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Disruption Outlook: The Politics of Healthcare

Disruptive Forces in Investing

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Anu Rajakumar: From Brexit to the U.S. China trade negotiations to the upcoming U.S. election, global financial markets continue to be challenged by an ongoing wave of political uncertainty. And as we head into 2020, this trend is likely to continue. My name is Anu Rajakumar and on the next several episodes of Disruptive Forces, we'll be diving into political disruptions that are affecting a variety of markets and sectors and their investment implications. Today, I'm pleased to be joined by Ari Singh, Senior Research Analyst on Neuberger Berman's Global Equity Research team specializing in healthcare. Ari, thank you for being here.

Ari Singh: It's good to be here.

Anu: So, Ari, it's clear that healthcare has seen a tough year, lagging the broader U.S. equity market year to date and it's now mid-November 2019. Talk about the key drivers that have weighed on your sector this year.

Ari: Well, first of all, you're correct that healthcare has lagged the larger market. The S&P 500 Healthcare Total Return Index is up year to date. However, the group overall is lagging the S&P 500 Total Return Index. Healthcare services stocks— those are companies that effectively don't make widgets but operate in the healthcare ecosystem. So, think health insurers, drug stores, healthcare IT companies, hospitals, et cetera. The underperformance I would argue is a confluence of a number of factors, the first being rotation to more economically sensitive sectors. This sector outperformed in 2018 by 10 points as it was viewed as a safe haven as the federal reserve was raising interest rates and China trade tensions were increasing. This year, the opposite has played out, and there has definitely been a repositioning to more economically sensitive names and that has hurt the healthcare services sector. Just look at the semiconductor index, which was down 8 percent last year and up about 50 percent this year. The home builders ETF was down 27 percent last year and up about 41 percent this year. The money has to come from somewhere and healthcare services, as well as overall healthcare, has probably contributed to those sectors' gains. The second point I would make is that there's definitely policy/political fears weighing on this sector as you suggested before. It doesn't help that there's a lot of noise coming out of D.C., whether it's the presidential candidates who are pushing Medicare for All or some version of Medicare being expanded to the federal court system looking at Obamacare and weighing in on the constitutionality of that bill. Or third, the senate finance committee or really all of Congress looking at drug price reform. Finally, I would say the third issue would've been fundamentals. Overall this sector has been okay but it hasn't been great and there have been some notable misses. So, put it all together and it leads to an underperforming year.

Anu: Now, we'll come back to politics in just a second, Ari. But before we go there, not everything in the healthcare sector has underperformed this year. Where have you seen bright spots?

Ari: Well, there have actually been very few bright spots. But out of the 26 names in the Russell 2000 Healthcare Services benchmark, six of them have outperformed the S&P 500 year to date. Of that group, I would say there are a couple themes to note. A couple names were take-outs. There was one massive capital deployment story that caught the market off guard. Activism was factor. And then we also had a turnaround story. But they were all unique situations in my mind.

Anu: Okay. So, now to the juicy stuff. If we shift back to presidential politics, a number of democratic candidates favor implementing Medicare for All as you mentioned. What's your reaction to that as an equity research analyst?

Ari: Yes. I'm very mindful of policy and I'm mindful of all the plans that have been proposed by the presidential candidates. Medicare for All seems to come up the most in my conversations with portfolio managers. From my vantage point, it's hard to imagine Medicare for All becoming the law of the land. Congress has a tough time passing big bills, especially in recent years. Just look at repeal and replace. Back in 2016 after President Trump won the election, people thought it was a certainty, a foregone conclusion, that repeal and replace would become reality. It did not. Even if the democrats win the senate, the majority is likely to be slim, and at least three senators, I'm quoting the senator from New Jersey, the senator from West Virginia and the senator from Arizona, have basically come out against Medicare for All. So, that is something to keep in mind. They simply do not have the votes right now. So, you could push back and say to me, "Well, what about the public option that I'm hearing about? Or Medicare for all those who want it?" Well, they're nice soundbites but it's unclear to me if they can get implemented nationwide. For example, Washington state just rolled out a public option and the expenses are actually came in higher than expected initially because they had to change the rates they were going to pay providers because of serious pushback in that marketplace. We'll see what the uptake is for the public option in that state. But the bigger point as you take this nationwide is that the costs will most likely be higher than advertised. And from my vantage point, policy makers always choose to maintain access versus lower price points. That is just simply the American way. They're not going to allow hospitals to close down and they would definitely threaten to close down if Medicare payment rates were applied across the board. Also, people don't fully understand the Medicare benefit design. They think it's perfect but in fact it is not. For example, take maternity benefits. Most people probably don't know that Medicare has a maternity benefit. Well, elective abortions are not covered under Medicare currently. That's part of the Hyde amendment. So, it's hard to imagine progressives wanting to take that away from women. So, put it all together and it's tough to see a path forward for any of these proposals becoming a reality. But they do go over well with the progressive community. I always tell people to remember the following cliché. The more things change, the more they stay the same and that is very applicable to healthcare.

