
- The perceived high prices of prescription drugs have become an increasingly hot topic. We believe significant changes in the way drugs are priced would be difficult to make, and with drugs making up only 10% of health care costs in the U.S., there may be more significant savings opportunities in other areas of health care.

Therefore we encourage clients to focus on the drivers of health care demand over the long term, which include: 1) positive demographic trends, 2) accelerating innovation, and 3) emerging market growth.

Predicting political outcomes is very difficult. Predicting what policies will be implemented with a new administration is even harder. However, we believe continued moderate economic growth and lower unemployment should lead to long-term earnings growth, which should support higher stock prices over time. We recommend that health care stocks comprise 15% of a client's diversified equity portfolio.

Election Years and Health Care Stocks

Election years usually feature much talk about health care (We define an election year from the beginning of the year to the end of October; just before Election Day).
However we believe it is important to look at all the economic factors surrounding health care stocks for the long run, and the election cycle is just one factor. For instance, we think the underperformance of health care stocks during the 2004 election year (Bush II-Kerry), as shown in Figure 1, had less to do with the election cycle and more to do with the fear of many drugs losing their patent protection in the next few years. Conversely, we believe the outperformance of health care stocks in 2008 was due to their defensive nature at the beginning of the "Great Recession," despite heightened election-year talk about the government's role in health care.

Figure 1:

<table>
<thead>
<tr>
<th>Election Campaign</th>
<th>Relative Performance of Health Care vs. S&amp;P 500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Clinton – Bush I (1992)</td>
<td>-19.0%</td>
</tr>
<tr>
<td>Clinton – Dole (1996)</td>
<td>+0.4%</td>
</tr>
<tr>
<td>Bush II – Gore (2000)</td>
<td>+29.4%</td>
</tr>
<tr>
<td>Bush II – Kerry (2004)</td>
<td>-8.1%</td>
</tr>
<tr>
<td>Obama – McCain (2008)</td>
<td>+10.3%</td>
</tr>
<tr>
<td>Obama – Romney (2012)</td>
<td>+3.0%</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td><strong>+2.7%</strong></td>
</tr>
</tbody>
</table>

Source: FactSet, Edward Jones Research

**International Exposure Helps Lessen Political Risks**

We believe it is important for clients to remember that for many large health care companies a good percentage of sales come from markets outside of the United States, as shown in Figure 2. This should help lessen political risk for most of the health care companies Edward Jones recommends. Therefore, even if there was much more election-year health care debate than normal, we don’t think this will have much, if any, long-term impact on health care stocks due to their international diversity.

<table>
<thead>
<tr>
<th>Company</th>
<th>% of Revenues International</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abbott Labs</td>
<td>69%</td>
</tr>
<tr>
<td>Novartis</td>
<td>63%</td>
</tr>
<tr>
<td>Zoetis</td>
<td>57%</td>
</tr>
<tr>
<td>Merck</td>
<td>56%</td>
</tr>
<tr>
<td>Pfizer</td>
<td>56%</td>
</tr>
<tr>
<td>Bristol-Myers Squibb</td>
<td>50%</td>
</tr>
<tr>
<td>Thermo Fisher</td>
<td>49%</td>
</tr>
<tr>
<td>Medtronic</td>
<td>45%</td>
</tr>
</tbody>
</table>

Source: Company reports

**Health Care Companies Adapt to Change Well, in Our View**

Even considering the expansive changes in health care laws in this country over the past six years, we believe many health care companies have done a good job navigating the new landscape, as evidenced by continued solid sales, driven by innovation, and improved profitability (due, in part, to cost saving programs). These companies include our Buy-rated names, which we think will continue to do well particularly due to their size and experience with health care system changes.

**Drug Costs Are a Relatively Small Portion of Health Care Spending**

The perceived high prices of prescription drugs have become an increasingly hot topic. While only 10% of health care costs are spent on prescription drugs, as shown in Figure 3 on the next page, the relatively high prices of new specialty drugs (treatments for complex or rare conditions) and certain cases of steep price increases have raised concerns among private organizations, doctors, pharmacy benefit managers, and even presidential candidates.

While we believe that significant changes to the way drugs are priced are difficult to predict and that the changes could take years, the recent spotlight and proposals have created more uncertainty during this election year, in our view. Although pricing pressure will be an ongoing concern for investors, we believe the drug industry will continue to be rewarded for innovation in the long run. We feel innovation should help mitigate any pricing pressure we may see in the future and lead to long-term earnings growth.
With only 10 cents of every health care dollar spent on pharmaceuticals, we believe there are better savings opportunities in other areas in health care. In fact, the government is experimenting with reimbursing doctors and hospitals on patient outcomes rather than on volumes of patients in order to help lower costs across the system.

Therefore, while health care often gets more than its share of election-year talk, which can lead to short-term volatility, we believe that there will be minimal, if any, impact on our long-term outlook. With favorable demographics, heightened innovation, and growing emerging markets, health care continues to have a place in a well-diversified equity portfolio, in our view. We recommend a 15% health care weighting. For ideas in this sector we feel clients should focus on health care companies on our Edward Jones Stock Focus List. Health care stocks on this list include Abbott Labs, AbbVie, Johnson & Johnson, Medtronic, Merck, Novartis, Pfizer, and Thermo Fisher.

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 and 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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