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Since mid-November, shares in **Bellevue Healthcare (BBH)** have risen by close to 25%. The trust still trades below its all-time high, but we may be seeing the start of a turnaround after a peculiar couple of years for healthcare.

The sector has experienced an extreme divergence in performance. That is partly the result of the hype surrounding anti-obesity drugs sold by the two large cap pharmaceutical companies, Novo Nordisk and Eli Lilly. So large have the inflows into Novo Nordisk shares been that it has impacted the price of the Danish kroner and, consequently, the country's central bank policy.

As the AI buzz of the last 18 months illustrates, it's easy to get wrapped up in a new phenomenon and think that it's going to make you lots of money. But as **we've noted before**, both of the two large drug manufacturers have products that produce highly questionable results. At the same time, they are almost certain to come under pricing pressure in the near term. Both factors suggest that long-term performance may not be as wonderful as current valuations imply.

On the other hand, the sorts of small and mid-cap stocks that BBH managers Paul Major and Brett Darke favour have seen softer performance since the end of 2022. Just as the fervour for the two obesity stocks has often seemed detached from fundamentals, so too has the negative sentiment directed towards the types of companies BBH holds.

The primary cause of this appears to be inflation and rate hikes. The latter in particular has caused deratings for higher-value, more growth-oriented companies. At the same time, smaller companies, with more concentrated business lines, have tended to be more subject to fears about their ability to perform in an economic downturn.

Again, there is a logic to this, but it doesn't necessarily stand up to scrutiny. Clearly, some small and mid-cap companies will be more resilient to a downturn than others. We would argue that this is illustrated by the BBH portfolio.

For example, in the final quarter of last year, Paul and Brett noted that of the 13 companies in their portfolio that released earnings updates in October, only two failed to meet or surpass expectations. It's worth noting too that the pair tends to run a concentrated portfolio, with a maximum of 35 stocks, so these 13 firms are not representative of a small proportion of their portfolio.

To give an example of this, fusion therapy company Option Care Health, which is a top 10 holding in the BBH portfolio, generated more in net income over the first nine months of 2023 than it did in the whole of 2022.

Earnings for that nine month period totalled $209.9m, compared to the $150.6m in net income the company generated over the course of 2022. Unless there was a dramatic deterioration in the company's profitability in the final quarter, this would mean earnings were up at least 40% year on year. This does not seem like a company that has struggled to perform well, even with rate hikes.

A similar argument could be made about Axonics, a company that makes bladder control devices. The company delivered 30% year-on-year revenue growth in its most recent quarterly results and moved from loss-making to profitability.

At the start of January, the company announced it was being acquired by medical devices conglomerate Boston Scientific. The acquisition price of $71 per share represented a nearly 25% premium on the prior-day closing price.

Again, we think this goes some way in supporting some of the claims that the BBH managers have been making, namely that the fundamentals of companies in the underlying portfolio remain strong and that sell-offs have been indiscriminate over that time. Indeed, it is hard to imagine a large corporate buyer offering to pay such a large premium if they didn't think that was the case.

The pick-up in performance that BBH has seen over the last couple of months suggests investors are coming around to this way of thinking too. Assuming there is more M&A activity and results akin to those delivered by Option Care Health keep emerging, then it's plausible we'll see that continue too.

Away from the idiosyncrasies of the portfolio, it's hard to ignore the wider macroeconomic and sectoral situation. More hype around obesity drugs could divert investment flows away from the small and mid- caps that BBH invests in. Rate cuts seem to be what investors are anticipating, but many may well sit on their hands until they become a reality.

However, for investors that do believe we're at the end of the rate-hiking cycle and that valuations in the wider healthcare sector are more a symptom of overexuberance than meaningful fundamentals, we think BBH potentially sits at an interesting juncture.

The trust continues to trade at a significantly wider discount than its average since its launch in 2016. At the same time, positive results continue to come through, but valuations in the underlying portfolio remain relatively low. It is hard to see the latter remaining the case if the former continues to hold true.

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