

Defensive Growth Story Continues

Stockholm (HedgeNordic) – The Rhenman healthcare strategy – **Rhenman Healthcare Equity L/S** – has annualized at an average of c.20% since inception in June 2009. Thanks to the magic of compounding, day one investors have roughly quintupled their money – and those who were also investors with Henrik Rhenman in his former role could have made around 40 times their money by now: the Carnegie Global Healthcare fund he ran was the world's top-performing healthcare fund, advancing by 800% between 1998 and 2008. But the performance has not traveled a linear path; there have been flat periods of consolidation and some pullbacks.

US Politics

“Our worst period was January 2016, in the early days of the US Presidential election campaign, when Trump, Clinton and Sanders were competing with each other to say negative things about pharma. The biotech index was down 20% in a month, which was a very humbling experience, as we could not understand why Twitter comments would have such an impact on stock-market valuations”, he says. Recently in 2019, political rhetoric around the 2020 US Presidential elections has also been a source of some volatility in healthcare equities.

Rhenman weighs up the risks as follows: “the worst Democratic candidate scenario would be if people start to view Elizabeth Warren as a credible candidate. The best Democratic candidate scenario would be Joe Biden, as he is an incrementalist who would not try to change much. The best scenario of all would be if Trump (or another Republican) is re-elected. And a US recession is, ironically, the biggest threat to the recession-proof healthcare sector, because a recession would reduce the chances of a Republican President”.

But even if a radical Democrat did win the Presidency, they would not be able to make radical changes to US healthcare without the approval of other law makers. For instance, “price control of drugs is extremely difficult, and we do not expect there would be a majority in Congress and the Senate, either now or after the election”, says Rhenman. Additionally, “drug pricing is much more than a pricing issue. Americans view access to drugs and healthcare as a right”, says portfolio manager, Susanna Urdmark. Indeed, the normal European practice whereby bureaucrats ration some types of healthcare and drugs according to criteria such as age is characterized as “death panels” in the US.

The volatility has provided some trading opportunities, particularly in US HMO groups, but with volatility coming mainly from US political posturing or the geopolitical trade war, overall portfolio turnover in 2019 has come down a bit. There has been more active trading in prior years: a different type of political risk was stalking the markets during the European sovereign debt crisis in 2011, when Rhenman scaled back net long exposure to a low point of 37% around the Greek crisis. On average, the strategy has run at net long exposure of 120%, which peaked at 153%. In 2019, the net exposure remains above 100% partly because Rhenman finds valuations attractive. The biotech index and some single stocks are used on the short side; it is not always possible to obtain stock borrow on the names that Rhenman might want to short.

Attractive Valuations

“The overall healthcare sector is on a PE ratio around 17, which is below its historic average. Within this, there is some variation. Medical technology companies are relatively richly valued, which reflects the generally high valuations ascribed to defensive growth stocks across all sectors. On the

other hand, some biotechs and pharmas are on PE ratios around 11 or 12, and some services companies are on single-digit PE ratios”, says Urdmark.

Biotech, pharmaceuticals and specialty pharmaceuticals have been the largest sub-sectors, typically making up over half of the fund. Medical technology and services can be around a third of it. After excluding pure R&D plays with no current earnings, Rhenman’s portfolio has a weighted average PE ratio of around 17, in line with the sector. In 2019 to August, Rhenman has had three takeover bids – Array Biopharma, Spark Therapeutics and Allergan – and he reckons three per year has been the average. Another stock, Abeona, recently jumped 100% in a day on a press release.

Rhenman remains very constructive on the growth prospects of the healthcare sector. It is growing faster than the global economy, and is tapped into the faster growth of emerging markets – China recently overtook Japan as the world’s second-largest healthcare market. Rhenman generally invests in companies that generate revenues globally, rather than local or domestically focused players. The healthcare strategy runs around USD 660 million and for many years there has been a plan to soft close at around USD 1 billion. This is partly because over half of the fund is in small and mid-caps (defined as market caps below \$20 billion). But the capacity target should be seen as something of a moving target as the sector itself grows.

Innovation

The portfolio is exposed to treatments for a wide range of conditions including some rare diseases, but in big picture terms, Rhenman identifies two families of treatments as very promising. “Oncology continues to generate many innovations and also offers a broad range of companies to invest in. Gene therapy holds out the prospect of completely new approaches to diseases that had previously been untreatable, and there are hundreds of clinical trials underway. If gene therapy can cure lethal diseases, its threshold for commercialization could be quite low and its pricing power could be high. Rather than viewing costs in isolation, they should be compared with the cost of lifelong care for chronic conditions, which can be many times greater than the cost of some new drugs or treatments”.

Similarly, analyst Kaspar Hallsten – who specializes in medical technology – points out that advances could save money by shortening hospital stays, and helping patients to make faster recoveries and return to work sooner. In the most common human ailment – cardio problems – more targeted methods of operating can remove the need to open up the entire chest. One example where European companies are leading the way in innovation is a company that has developed a cardiovascular valve for heart treatments. Abiomed is another firm involved in cardio treatments that Rhenman likes.

“These are exciting times. We have low PE ratios, low interest rates, a stock-market that is somewhat inclined to defensives, and good demand for healthcare products. We are as excited as we have ever been about our prospects”, says Rhenman.

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