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## Healthcare Industry In Uncertain Times

### Executive Summary

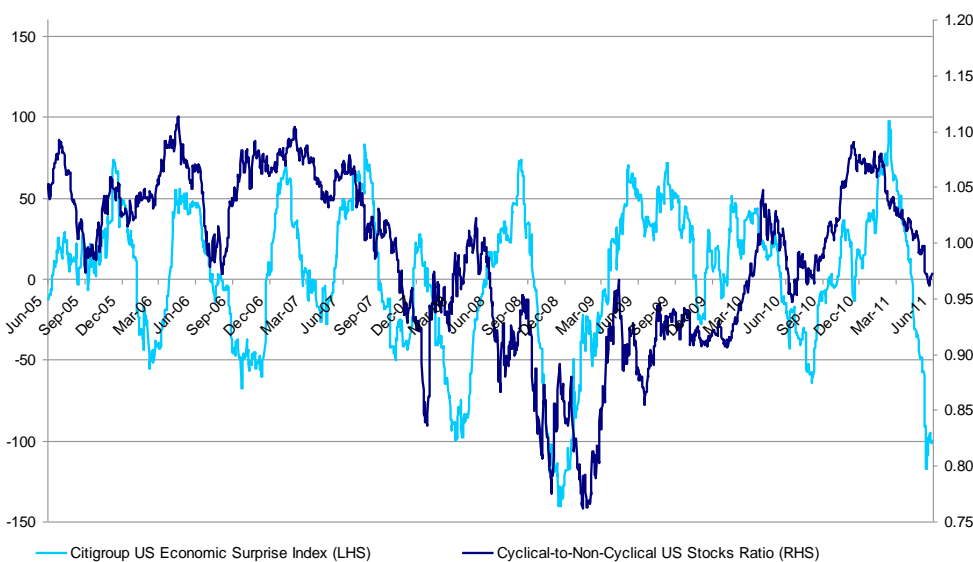
- The recent increase in negative US economic surprise could drive non-cyclical stocks to outperform cyclical stocks according to historical trend.
- Overall, non-cyclical sectors have lower risks as compared to selected regional equities based on maximum drawdown and volatility in the 1 and 3 year period. The MSCI World Healthcare Index outperformed the MSCI World Index on the YTD and 3-year basis, with lower volatility and maximum drawdown.
- The EPS of MSCI World Healthcare Index has illustrated a significantly more stable growth trend as compared to the MSCI World Index in the past 10 years.
- Earnings growth of healthcare industry is likely to be supported by increasing healthcare expenditure globally, and especially in US.

### Introduction

Recent weaker economic data, coupled with the ongoing Europe debt crisis, lead a retracement in the equities market as the MSCI World Index fell 2.78 percent in the 1-month period ending 22 June 2011. Given the uncertainty surrounding the outcome of Europe debt crisis and growth of China and US, investors can consider adding healthcare-related stocks to their portfolio for return and risk reduction purposes. This article aim to discuss opportunities in healthcare equities during uncertain times.

### Chart 1: Positive Relationship Between US Economic Surprise and Cyclical-to-non-cyclical US Stock Ratio

**Cyclical-to-Non-Cyclical US Stocks vs U.S. Economic Surprise**



*Citigroup US Economic Surprise Index demonstrated a positive relationship with cyclical-to-non-cyclical US stocks ratio in the past 6 years.*

Source: Bloomberg, as of 20 Jun 2011



**Negative Economic Surprises Could Drive Non-cyclical Stocks to Outperform**

The Citigroup US Economic Surprise Index measures actual economic data relative to economist estimates. A positive (negative) reading of the index suggests that US economic data released have, on balance, beat (lagged) consensus estimates. As shown in Chart 1, the Citigroup US Economic Surprise Index has demonstrated a positive relationship with the cyclical-to-non-cyclical US stocks ratio, which measures the relative performance of cyclical against non-cyclical US stocks. Cyclical stocks tend to perform better during periods of economic growth, possibly explaining the rise in cyclical-to-non-cyclical US stock ratio when positive economic surprises increase and vice versa.

