Edward Jones
MAKING SENSE OF INVESTING

Investing in the Health Care Sector

HEALTH CARE SECTOR REPORT

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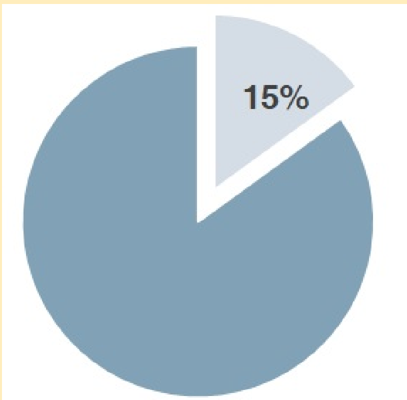
ANALYST(S)

Ashtyn Evans, CFA

Rec. Equity Weight for Health Care: 15%



Buy-rated companies mentioned in this report:

- Johnson & Johnson (JNJ - $147.88)
- Merck (MRK - $80.04)
- Thermo Fisher (TMO - $452.36)
- Abbott Labs (ABT - $107.74)
- Cerner (CERN - $71.48)
- Cigna (CI - $176.30)
- Medtronic (MDT - $105.66)

Hold-rated companies mentioned:

- CVS Health (CVS - $59.42)
- Gilead (GILD - $62.84)
- McKesson (MCK - $148.13)
- Walgreens (WBA - $36.49)

Prices and opinions ratings are as of market close on 10/7/20 and subject to change. Source: Reuters.

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SECTOR INVESTMENT SUMMARY

Health care is a large and growing part of the global economy. While we have a favourable view of the sector's long-term growth prospects, risks exist as rising health care costs appear unsustainable. We believe companies that are diversified by product and geography and that have exposure to innovation will be rewarded over time. Overall, we believe our Buy-rated recommendations will be able to adapt to the rapidly changing landscape.

GROWTH DRIVERS

1. **Favourable Demographic Trends** – The aging of the population and unhealthy lifestyle choices should lead to increased health care spending.
2. **Growth in Emerging Markets** – As many emerging-market countries become wealthier, they will increasingly look to become healthier.
3. **Accelerating Medical Innovation** – Given advances in technology, we believe growth in medical innovation will lead to new products and services.

CHALLENGES & RISKS

1. **Politics and Reform Create Overhang on Sector -** Growth in health care spending has led to a focus on reducing costs, and we believe that the U.S. government will become increasingly involved in health care.
2. **Rapidly Shifting Landscape and Coronavirus Effects -** Health care companies are demonstrating their value with personalized new products and data-driven payment models. Additionally, the coronavirus pandemic could accelerate changes in how patients receive care.
3. **Regulatory Risks and Product Failures -** Changes in regulation, unexpected product failures, or liabilities are additional risks in the sector.

CURRENT VALUATION

Health care stocks are currently trading at a price-to-earnings ratio (P/E) of 15.5 times 2021 earnings, which is in line with their historical average. On a relative basis, health care is trading 25% below the average P/E of the market, when it has historically traded in line with the market. The P/E ratio represents how much investors are paying for each dollar of earnings. We believe the sector can grow earnings 7% a year over the long term, in line with historical growth rates.

Please see important disclosures and analyst certification on page 5 of the report.

RECENT NEWS

Coronavirus and Health Care

Earnings for health care companies have generally held up relatively well during the coronavirus pandemic. This is because health care spending is more difficult to defer in economic downturns. Biopharmaceutical companies have mostly maintained earnings guidance and have not seen a meaningful change to the demand for drugs, though there has been some disruption in hospital-administered drugs and minor delays in clinical trial starts. For the equipment and services subsector, medical device companies that have exposure to procedures, particularly procedures that are elective or can be delayed, have been the most negatively impacted. However, volumes are gradually returning, and we expect these impacts to be short-term in nature.

