Bellevue Healthcare

BBH is resolutely aligned to the long-term growth tailwind of healthcare demand...

Update
09 November 2022

Overview

Bellevue Healthcare (BBH) invests in companies that provide innovative products and solutions to what the management team view as a 'broken' healthcare system. Key to this is their belief that the capacity and efficiency of global healthcare systems are not adequate to meet the demands of ageing societies and the world's growing population. BBH's managers Paul Major and Brett Darke therefore seek companies that can benefit from this long-term secular-demand driver. They run an unconstrained, high-conviction portfolio of around 30 stocks, aiming 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.

Paul and Brett have historically been successful in exceeding these goals (see **Performance section**), which they have achieved through having a portfolio that is highly differentiated from BBH's benchmark and peers (see **Portfolio section**). They tend to run the portfolio with a growth tilt and a large allocation towards mid-cap stocks and companies at the intersection of healthcare, technology and big data.

Te fund pays out dividends largely from capital, allowing the managers to focus on their total return objective (see **Dividend section**). The dividend is based at a rate of 3.5% of the NAV at the end of the financial year (30 November), thus investors should be aware that the dividend can rise as well as fall year on year. The managers have kept to a modest gearing level which is currently at around 6%, and the shares have generally traded around par. BBH has an OCF of 1.06%, a figure that has been coming down over the years as the fund grows.

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Analyst's View

BBH is highly differentiated from its benchmark and peer group through its strong bias towards mid-cap stocks. We share Paul and Brett's view that this is where the greatest level of innovation and growth potential lies within the healthcare industry. The long-term performance of the fund since launch, a time frame which has already seen it go through several periods of rapidly changing sentiment, has vindicated Paul and Brett's positioning through delivering superior risk-adjusted returns.

That said, 2022 so far has been a tough year given the wider economic backdrop and the inevitability of growth stocks facing valuation compression. However, the team feel that many of the underlying stocks' operational performances have remained resilient and so they have taken this opportunity to add to some positions on share price weakness.

Given the dynamics of healthcare demand growth are demographic rather than economic, it seems reasonable to believe that this current period of market uncertainty will eventually give way to a brighter outlook with respect to 'growth' healthcare, and we take the view that investors could be well rewarded by the managers' resolute fund positioning. That said, investors must be prepared to ride through the higher volatility associated with the fund's growthier stance and exposure to mid and small caps.

We take the view that BBH could be a highly complementary choice for an income investor looking for a differentiated exposure that is set to benefit from the long-term secular tailwinds offered by changing population dynamics.

BULL
Very differentiated offering, with highly active approach
Excellent long-term track record, 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, and trust currently seeing headwinds in performance terms
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 concentrated portfolio, can translate into high NAV volatility

Portfolio

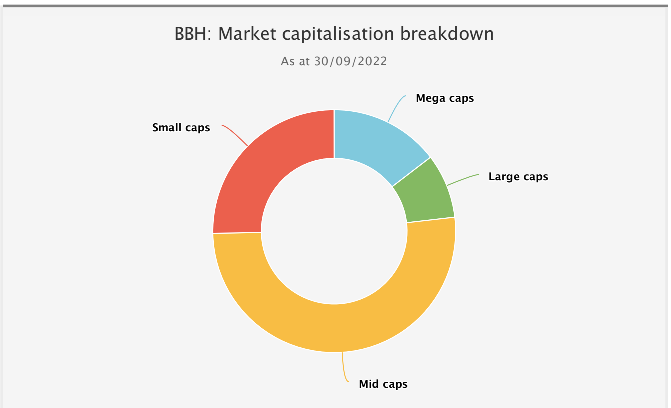
Bellevue Healthcare (BBH) is managed by Paul Major, who has managed the trust since its launch in December 2016, and Brett Darke, who joined as portfolio manager in 2017. They both have a significant number of years' experience in healthcare investment and finance. Paul and Brett aim to run a concentrated portfolio (with a maximum of 35 stocks) of healthcare companies that focus on providing solutions to what they believe are 'broken' healthcare systems around the world. The overarching view is that the demand for healthcare is rising fast due to ageing populations, particularly in developed nations, but also because of rising income levels and healthcare spending in developing nations. The implication is that both capacity and efficiency/productivity in the global healthcare industry need to rapidly increase. The team therefore take a holistic view of what constitutes a healthcare company, including the more conventional healthcare companies such as pharmaceuticals, biotechs and private hospital services, as well as insurance companies, IT software suppliers and other ancillary service providers in their universe of potential stocks.

