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Avoiding the perils and pitfalls for high impact healthcare investment

Stewart Investors
Sustainable Funds Group

Investing in healthcare companies seems an obvious choice for sustainable investors. After all, any company that helps cure disease, and improve health and wellbeing must be making a positive contribution to sustainable development.

However, the interplay between patients, doctors, governments and healthcare companies brings potholes and landmines for sustainability-focused investors. Consider the US$4.45bn healthcare companies spent on lobbying in the US over the 22 years to March 2020[1]; a third higher than the next highest spending industry. Or that some companies spend more on marketing than they do on research and development (R&D), despite using R&D as justification for high prices.[2] Or the finding of a 2014 study that doctors receiving payments from pharma companies prescribe more of the pharma companies' drugs, even when cheaper generics are available.[3]

Like any other sector, healthcare has good and bad companies; some have a history of scandals going back decades.[4] While rules are tightening globally in some of these areas, the difficulty of finding truly sustainable healthcare companies remains.

While these issues are real, good operators in the industry provide significant tangible benefits. We believe there are four points to be considered when looking for sustainable healthcare companies:

1. Healthcare is about human health outcomes, not about Global Industry Classification Standard (GICS) sectors or benchmarks.
2. The business model of a sustainable healthcare company should deliver access and affordability, preferably to large underserved markets.
3. Sustainability and corporate quality are deeply intertwined - for good and for bad.
4. Stewardship, ethical leaders and strong cultures are as important as any quantitative factor in assessing healthcare companies.

This article explores each of the areas outlined above. You can explore the healthcare companies we own by visiting our microsite and filtering the interactive map by Sustainable Development Goal 3 – Good Health and Wellbeing.

Healthcare is about human health outcomes, not about GICS sectors or benchmarks

As long-term, bottom-up investors, we are primarily concerned with the quality and sustainable development contribution of individual companies, rather than seeking exposure to themes or sectors. This gives us the luxury of not needing to invest in any healthcare companies, but the responsibility of ensuring that we have validated the actual sustainable development contribution of each company when we do.

It also means we are not constrained by GICS sectors or benchmark weights and so can take a broad view of health and wellbeing across the system, and around the world. Rather than seeing a GICS sector dominated by large pharmaceutical companies, we have found medical device companies, diagnostics companies and generic medicine manufacturers, all making real contributions to improving access and reducing costs. Looking broader still, take the example of Unilever.[5] One of the core investment drivers for this Consumer Staples classified company is health related, as selling soap and providing hygiene education to more than a billion people is arguably a very significant human health contribution.

The broad view also includes companies like Zebra Technologies, which is classified as Electronic Equipment, Instruments & Components by GICS, but whose technology is widespread in pathology labs (and in hospitals) around the world, as their bar code and logistics technology drives more accurate sample tracking and system efficiencies.

Business models should deliver access and affordability to underserved markets

This broad view means we must understand how a company's business model supports lowering health system costs, expanding access and producing real world health outcomes. It also recognises that prevention is better than cure with many healthcare company business models being reliant on preventive approaches not being adopted.

Instead, we believe that companies seeking to support large and underserved addressable markets, or disrupt rent-seeking incumbents, are more likely to deliver long-term revenue growth. Underserved markets are often developing markets where affordability and access are critical for underpinning a sustainable business model. Lastly, we believe business models which reduce overall system costs will be more resilient as they are likely to benefit from, rather than be targeted by, regulatory interventions.

An example of a high impact health outcome in large addressable markets is vision correction, with 4.6bn people globally requiring it and almost 60% not having access.[6] Vision correction is also one of the most important interventions which can be made to support quality education, showing the interrelationship of different aspects of human development.

Swiss-listed Alcon, whose long-term success relies on building trust and access to affordable vision correction interventions, partner with organisations to provide training and equipment to surgeons in emerging markets and have developed portable machines for procedures where there is no water or electricity. In addition to the hundreds of thousands of underserved patients benefiting from these products, more than 6m people have been served by Alcon's philanthropy programmes from 2009 to 2019.[7]

Sustainability and business quality are deeply intertwined

In addition to making a contribution to sustainable development, company quality is also essential. For us, quality of franchise, management and financials are considered for every company, and we only invest in companies that offer both quality and sustainability. We don't view these as competing items to be balanced, rather quality and sustainability are almost always interlinked, particularly in high-impact sectors like healthcare.