On the treatment side, there are hundreds of clinical trials ongoing to find a drug or vaccine to treat the virus. We do not recommend buying any particular health care company solely due to its exposure to a potential treatment. Treatments and vaccines during the pandemic may be donated or sold for a minimal profit. Additionally, because of the large number of treatments in development, it is difficult to predict which ones will be successful. Once a vaccine is developed, the demand for any particular treatment will likely decline. For small manufacturers, the success or failure of a vaccine could cause volatility in share prices. If large vaccine manufacturers, such as Johnson & Johnson (JNJ - Buy) and Pfizer (PFE - Buy), are successful with a vaccine, the vaccine would likely only modestly contribute to earnings. If vaccines end up being used on an annual basis (similar to the flu vaccine), we anticipate that there will be several approved and used globally. For context, the entire global flu vaccine market is around $5 billion. This compares with Johnson & Johnson's annual sales of over $80 billion and Pfizer's over $40 billion in annual sales.

Related to coronavirus testing, several health care companies are benefiting from newly approved coronavirus tests. Of our coverage, we believe Abbott Labs (ABT - Buy), Thermo Fisher Scientific (TMO - Buy) and Danaher (DHR - Buy) will all see a benefit to earnings in their diagnostics businesses from coronavirus tests. Additionally, we believe Becton Dickinson (BDX - Buy) will benefit from increased demand in medical supplies such as needles, syringes and ventilators as a result of the coronavirus.

Opioid Crisis Litigation

Several health care companies, including drug manufacturers, pharmacies and drug distributors, are named in various opioid-related lawsuits brought on by state and local governments. These cases began to appear several years ago. However, the issue is back in the news as litigation is progressing. While the largest manufacturer of opioids is a private company called Purdue Pharmaceuticals, we cover several companies named in litigation, such as Johnson & Johnson (JNJ – Buy), Pfizer (PFE – Buy), McKesson (MCK – Hold), Walgreens (WBA – Hold) and CVS Health (CVS – Hold).

The opioid crisis is clearly a major issue in the United States, as state and local governments look to certain health care companies to be held accountable for their alleged role. The uncertainty around the potential cost to the companies involved has created volatility in share prices. Overall, it is very difficult to predict what the ultimate cost will be for each company. However, a better-than-expected comprehensive settlement by many of the companies involved is looking increasingly likely. Under the proposal, Teva would provide over $20 billion of free opioid addiction drugs and $250 million over a period of 10 years. Separately, JNJ has offered to pay $4 billion. Three primary drug distributors, which include McKesson, have proposed to pay close to $20 billion over 18 years. These settlements have not been finalized. We believe this is a very complicated issue that involves multiple stakeholders, such as health care companies, doctors and regulators. While this overhang is likely to continue until settlements are agreed upon, we believe our Buy-rated stocks are in a strong financial position, generate significant annual cash flow, and have the ability to plan for any potential costs.

ATTRACTIVE LONG-TERM GROWTH DRIVERS

Favourable Demographic Trends - The U.S. and other developed countries are faced with aging populations. Health care spending jumps dramatically as people age. For example, those over 84 years old in the U.S. use roughly $36,000 of care per person, per year on health care expenses compared with people aged 19-64 who use roughly $8,000 of care per person. 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.

Another demographic trend is the unhealthy lifestyle choices that many people make by eating poorly and not getting enough exercise. As a result, about two-thirds of adult Americans are either overweight or obese (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.

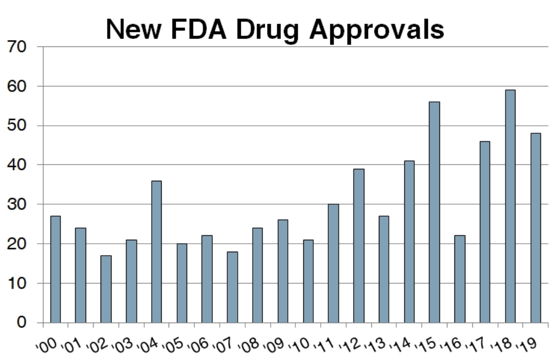
Growth in Emerging Markets - While health care spending continues to grow in the U.S., faster growth is occurring in emerging markets. The most notable emerging markets are the BRIC countries of Brazil, Russia, India, and China. Given the emerging nature of these countries, their spending on health care is relatively low. While U.S. health care spending is over $10,200 per person annually, China spends about $760 and India spends about $240 (see below). In general, as these countries become wealthier, we expect they will increasingly look to become healthier, benefiting many global health care companies.