The portfolio is constructed principally through a bottom-up stock selection approach, with quantitative valuation and long-term growth measures at the heart of the process. The team will also make qualitative assessments of management teams and their strategic and financial clarity. Top-down assessments of the markets and themes also feature in their inputs. Alongside the key secular driver of ageing populations, they believe that technology and healthcare will intersect as never before, with AI and big data (including genetic data) playing a huge role in insight, diagnosis and creating prevention plans. The team are also very cognisant of the political and regulatory environments of the various geographies under which a company operates. They aim to uncover companies whose prospects have not been fully recognised by the market and take a three- to five-year investment horizon based on a five- to seven-year outlook on earnings and cash flow. There are no investments in privately listed companies as the team like to maintain a good degree of liquidity.

BBH's investable universe is very open, and there are no restrictions made on the constituents of the portfolio based on benchmark, geography, market capitalisation or industry. Potential investments just have to provide products or services that support the delivery of healthcare in some form. However, the geographical breakdown shows that c. 95% of the exposure is towards companies listed in the United States, with the remainder split between China and Switzerland. Many healthcare, biotech and technology companies have a tendency to opt for a US listing, especially on the Nasdaq, where there is a deeper pool of investors and where valuations can command a premium compared to in other markets.

BBH's benchmark index is the MSCI World Health Care Index, although the portfolio is highly differentiated from this index as well as from healthcare investment peers. The key difference is that BBH is highly focussed towards 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. The team believe that the greatest opportunities lie in small and mid caps because these companies tend to be more innovative in finding solutions to healthcare needs in comparison to the mega caps and large caps. Many small and mid caps end up in the hands of bigger players who need to replenish flagging product lines and growth. M&A activity is therefore another crucial aspect expected to drive returns in the sector. However, despite valuations being low, there hasn't yet been another round of M&A activity, the last of which was a short burst after the vaccine rally. The team believe that smaller companies are burning cash and will need financing at some point, but the dilemma for big companies is whether to buy now or wait. Asset prices have come down due to a higher cost of equity, and the question remains how much higher this could go.

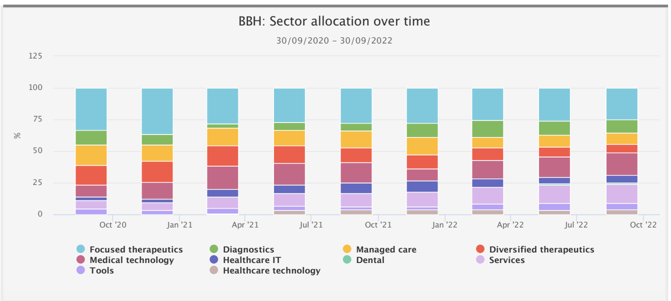
Fig.1: Market Capitalisation Breakdown



Source: Bellevue Asset Management

In our recent conversation with the managers, they remained optimistic despite the weakness of underlying shares in the portfolio since the start of the year due to the wider market volatility. Where valuations have held up are in the more defensive areas such as big pharmaceuticals and health insurance, but they believe these companies are now fairly expensive and don't necessarily fit with BBH's longer-term growth objectives. It is very difficult to time the bottom of a market, but over the year the team have been moving away from the defensive end of the market and adding to growth stocks. Some of this has been in companies they already own, although they note this has been painful on the way down as valuations have been slowly compressed. The portfolio has seen a big increase in medical technology since the start of this year, with the allocation to that almost doubling to 18.1% (see chart below). This has come largely at the expense of diversified therapeutics and managed care services.

Fig.2: Sector Allocation



Source: BellevueAsset Management

BBH currently has 29 stocks in the portfolio and the managers believe that 30 stocks are ideally where they want to be, although the mandate allows up to 35 stocks. It should therefore be no surprise that the portfolio is relatively concentrated. In the table below we show the top ten stocks as at 30/09/2022, which accounted for 55% of the portfolio at that time. An active share figure of c. 93%, along with the fact that BBH has a beta of 1.29, suggests that the portfolio is likely to be more volatile than the index, which it certainly has been during this year so far (see **Performance section**). However, in our view investors in BBH need to be prepared to take this sort of volatility in their stride: the aim of this portfolio is not to gain defensive exposure but to seize opportunities presented by unambiguous secular drivers in the healthcare space, such as ageing populations. Paul and Brett take the view that the sell-off has been indiscriminate, especially amongst the small- and mid-cap stocks; however, their operating performances have not followed share prices lower, and so they remain resolute. The team have therefore been adding to existing positions and have maintained a modest level of gearing.

