Why healthcare stocks are here to stay

It's been a volatile couple of years but that looks unlikely to stop tailwinds boosting the sector...

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Most readers probably don't need to be told that rising interest rates and the invasion of Ukraine have sent jitters through markets over the past 12 months. Valuations have come crashing down, particularly in sectors that were trading at large earnings multiples.

In many instances this was understandable. Companies with no earnings, for example, are going to find it harder going forward to raise cash as they try to drive towards profitability.

Even profitable firms will likely find it tough to justify high valuations, given that future growth may be harder to attain and investors are also likely to have access to higher "risk-free" returns simply by leaving cash in the bank.

Nonetheless, these factors, combined with the panic that the war in Europe has created, have arguably driven investors to not be particularly discriminating in their sell offs, as businesses that are producing respectable results have still seen declines in their share prices.

This a problem that the team at **Bellevue Healthcare Trust (BBH)** believes they've been facing. Managers Paul Major and Brett Darke invest in focused companies that provide innovative solutions to the healthcare sector, believing that due to the distinct products and services these companies offer they'll be able to deliver better long-term returns than a large, more diversified healthcare company. They cover a broad set of sub-sectors, including pharmaceuticals and biotech, but also insurance providers and software developers that provide solutions to the healthcare industry.

These also happen to be some of the areas of the market that have been particularly impacted so far this year. Smaller companies, tech businesses, and large swathes of the medical sector have all been hit by the sorts of dynamics described above. Perhaps frustratingly for the managers, this is almost an exact inversion of what happened during the pandemic. Enthusiasm for tech and healthcare stocks soared, pushing up valuations to often eye-watering levels.

For instance, Align Technology, a company that makes orthodontal technology, saw its share price increase more than fourfold in the 12 months to 24/09/2021, when it peaked at just under $724. Paul and Brett had already sold their stake in the firm by that point, believing that the valuation – at one point over 100x earnings - had become detached from reality.

That was ultimately the right move to make, given that Align has declined in value by almost 75% since that September high. But just as they moved out of overvalued positions during the pandemic, this year Paul and Brett have been adding to holdings that they believe have now been unfairly punished by the sell-off.

In some instances, there has already been something of a bounce back. For example, Sarepta Therapeutics, the Trust's largest holding, has actually increased in value in the 12 months to 24/11/2022, even though it was down almost 20% in June.

That's likely due to a couple of factors. One is that the company continues to generate impressive revenue growth, with Q3 sales up more than 20% on the equivalent period last year. And although it's not profitable, the company was able to raise $1.2bn via a convertible bond issuance in September. The interest rate on those bonds, at 1.25%, was lower than its existing debt, and the company has said it believes this round of funding will be sufficient to carry the business to profitability.

It's a somewhat similar story with Charles River Labs, another large holding in the BBH portfolio. The company provides a huge range of products and services to the pharmaceutical industry and saw its revenue increase from $2.3bn in 2018 to $3.8bn last year. It is on track to grow that amount by double digits again this year and is already very profitable. Despite these positives, its share price fell by 36.1% in the 12 months to 24/11/2022.

It's entirely plausible that Charles River Labs will see further declines and that Sarepta's share price may fall again. Predicting short-term volatility is nearly always a fool's errand though and this has arguably never been truer in the period we've had since the pandemic started.

However, the long-term potential of both companies, as well as the rest of the BBH portfolio, remains strong. As the managers noted in their most recent monthly commentary, more than a quarter of the UK's population is set to be over 65 by 2050, according to the Office of National Statistics.

That fits with a global trend. According to the World Health Organisation, 22% of the world's population will be in the same age bracket as the UK by 2050. Older people require and spend more on healthcare. That's not a guarantee of success for BBH, but if the managers can sort the good from the bad in the healthcare sector, then it should provide some positive tailwinds.

Underpinning this are advancements in medical technology. For instance, BBH holding Axonics has developed an implant that helps eliminate loss of bladder control, using a device that sends small electric pulses to nerves in the pelvis. Sales have risen from almost zero to over $240m in the last five years.

Aside from demonstrating the wonders of human ingenuity, it's also a sign of how advances in healthcare technology can cater to the demographic changes described above. In simpler terms, an aging population should create more demand for healthcare solutions, but technological advances are also increasing the extent to which that demand can be catered to.

Of course, none of this guarantees success for BBH, and it's unlikely we'll enter a utopian future where all diseases can be cured using technology. Nonetheless, the trends are there, and for those that believe the BBH managers are capable of sorting the wheat from the chaff, today's volatility may eventually smooth out and result in long-term returns for investors.

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