Bellevue Healthcare

BBH offers a very differentiated way to invest in the bombed-out healthcare sector...

Update
03 July 2022

Overview

Over the medium term, the healthcare sector benefits from the secular tailwind of the desire to provide for an ever older and richer human population. However, Bellevue Healthcare (BBH) offers a very differentiated way to get exposure to this theme, because of the manager's preference for running a highly concentrated portfolio (a maximum of 35 stocks), and a willingness to invest across the market capitalisation spectrum (see **Portfolio**), but more importantly, because they focus on the most operationally geared investments whose product, technology, or service best contributes towards bringing healthcare systems onto a sustainable footing, on a multi-year basis.

Since launch, BBH's managers Paul Major and Brett Darke have generally delivered on their objectives: to beat the total return of the MSCI World Health Care Index on a rolling three-year period and also deliver double-digit returns over the same time frame. That said, as we discuss in the **Performance section**, the team have underperformed more recently. Within the healthcare sector, two GLP-1 obesity plays (Eli Lilly and Novo Nordisk) have accounted for all of the performance of the benchmark so far this year. In the context of BBH, which has an active share of 91%, it is perhaps no surprise that in a market driven by a very narrow number of stocks, BBH finds itself behind the pace.

BBH has typically been modestly geared on a net basis, with the ambition to run a mid to high single-digit level of gearing over time. The team reduced exposure in May/June 2023 with the uncertainty presented by the US debt ceiling deadline, and gearing currently sits at a mere 0.9%.

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Analyst's View

BBH is highly differentiated from its benchmark and peer group through its strong bias towards focussed companies, aiming to provide innovative solutions which lower cost inflation in the healthcare ecosystem, driving efficiency gains, and/or producing better outcomes for patients. Small- and mid-cap stocks are where the greatest level of innovation and growth potential lies within the healthcare industry, but the trust's exposure to small and mid caps has counted against the trust in current markets. As such, the long-term performance of the fund has taken a knock. As we illustrate in the **Performance section**, BBH does demonstrate significantly higher volatility than the benchmark, but this extra risk taken on by the managers has historically been rewarded by outperformance.

With a consistent investment process, in order to outperform over the long term, it is sometimes inevitable that short-term underperformance needs to be endured – especially at times when fundamentals are ignored by a market that is driven by macro factors. It is precisely this sort of scenario that the managers believe we are in currently.

In our view, given nothing has changed in terms of the personnel or investment process, when the market stops being driven by macro factors, as inevitably it will at some point, there is clear potential for Paul and Brett's alpha generation to kick back in once again. In the meantime, BBH's discount to NAV is c 6%. As such, investors who share the managers' conviction in the medium- to long-term prospects may therefore see the current discount level as an opportunity.

BULL
Very differentiated offering, with a highly active approach
Barring recent travails, consistent record of outperformance, with managers having added significant value through stock picking
Attractive dividend yield (paid from capital)

BEAR
Narrow focus and concentrated portfolio present risks relative to a more diversified portfolio
Dividend based on NAV, which means that if the NAV falls year on year, it could mean a decline (although the board could choose not to pay a lower dividend)
Potential to gear, combined with a concentrated portfolio, can translate into high NAV volatility