In the recent three month period, the Citigroup US Economic Surprise Index has fallen sharply to near the -100 region, which was last seen during the 2008-2009 financial crisis. Although the cyclical-to-non-cyclical US stock ratio has fallen along with the economic surprise index, its level remains higher than that witnessed during previous periods where the index was near the -100 region. If economic data continues to surprise on the downside as compared to consensus estimates, non-cyclical stocks might outperform cyclical stocks according to historical relationship previously demonstrated.

**Healthcare Sector Outperform World Equities on YTD and 3-Year Basis**

Non-cyclical industries are usually not affected significantly by economic cycles. Examples of non-cyclical industries include healthcare, telecommunication and utilities. These industries produce goods or services that are necessities, so they are likely to enjoy relatively stable demand, even during economic downturns.

Table 1 compares the returns and risks of various non-cyclical sector indices against selected regional indices. In terms of performance, the MSCI World Healthcare and Telecom Index stood out as they outperformed the selected regional indices in most of the periods used. On the risks front, the MSCI World Healthcare Index has the lowest 3 year maximum drawdown and 1-year and 3-year volatility. Overall, the risks of non-cyclical sectors are lower as compared to the regional indices, as demonstrated by their lower maximum drawdown and volatility. Given the uncertainties surrounding the markets, the lower risk of healthcare, possibly contributed by its resilient earnings, is likely to benefit investors. Moreover, the outperformance of healthcare sector are likely to be fueled by its rising healthcare expenditure around the globe.

**Table 1: Healthcare Equities Outperforms with Lower Risks**

| Index                        | YTD Return % | 1 Yr Return % | 3 Yr Ann. Return% | 3 Yr Max Drawdown | 1 Yr Vol     | 3 Yr Ann. Vol |
|------------------------------|--------------|---------------|-------------------|-------------------|--------------|---------------|
| MSCI AC Asia Pac ex Japan    | 0.36         | 27.97         | 6.90              | -52.93            | 17.76        | 31.08         |
| MSCI Emerging Markets        | -0.37        | 26.39         | 4.00              | -57.69            | 16.65        | 33.26         |
| MSCI Europe                  | 0.23         | 14.28         | 1.10              | -45.19            | 17.10        | 27.95         |
| MSCI World                   | 4.26         | 29.56         | 0.65              | -49.95            | 15.57        | 26.77         |
| <b>MSCI World Healthcare</b> | <b>12.75</b> | <b>28.05</b>  | <b>6.52</b>       | <b>-34.38</b>     | <b>12.05</b> | <b>21.36</b>  |
| MSCI World Telecom           | 7.28         | 34.23         | 3.55              | -37.68            | 14.51        | 23.76         |
| MSCI World Utilities         | 2.74         | 17.09         | -6.35             | NA                | 13.80        | 23.35         |

*The MSCI World Healthcare Index outperformed the MSCI World Index on the YTD and 3-year basis, with lower volatility and maximum drawdown.*

Source: Bloomberg, as of 28 June 2011

\*Returns are calculated assuming dividends are reinvested.

