Review & Outlook

THIRD QUARTER 2015

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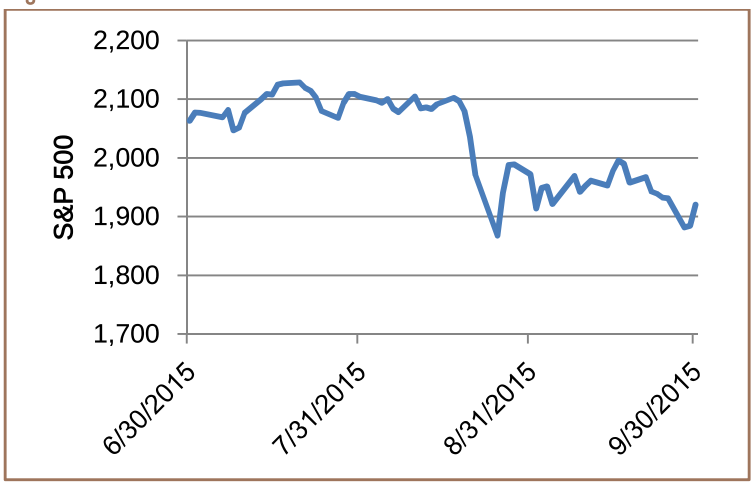
Review

The third quarter of 2015 was a rough one. With a total return of -6.44%, the S&P 500 index ended its worst quarter in four years. The second half of the quarter was particularly difficult, as illustrated in Figure 1.

All of the stock capitalization categories had a tough quarter. Healthcare stocks have been the best performers for many quarters, but struggled in the 3rd quarter with pending changes to healthcare coding protocols, talk of regulations that would affect pharmaceuticals, and other factors. Energy stocks started declining in value in the 4th quarter of 2014, and have struggled ever since.

Figure 1: S&P 500 Index Performance[1]



Outlook

In previous quarters, we based our outlook on the strength of the domestic economy, and the impact on corporate earnings. We continue to think the U.S. economy will do well in terms of employment growth and low inflation. However, the weak global economy is hurting enough large U.S. companies to be something of a drag on U.S. data. The Federal Reserve is now looking at the global economy, along with stock and credit markets, as it struggles to decide when to start raising interest rates.

The June forecast from the National Association for Business Economics called for GDP growth to reach an annualized rate of 3% in the third and fourth quarters of 2015.[2] We expect the actual numbers to be a bit lower when they are released later this year, given the headwinds from Europe and China. We also think the next consensus forecast from NABE economists (expected in December) will be less optimistic than their June forecast.

We saw glimpses of these problems in early June and became more defensive with our portfolios, especially as concerns about a downturn in the Chinese economy began to trump anything that Greece was stirring up. We continue to analyze the possible impact of these factors, and remain relatively defensive with our investing. However, the decline in stock prices is resulting in more favorable valuations, so we believe there will be more attractive investment opportunities in the near future.

In Focus

The best performing market sector in recent years has been Healthcare. In fact, every industry group within the Healthcare sector has outperformed the S&P 500's average over the past several years, and that sector now accounts for 14.7% of the entire S&P 500 index.

Industry groups within the Healthcare sector include: Healthcare Equipment and Supplies; Healthcare Providers and Services; Healthcare Technology; Biotechnology; Pharmaceuticals; and Life Sciences and Tools.

Most of the industry groups within the Healthcare sector are fairly self-explanatory. Large healthcare insurers fall within Healthcare Providers and Services, as do hospitals. This means that even within a particular industry group there is some significant variation among the underlying business models. One company we have owned for some time (and which we recently sold), ICON PLC, undertakes clinical trials, and falls within the Life Sciences and Tools industry group. Of all the industry groups within the Healthcare sector, the stand-out, high flier has been Biotechnology, followed by Pharmaceuticals and Life Sciences and Tools.

There are plenty of reasons why this sector should be a good place to invest money over the next 20 years: the population is aging, and older folks tend to spend more on health care. According to U.S. census data, the U.S. population grew 9.7% from 2000 to 2010. However, the numbers of 65 and older grew 15.1%, and those in the age group 65 to 69 grew 30.4%. Many other countries are experiencing similar trends in terms of aging.

Market Index Performance Data: Total Return (%)[5]

Index	As of 9/30/2015 Q3 2015	Trailing 12 Months
S&P 500 Index	-6.44%	-0.61%
S&P 400 Index	-8.50%	1.40%
Barclay's Capital Intermediate-Term U.S. Government/Credit[3]	0.95%	2.68%
Barclay's Capital U.S. Treasury 1-3 Years	0.30%	1.19%

The investment thesis, however, is complicated by a high level of government spending in healthcare. This high level of spending means that government policy related to healthcare expenditures matters a lot when it comes to the potential earnings of companies operating within this sector, and that matters when thinking about the value of different investment options in the sector.

In the United States, health care expenditures accounted for $2.9 trillion in 2013, or 17.4% of the Gross Domestic Product (GDP). This is equivalent to $9,255 per person. Total government spending on healthcare is 43% of the total, approximately $1.25 trillion, or 7.5% of GDP (or $3,967 per person).[3] Government expenditures on healthcare in the United States are similar to or higher than Government expenditures in most other developed countries. For example, in Canada about 7.7% of GDP is government spending on healthcare, or $3,255 (U.S.) per person.

Given its sizable role, government is active in efforts to control the rising cost of health care in the U.S. One of many areas that has attracted increased attention of late is the high (and rising) cost of pharmaceuticals in the U.S. It is apparent that pharmaceutical pricing is going to become a major campaign issue in the upcoming presidential election.

Not only are there easy villains, like the hedge fund manager who bought rights to a long used generic drug, then attempted to raise the price from $13.50 to $750 per pill, there is also demographic pressure where the number of people most directly affected by pharmaceutical prices is increasing dramatically, and, moreover, those folks tend to vote. According to recent polls, 83% of the American public thinks the federal government should be able to negotiate with drug makers to determine the prices that Medicare pays, something currently prohibited by law. So it really should not have been surprising when Hillary Clinton recently released a proposed pharmaceutical policy that would disallow tax write-offs of consumer advertising expenses for drugs, allow Medicare to directly negotiate drug prices, allow drug imports from abroad, and more.[4]

We understand the rationale and public policy goals behind her proposed policy. However, we believe the level of attention that high drug prices is getting should give pause to anyone considering investing money in the drug related areas of the health care sector. We also think Mrs. Clinton's proposal is likely to result in debates about policy changes that will last beyond the current campaign, and might result in actual policy changes. The debates and/or the policy changes will likely affect the earnings of pharmaceutical companies and, therefore, their stock prices.

1. Figure 1: S&P 500 Index performance chart from www.finance.yahoo.com.
2. http://www.nabe.com/NABE_Outlook_June_2015.
3. https://www.cms.gov/research-statistics-data-and-systems/statistics-trends-and-reports/nationalhealthexpenddata/nhe-fact-sheet.html.
4. http://www.usatoday.com/story/news/politics/elections/2015/09/22/hillary-clinton-prescription-drug-plan/72598898/.
5. S&P 500 Data: http://us.spindices.com/indices/equity/sp-500. S&P 400 Data: http://us.spindices.com/indices/equity/sp-400.
   Barclay's Index Data: https://index.barcap.com/Benchmark_Indices/Aggregate/Bond_Indices.