Portfolio

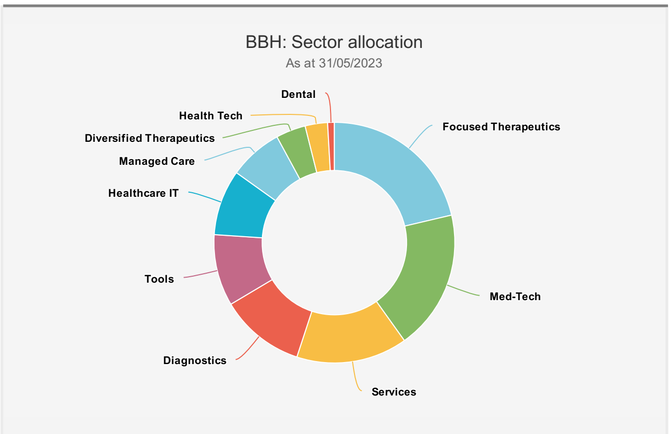
Within an equity market which is seemingly beset by macro challenge after macro challenge, Bellevue Healthcare (BBH) and the wider healthcare sector should theoretically offer a place of refuge for rationally-minded investors. As we discuss in the **Performance section**, the experience since 2022 has not matched up with this sentiment, with the BBH's NAV underperforming the benchmark and global equity markets. As within many equity sectors, one can find plenty of high growth or potentially defensive opportunities. The healthcare sector is no different, but it does benefit from the secular tailwind of the resilient, and ever-present necessity of providing for a human population which continues to get older and richer, with an ever-greater propensity to pay for the increasingly innovative ways of countering ill health. BBH differs from the main global healthcare benchmark (MSCI World Health Care Index) because of the manager's preference for running a highly concentrated portfolio (a maximum of 35 stocks), a willingness to invest across the market capitalisation spectrum, and their focus on companies that provide the best new solutions towards putting healthcare systems around the world onto a sustainable footing, financially and operationally.

Paul Major and Brett Darke are specialists, that employ their own fundamental analysis to research and invest in companies whose prospects have not been fully recognised by the market. They try to take a three- to five-year investment view on the outlook for companies' earnings and cash flows over five to seven years. They focus on those companies that they believe are making a significant contribution towards fixing 'broken' healthcare systems. In doing so, and recognising that governments' stretched finances mean making these systems more efficient and productive are high priorities, they take a holistic view of what constitutes healthcare. For example, Paul and Brett see their investment universe as constituting any companies that have their principal focus as the healthcare industry, which could include IT software suppliers, health insurance providers, as well as more traditional exposures such as therapeutics and healthcare tools. This shows up in the sector allocation shown below, which looks very different to the breakdown of market capitalisation-weighted indices, which are heavily represented by global pharmaceutical and biotechnology companies.

Of relevance in the current market, which has so far this year been driven by huge optimism on AI, the team remain of the view that the intersection of technology and healthcare will be a fruitful area for investment over the long term. As the managers discuss at length in their most recent factsheet (available **here**), AI and big data will, in their view, undoubtedly play a role in future healthcare successes. However, as in more general applications, AI technology is still relatively rudimentary in terms of its output, and the winners from a new AI era are far from clear. The managers draw parallels with the dot.com era, where exaggerated expectations of a fundamentally transformative technology resulted in a significant boom and bust. The team observed that over the last six months, "AI plays drove around three-quarters of the total return..." of world equities, the vast majority of returns being driven by only four stocks. Within the healthcare sector, the same narrow leadership phenomenon has also been seen, with two GLP-1 obesity plays Eli Lilly and Novo Nordisk accounting for all of the performance of the benchmark. In the context of the trust, which has an active share of 91%, it is perhaps no surprise that in a market driven by a narrow number of mega-cap stocks (generally, and specifically within the healthcare sector), BBH finds itself behind the pace (see **Performance section**).

Aside from being unashamed growth investors, Paul and Brett are sensitive to valuations, both in terms of informing their investment activity, but also with respect to decisions on **Gearing**. They observe that in the rush for AI winners, the market is ignoring everything else, and as a result valuations for their portfolio companies are attractive.

Fig.1: Sector Allocation



Source: Bellevue Asset Management

Top Ten Holdings

	BBH %
Exact Sciences	6.9
Option Care Health	6.1
Axonics	5.7
Pacific Biosciences of California	5.4
Charles River Laboratories	5.1
Evolent Health	5.1
Apellis Pharmaceuticals	4.5
Bio-Rad Laboratories	4.3
UnitedHealth Group	4.3
Total	**53.0**