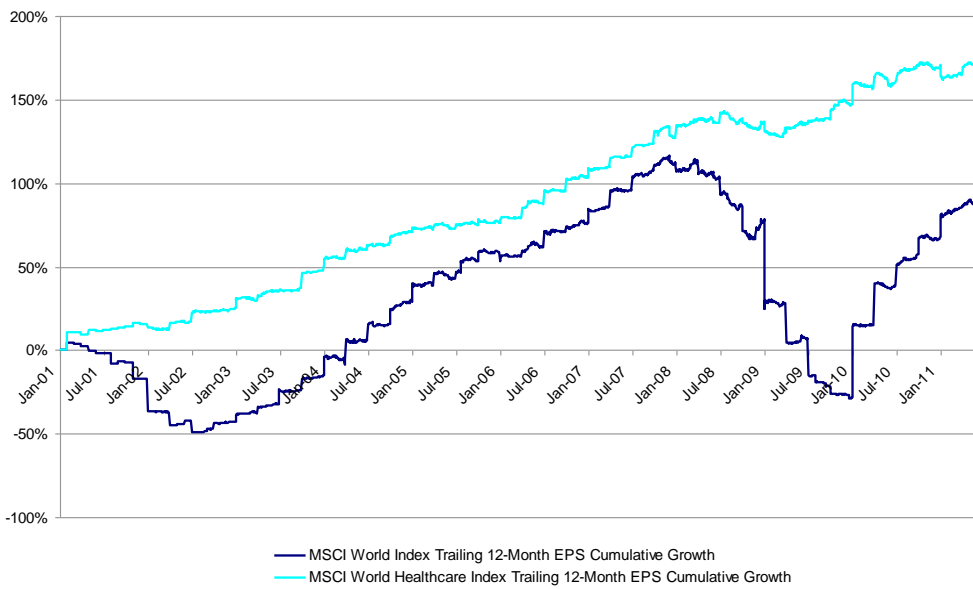


**Resilience in Healthcare EPS**

Earning is a significant factor that determines companies' profitability, and tends to affect stock prices directly. Non-cyclical companies, given their defensive nature, should generate more stable earnings and profitability as compared to cyclical companies. This trait is illustrated in Chart 2, which shows that cumulative earnings-per-share (EPS) growth of the MSCI World Healthcare Index had a much more stable upward trend as compared to the MSCI World Index in the past 10 years. In addition, the MSCI World Healthcare Index EPS only fell by 1 percent in 2008 while the MSCI World Index EPS fell by 40 percent, again demonstrating the resilience of healthcare companies' earnings. In view of the global financial crisis in 2008-09, the resilience in healthcare earnings might be one of the factors that attributed to the lower volatility and maximum drawdown of healthcare equities.

**Chart 2: Greater Stability in Healthcare EPS Growth**

**Trailing 12-Month Earnings-Per-Share Cumulative Growth**



*The EPS growth of MSCI World Healthcare Index illustrated a more stable trend as compared to the MSCI World Index.*

Source: Bloomberg, as of 20 June 2011

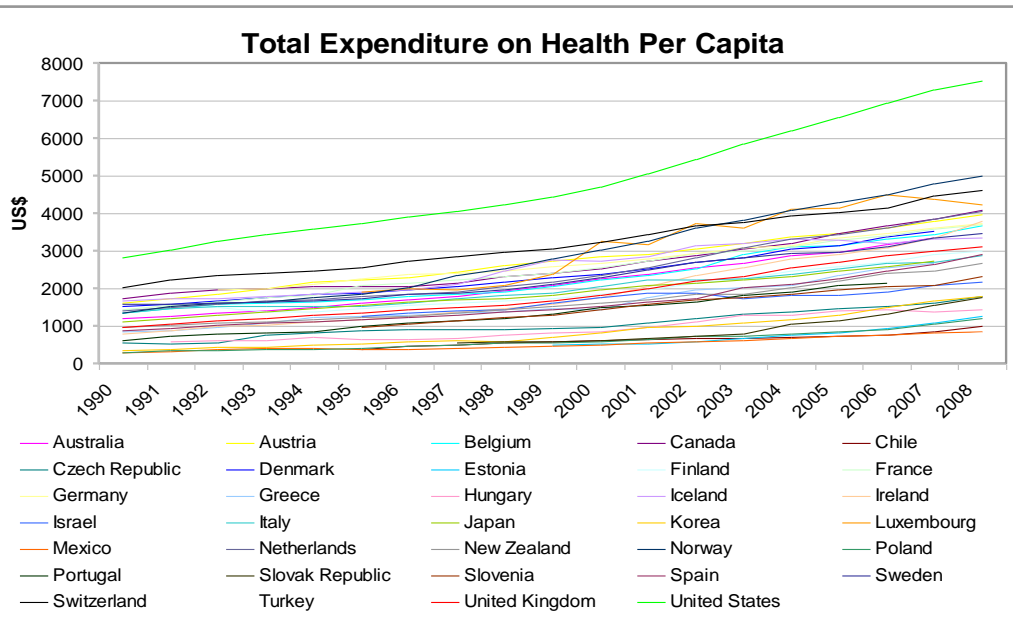
**Healthcare Earnings Growth Likely To Be Supported**

Aside from stability of earnings, we note from Chart 2 that healthcare company earnings have grown significantly in the past ten years. One contributing factor for the earnings growth could be increasing healthcare related expenditure globally and especially in US, which has the highest healthcare expenditure per capital and as a percentage of GDP in 2008, according to World Health Organisation.

