Investing in the Health Care Sector

HEALTH CARE SECTOR REPORT

Companies mentioned in this report

Buy-rated:

- Johnson & Johnson (JNJ - $155.76)
- Merck (MRK - $123.85)
- Pfizer (PFE - $27.70)
- Eli Lilly (LLY - $772.86)
- Thermo Fisher (TMO - $580.05)
- Abbott Labs (ABT - $111.50)
- Danaher (DHR - $251.68)
- UnitedHealth Group (UNH - $494.23)
- Medtronic (MDT - $84.04)

Hold-rated:

- Amgen (AMGN- $273.05)

Prices and opinions ratings are as of market close on 3/20/24 and subject to change. Source: Reuters.

For more information:

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Investment Summary

Health care is a large and growing part of the global economy. While we have a favorable 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. **Favorable 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 19.7 times 2024 earnings, which is above their 10-year average of 17.4. The health care P/E is lower than the average P/E of the broader U.S. market based on 2024 earnings. The P/E ratio represents how much investors are paying for each dollar of earnings.

Analyst: John Boylan, CFA

Recent News

Diabetes/Weight-Loss Drugs - Weight-loss drugs that make up a drug class called GLP-1 (glucagon-like peptide-1) have been top of mind for many investors due to their ability to treat diabetes, obesity, and possibly other related diseases. We believe this drug class shows a substantial amount of long-term potential and could change how some diseases are treated.

GLP-1 drugs include Mounjaro, a diabetes drug made by Eli Lilly (Lilly); Lilly's recently approved weight-loss drug for obese patients called Zepbound; and Wegovy, which is manufactured by a European pharmaceutical company. Wegovy also goes by the brand name Ozempic when prescribed for type 2 diabetes. Pfizer and Amgen are in early clinical trials with their own versions of GLP-1 weight-loss drugs. However, we think it is premature to incorporate these drugs into our long-term outlook for Pfizer and Amgen.

GLP-1s are weekly injections, but new, longer-lasting injections and pills are being tested. Researchers are also exploring uses for other diseases. Though GLP-1s offer a lot of promise, there are still many unknowns about long-term adoption. We believe investors are better understanding the significant potential for GLP-1s.

We have a Buy rating on Lilly based in part on the potential that we see for GLP-1 drugs to treat diabetes, obesity, and likely other related diseases. Additionally, it should take time for competitors to enter the market, helping keep Lilly's future earnings growth rate higher than nearly all of its peers. Regarding the impact of GLP-1s on medical-device companies, there are several factors that may offset these drugs' effects on this industry over the long term, and may even help. Therefore, our positive outlook for the device industry is unchanged.

Inflation Reduction Act - The Inflation Reduction Act (IRA) was signed into law by President Biden on August 16, 2022. Part of the IRA allows the U.S. government to negotiate prices directly with drug manufacturers on behalf of the Medicare program. The first 10 drugs facing negotiation were named in August 2023, and the new negotiated prices should go into effect in 2026. The number of drugs that face price negotiations will rise over time, reaching 60 cumulatively by the end of the decade and expand further beyond that.

> We do not see a notable impact on the drug industry, as the number of drugs affected is small and most of the drugs facing negotiation would be nearing their patent expiration dates and could encounter generic competition anyway. We also believe that drug companies could make up for the lower prices of affected drugs by lowering expenses and setting higher prices on new drugs. On a positive note, the IRA eliminates patient co-insurance payments during the catastrophic phase in Medicare and implements a $2,000 cap on out-of-pocket drug costs for the Medicare program starting in 2025. This should help increase the number of drugs sold, as Medicare patients should be better able to afford them. However, like any government program, we may see changes to the IRA over time, and this is something we are monitoring closely.

Attractive Long-Term Growth Drivers

Favorable 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.