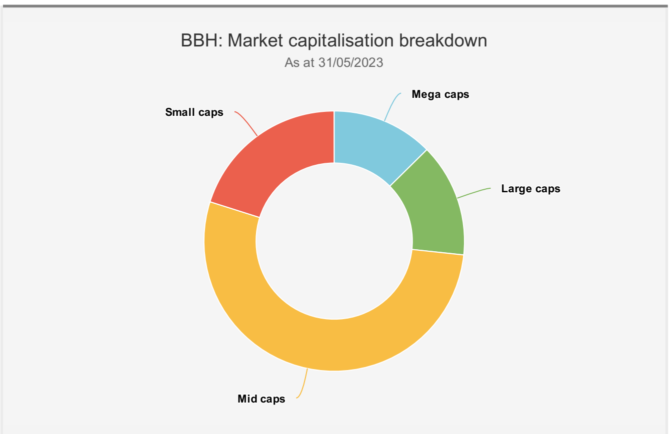
Source: Bellevue Asset Management, as at 31/05/2023

In a sign that fundamentals are not currently driving share prices, Paul highlighted Exact Sciences, the largest holding in the portfolio currently, which saw its share price rise 28% over May 2023 on limited newsflow, whilst the previous month the opposite happened, again on limited newsflow. The team are looking for signs that markets become more stock-focussed once again, and are being driven less by macro data. In the meantime, Paul and Brett remain cautiously optimistic given that their portfolio of companies continue to do operationally what they expect them to do.

We note from the table above that the portfolio remains highly concentrated, with a total of 28 stocks in the portfolio at the time of writing, and over 50% of the NAV exposed to the top ten holdings. As we illustrate in the **Performance section**, BBH does demonstrate significantly higher volatility than the benchmark as a result of the highly active mandate and concentrated portfolio. However, despite the challenging recent performance, we believe that the statistics show that the extra risk taken on by the managers has historically been rewarded by long-term outperformance, although more recently this has not been the case.

In terms of BBH's concentrated exposure, there are no restrictions on the managers as regards benchmark, geography, market capitalisation, or sub-sector. The majority of exposure is towards companies listed, but not necessarily solely operating, in the United States. BBH is currently focussed on mid caps, as the chart below shows, with just over half of the portfolio allocated to this segment of the market. Small caps also have a sizeable allocation. Broadly, the team are agnostic on what size company they invest in but want as focussed exposure as possible to the most operationally geared investments in companies whose product, technology, or service best contributes to fixing healthcare systems. These companies may provide innovative solutions which lower cost inflation in the healthcare ecosystem, drive efficiency gains, and/or produce better outcomes for patients. In the team's view, it is these sorts of solutions that will make healthcare systems sustainable on a multi-year basis, rather than by governments throwing more and more money into the system to cope with an ever-growing and ageing population. In looking for focussed and innovative companies, the team are typically led into the small-/mid-cap arena, rather than having a specific preference for this segment of the market.

Fig.2: Market Capitalisation Breakdown



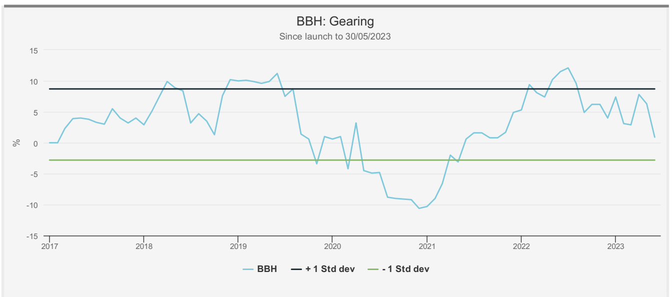
Source: Bellevue Asset Management

Gearing

BBH's managers have the latitude to operate within the range of a maximum of 20% gearing and 10% net cash. They believe that gearing has the potential to enhance returns, but at times, holding cash can help protect capital during periods of market volatility. We note that gearing, if applied at times of rising markets, can enhance returns for shareholders. On the other hand, gearing can exacerbate losses during periods when markets fall. Whether the team employ gearing at any one time is guided by what the team make of the bottom-up opportunities they see, as well as on top-down views of the market.

The graph below shows that since its launch in late 2016, BBH has typically been modestly geared on a net basis (based on month-end data). The average is 3% since launch, and the maximum level of gearing so far deployed has been c. 12% of NAV. At launch, the ambition was to run a mid-to-high single-digit level of gearing over the lifetime of the trust, and this was the case until COVID, US Presidential election, and Brexit negotiations prompted the team to hold a double-digit cash balance over much of 2020. The team lifted gearing above the long-term average once again but reduced exposure in April and May 2023 with the uncertainty presented by the US debt ceiling deadline. As of 31/05/2023, BBH had net gearing of 0.9%.