Country	Health Care Spending per Person	Population (Millions)
U.S.	$10,209	319
China	$762	1,386
India	$238	1,252

Source: OECD 2018

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, medical innovation has picked up markedly.

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 likely lead to better health outcomes at lower costs. We believe innovations such as these have led to an increase in FDA drug approvals.



Source: US Food & Drug Administration

CHALLENGES & RISKS

Health Care Politics and Reform - Growth in health care spending is outpacing economic growth in most developed nations due to medical advances, demographics, administrative costs, and high expectations of care. In the U.S., health care spending is expected to increase from $3.3 trillion in 2016 to $5.4 trillion by 2025 according to the Centers for Medicare and Medicaid. Given this growth, we believe the current trajectory of spending is unsustainable. Significant changes will likely have to be made in the U.S. health care industry, and as a result, we believe that the government will become increasingly involved in health care over the long term. Pricing pressure will be a long-term risk for the sector, in our view.

In the U.S., various proposals exist to try to lower health care costs. Most significant changes would require congressional approval, which could be difficult. However, incremental changes are slowly being implemented. Areas that we believe could face greater pricing-pressure risks are drug companies and, in turn, the health care service companies, such as distributors and pharmacies. While only about 10%-15% of total health care spending is on prescription drugs, drug prices have become more visible as out-of-pocket costs have risen. More and more people are having to pay the list price of a drug, while the negotiated rebates given by drug companies are often used by insurers to lower health care premiums instead of given to the customer directly. In fact, the actual net price received by drug companies after rebates has been declining.

U.S. Election - With the next presidential election approaching, health care rhetoric will only increase, which could cause volatility in share prices. This year has been unique due to the goodwill that health care companies have generated as a result of their role in helping manage and treat the coronavirus. However, the sector has recently underperformed the broader market as the election approaches, and the uncertainty surrounding potential changes to health care reform has grown. A democratic sweep in Congress and the White House could lead to changes to health care reform and drug pricing that could create risks to profits in the sector. However, democratic candidate Joe Biden is not advocating for a "single payer" health care system, which would create the most risk to health care company earnings. His proposals center around incremental changes to the Affordable Care Act and include creating a public insurance option, expanding Medicaid, lowering the Medicare age, and focusing on lowering drug prices. These policies could negatively impact health care service companies, such as insurers, and drug companies. However, we believe the changes would ultimately be manageable. Any election scenario other than a democratic sweep could remove an overhang on the sector, in our view.

A Rapidly Shifting Landscape - The health care landscape is rapidly changing. As payers, politicians and patients increase their calls for high-quality care at lower costs, and with the looming threat of disruption by outside forces such as Amazon, health care companies are being pressured to demonstrate their value with new products, often involving the use of technology, that help lower health care costs.

We believe that the level of investment we are seeing in data analytics (big data) across the health care spectrum, along with the wave of mergers involving health care services companies, reflects these companies' attempts to adapt to this new environment. Due to the changing landscape, two data-driven trends are shaping the industry: personalized medicine and value-based care. In our view, companies that are able to adapt to these trends, use data to lower costs, and deliver innovative products and services will be compensated for the value they add to the system and patients.

- **Personalized Medicine** – Improvements in technology and genomics are enabling the creation of medicines tailored to each patient. Personalized medicine offers the possibility of more effective treatments and reduced side effects.
- **Value-Based Care -** Health care is moving from a fee-for-service to a value-based-care model, where compensation is based on the measured improvement of patient health.