We believe a franchise that depends on boosting prices of patented medications, and consequently limiting access, is inherently weak. We regularly discuss the risks of companies overearning, given the privileged and trusted positions they hold, and recognise the risks that overearning today invites in regulation and competition tomorrow. Traditional considerations, viewed over the long term, such as the proportion of recurring revenues, R&D spend and the sustainability of margins also help us understand the quality of these businesses.

Diagnostic companies are a good example. These companies make up around 5% of total hospital costs but can influence 60-70% of healthcare decision-making.[8] While there is the potential in some healthcare systems to incentivise overuse of diagnostics, the overall value to the health system is significant and extends well beyond detection of disease to include early intervention, better selection of treatments and, in the case of infectious diseases like COVID-19, has been critical in tracing and isolating cases to prevent further spread. These companies also tend to have resilient business models due to recurring revenues from consumables. Companies like DiaSorin, bioMérieux, and Tecan all play leading roles in delivering these benefits.

Integrated Diagnostics operates a chain of diagnostic centres across Egypt, Jordan, Sudan and Nigeria, which provide a range of tests to identify illness and aid medical diagnoses. The company conducted 30.5m tests for 7.5m patients in FY19, for an average price of US$4.57 per test.[7] These tests help early diagnosis of a range of illnesses, which is essential to treatment and survival rates in countries which have relatively weak healthcare systems.

Stewardship and ethical leaders are essential

Healthcare companies often become most important in times of crisis for individuals or societies. The temptation to exploit this vulnerability has resulted in a series of pricing scandals, infamously including Mylan, the maker of Epipens, increasing prices six-fold in 2008 and deliberately misleading the US government to avoid paying rebates. These actions damaged its reputation and resulted in a US$465m settlement with the US Justice Department.[9]

The US opioid crisis and the role of the Sackler family-backed Perdue Pharma is another example where short termism and a failure of stewardship came with tragic consequences, resulting in the company facing criminal charges and billion dollar fines for actions taken to turbocharge sales of OxyContin.[10]

While a good business model can help, taking the long view requires excellent and ethical management and stewardship, another key factor in our quality assessment. We believe New Zealand-based Fisher and Paykel Healthcare is a world leading manufacturer of ventilators and respiratory devices for hospitals and homes. The demand for their products surged during the COVID-19 pandemic due to undersupply in hospitals. While the company's costs increased due to supply chain issues and shifting deliveries to air freight, they chose not to raise prices for customers, impacting margins in the short term, but strengthening trusted relationships with customers and accelerating the rollout of their machines. This should benefit both the health system and the company in the long term as most of their revenue comes from consumables.

Another example is Dr. Lal PathLabs, an Indian pathology provider with partners in 22 countries, which performs more than 100,000 diagnostic tests per day.[7] The company's services offer early detection and intervention for illnesses which otherwise might result in costly hospitalisations. The Chairman has said that their strategy prioritises patient numbers over pricing, driving both access and affordability, while underpinning the growth and market leadership of the company for years to come.[7]

Looking to the future of healthcare

One final area of sustainable healthcare investment which is important to touch on is the future. While access and affordability in underserviced markets remain powerful long-term drivers for growth in sustainable healthcare companies, COVID-19 has given us a window into the challenges the health system faces and has also accelerated some positive trends.

Tele-health and the 'internet of things' as it relates to medical devices, has seen accelerated adoption in healthcare in the same way as work-from-home arrangements in business. We believe companies like Philips are well positioned for this trend, following a corporate restructuring, including divestment of the household appliances they are better known for. We believe Philips holds leading market share and technological advantages in their connected care, diagnosis and treatment divisions, giving the company long-term tailwinds in the digitisation of health. This business opportunity can deliver better outcomes, greater access and lower costs. Studies by Philips and others, include a five-year study which found significant benefits, such as 26% fewer ICU deaths[11] through the use of these technologies.