Fig.3: Gearing



Source: BellevueAsset Management

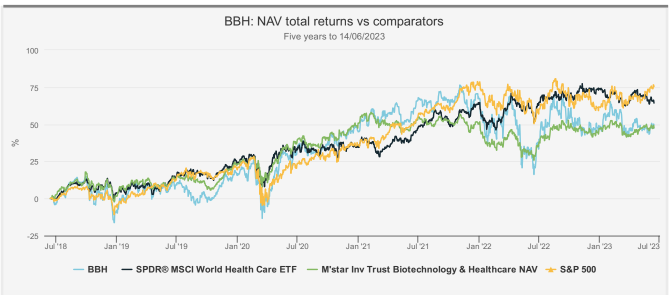
Performance

BBH has a good long-term track record, and since launch has delivered a NAV total return of 101.6%, which compares to the SPDR MSCI World Healthcare Index ETF return of 97.2%, and the Morningstar Biotechnology & Healthcare peer group NAV return of 98.6% (all numbers are to 14/06/2023). As we illustrate below BBH's degree of outperformance has come back somewhat over the last 12-18 months, initially having outperformed by a significant margin.

The ultimate reason for this is that BBH, as well as many other growth focussed strategies, has had a challenging period since the outbreak of war in Ukraine and the increased market volatility that it caused. Initially, investor appetite in the wider market shifted towards defensive value plays, rotating away from growth stocks and preferring those more liquid, at the large- and mega-cap end of the equity market. Latterly, as we discuss in the **Portfolio section**, stock markets have been led by a very narrow set of AI-related companies. These same themes have also played out within the healthcare sector, with large-cap defensives such as the pharmaceutical majors performing best during 2022 and then two large multinationals with exposure to obesity drugs contributing to most of the growth in the healthcare sector during 2023 so far. For companies not exposed to AI or obesity, stock market conditions have been very much more difficult, and the smaller the company is, the more challenging. As a result, the team note that stock prices do not currently seem to reflect fundamentals or newsflow, which has clearly contributed to the recent underperformance.

Observable in the graph below, which shows NAV performance over five years, is how the last 12-18 months have interrupted BBH's previously strong relative performance. Over this five-year period, BBH delivered total returns of 47.4%, which compares to the benchmark's return of 64.3%. With a concentrated portfolio and very little resemblance to the benchmark, BBH has a high tracking error of 20.8% and a high active share of 94.1 (Source: Bellevue Asset Management, as of 31/05/2023). As such, a deviation from the benchmark in performance terms is not outside of what one might expect. However, as we examine below, historically BBH has delivered strong outperformance. As such, the most recent period might

Fig.4: Five-Year Performance



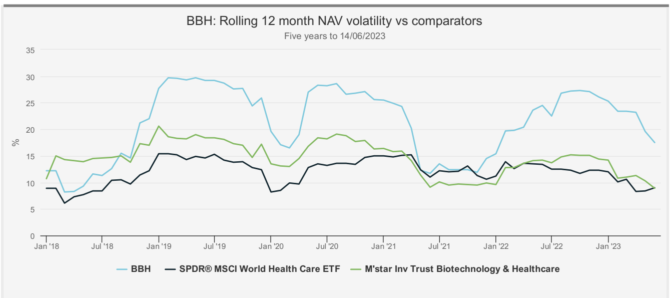
Source: Morningstar

Past performance is not a reliable indicator of future results.

be considered out of character. Certainly, nothing has changed in terms of the personnel or investment process, and so when the market stops being driven by macro factors, as inevitably it will at some point, there is clear potential for Paul and Brett's alpha-generating process to start to deliver once again.

A high tracking error and active share have historically delivered outperformance, but it does also result in higher volatility. A beta of 1.37 as of 31/05/2023, only tells part of the picture. We show below the rolling 12-month volatility of the NAV compared to that of an ETF of the benchmark and the AIC peer group. This shows that BBH has historically exhibited higher volatility when the market itself is in a period of extended volatility and provides at least some explanation as to why the beta (as a backwards-looking measure) appears so high currently.