Top Ten Holdings

STOCK	BBH %
Option Care Health	6.7
Axonics	6.7
Sarepta Therapeutics	6.6
Jazz Pharmaceuticals	6.2
Insmed	5.6
UnitedHealth Group	5.4
Apellis Pharmaceuticals	5.4
Charles River Labs	4.2
Amedisys	4.1
Tandem Diabetes Care	4.1
Total	**55.0**

Source: Bellevue Asset Management, as at 30/09/2022

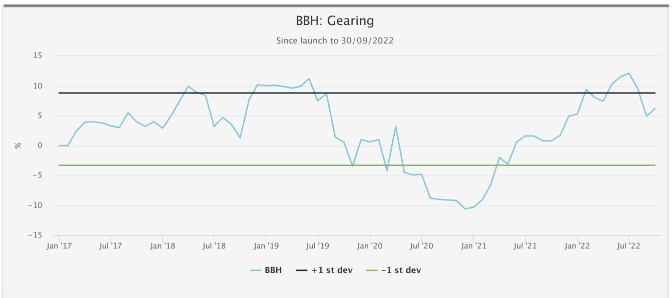
Gearing

One of the advantages of investment trusts is that they can employ gearing, which, if applied at times of rising markets, can enhance returns for shareholders. That said, gearing can exacerbate losses during periods when markets fall. BBH's managers believe gearing can improve returns over time, but that at times cash can be used defensively to protect investors' capital during periods of volatility. They have the latitude to operate within the range of a maximum of 20% gearing and 10% net cash. Whether they employ gearing at any one time depends on what they make of the bottom-up opportunities they see, as well as on top-down views.

Over time BBH has typically been modestly geared, with an average gearing level of 2.7% since launch in late 2016 on a net basis (based on month-end data), while the maximum level of gearing so far deployed has been c. 12% of NAV. At launch the ambition was to run a high single-digit level of gearing over the lifetime of the trust, and this was the case until late 2020, whereupon various COVID-related uncertainties in H2 2020 prompted the team to hold a double-digit cash balance through the rest of the year and into early 2021, which has skewed the average gearing data.

More recently the team have maintained gearing above the long-term average (at approximately 6.2% as at 30/09/2022), reflecting their view that current market dynamics offer attractive investment opportunities for long-term healthcare investors. When we spoke to the team recently, they commented that depending on Q3 trading updates from portfolio companies, they might consider adding further gearing into the year end.

Fig.3: Gearing



Source: BellevueAsset Management

Performance

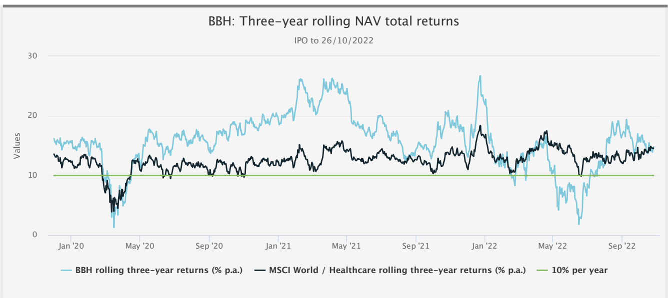
BBH's investment objective is to provide capital growth and income over the long term. More specifically, its return objectives are:

- 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. It is clear that for the majority of the period since three-year rolling returns have been available (December 2019 and onwards), BBH has clearly achieved its objectives both against the benchmark and the rather demanding absolute return target.

The exceptions to this have been in the immediate aftermath of the first lockdowns when markets were in freefall, and earlier this year amidst the wider market volatility. Since the launch of the fund in December 2016 to 26/10/2022, BBH has provided NAV total returns of 110.5%, beating the benchmark's 106.6%. Meanwhile its three-year rolling return to 26/10/2022 stands at 14.8%, just ahead of the benchmark's 14.6%.

