Staying Defensive in Healthcare

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Against a challenging backdrop, the healthcare space was one of the best performing sectors in 2018 due to its low sensitivity to global growth. In the following interview, Erin Xie, Head of Health Sciences, Fundamental Active Equity of BlackRock shares her outlook for the healthcare sector and its late-cycle potential to outperform.

Erin Xie,
Head of Health Sciences,
Fundamental Active Equity of BlackRock

Q1 How did the healthcare sector perform overall in 2018 as volatility jolts? Also, as the late-cycle approaches, how do you see the sector performing moving forward?

2018 was an eventful year for global equity markets, with significantly more volatility than in the past 10 years. Performance for the MSCI World Index was more than -5% negative and this was a stark reminder to investors that despite the experience of the last 9 years, equity markets don't always go up and to the right. One of the bright spots during the year was the healthcare sector, which delivered more than 2% over the full year and displayed relative stability in a volatile market.

Looking at the historical analysis of sector performance through market cycles in the past 25 years, healthcare has consistently outperformed other sectors during late cycle and recessionary periods. For example, the healthcare sector has on average outperformed by +7.0% during late cycle periods relative to broad equity markets[1].

The analysis also concluded that the healthcare sector has displayed the least sensitivity to global growth historically. The sector displayed the lowest beta (4.3) versus the quarterly change in real GDP since 1995, compared with a median of 7.7 across the remaining Global Industry Classification Standard (GICS) sectors[2].

With this in mind, we see today's late cycle environment as being an attractive entry point. We continue to hold conviction on healthcare, not solely based on the current market cycle outlook, but also due to the secular growth and product innovation that are underpinning the sector.

Q2 What are the key drivers and catalysts for the healthcare sector?

Healthcare is first and foremost a very idiosyncratic sector. The performance drivers of a mega-cap healthcare insurer are very different than those driving the success of a small-cap early stage biotechnology firm. On a broader basis, two major forces are driving the continuous growth of the sector:

Changing demographics: As fertility declines and life expectancy rises, the proportion of the population above a certain age rises. Population ageing is poised to become one of the most significant social transformations of the twenty-first century, with implications for nearly all sectors of society. Globally, the number of persons aged 80 or over is projected to triple by 2050 (source: UN World Population Database, July 2017).

As people age, their healthcare needs increase across a wide range of sub-sectors including pharmaceuticals, hospital care and medical device, which drive long-term, secular growth for the healthcare sector. It's estimated that a person's healthcare costs triple during the period of life from age 65 and older, relative to the rest of their life cycle. This will have a powerful impact on the proportion of global GDP that is allocated to healthcare, and therefore the growth of the sector from an investment perspective[3]. This secular trend is continuing regardless of what is happening in markets, macroeconomics, or politics.

Innovation in medical devices: Increased innovation in the sector is an additional source of tailwinds. While the biotechnology and pharmaceutical sub-sectors are benefiting from the acceleration in new drug discovery and development, we continue to see broad opportunities in the medical device industry with numerous companies developing innovative products to improve their growth profile.

In addition to the devices themselves, we have seen the development of pioneering surgical methods, which lessen the invasive nature of surgery and ultimately improve the patients' experience and reduce recovery time. The regulatory environment for these innovative devices has also been improving, with approval rates accelerating and duration to receive approval reducing.

Q3 Drilling into sub-sectors (Eg. pharmaceuticals, biotech, medical devices, etc,) within the healthcare space, which segment do you see most innovation and opportunities?

Medical devices and supplies is a sub-sector where we have a favourable outlook due to the product innovation in the space today. One example where we have seen considerable development is in robotic assisted surgery, where surgeons are utilizing robotic components to improve the precision of, amongst other things, joint replacements. When a patient is undergoing a robotic-assisted joint replacement, the surgeon first uses the robotic system to generate a 3-D virtual model of the joint based on a CT scan.

In addition, we continue to see strong drug innovation in both the pharmaceuticals and biotechnology subsectors. In 2018, there were more FDA approvals for new molecular entities (pharmaceutical drugs) and biologics license applications (biotechnology treatments) than in the previous 12 years[4]. Over the past year, our strategy has benefitted particularly from a drug company that exerts drug innovation, thanks to the positive clinical program progress with the FDA. We initiated this position due to the company's strong pipeline in a niche but under-resourced therapy.

Q4 How about valuations, are they looking attractive now post-sell-off? Are you looking to buy, what is the strategy forward?

We believe that the current environment provides an attractive entry point for the healthcare sector, especially given where we are in the business cycle today. It is also important to note that on a valuation basis, the sector continues to look attractive versus broader equity markets and relative to the sector's long-run average on a forward-looking price to earnings basis.

In terms of outlook, our strategy continues to be a diversified, all-weather healthcare strategy that centers around the investment team's bottom-up, fundamental investment process. From an aggregate level, there are two broad themes: innovation and value-based healthcare.

Innovation in medical technology remains a secular growth driver for the sector as companies continue to develop new therapies or products that are either meeting an unmet medical need or improving from current treatments. This encompasses not only biotechnology, but also the pharmaceuticals and medical devices and supplies sub-sectors.

Secondly, for value-based healthcare, our strategy is overweight the healthcare providers and services subsector. It is largely due to the sizeable overweight to the managed care industry which we believe will continue to execute on their underlying businesses and well positioned to leverage their scale and analytical capabilities to lower healthcare costs. Additionally, select healthcare services industry holdings offer business models that provide lower costs options, such as home health, which is an emerging trend in the sector.

Sources
1. BlackRock and Bloomberg, January 1st 1989 to December 31st 2018. Cycles defined using OECD data.
2. BlackRock Investment Institute, with data from Thomson Reuters, Bloomberg and Oxford Economics, November 2018.
3. UN World Population Database, July 2017.
4. Centre for Drug Evaluation and Research, Food and Drug Administration, U.S. Department of Health and Human Services, "CDER New Drugs Program: 2018 Update". Data through 11/30/2018.