Fig.5: NAV Volatility

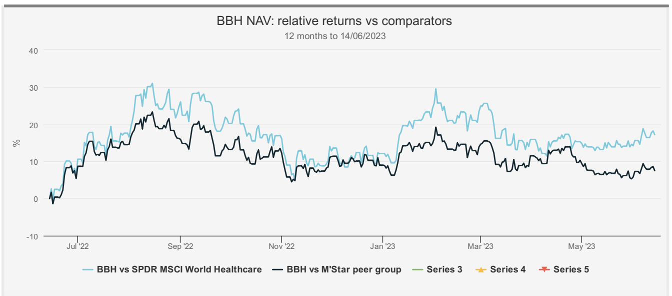


Source: Morningstar

Past performance is not a reliable indicator of future results.

Over the past 12 months, it hasn't been all one way, as the graph below shows. This graph shows relative performance against the benchmark and the AIC peer group (which includes biotechnology- focussed trusts), where an upward-sloping line shows BBH's outperformance and downward sloping, underperformance.

Fig.5: NAV Volatility



Source: Morningstar

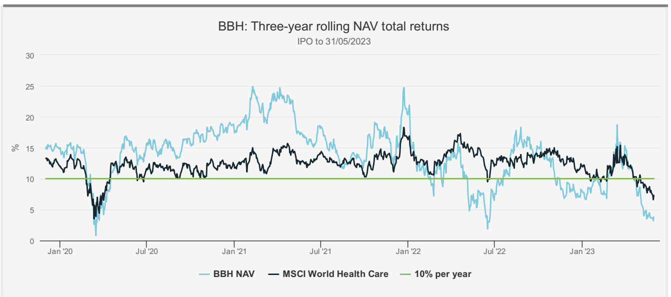
Past performance is not a reliable indicator of future results.

As fundamental investors with a consistent investment process, the team understand that in order to outperform over the long term, it is sometimes inevitable that short-term underperformance needs to be endured – especially at times when fundamentals are ignored by a market that is driven by macro factors. The graph below shows that almost consistently since launch, BBH has been delivering on its twin investment objectives which are formally:

- To beat the total return of the MSCI World Health Care Index (in sterling) over a rolling three-year period.
- To seek to generate a double-digit total shareholder return per annum over a rolling three-year period.

In the graph below we show BBH's three-year rolling return compared to that of the MSCI World Health Care Index and the 10% absolute return target. On a rolling three-year basis it is only really since Q1 2022 that BBH started to materially underperform its absolute return objective, and Q2 2023 that it has underperformed on a relative basis. As we observe above, given the higher beta/volatility of the portfolio, the main exceptions to the periods of outperformance have been when markets were in freefall in the immediate aftermath of the first lockdowns, and more recently.

Fig.6: Three-Year Rolling Total Returns Since IPO



Source: Bloomberg

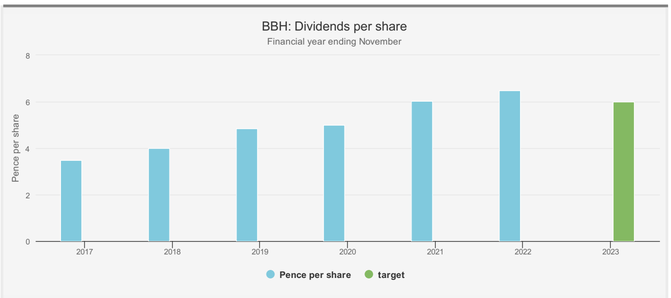
Past performance is not a reliable indicator of future results.