Anu: So, based on what you've just said, it sort of sounds like in the case that a democratic candidate is elected president, not much could really change.

Ari: Well, I hope there would be some change. But I'm just talking more about baby steps, not wholesale change. If you step back and ask yourself why is Medicare for All so popular? It's because people aren't satisfied with the status quo and want something different. That was the same thing behind repeal and replaces popularity. People weren't happy with the status quo. They wanted something different. There was a nice soundbite with repeal and replace. And it wasn't until people actually saw the bill that they realized, "No. This is worse than the status quo," and it didn't become reality. People see their current coverage as unaffordable. The benefits package in the commercial market is too skimpy. You know, some people don't have dental coverage, vision coverage, et cetera. And people would feel much more comfortable if they were always guaranteed some form of coverage regardless of their employment status. Anything that the future administration does to plug those holes would definitely be a benefit for the sector and a good thing, I think, for Americans across the board. Yes, under a democratic president, the regulatory environment could become more difficult. But healthcare services companies are very good at adapting to changing environments and I think they would be able to figure it out.

Anu: So, that's a good lead in to my next question. How do you think about stock selection given this political uncertainty in the early stage of the election cycle? Is it sort of best to wait until after super Tuesday to really start pricing predictions in?

Ari: Obviously, the longer you wait, the better visibility you will have in terms of the outcome of the election. Unfortunately, there are no guarantees that stocks will continue to trade at the current valuation on March 3rd. So, you are taking some risk by taking that view. I would argue that the stocks are already exhibiting a heightened sensitivity to the presidential polls and betting outcomes. In my opinion, the correlation between the two spiked on September 21st when President Trump admitted to asking the President of the Ukraine to investigate the Bidens. This sector sold off on that event as a probability of Senator Warren's nomination spiked. The probability for winning has come down in recent weeks but it's quite clear that the upcoming election is officially a focal point for the market. I couldn't say that with confidence back in the spring. It seems to me that the market would be most comfortable with either a Biden or a Mayor Pete nomination. But that list of names could expand as more candidates enter the race. Mayor Bloomberg, for example. In terms of timing, I'm more interested in the primaries/caucuses that pre-date super Tuesday. I think if Senator Warren cannot win Iowa or New Hampshire, then her odds of becoming a nominee are greatly reduced. I don't think many people think Senator Sanders can carry the nomination at the end of the day. Not only do you have to take the presidential election into account but also keep in mind you do have to think about the senate outcome, too. The base case is that the republicans will hold the senate and a democrat will become president. If that scenario plays out, then I would expect Medicaid oriented names to fair well on the day after the election. However, if we do have a democratic sweep, the dental names will perform well. Of course, if you look back at the last two election cycles, the knee jerk reaction on the day after the election has proven to be a buying opportunity. So, keep that in mind.

Anu: You mentioned that if it's a democratic sweep, the dental companies will do well. Why is that, out of curiosity?

Ari: Because they're not directly affected by material change with Medicare for All. If anything, you step back to Medicare for All under the Sanders plan, you would expand coverage to dental. So, the pie would actually increase.

Anu: Okay. Interesting. Thank you. And now, Ari, you're obviously speaking to a lot of different companies, hearing from them directly. What's their take on the situation? Is it business as usual?

Ari: For the most part. Generally speaking, investment in M&A fall into three categories and they're staying the course on that front. One, do deals that improve your cost position. So, scale is important because, ultimately, that could help you drive lower price points in the marketplace. Two, diversify the business. Right? So, hedge essentially. And three, invest in technology that will improve the consumer experience. Consumerism is very important for this sector. The space is becoming more B to C oriented. So, having technology and apps that are user friendly is very important. So, they're making acquisitions on that front to drive change there. If there has been a change over the last several years, there's been a great anticipation that the payer system or how companies get paid would ultimately evolve and that's been slow to come to fruition.

Anu: I often read articles highlighting how big tech companies are going to disrupt healthcare. Ari, is that fact or fiction?

