Equity Insights | May 2, 2022

A new age of opportunity in health care

Shep Perkins, CFA, Chief Investment Officer, Equities, presents research and insights from Putnam's equity team on market trends and opportunities.

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After being in the spotlight for two years, health care has entered a new phase. Investor concerns — largely dominated by Covid-19 since 2020 — have shifted to inflation, war, and interest rates. Our focus, however, remains on health care, where we see many near-term and long-term trends that we believe bode well for investors in the sector.

A solid foundation: The case for health care over the long term

In this year's volatile market conditions, health care's defensive qualities are worth noting. The sector doesn't tend to be heavily influenced by macroeconomic issues or shifting business cycles. Remarkable innovation, especially in biotech and devices, has helped health care stocks outperform in a range of economic environments. Also, health care currently represents about 17% of U.S. GDP, a figure that is likely to grow due to aging populations across developed countries. Another trend — the opening of emerging market economies to more-advanced health care delivery — is an underappreciated long-term tailwind, in our view.

Why now? The pandemic-to-endemic opportunity

As the Covid pandemic transitions toward an endemic, we see greater opportunities, particularly among stocks that have been left behind by investors. Late last year, the global surge in Covid cases caused by the Omicron variant led to another round of postponements of routine exams, medical screenings, and elective surgeries. Stocks of medical device providers and diagnostic equipment manufacturers declined as patient utilization rates dropped. But by February 2022, the number of Omicron infections had peaked in the U.S., mobility restrictions were again relaxed, and health care utilization rates were on the rise.

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Looking ahead, we expect the volume of patients to return to normal over the next 6 to 12 months. We also forecast an increase in elective procedures and overall health care utilization. While this should benefit many pharmaceutical, biotech, and device companies, they may face inflationary cost pressures. We believe pricing power will be critical, and innovative businesses tend to have the greatest pricing power.

Unmet needs + undervalued stocks = potential opportunities

Health care stocks have felt the pain of this year's market declines. Biotechnology stocks have been among the hardest hit, especially after they declined more than 20% in 2021. Biotech stocks rallied in 2020, when investors were focused on their potential at the height of the pandemic. However, Covid concerns have now eased, and many investors have fled high-growth industries like biotechnology in favor of stocks with lower risk characteristics.

These undervalued stocks present us with compelling investment choices. Innovation remains the main driver of our research focus and stock selection. We seek companies that offer first-in-class or best-in-class drugs or devices that address critical unmet medical needs. Examples include targeted mutations in oncology and treatments for orphan diseases — rare conditions that affect a relatively small number of people. Unprecedented scientific advances are also underway to address needs across larger populations, such as the treatment and prevention of obesity, diabetes, and cardiovascular disease. The outlook for treatments related to Alzheimer's disease is a notable wild card, with much depending on upcoming clinical data.

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Expiring patents and innovation: A perfect storm for M&A

Many large-cap pharmaceutical and biotech firms are facing patent expirations for key drugs and treatments over the next few years. As a result, we expect these firms will seek to build out their product pipelines, a goal that is often achieved through mergers and acquisitions.

Post-pandemic demand should boost life sciences

We have a favorable outlook for the life sciences industry, which comprises a broad group of businesses, such as clinical research organizations (CROs). The underlying fundamentals for the life sciences group remain strong, with research and funding at healthy levels. In addition, we expect the rapid evolution of new cell and gene therapies will increase demand for medical tools and analytical equipment. We also have an optimistic outlook for contract manufacturers serving pharmaceutical and biotech firms, many of which outsource their production to help improve profit margins. Finally, we are monitoring new developments and growth potential related to mRNA, the technology used to develop the world's first Covid vaccine.

Providers and services face the challenge of wage inflation

Some Covid-related pressures continue to impact the health care sector. For health care providers, labor challenges have been pervasive, driving up wage inflation and weighing on margins. Hospitals have experienced increased reliance on temporary staffing and travel nurses, with higher demand driving much higher wages for these workers. Managed care companies adopted a conservative stance for 2022, assuming a cost trend above baseline to account for Covid-related uncertainty. Further Covid-related relief for providers seems unlikely. Barring another significant surge in Covid cases, the U.S. Public Health Emergency should come to an end in 2022. Also, major legislative or regulatory changes seem unlikely to occur ahead of the 2022 midterm elections. In our view, the Medicare Advantage market remains the most attractive growth segment given strong demand trends and lower regulatory and legislative risk.

Examples from our research

We are weighing many new opportunities against risks, such as a difficult reimbursement environment and potential legislative changes. We continue to use bottom-up research to assess the fundamentals and long-term growth potential of businesses across all health care industries.

AbbVie (ABBV). This U.S. biopharmaceutical company faces the challenge of a 2023 patent expiration for its best-selling immunologic drug, Humira. In response, AbbVie has successfully launched two key pipeline assets, Skyrizi and Rinvoq, that we believe are poised to drive the next phase of growth. These drugs address large patient populations, including those suffering from rheumatic arthritis, psoriasis, atopic dermatitis, and other immunologic conditions. AbbVie's purchase of Allergan, manufacturer of the world's leading Botox cosmetic, also provides a catalyst for future growth, in our view.

UnitedHealth Group (UNH). This managed health care and insurance company serves all key subsegments of managed care, including patients enrolled in Medicare, Medicare Advantage, and Medicaid. The company's fastest-growing business, Optum, provides technology and managed services solutions to hospitals, physicians, health plans, governments, and life sciences companies. In our view, Optum's focus on making health care more affordable and equitable can provide a long runway for growth.

From pharma and biotech to devices and providers, our research goes far beyond screening. We dig deep with extensive due diligence, including meetings and conversations with medical experts, physicians, and company managements. As Covid concerns ease and investors focus elsewhere, we remain bullish on health care investing, which we believe includes promising emerging and long-term trends and opportunities across a range of industries.

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Putnam Global Health Care Fund holdings as of 3/31/22: AbbVie (6.36%); UnitedHealth Group (8.83%).

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