Dividend

BBH's investment objective is to provide shareholders with capital growth and income over the long term. In December each year, the board sets a dividend target based on a rate of 3.5% of the NAV at the end of the previous financial year. This gives a high degree of visibility for shareholders, but given it is based on NAV, does mean that it is not necessarily progressive. As the graph below shows, the target dividend for the 2023 financial year, representing 3.5% of the NAV as of 30 November 2022, is 5.99p, a reduction from the 6.47p paid in the last financial year. Dividends are paid in two equal instalments, and a dividend of 3.235p per ordinary share has already been paid in September 2022, with the second payment made in May 2023. There is also the option to elect for a scrip dividend for those who would prefer it. The target dividend represents a yield on the current share price of c. 4% (as of 23/06/2023).

The advantage of paying a dividend, majority funded from capital is that it gives the managers total flexibility to pursue the best total returns they can achieve from the investments they make. At the same time, shareholders benefit from a regular income. Indeed, the managers observe that within the healthcare sector, investing in companies that pay high dividends may not achieve the highest total returns, given that, by definition, dividends are paid out rather than being reinvested in the future growth of the business in question. Moreover, US growth healthcare companies tend not to pay any dividends at all, resulting in a very low organic yield from the portfolio. For equity income investors, we observe that BBH offers a very complementary exposure – with an attractive level of dividend derived from capital and an underlying exposure that is very different from typical income exposures to the healthcare sector. The chart below shows that, aside from the current year, the annual dividend has been steadily increasing.

Fig.7: Historical Dividends



Source: Bellevue Healthcare

Management

Paul Major and Brett Darke co-manage BBH. Paul has worked in healthcare-related finance for more than 26 years. For the majority of his career, he has worked as a sell-side research analyst but has also worked in corporate finance. Initially at UBS, he then worked at Redburn for 13 years. He joined Bellevue in May 2016 in his first buy-side role in order to launch Bellevue Healthcare. In September 2017 Paul was joined by Brett Darke, who similarly has a medical and healthcare investments background, having previously spent 11 years on the buy side at TT International and also having worked in healthcare corporate finance. The two have known each other professionally for a number of years, and they both work from London. The Bellevue Healthcare strategy is their sole focus.

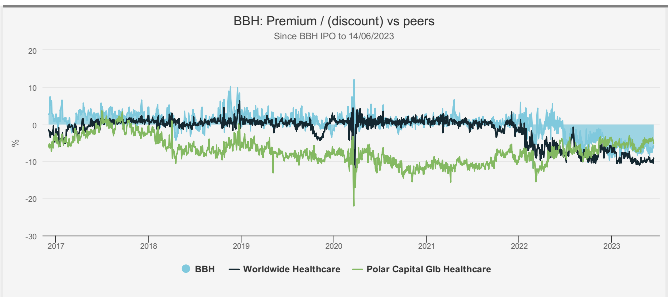
Bellevue Asset Management is a Swiss asset-management company listed on the Swiss stock exchange, which has grown from being a specialist healthcare investment boutique to providing many other strategies for clients around the world. In total, Bellevue manages £11.3bn, of which c. £9.2bn is in healthcare strategies. Paul and Brett can draw upon the experience and resources of a wider team of 18 healthcare investment professionals managing 16 different healthcare-focussed strategies.

Discount

BBH's shares have tended to trade very close to NAV, and for the majority of the time since launch, at a premium. This pattern changed at the start of 2022. Growth strategies of all types saw a sharp de-rating over 2022, and BBH has not been insulated as we show in the graph below. Over the period represented in the graph, BBH has traded at an average premium of 0.1%, whilst its peers Worldwide Healthcare and Polar Capital Global Healthcare have on average traded at discounts of 1.5% and 7.1% respectively. In our view, the historical premium rating reflects the differentiated investment proposition that BBH and its managers offer (see **Portfolio section**). The premium has allowed BBH to issue shares regularly and thereby grow, which has, in turn, meant the OCF has reduced progressively each year (see **Charges**). At the same time, growth also improves the liquidity of the shares in the market.