Fig.4: Three-Year Rolling Total Returns Since IPO



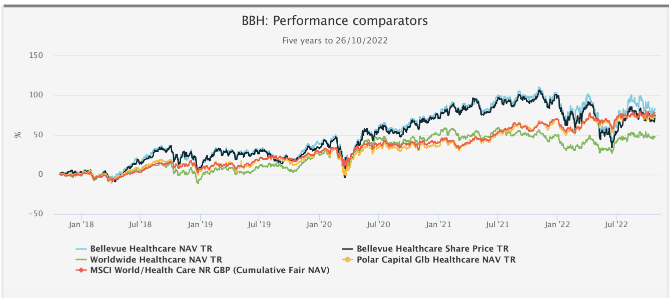
Source: Morningstar
Past performance is not a reliable indicator of future results.

Since the outbreak of war in Ukraine and the increased market volatility that caused, conditions for BBH and indeed mid-cap healthcare (as evidenced by the performance of indices such as the US's Russell 2000 Healthcare Index) have become much tougher. Investor appetite in the wider market has shifted towards defensive value plays while rotating away from growth stocks and moving up the market-cap scale to preserve liquidity. This theme has also played out within the healthcare sector, with large-cap defensives such as the pharmaceutical majors and health insurance companies holding up.

Going back to basics, the team note how small changes in assumptions under the Gordon Growth Model can have a magnified effect on valuations. Global market conditions have increased the discount rate while growth assumptions have moderated, both working to increase the denominator. So investors should not be too surprised by the scale of the pullback in growth stocks, although the team believe the selling has been indiscriminate, leaving some underlying portfolio companies with resilient operations to trade at compressed valuations. As discussed in the **Portfolio section**, the team believe this has opened up opportunities to add to some existing positions.

Over the five-year period to 26/10/2022 BBH delivered NAV total returns of 83.7% (see graph below), outperforming its nearest peers Worldwide Healthcare (WWH) and Polar Capital Global Healthcare (PCGH), which delivered 47.6% and 72.9% respectively. BBH also outperformed the benchmark, which delivered 78%.

Fig.5: Five-Year Performance



Source: Morningstar
Past performance is not a reliable indicator of future results.

What is evident from the graph above is that BBH has delivered outperformance whilst also being more volatile than the benchmark and the two peers. This is at least partly explained by BBH's concentrated portfolio, which is geared towards mid and small caps, and also by its higher beta (of 1.29 as at 30/09/2022), meaning that short-term periods of uncertainty will naturally result in underperformance. We believe that periods such as we are experiencing now could be used as an opportunity to gain exposure to the long-term secular growth attractions of the global healthcare sector.

Dividend

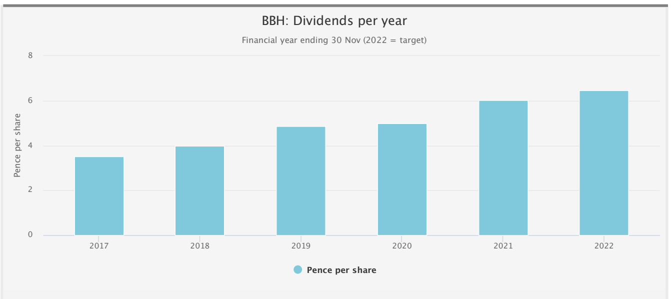
BBH's investment objective is to provide shareholders with capital growth and income over the long term. In December each year, the board sets a dividend target based on a rate of 3.5% of the NAV at the end of the previous financial year. As such, the target dividend for the 2022 financial year, representing 3.5% of the NAV as at 30 November 2021, is 6.47p. This target dividend represents a yield on the current share price of c. 4% (as at 03/11/2022). 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 due in February or March 2023. There is also the option to elect for a scrip dividend for those who would prefer it.

Since launch the majority of the dividend has been funded from capital, giving the managers flexibility to pursue the best total returns they can achieve from the investments they make. 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.

Paying a dividend from capital therefore enables shareholders to benefit from a regular income but does not hinder total returns by the managers having to invest in dividend-paying companies with lower growth prospects. 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 the annual dividend has been steadily increasing every year. That said, because the dividend is calculated as a proportion of the year-end NAV, it is possible that the dividend could fall if the NAV has also fallen. Whether the board chooses to override this and provide a progressive dividend in such an eventuality is so far unproven, although we are told that it has been discussed by the board, and the merits of maintaining a progressive policy by paying at least a flat dividend year on year are well understood.