Chart 3 illustrates the total expenditure on health, per capita, for OECD members since 1990 to 2008. Overall, healthcare expenditures have witnessed relatively steady upward trends in the past 18 years. Possible factors that might have attributed to the rising healthcare expenditure can be aging population, air pollution or higher obesity rate. As these factors will probably not change drastically in the next couple of years, we are likely to witness a continued trend in healthcare expenditures and healthcare company earnings.



**Chart 3: Growing Total Expenditure on Health Per Capita**

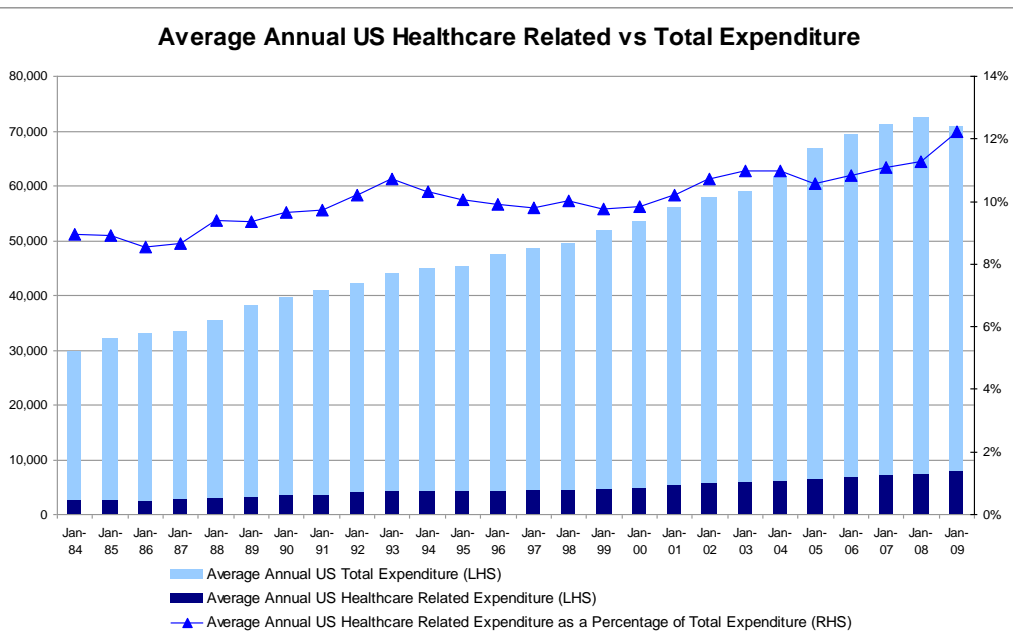


*Global healthcare expenditure have been rising steadily from 1990 to 2008, with US leading the pack.*

Source: OECD, as of Oct 2010

From Chart 3, we also note that US has the highest healthcare expenditure among the OECD members and did a closer inspection at US healthcare expenditures. The healthcare and total expenditures per American family has shown steady upward trend in the past 26 years. (Chart 4) In addition, healthcare expenditure has an annual growth of 4.8 percent, higher than annual inflation of 2.6 percent between 2005-09. As we expect this trend to continue on the back of demographic changes such as aging population and greater prevalence of chronic diseases, healthcare earnings are likely to be supported by the rising health-related expenditure.

**Chart 4: Growing Healthcare-related Expenditure in US**



*Healthcare related expenditure has been increasing both in the absolute term and as a percentage of total expenditure.*

Source: Bloomberg, as of 20 June 2011



## Risk

As mentioned previously, non-cyclical sectors tend to outperform cyclical sectors when economic data surprise on the downside as compared to consensus estimates, usually during economic downturns. Intuitively, if economic conditions improves from hereon, non-cyclical sectors may underperform as compared to their cyclical counterparts. Therefore, we feel that investments into defensive sectors are more suitable for investors who are of the view that economic growth will slow in the coming quarters, but would like to maintain their exposure in equities.

