Turner Investments

A close look by Turner's analysts at the market sectors they cover

Sector Focus

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Why health-care stocks may shine in the near term

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Talk about a turnaround in performance: last year health care was the worst performer of the nine sectors in the broad-based Russell 3000 Index, but this year it's the best.

In 2010 the health-care sector lagged badly, gaining just 3.89%, compared with a 25.84% return for the leading sector, consumer discretionary, and 16.93% for the overall Russell 3000 Index. And relative performance in the previous year was similarly dismal: in 2009 the sector rose 19.06%, trailing the 62.58% return of the top sector, technology, and the Russell 3000's 28.36%. Conversely, for the year to date through May 31, the sector is up 14.78% -- a return exceeding that of the second-best sector, energy, by 2.46 percentage points and the index by 6.48 percentage points (*see display, below*).

After two years of underperformance, the health-care sector is generating superior results in 2011

Total returns

	2011 through May 31	*2010*	*2009*
Russell 3000 Index Health-Care Sector	**14.78%**	**3.89%**	**19.06%**
Russell 3000 Index	8.30	16.93	28.36

What's behind this striking turnabout?

In our estimation, health care's outperformance this year is due in no small part to the slowdown in the U.S. economy. The stock market has been rattled by a jangling assortment of negative economic developments, such as slower manufacturing growth, higher commodity and energy prices, rising inflation, lackluster consumer spending, the ripple effects from China's tightening of credit, and the threat that Europe's government-debt problems may morph into the second global financial crisis in three years. Investors are questioning whether the U.S. economic slowdown is temporary or the start of a recession. (We think it *is* only temporary, that the economy should reaccelerate as the year progresses.)

Defensiveness pays

At any rate, when economic growth has been as sluggish in the past as it is now, health-care stocks have tended to perform well. That's because health care is a "defensive" sector: it benefits from relatively stable demand and is thus less subject to the fluctuations in the economic cycle. In short, health care is a non-discretionary expense; people typically spend on health care to maintain or restore their health when they need to, no matter how the economy is behaving. (Currently global health-care spending totals more than $6 trillion, accounting for about 9% of global gross domestic product.)

So while the U.S. economy remains stuck in a soft patch, in what we characterize as a mid-cycle slowdown, we think health-care stocks are likely to continue to perform well. The typical soft patch lasts about six months, according to Bank of America Merrill Lynch, so the economy may limp along for at least a few more months before it regains its stride, which we think is likely. It's our perception that Wall Street market strategists generally believe the health-care sector should be a prime beneficiary of that economic weakness. In essence, Wall Street is cheering on the sector in the near term, yelling, "Dee-fense! Dee-fense! Dee-fense!"

As a defensive sector, health care historically has produced relatively good returns not only in times of economic weakness but at this particular time of the year as well. Standard & Poor's has found that over the past 20 years, the health-care sector of the S&P 500 Index has outperformed the index in aggregate from May through October, a six-month period that's notorious for producing puny stock-market gains. We think this year's May-October cycle may be no exception, in light of investor concerns about the economy. In previous May-October periods since 1990, the S&P 500 Index returned a mere 1.4% annualized, while the health-care sector gained 4.8% annualized.

Besides the auspicious timing in both the economic cycle and the Gregorian calendar, we think there are two other reasons why health care may continue outperforming in the near term:

Weightings rise

First, health care has generally been underweighted in institutional stock portfolios in the past two years. As the sector's investment results get better, portfolio managers are chasing that performance and increasing their weightings in health-care stocks, which is helping to fuel demand for those stocks.

According to Ned Davis Research, the majority of market strategists worldwide are recommending that stock portfolios overweight the sector now. For instance, beginning in 2009 J. P. Morgan ranked health care's return potential as neutral, indicating that the sector deserved only a market weighting in portfolios. But recently, in May, J. P. Morgan upgraded health care's ranking to overweight. Among the reasons cited for that reassessment, the firm said it anticipated a "flattish" June-September period for the stock market, which should bode well for a defensive sector like health care.