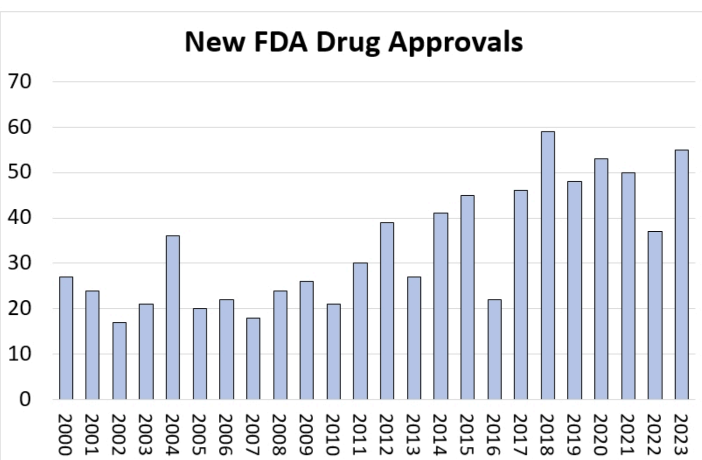
Growth in Emerging Markets - While health care spending continues to grow in the U.S., faster growth is occurring in emerging markets. The most notable emerging markets are the BRIC countries of Brazil, Russia, India, and China. Given the emerging nature of these countries, their spending on health care is relatively low. While U.S. health care spending is over $12,500 per person annually, China spends about $979 and India spends about $212 (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.	$12,555	333
China	$979	1,426
India	$212	1,417

Source: OECD 2022

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. Politics - While Biden has advocated for the expansion of health care reform and lower drug prices, he is not advocating for a full government-pay health care system in the U.S. A narrow Democratic majority in Congress will make it difficult to implement sweeping changes that could meaningfully disrupt earnings growth for the companies in the sector. In our view, health care will continue to be a focus for governments given the rising cost of care. While pricing pressure will remain a risk for stocks, we believe companies that are diversified by product and geography and that have exposure to innovation will be rewarded over time.

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.

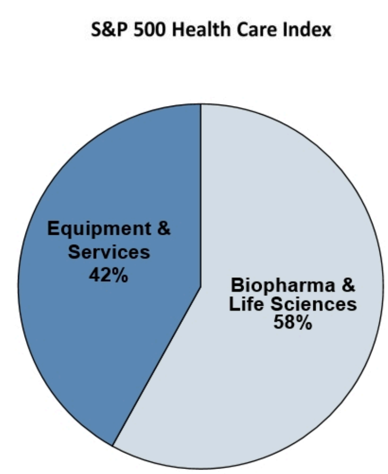
Regulatory Risks and Product Failures - Changes in regulation, such as U.S. FDA policies, represent a key risk for the sector. The FDA has become increasingly focused on safety, which could cause a delay in new products being approved and brought to market. Research & development (R&D) is typically one 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.

Environmental, Social and Governance (ESG) Considerations

ESG risks in the health care sector primarily consist of product safety and quality issues, such as product recalls and liability lawsuits. Business ethics such as policies and practices related to bribery and corruption, particularly in emerging markets, can also create risks. Most of the companies we recommend do a good job of managing these risks. While the financial impact of product liabilities is less meaningful for a larger company, reputational risk can exist in high-profile product issues, and the lawsuits can take many years to resolve. In health care, there are also favorable ESG practices that can create opportunities. Many companies in the sector help improve access to health care in emerging markets by offering products at lower prices to help ensure fairness.

How to Invest in the Sector

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.



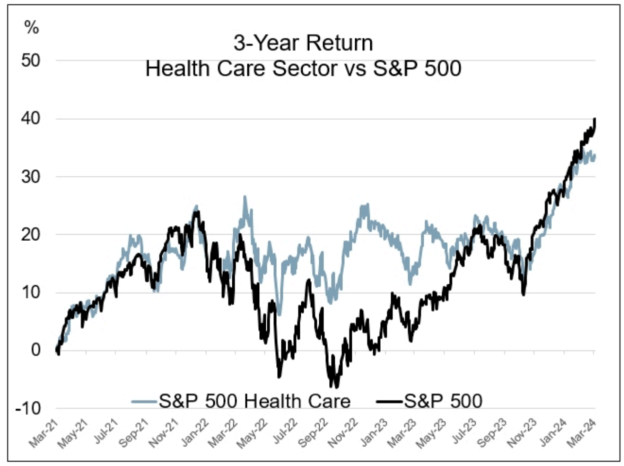
Source: FactSet 3/20/24

Biopharmaceuticals & Life Sciences (58% 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 (42% 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. We have a Buy rating on **UnitedHealth Group (UNH)** and it is on the Edward Jones Stock Focus List**.**

Recent Sector Performance



The S&P Health Care Index has slightly underperformed the broader market over the last three years. This is generally due to political uncertainty as the U.S. presidential election season nears and as the benefits of COVID-19 product sales begin to fade.

Source: FactSet 3/20/24. 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.

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John Boylan, CFA

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