Since the de-rating, BBH's board has been actively buying shares back, at the time of writing, the last being in early June at a discount of c. 7%. The share buyback mechanism is managed at arm's length by the trust's broker. The conditions under which it is triggered have not been disclosed. As a longer-term protection for investors against a persistent discount to NAV, BBH has an annual redemption with the redemption point being the last business day of November each year. At the last redemption point in November 2022, the board received redemption requests for 30.6 million shares (representing 5.2% of the shares in issue at that time). In prior years the small size of the redemption pool has allowed all of these shares to be matched with buyers, and so there was no change to BBH's share capital. However, given the discount to NAV at which the shares traded, all of the shares redeemed last year were cancelled. Next November, absent any buybacks that may occur before then, the redemption event may 'clear out' further potential sellers, allowing the supply/demand tension to return and thus re-establishing a premium.

Fig.8: Premium/(Discount) To NAV



Source: Morningstar

At the time of writing, BBH's discount to NAV is 7.6%. Investors who share the managers' conviction in the medium- to long-term prospects of the portfolio companies may see the current discount level as an opportunity.

Charges

We believe that BBH's charging structure is as close to best practice as possible. BBH pays a flat management fee of 0.95% per annum on its market capitalisation. This aligns the managers with shareholders and helps incentivise the managers to prevent the shares from trading on a discount for any period of time. It also deals neatly with the question of gearing, with the managers not incentivised through the fee to employ gearing (which might be the case if fees were based on gross assets). There is no performance fee payable. It is also worth noting that the trust's board is entirely remunerated in shares, and these are locked up for a minimum period of three years after issuance. BBH is a large trust, with net assets of c. £800m at the time of writing (June 2023). The most recently reported OCF figure (according to the 2022 full-year report to 30/11/2022) is 1.04%, representing a continuation of the decline in the OCF that we have seen over the past years.

This reduction has been achieved as a result of the trust issuing shares and growing but is also due to reduced basis point fees from service providers. Bellevue has also absorbed various costs over time into the management fee and as at the beginning of the 2022 financial year began to absorb the majority of marketing costs and third-party support costs. In our view, it is encouraging that Bellevue continues to invest in the trust and indicates that the board is doing a good job of keeping expenses down. The OCF compares favourably with the simple average of the AIC Biotechnology & Healthcare peer group's average of 1.01%. Worldwide Healthcare, a much larger peer with net assets of c. £2.2bn, has an OCF of 0.9%. This cost advantage is partly a result of its significantly larger size, but it is worth noting that Worldwide Healthcare also benefits from a performance fee that could meaningfully take the OCF up in certain circumstances. BBH's latest KID RIY is 1.15% (as of 28/02/2023).

ESG

BBH is now an SFDR Article 8 fund, meaning it is a fund that "promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices". The team responsible for BBH spell out in detail their specific approach to ESG in the most recent report and account, available **here**.

Bellevue Asset Management is a signatory to the UN Principles for Responsible Investment (UNPRI). The company has a centralised ESG team who work with managers on each strategy to integrate ESG analysis into all aspects of the investment-management process. As fundamental stock pickers, Paul and Brett embrace ESG as part of the investment process in a number of ways. As a first step, the team filter prospective investments for potential ESG issues so as to screen out companies that would not meet their criteria as early as possible.

In terms of detailed due diligence, the team use MSCI reports and their own internally generated metrics to form the basis of decision making. Scores are not used to exclude companies but more as tools to consider investments within a much more comprehensive and holistic approach. The team note that larger companies tend to report more fully and, as a result, tend to score better on ESG scores. Given the strategy tends to focus on mid-cap companies, the team recognise that the portfolio may at times tend to score lower than the MSCI World Health Care Index. For example, as of 30/11/2022, the MSCI ESG quality score for BBH's portfolio was 6.5 compared to 10.0 for the MSCI World Health Care Index.

The team believe that ESG considerations do not end with the selection of portfolio constituents and see engagement with management teams as a key part of their role and an opportunity to add value. As such, both BBH's board and the managers take voting obligations very seriously, and the team try to ensure that they vote in all shareholder meetings. The team reveal that they voted against, withheld, or abstained on board recommendations for at least one meeting resolution in 12 of the 33 meetings they participated in during 2022. BBH has been expanding the visibility of ESG initiatives over time, which we continue to view as welcome. Morningstar's Sustainalytics does not assign a score for BBH, in our view likely because of the small- and mid-cap focus of the managers, which means that only 61% of the portfolio is covered by their analysis.

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