Second (and most important, we think), the health-care sector's fundamentals are almost uniformly strong:

- The sector's earnings growth is being sustained, and the sector is reaping a high level of positive earnings surprises. In our view, health care's consistent growth may be especially prized by investors at the moment, when the rate of earnings growth for the rest of corporate America is beginning to slip to the low double digits.

Steady as she goes

Health care's steady-as-she-goes character is perhaps nowhere more evident than in earnings. In every quarter since 2006, the sector's earnings for the past 12 months have risen without fail. As J. P. Morgan notes, health care's earnings "continued to grow throughout the [most recent] downturn and recovery, while earnings for the overall S&P 500 plunged sharply and have recovered to only slightly above the 2007 level."

In the first quarter, 86% of all health-care companies beat Wall Street's earnings expectations, versus a 69% average for all S&P 500 Index companies. Health care's earnings exceeded Wall Street consensus projections by 12.4%, according to Thomson Reuters.

- Return on assets has been rising since September 2010. The sector's return on assets (a gauge of how efficiently a company uses its assets to produce earnings) is currently 1.40 times that of the S&P 500 Index and is at a near-record for the past six years. The sector's average return on assets during those six years is 1.27.

A superior return on assets is being accompanied by a high level of free cash flow. In the first quarter the sector's free cash flow hit $121 billion, representing a compound annual growth rate of 11.3% since the third quarter of 2006. In contrast, the free cash flow of the S&P 500 Index companies, excluding financial services, compounded at 8.6% annually. Among sectors, health care has been a free-cash flow juggernaut historically, owing to its pricing power and its need to spend relatively little on production plants and equipment.

Cash return up

- Dividends and share buybacks are accelerating. The sector's cash return to shareholders, in the form of dividends and buybacks, is up 59% in the past 12 months ended March 31, totaling $78 billion. Dividends paid amount to $28 billion, an all-time high. We think the share buybacks, at $50 billion, may climb higher by 2012, possibly surpassing the previous peak of $68 billion in 2008.

- The pace of mergers and acquisitions is picking up, which we think is a response by health-care firms to their improving fundamentals. Over the past 12 months ended April 30, the sector has been a notably busy acquirer, making deals worth $150 billion. Outlays in some of the biggest deals include $24.5 billion by Sanofi-Aventis for Genzyme, $7 billion by Merck for Millipore, $6.1 billion by HCP for HCR Manor Care, and $5.5 billion by Valeant Pharmaceuticals International for Biovail.

Historically, when the number of health-care acquisitions is on the rise, it has correlated with outperformance by health-care stocks, J. P. Morgan's research shows. So we think increased M&A activity is yet another sign that the sector's return potential in the near term is favorable.

- Health-care stocks have attractive valuations. Health-care companies' earnings are 37% *higher* than in 2007, but as of April 30 their share prices are 2% *lower*, even with their recent burst of outperformance. However, as we see it, if market sentiment for the sector remains positive, health-care valuations may increase, which would lead to additional gains in the shares.

In sum, because of the sector's defensive nature, its sound fundamentals, and the current economic doldrums, we think health care's stock-market prospects look good in the months ahead. Dee-fense! Dee-fense! Dee-fense!

established companies. Health-care-related companies may also be strongly affected by scientific or technological developments and their products may quickly become obsolete. Finally, many health-care-related companies offer products and services that are subject to governmental regulation and may be adversely affected by changes in governmental policies or laws.

Turner Investments, founded in 1990 and based in Berwyn, Pennsylvania, is an investment firm with more than $18 billion in assets under management in stocks, as of March 31, 2011. Turner manages growth, global/international, core, value, quantitative, and alternative separately managed accounts and mutual funds for institutions and individuals.

For a quick rundown of Turner Investments' views on the stock market and growth-investment strategy, watch the *Quarterly Perspectives With Bob Turner* video at this link:

http://www.turnerinvestments.com/index.cfm/fuseaction/content.page/CSID/582

As of May 31, 2011, Turner held in client accounts 61,580 shares of Merck and 3.1 million shares of Valeant Pharmaceuticals International. Turner held no shares of Sanofi-Aventis and HCP.