



# Health care sector may offer growth opportunities

April 23, 2018

*Even with the political uncertainty surrounding health care, the pursuit of innovation and the value placed on lifesaving initiatives make it an area for potential growth.*

Health care spending is expected to expand exponentially in the next decade — and the potential for innovation is exciting. But how can investors tap into this growth opportunity? Portfolio Managers David King and Tchintcia Barros share their insights.

**Q: What role does the health care sector have in your investment universe?**

**Dave:** I focus on investing in convertible securities, which are bonds or preferred stocks that can be converted into common stock. Health care is a significant part of this universe, and the health care companies in this space tend to be very growth oriented and smaller than typical large-cap equities.

**Tchintcia:** Health care is the third largest sector in the Russell 1000 Growth Index, so for equity investors with a focus on growth, it can be a significant part of their portfolio. I target innovative companies gaining market share in industries that represent a large segment of the economy, and health care is one of them.

**Q: How would you describe the health care sector today?**

**Dave:** The first word that comes to mind is chaotic. Federal government policy is

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—Tchintcia Barros, Portfolio Manager



inconsistent. There isn't a consensus for repealing the Affordable Care Act without a replacement, yet there hasn't been a solution that's gained any traction in Congress. The macro backdrop for the sector would be poor, except that life is everybody's top priority, and the population in the developed world continues to grow older. Demographics and market forces far outweigh political factors in a free economy, so the long-term outlook for health care investing is favorable.

**Tchintcia:** The sector has never been more polarized. On one hand, you have amazing innovation in industries such as robotics, precision medicine, disease-modifying therapies and minimally invasive procedures. On the other hand, industries such as pharmacy benefit management, generic drug manufacturing and third-party distribution are coming under significant pricing pressures. Ultimately, this dichotomy should allow investors to find opportunities — both domestically and internationally. I foresee more innovation and a U.S. Food and Drug Administration that allows these breakthroughs to get to market faster.

**Q: What's a key trend among the health care industries you cover?**

**"For health care investors, innovation is the most important trend to watch, followed by consolidation."**

—Dave King, CFA, Senior Portfolio Manager



**Dave:** Innovation is the most important trend, followed by consolidation. Convertible securities are often issued to finance growth and new initiatives, but an important secondary purpose is to finance consolidation through mergers and acquisitions. The investments we consider are usually related to new health care products and services, and the rest almost always involve mergers and acquisitions.

**Tchintcia:** Technology has been used more and more to diagnose

and analyze information. We can now monitor diabetes patients better; more accurately diagnose cardiac arrhythmias; lower the costs of running genome sequencing; transform orthopedics with robotic-arm assisted surgery; tailor cancer treatments using small molecule inhibitors, antibodies, antiangiogenics and viral therapy; use a patient's own immune system to attack cancer cells. Advances in big data and machine learning also offer the prospect for more efficient drug discovery and more personalization of medicines based on an individual's genetic makeup.

**Q: How would you summarize health care spending?**

**Dave:** Health care spending in the United States is 17.9% of gross domestic product (GDP). Barring a major shock to the system — like world war or a

depression — this spending is expected to grow substantially in the coming decades, outpacing projected growth in GDP by 1.2% each year.<sup>1</sup> This isn't a bad thing. Rising health care expenditures, combined with a declining percentage of these expenditures wasted on bureaucracy, legal activity, inefficiency and poorly planned research, will help improve society.

**Tchintcia:** National health care spending in the U.S. is projected to grow at an average rate of 5.5% per year from 2017 to 2026, when it could reach \$5.7 trillion.<sup>2</sup> This underscores the need for additional cost transparency and efficiency throughout the entire health care system. In many emerging markets, the growth of the middle class will offer investment opportunities as more consumers use health care products and services.

**Q: What's the greatest health care innovation you've seen in your lifetime? What do you anticipate is next?**

**Dave:** There's no doubt that the Salk vaccine is the most significant innovation in my lifetime. I grew up seeing otherwise healthy adults in wheelchairs or walking with a limp because they had polio as children. They were the "lucky" ones; they survived. But then, with three little sips from a paper cup from preschool to first grade, I never had to worry about polio.

The next mega-development will be customized medical treatments based on an analysis of someone's genetic makeup. Cancer will not be cured, but in 20 years it will be more like having an infection if detected early. Instead of treating people through trial and error and generalized research experience, an oncologist will essentially know what treatment will work for your cancer in your body. In advanced nations, it could become rare to die from cancer before a very old age. Genetically customized treatments will also make significant inroads into conditions such as muscular dystrophy, multiple sclerosis and Parkinson's disease.

**Tchintcia:** Using an individual's immune system to attack cancer cells and the ability to take into account variability in genes, environment and lifestyle are incredible innovations. There's been tremendous success with immunotherapies to treat subgroups of cancer patients.

I think we could potentially see a cure to certain cancers in our lifetime. While this is exciting and provides hope of longer term survival for many advanced cancer patients, the big breakthrough for a cure will be to find cancer earlier. The ability to characterize a tumor's genome — combined with new methods of processing complex data, including machine learning — will enable early detection of cancer when it's more likely to be cured.

#### **Bottom line**

Long-term investors should expect the health care sector to be above average

with regard to both volatility and return. The political backdrop is not ideal, and the pursuit of innovation is always commercially risky. However, these factors will continue to be overshadowed by the extreme importance of life and health over everything else and the constant breakthroughs in the sector.

<sup>1</sup> Centers for Medicare & Medicaid Services' Office of the Actuary, 2017-2026 Projections of National Health Expenditures, 2017.

<sup>2</sup> Ibid.

The Russell 1000 Growth Index measures the performance of those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values.

It is not possible to invest directly in an index.



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