AllianceBernstein

International Health Care Portfolio

Market Overview

Health care stocks fell in May, but outperformed the overall market during a tumultuous month for global equities. Economic turmoil in Greece drove fears of European contagion, leading to declines in the euro and global stock markets.

Within the health care sector, medical service stocks outperformed, biotechnology and medical product stocks underperformed, and pharmaceutical stocks were essentially in line. Corporate earnings and clinical data dominated the month's headlines.

Shares of McKesson increased after the company reported fiscal fourth-quarter earnings and issued fiscal 2011 guidance that was above expectations. While earnings in the quarter were slightly below estimates, up 3% versus the prior year's quarter, investors were relieved by management's forecast for the coming year, which calls for earnings to grow by 3-7%. The company also announced a new US$1 billion share repurchase program.

Vertex announced very positive results from its highly anticipated phase 3 study evaluating key compound telaprevir in "treatment-naïve" hepatitis C (HCV) patients. The cure rate of 75% in the trial came in at the high end of analyst forecasts, while adverse events were lower than expected. Overall, the data bodes well for results from the drug's remaining two pivotal trials, which will be reported later this year, with a regulatory filing expected by year end. The strong cure rate also sets a high bar for the competitive hepatitis product from Merck, which will report its own set of phase 3 study results later this year.

Fresenius Medical Care reported solid first-quarter results. Sales grew 13%, topping consensus estimates, while earnings per share (EPS) were in line, up 6%. The results included solid growth in dialysis care, which was driven by increases in both volume and revenue per treatment. For 2010, the company reiterated its guidance for revenues to rise at least 7% and profit to rise 7%-10%.

Merck issued results for the first quarter that topped consensus estimates on both the top and bottom lines. Higher drug sales and lower operating expenses drove significant earnings upside versus consensus. Management also announced initial guidance for 2010, which calls for sales growth of more than 65%, aided by the acquisition of Schering-Plough, and adjusted earnings growth in the low single digits. Importantly, the company continues to project that adjusted earnings will increase at a high single-digit compound rate over the next four years.

Edwards Lifesciences shares moved higher after the company reported positive results for its next-generation transcatheter aortic heart valve Sapien in a 1000-patient European post-approval registry. One-year survival in the key transfemoral arm (in which patients have the valve implanted through the femoral artery) was 81%, which was viewed as quite strong considering the very sick nature of the registry's patients. The results are being viewed as a positive indicator for the US pivotal trial, which will present results from one of its cohorts in September. If the cohort meets its primary endpoint, the company intends to file for US approval of the Sapien valve before year-end, with approval expected in 2011.

Teva reported a solid first quarter, with in-line sales and better-than-expected earnings. Revenues rose 16%, driven by strong North America sales and robust global sales of the multiple sclerosis drug Copaxone, while adjusted EPS grew 31% from the prior year's quarter, aided by a higher gross margin and lower R&D expense. For the full year the company continues to expect revenues to grow 15% and adjusted earnings to increase at least 30%.

Volcano delivered another solid quarter, with revenues increasing a better-than-anticipated 36% over the prior year, paced by rapid growth in both of its major segments. Intravascular ultrasound (IVUS) products rose 26%, while functional measurement (FM) sales rose an impressive 67%. While higher-than-expected expenses in the quarter produced a net loss, the company reiterated its guidance for 200 to 300 basis points of gross margin expansion in 2010, driving a transition to sustained profitability. In addition the company expects annual sales to grow 22%-24%.

Portfolio Commentary

Trading in the Portfolio was fairly active during the month, though this was mostly due to small adds and trims around relative stock performance.

In the pharmacy-benefit manager (PBM) space, we reduced our weighting of Medco and increased our holding of rival Express Scripts. We expect Express to benefit not only from the industry-wide wave of generic drug launches, but also from synergies attributable to the company's acquisition of WellPoint's PBM.

Other purchases of note included adding to positions in Bristol Myers, Celgene and Human Genome Sciences. Other noteworthy sales included trims of Edwards, Hospira and McKesson, all on outperformance.

Contributing to returns in May were positions in McKesson, Express Scripts and Edwards. Detracting from returns were positions in Celgene, Roche and Covidien.

The Portfolio is overweight biotechnology and medical services, and underweight pharmaceuticals and medical products.

Outlook

Although volatile markets may tempt investors to question their investment strategy, we believe it is best to stay the course and maintain a long-term investment approach.

Health care's traditionally defensive image and stable growth potential make it an appealing sector in the face of ongoing economic uncertainty. In addition, major secular trends, particularly an aging global population, will continue to drive increased spending in many areas of health care for the foreseeable future. In this environment, cost-cutting is important, and we continue to emphasize several companies that should benefit from the significant wave of generic drug utilization.

Furthermore, the uncertainty surrounding US health care reform has been a significant overhang for the sector for much of the past year. As a result, the health care space is attractively valued relative to the overall market. We believe that the recent resolution of the health care reform issue could serve as a positive catalyst for health care stocks and help drive multiple expansions for the sector going forward.

Over the long-term, health care industries and stocks with consistent stable growth and solid fundamentals tend to demonstrate relative strength. We would continue to favor stocks that exhibit such criteria, particularly those that we believe will exceed consensus expectations.