In addition, despite having lower volatility and risks, healthcare equities are still susceptible to risks that affects equities to a certain extent. Therefore, healthcare equities is likely to be affected during periods of sharp equities sell-off as well. That being said, it is still likely to have risk reduction benefits within an equities portfolio given its lower volatility and maximum drawdown.

## Conclusion

Given the recent influx of negative economic surprises, non-cyclical stocks might outperform cyclical stocks according to historical trends. Healthcare belongs to the non-cyclical category as it is relatively independent on economic cycles. Healthcare equities have outperformed the various regional indices in the past 1-year and 3-year period, with lower risks as demonstrated by volatility and maximum drawdown. Healthcare equities EPS growth exhibits a more stable trend as compared to world equities, highlighting its resilience during economic downturns. Moreover, the growth of healthcare industry is likely to be supported by increasing healthcare expenditure globally and especially in US. With the abovementioned factors, we feel that the healthcare industry could be a possible investment avenue, for both return and risk reduction purposes.



**Fund in Focus – UOB United Healthcare Fund**

One possible way of gaining exposure into healthcare companies would be through unit trusts with a focus on healthcare equities. Investing into unit trusts offer benefits such as diversification and professional management. Risks of such an investment include, but are not limited to, liquidity, single sector and equities risks.

There are four healthcare related unit trusts listed on Phillip Capital's platform listed in Table 2. Lion Global - Healthcare Investment A invests more than 95 percent into the Fidelity - Global Health Care A as of the latest factsheet. In terms of country allocation, Fidelity - Global Health Care A has approximately 48.5 percent in United States with the rest mainly spread across several developed nations, while AB - International Health Care Portfolio A and UOB - United Global Healthcare has over 70 percent in United States. United States has the highest total healthcare expenditure both as a percentage of GDP and in absolute term. Despite the healthcare reforms adopted to lower healthcare costs in US, demographic trends such as aging population and high obesity are likely to continue to fuel the ongoing momentum of growth in the healthcare sector. Therefore, we favor funds with higher allocation into US healthcare equities given their growth prospects.

**Table 2: Equities Pharma and Health Unit Trust**

| Name                                           | 1 Mth Return | YTD Return | 1 Yr Return | 3 Yr Return (Ann.) | 1 Yr Max Drawdown | 1 Yr Vol | 3 Yr Vol (Ann.) | 1 Yr Sharpe Ratio | 3 Yr Sharpe Ratio |
|------------------------------------------------|--------------|------------|-------------|--------------------|-------------------|----------|-----------------|-------------------|-------------------|
| AB - International Health Care Portfolio A SGD | -4.16        | 4.03       | 1.89        | -1.83              | -7.15             | 10.27    | 18.91           | 0                 | 0                 |
| Fidelity - Global Health Care A Inc EUR        | -2.12        | 5.46       | 5.97        | 2.07               | -5.81             | 9        | 18.51           | 0.48              | 0.06              |
| Lion Global - Healthcare Investment A Acc      | -2.73        | 4.33       | 3.84        | -2.11              | -6.05             | 8.96     | 20.63           | 0.35              | -0.01             |
| UOB - United Global Healthcare SGD             | -1.4         | 7.75       | 11.28       | 4.76               | -5.35             | 9.53     | 19.27           | 0.85              | 0.2               |

Source: *Financial Express*, as of 20 June 2011

In terms of performance comparison, UOB - United Global Healthcare has consistently outperformed the other three funds in all the time periods used. Its risk, as measured by volatility, is slightly higher, but its risk adjusted return, as measured by Sharpe ratio, outperformed its peers. In addition, it is the only fund to outperform its benchmark in 3-year, 5-year, 10-year periods and since inception.

Overall, we prefer UOB - United Global Healthcare due to his higher allocation into US, better risk-adjusted return and outperformance against its benchmark.



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