Ari: That was definitely a big overhang back in 2017 but it rarely comes up in my conversations today. The only true disruptor in healthcare, as far as I'm concerned, is the federal government. And that's why policy is such a focal point. A couple years ago, the big talk was about Amazon entering the pharma supply chain. And my view has been that they don't have the assets in place to be truly disruptive at this point in time. Of course, they can buy them but their current suite of assets isn't enough to move the needle. Mr. Bezos himself has said that he disrupts markets by winning on price, selection and convenience. He can't win on any of those three metrics today from my vantage point. Regarding price, the retailer does not set the price for most of the transactions in the U.S. in drugs. It's actually set by the pharmacy benefits manager or the managed care plan. So, that limits his ability to drive share. On selection, no one questions whether or not a drug store has a drug. It's just a simple fact. In terms of convenience, there's more than enough drug stores across this country that you can easily pick up a drug in a short period of time. In fact, beyond that, you can get mail order drugs. So, they arrive whenever you want without leaving your home. So, that service is already available. So, that's why I think it's tough for him to disrupt the marketplace with his current suite of assets. That said, there is significant white space for tech companies to leverage their strengths to make the healthcare ecosystem operate more effectively, as the consumer experience definitely needs to improve dramatically and they could definitely help there. For example, 25 percent of the commercial market is healthy but at risk of suffering chronic conditions. In short, they are low cost today but have an 85 percent probability of becoming high cost chronic patients down the road. This group accounts for 50 percent of the commercial population's lives, but they also account for 75 percent of the costs. So, there could be a lot of money to save if you can prevent the healthy at-risk lives from falling into the chronic bucket over time. An example is diabetes. Today, there are 30 million diabetics in the U.S. and they cost three times the amount of a non-diabetic. There are also 85 million people who are "pre-diabetic" but only 12 percent know it. So, if you can make the 88 percent aware of the fact they're pre-diabetic leverage some of the technology tools to keep them in the pre-diabetic state or to get them off of the pre-diabetic state and prevent them definitely from becoming diabetic, that's a huge savings for the system. And that is where technology can really add value because these companies have great core competencies in offering applications or solutions that are user friendly that people can use. Of course, when one thinks about technology and the opportunity for disruption, you also have to think about privacy concerns. And those are definitely heightened here. If you go back to this week only, a large non-for-profit hospital system called Ascension announced a partnership with Google. What do we find out the next day? The health and human services was looking into it over privacy concerns. So, innovation can happen in healthcare. It's just slower than everywhere else.

Anu: Yeah. That's super interesting. Back to the outlook for healthcare policy, what's the expectation for drug pricing reform and the potential ramifications for healthcare companies there?

Ari: Yeah. I think it's important to step back and think about drugs for a minute and why it's different. There are 4.5 billion transactions in the drug ecosystem per year. The next biggest healthcare touchpoint is doctor visits, and that's at 900 million. In short, everyone touches the drug benefit. A few people touch the medical benefit. My bias is that something small gets squeezed into the final omnibus bill that Congress will ultimately pass that contains a continuing resolution that will ultimately fund the government through the upcoming election cycle. It would entail the redesign of the part D benefit—and if you're not aware of that, that is the benefit for drugs for seniors over 65. And what it will do is it will cap out of pocket liabilities for that population. Who will fund it? Managed care and pharma. Of course, there will be winners and losers from this proposal but overall, I would see it as a net positive for the sector as it should relieve some tension and eliminate an overhang. The biggest risk, of course, is that if there is a policy surprise in the final bill. Of course, majority leader McConnell will have to weigh the pros and cons of submitting such language in a bill, as it could ultimately lead to a filibuster that could ultimately prevent the bill from becoming a reality. So, keep that in mind.

Anu: And finally, Ari, how does ESG or environmental social governance factors, play into the healthcare sector? Are there factors that investors should be mindful of?

Ari: Yes. In healthcare services, from my vantage point, it's all about access and affordability. So, that is really the key ESG metric outside of governance. So, if we focused on social, that's what matters the most. At the end of the day, the biggest decision makers, as we touched on before, it's really the federal government. They set the rules of the road. But then you also have to consider the plan sponsors. The plan sponsors are the entities that ultimately pay the majority of the bill. So, in our case, it would be Neuberger Berman, our employer. Managed care and pharmacy benefit managers try to come up with plan designs that ultimately optimize outcomes under the constraints imposed by those two parties. So, it has to be consistent with the laws set by the federal government, but also consistent with the needs and the cost profile that the plan sponsor wants to follow. Still, even despite those constraints, they are rolling out programs that should help alleviate some of the financial burdens facing beneficiaries. CVS Health, for example, is rolling out 1,500 of these new store concepts called health hubs. These are stores that are going to have a lot more healthcare services in them than you see today. This should help fill a void as more Americans aren't engaging primary care physicians today. The other thing to consider is that more companies are coming up with new innovative benefit designs to offer beneficiaries relief at the point of sale. So, that's also a positive. Still, for material change to happen, the federal government will need to step up.

Anu: You know, Ari, as we wrap up here, I think the big take away is that all roads lead to the federal government. Is that a fair assessment?

Ari: I would say so.

Anu: Thank you so much for being on the show today and for sharing your insights on healthcare.

Ari: Thank you.

Anu: Thanks for joining us for today's episode of Disruptive Forces. As a reminder, our next two episodes will continue on this theme of political disruptions affecting the investment landscape. So, I hope you will tune in for those. Don't forget to subscribe to the show via Apple podcast or Google podcast. For previous episodes, as well as more information about our firm and offerings, please visit www.nb.com/disruptiveforces.