Health Care Reform's Impact on Value Investing

The following is a question and answer session with the U.S. Value strategy's Senior Portfolio Manager Mike Liss, CFA, CPA, who is also our chief analyst for health care securities. Liss provides perspective on the Affordable Care Act (often referred to by its nickname, Obamacare) and reveals where he sees the greatest opportunity within the health care sector, including some of the industries and securities we currently favor. He views the legislation as a green light for health care investors primarily due to the influx of millions of new patrons into the health care system.

Q: What has been the recent impact of health care reform on value investing?

A: We're finding value investing opportunities in health care across the spectrum because of the recent Affordable Care Act, which was designed to provide more Americans with health insurance. We find that millions of people will gain insurance on exchanges and through Medicaid, and this will lead to increased utilization of health care services. Therefore, we believe that health care companies will benefit, and earnings for these companies will accelerate over the next three to five years due to the new legislation.

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Key Health Care Marketplace Enrollment Statistics

- Over 8 million people have selected a plan through the Health Insurance Marketplace from October 1, 2013, through March 31, 2014
- 6 million people have signed up for Medicaid in the 25 states that are participating
- 5.3 million people, or 66% of the total, were 35 years of age or older
- 2.7 million people, or 34% of the total, were between birth and 34 years old—most of which were 18-34 (28%)
- 46% of the enrollees were male and 54% female
- 85% selected a plan with financial assistance

More than 10 million people will gain access to health insurance through Obamacare over the next three to four years.

Q: Will the impact be long-term or short-lived?

A: I think the impact will be long-term because you are going to have a step-up in utilization over several years—really over the next three- to four-year time period. The majority of it will be felt most strongly in years two and three (we are currently feeling some positive impacts in year one), and then it will level off and operate at a new (higher) level or base and grow from that point.

Health care costs have grown at two to three times the rate of inflation for the past 30 to 40 years, but it won't grow that fast going forward because we can't sustain it. And we can't sustain it because health care already makes up about 18% of the economy and should remain at that level of participation, as more than 10 million people gain access to health insurance through Obamacare over the next three to four years.

Q: What is the effect of the recent reforms on health care insurers?

A: We have already seen a tremendous amount of consolidation within the health insurance industry—there's not nearly as many health insurers as, let's say, 10 to 20 years ago. These companies now operate in a much more disciplined fashion, returns on capital are pretty good (not at peaks, but closer to peaks than troughs), and the companies appear to be much more stable than they were in the late 1990s and the first part of the 2000s because the competitive environment is less extreme.

While these companies can have a bad quarter or two when costs creep up, or they mis-priced a product in any individual state, it can negatively impact you for the next three quarters going forward. But, they are operating with less competition than in the past with a narrower band of outcomes (because companies can only make so much within the Obamacare structure, including minimum medical loss ratios). The insurers have also been hesitant to price their products too aggressively because they are unsure of both the exact composition of the approximately eight million new members (pinpointing existing medical conditions) and also who their competition is. However, we do have an idea of the age makeup of the participants, and there appears to be a shortage of Millennials (ages 18 to 25) enrolling.

![Marketplace Plan Selection by Age](chart.png)

Q: What industries do we see benefiting the most and why?
A: Hospitals should benefit the most from this surge of activity/enrollment within the health care sector. This industry should grow over the next three years and then remain at that stepped-up level going forward. We have seen this kind of positive activity in states such as Massachusetts and Oregon (Medicaid sign-ups escalated), and this should spread to other states throughout the country.

We are just starting to see more people walking into emergency rooms with insurance, as people without insurance has begun to drop. In the past, uninsured people would come to a hospital and the hospital couldn’t turn them away. The hospital would bill them and then wind up writing it off because they could not collect on the services provided. Historically, hospitals would have to write off up to 15% to 20% of revenues due to these types of transactions, but I believe that bad debts will probably be sliced in half now that more people will be insured.

The positive effects of this change will permeate through the entire health care system, including:

• Health care/medical equipment and supply companies, who will profit from the influx of people going to doctors and hospitals.
• Information and health care information technology providers, who will benefit from an increase in patient data/information, which will need to be shared more efficiently system-wide. Health care is woefully behind other industries in modernizing the use of technology.

Q: What specific traits or attributions do we look for in health care companies for our value portfolios?
A: We are focused on companies that we believe have a sustainable business model and market leadership; financial productivity, through high returns on capital and free cash flow generation; and balance sheet strength, generally through lower degrees of leverage. Dividend payers and, more specifically, dividend growers, are also an important component of many of the quality companies we select. The value of any leading business usually grows in direct proportion with the cash it generates. If dividend payments are internally funded through free cash flow generation, the quality of the company becomes less in question and less prone to creative accounting methods.

The team maintains a universe of companies that have met our investible criteria—these names are typically perceived as high-quality businesses that maintain a competitive advantage relative to other companies within their industry. The universe of companies tends to be relatively steady because only so many companies can fulfill our stringent requirements—and this stability lends itself to a higher level of familiarity from our team and potentially gives us a design advantage.
Q: Can you give examples of companies that have benefited, or will benefit, from health care reform?

A: LifePoint Hospitals is an example of a company we own that is benefiting, and we believe may continue to benefit, from health care reform. The company is benefiting from rural hospitals coming under financial pressure—most of them are sole community hospitals and are selling themselves to larger chains. LifePoint, being a predominantly rural operator, has been able to buy these businesses at attractive multiples. The company is also trying to move into more suburban areas, which would give them access to increased volumes/people and stay in line with recent population trends. In addition, 35% to 40% of the company’s hospitals are located in states that are expanding Medicaid coverage.

We also find the following companies to be of interest:

- Medicaid insurers United, Cigna, Aetna and Humana
- Medicaid-focused companies Centene and Wellcare Health Plans
- Medical supplier CareFusion
- Hip/Knee/Joint replacement company Zimmer Holdings
- Pharmaceuticals industry companies Pfizer and Merck
- Quest Diagnostics, Johnson & Johnson, and Medtronic

Zimmer Holdings should also benefit from the increase in hip/knee/joint replacements.

In the pharmaceuticals industry, we are interested in Pfizer and Merck due to an industry-wide increase in drug utilization resulting from the influx of new participants. Companies such as Quest Diagnostics should also profit from increases in various types of medical testing. And, finally, Johnson & Johnson and Medtronic should benefit on a number of fronts because of their broad exposure to many health care markets.

### Top 10 Holdings* (3/31/14)

<table>
<thead>
<tr>
<th>U.S. Value</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Exxon Mobile</td>
<td>3.83%</td>
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<tr>
<td>Chevron Corp.</td>
<td>3.21%</td>
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<tr>
<td>Wells Fargo &amp; Co.</td>
<td>3.03%</td>
</tr>
<tr>
<td>General Electric Co.</td>
<td>2.97%</td>
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<tr>
<td>Pfizer Inc.</td>
<td>2.78%</td>
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<tr>
<td>Proctor &amp; Gamble Co.</td>
<td>2.75%</td>
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<tr>
<td>JPMorgan Chase &amp; Co.</td>
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<tr>
<td>Republic Services Inc.</td>
<td>2.25%</td>
</tr>
<tr>
<td>AT&amp;T Inc.</td>
<td>2.14%</td>
</tr>
<tr>
<td>Northern Trust Corp.</td>
<td>2.11%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>27.48%</td>
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</tbody>
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*Represents the top 10 holdings included in the portfolio on a percent of asset basis.

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