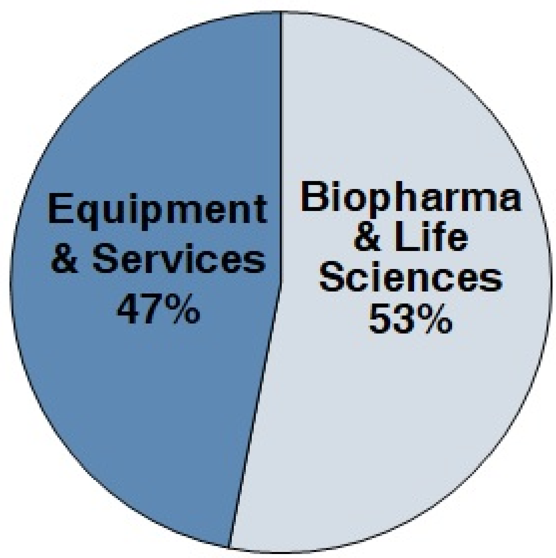
We believe the coronavirus pandemic has accelerated a shift in how patients receive care. We anticipate a continued increase in patient care outside of the traditional hospital, including virtual doctor visits. As where care is received evolves, it will increase the need to have patient health care information and histories more readily available through the use of technology. As technology is used more and more in the health care setting, more efficient processes could help reduce the overall cost of care.

Regulatory Risks and Product Failures - Changes in regulation, such as U.S. FDA policies, represent a key risk for the sector. 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.

HOW TO INVEST IN THE SECTOR

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. However, there are differences between health care subsectors, and we therefore encourage clients to establish a base of holdings with the larger, more diversified companies, and then diversify by adding stocks with more specialized exposure.

THE S&P HEALTH CARE INDEX



Source: FactSet 10/1/20

Biopharmaceuticals & Life Sciences (53% of the Health Care Sector) - Overall, the industry is past its major patent cliff and is in the midst of an impressive uptick in innovation. We believe 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. **Johnson & Johnson (JNJ), Merck (MRK)** and **Thermo Fisher (TMO)** are on the Edward Jones Stock Focus List.

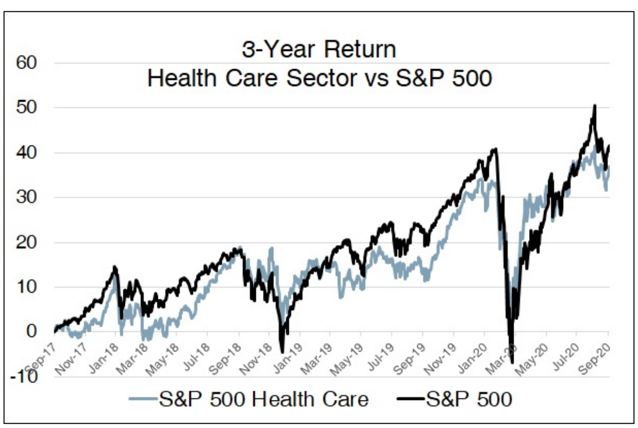
Equipment & Services (47% of the Health Care Sector) – New, innovative products include devices that not only treat diseases, but also have the ability to use a patient's smartphone or tablet to download data from a medical device, such as a pacemaker, and transmit it to their doctor to help diagnose issues. This may allow doctors to make timely treatment decisions, sometimes before a patient even realizes he or she has a problem. We feel the medical device industry is well-positioned to show sustained sales growth for the long term. While valuations tend to be higher for equipment and device manufacturers compared with pharmaceuticals, we think this industry is attractive given the long-term growth opportunities noted above. **Abbott Labs (ABT)** and **Medtronic (MDT)** are on the Edward Jones Stock Focus List.

Health care services encompasses a broad array of industries involved in the distribution and administration of health care, such as insurers and distributors. We prefer health care services firms that add value by containing costs or improving health care outcomes. In this space, we have a Buy rating on **Cigna (CI).**

Health care data and technology will play a growing role in patient care, and we are seeing companies and organizations invest in improving their technological capabilities. We think that **Cerner (CERN)**, a health care IT company that develops software used by hospitals and doctors, is poised to benefit from this trend.

RECENT SECTOR PERFORMANCE

The S&P Health Care Index has slightly underperformed the broader market over the last three years as a result of concerns surrounding potential changes to health care reform and drug pricing in the U.S.



Source: FactSet 9/30/20. These are unmanaged indexes and cannot be invested in directly. Past performance is no guarantee of future results. The S&P 500 Index is based on the average performance of 500 widely held common stocks. The S&P 500 Sector Indexes are subsets of the S&P 500 Index.

Please see the full opinions of the individual companies for additional information, including valuation and risks.

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Ashtyn Evans, CFA

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