The second area is genetic diagnosis and treatments. In this regard, we believe Illumina is the clear leader in gene sequencing technologies that are used by scientists and researchers across life sciences, oncology, reproductive health and other emerging segments. From diagnosing rare diseases to understanding the biodiversity in our ecosystems, Illumina is helping to unlock the power of the genome.

Their technology advancements have helped to reduce the cost of sequencing a human genome from US$1m in 2007 to less than US$600 today and they are pushing to reduce this to just US$100 per person.[7] The company has an innovative and ethical culture and a high-quality supervisory and ethics board. It earns significant recurring revenues from the sale of consumables and services and is benefitting from the growth in preventive healthcare and personalised medicine.

Current portfolio positioning

While our healthcare investment by GICS classification ranges from 3% to 29% across strategies[12], our approach to healthcare investment indicates that we:

- Invest in more companies contributing to good health and wellbeing outcomes than is indicated by the GICS sector.
- Completely avoid the mega-cap, big pharma companies which comprise a substantial proportion of the MSCI AC World index's health care companies.[13]

The best way to view our healthcare exposure, at least as we see it, is to filter the interactive portfolio map on our microsite by Sustainable Development Goal 3 – Good Health and Wellbeing, as it provides a complete list of holdings across all strategies and our reasons for investing in them.

The investment implications of our approach are twofold. Firstly, different to popular perception of healthcare performance during 2020, COVID-19 didn't lift all of our healthcare companies but roughly split our holdings into relative 'winners' through stimulated demand, for example in diagnostics, and 'losers' through deferred demand for anything to do with elective surgeries. As these trends reverse we expect the short-term implications for our companies could be the same. However, none of our investments were made with COVID in mind or to ride a COVID wave, rather like all our investing, it was focused on the long term, where we still invest on the expectation that all the companies we invest in will do well.

The second implication relates to valuation and whether healthcare as a sector is currently overvalued or whether we are overexposed. We are concerned by valuations across the market; indeed a core part of our investment philosophy is capital preservation. In this respect, our healthcare companies are similar to every company we invest in. They are high quality, offer reasonably predictable growth supported by long-term sustainability tailwinds and carry less debt.

Healthcare investment offers opportunity and impact, but not by ticking a box

Systemic issues and the practices of some companies can make healthcare investment a challenge for sustainable investors. But finding business models which succeed by reducing costs and increasing access, can produce real benefits in global health systems and for investors.

While ethical and long-term stewardship are fundamental requirements for all the companies we invest with, in healthcare it is literally the difference between life and death. However, these qualitative factors cannot be metricated, and do not appear in ESG scores. Nor should they be taken as a given because a company appears in a given GICS sector. They can only be assessed over time, with experience and mistakes as guides.

[1] Source: Investopedia. 'Which Industry spends the most on lobbying?' May 2020.

[2] Source: Regulatory Affairs Professionals Society. 'Do Biopharma Companies Really Spend More on Marketing Than R&D?' July 2019.

[3] Source: Engelberg, J. Parsons, C.A. and Tefft, N. 'Financial Conflicts of Interest in Medicine'. January 2014.

[4] Source: Drugwatch. 'Big pharma and medical device manufacturers.'

[5] For illustrative purposes only. Reference to the names of each company mentioned in this communication is merely for explaining the investment strategy and should not be construed as investment advice or investment recommendation of those companies. Companies mentioned herein may or may not form part of the holdings of Stewart Investors.

[6] Source: EssilorLuxottica. Capital Market Day presentation, September 2019.

[7] Source: Stewart Investors investment team and company data.

[8] The Lewin Group - The Value of Diagnostics Innovation, Adoption and Diffusion into Health Care (2005)

[9] Source: The United States Department of Justice. 'Mylan agrees to pay $465 million to resolve false claims act liability for underpaying EpiPen rebates.' August 2017.

[10] Source: The Guardian. 'Purdue Pharma pleads guilty to criminal charges related to US opioid crisis.' November 2020.

[11] Source: National Library of Medicine. Lilly, C. M. et al. 'A multicenter study of ICU telemedicine reengineering of adult critical care.' March 2014.

[12] Source: Stewart Investors.

[13] Source: MSCI.

Investment terms

View our list of investment terms to help you understand the terminology within this document

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