Fig.6: Historical Dividends



Source: Bellevue Healthcare; note: 2022 is the board's target dividend

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 now manages £11.3bn, of which c. £9.2bn is in healthcare strategies. The firm has another investment trust – the Swiss-listed fund BB Biotech (BION). 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.

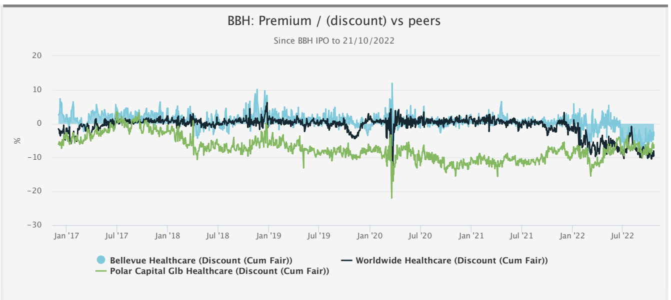
Discount

Since launch, BBH's shares have tended to trade very close to NAV, and for the majority of the time at a premium, as we show in the graph below. Over this period BBH has traded at an average premium of 0.8%, while its peers Worldwide Healthcare and Polar Capital Global Healthcare have on average traded at discounts of 0.8% and 7.3% respectively. In our view, the historical premium rating reflects the differentiated investment proposition that BBH and its managers offer. 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. As a result of the volatility in markets, from the beginning of the year to 21/10/2022 the shares have largely traded at a discount and have averaged a discount of 2.1% (Source: Morningstar). Investors who share the managers' conviction in the medium- to long-term prospects of the portfolio companies may therefore see the current discount level as an opportunity.

BBH's board employs a strict discount control mechanism which should mean that discount risk is minimised for shareholders. That said, over the short term there remains a risk that the shares might trade at a discount – as we are experiencing at the moment. The graph below shows that so far, this risk has been minimal and arguably less of a risk than for BBH's closest comparators. BBH has an annual redemption facility for 100% of shares in issue at year end, 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, this is very unlikely to be possible with the larger redemption amount that has just been announced and it is expected that the shares will be cancelled or held in treasury. It is too early to see if the redemption event has 'cleared out' potential sellers, allowing the supply/demand tension to return and thus re-establishing a premium.

We note that a share buyback mechanism is also in place, managed at arm's length by one of the trust's brokers. The conditions under which this is triggered have not been disclosed, and the fact that no shares have yet been bought back suggests that these have not yet been met, most likely because the discount has been fairly modest. However, this does provide some reassurance that the discount is being monitored outside of the annual redemption window.

Fig.7: Premium/(Discount) To NAV



Source: Morningstar

Charges

We believe that BBH's charging structure is as close to best practice as is 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). It is worth noting that the trust's board is also fully remunerated in shares, and these are locked up for a minimum period of three years after issuance. There is no performance fee payable.

BBH is a large trust, with net assets of c. £1bn at the timing of writing (October 2022). The most recently reported OCF figure (according to the 2022 half-year report to 31/05/2022) is 1.06%, 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, which should lead to a further reduction in the OCF at the margin, irrespective of whether the trust continues to grow.

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 1.07%. Worldwide Healthcare, a much larger peer with net assets of c. £2.3bn, has an OCF of 0.9%. This cost advantage is partly a result of its significantly larger size, but it is worth noting that the managers also benefit from a performance fee that could meaningfully take the OCF up in certain circumstances. BBH's latest KID RIY is 1.53%.

ESG

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. The team responsible for BBH spell out in detail their specific approach to ESG in the most recent report and account, available **here**. 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. The most common reasons for companies falling at the first hurdle have been governance structures or reporting quality.

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. However, as detailed in the report and accounts, the MSCI ESG quality score for BBH's portfolio was 6.4 as at the end of November 2021, compared to 6.24 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 in line with board recommendations for all resolutions in the 30 meetings they participated in during 2021. BBH has committed to increasing the visibility of ESG initiatives over time, which we view as a welcome development that allows shareholders to engage in what is a journey for professional and retail investors alike. Morningstar's Sustainalytics assigns a 'below average' score for BBH. In our view, this is likely because of the small- and mid-cap focus of the managers, and may therefore not be fully justified.

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