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HEDGE AGAINST VOLATILITY WITH HEALTH CARE STOCKS

Expert portfolio manager explains why Canadian investors who overlook health care stocks are missing out on stable growth and reliable monthly income

CANADIAN INVESTORS looking to manage volatility will find consistency in health care stocks, says Robert Moffat, portfolio manager at Middlefield. "Stability has long been a defining characteristic of the health care sector. Exposure to the rate environment is comparatively minimal, and with steady returns, investing in health care is the perfect solution for today's market conditions," Moffat says.

Health care equities offer investors a mix of defensive qualities and growth. Middlefield's actively managed health care portfolios hold approximately 30 to 40 stable, mature, large-cap companies. These larger, more established entities have historically demonstrated significant resilience during downtrends. Historical US drug volume growth slowed by just one to three percent during earlier recessions, but remained positive. This compares to more discretionary sectors across the market that experienced a significant contraction in sales.

"The health care sector trades at a discount to the broader market," says Moffat. "These lower valuations mean fluctuations in interest rates have less of an impact." Companies within this sector are also less leveraged. "The current net debt-to-EBITDA ratio for the sector as a whole is about 1.2x compared to 1.35x for the broader market," says Moffat, who notes pharma is hovering around 0.85x compared to 1.35x on the S&P.

Health care and portfolio strategy

Health care has a broad set of opportunities that offer varying degrees of risk. "At one end of the spectrum are defensive companies that pay dividends," says Moffat. "Companies in this group, such as pharmaceuticals, display stable and predictable earnings underpinned by diversified businesses – a safe choice in this environment."

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At the other end of the spectrum are the more innovative and disruptive companies – those found in the biotech subsector, for example. "These companies are generally in the earlier stages of their product development. They can be more volatile, but it's important to have some exposure to that high-growth potential."

Biotech and biopharma are currently on the cusp of a multi -decade innovation cycle expected to deliver groundbreaking therapeutics and treatments. They have unique revenue cycles rooted in patent protection that typically offers exclusivity for 12 to 16 years. Toward the end of exclusivity periods, companies either direct resources to R&D or look for M&A opportunities with earlier-stage or mid-cap companies.

"At the end of that period there's a huge fall-off in earnings we need to offset," explains Moffat, who says Middlefield pays close attention to these cycles to introduce new products at strategic intervals to backfill lost revenues.

Fundamentals that count

The needs-based nature of health care products creates inelastic demand that lends itself to recession- and inflation-resistant performances.

"No matter what's happening in the economy, people need to take their medicines and need to fill their prescriptions. Additionally, prescriptions and medication are generally reimbursed by the government or through insurance, which takes the burden off personal and household budgets," says Moffat.

Long-term trends

In 2021, total health spending in Canada reached over $300 billion, or a little over $8,000 per individual, according to the Canadian Institute for Health Information. The 2016 census revealed Canadian seniors now outnumber children for the first time in history. Healthier lifestyle trends are also pushing health care entities to deliver innovations in physical and mental health, fitness, and nutrition. All these factors are driving an upward trajectory in demand for medicines, surgical equipment, medical devices, and managed care that is predicted to affect health care stocks positively for the foreseeable future.

Strategizing the ideal asset mix

"At the beginning of the year we were tilting our health care funds more defensively, adding to industries such as biopharma, health care distributors, and managed care – areas that have stable margin profiles," says Moffat. "More recently we've been taking profits in some of the stocks that are trading at all-time highs and reallocating into some of the higher-growth names that have lagged." Moffat says this includes incremental top-ups in med tech, companies in the life sciences, equipment, and certain services. "Right now, the allocation is roughly in line with the benchmark established by the MSCI World Health Care Index," he says.

Two of the most important industries within the health care sector are med tech and biopharma. Together, they help the investor navigate most market conditions.

"Collectively they represent close to 70 percent of that MSCI benchmark," says Moffat. "Investors can really accomplish a lot by focusing on those two areas."

Other industries that should complement med tech and biopharma include managed care on the defensive side, and the more cyclical industries on the higher-growth side.

"On the defensive side you have managed-care organizations and health care distributors. Health care distributors actually touch over 90 per cent of the pharmaceuticals that are distributed to hospitals, pharmacies, etc. These are examples of companies that have performed extremely well. On the other side are life sciences tools, equipment, and services – the picks and shovels of biopharma R&D engines that unlock the potential of genomics, gene sequencing, and other innovations that are good to include as a complement to core biopharma and med tech industries."

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Moffat says advancements in med tech are especially compelling right now. "This is an area where you're seeing a blend with technologies from other industries. Health care has historically been a little bit slow to innovate, but now we're seeing applications that include AI, digitization, robotics, and remote monitoring of devices."

Tactical stock selection

Health care is the second-biggest weight in the S&P 500. "It's about a 15 percent weight, and in Canada it's less than 50 basis points. Canadians not investing in health care are missing out on a very important sector that drives impressive performance on the S&P," says Moffat, noting that as of

September 30, the S&P 500 health care sector generated an annualized return of 13.7 percent over a 10-year period. That compares to the S&P 500 annualized return of 11.7 percent over the same period. "Two percent annualized over 10 years is significant when you take compounding into consideration," says Moffat.

When the market has sold off significantly, adding risk to the portfolio makes sense. When the market has been on a run, removing risk and positioning more defensively is the better choice. "Unlike past years, when the markets have essentially progressed upward in a straight line, right now it makes more sense to be a little more active. At Middlefield, we monitor markets every day to actively manage funds. We're primarily long-term investors, but when high-quality companies are overly discounted, it makes sense to top-up positions. When stocks have exceeded expectations, it makes sense to trim."

Tomorrow has been 10 years in the making

Markets are moving fast, and health care is an all-weather sector. Its defensive characteristics, underpinned by inelastic demand combined with advancements in new medicines, devices, therapies, robotics, and AI, point to immense growth potential.

Moffat notes many of the products and technologies coming to market now began their clinical trials eight to ten years ago. "If you project today's drug pipelines forward, taking advancements in genomics, AI, and all the other innovations in this sector into consideration, it paints an exciting picture."

Read the full article at www.middlefield.com