STATE STREET GLOBAL ADVISORS

Active Quantitative Equity

Time to Re-Evaluate Health Care Stocks

- Political uncertainty sparked a selloff in US health care stocks in March and April.
- Our multi-dimensional analysis of return and risk suggests that reducing our position size in this sector may be warranted.
- Nevertheless, fundamental drivers of performance remain strong in the sector, and we will likely retain some exposure to pharmaceuticals and health care providers.

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In September 2018, we suggested in this commentary that the time was right to explore further opportunities in US health care stocks, particularly in the pharmaceuticals and providers and services segments. Since then, however, political uncertainty has spawned an indiscriminate sell-off in many health care names, beginning in March 2019 and hitting lows around April 17 – even as equity markets continued to grind higher. The key point of uncertainty is whether a change in party power following the 2020 US elections could lead to sweeping health-care reform.

In this month's commentary, we'll revisit US health care stocks through the framework of our investment process. Rather than pondering the probability of a given election outcome and considering whether large-scale health care reform is likely to take shape in 18 months' time – and then attempting to estimate earnings impact based on those probabilities – we rely instead on our well-defined investment processes and discipline to respond to this political uncertainty.

Assessing return and risk

As we outlined in September, our generally positive view of US health care stocks was based on its broad source of secular growth (via an aging population and advances in technology), the availability of value within the sector (selectively, not in aggregate), the improvements in earnings growth across the sector, and its lower variability in earnings (with the exception of biotechnology) compared to other sectors.

The return estimates we create for any stock in the equity market include value and quality metrics, which provide long-term evaluation of fundamental drivers of stock prices. Our return estimates also include measures of market sentiment, which gauge short-term return drivers. Broadly speaking, our analysis suggests that the fundamental drivers of return for US health care stocks remain strong, but sentiment has deteriorated.

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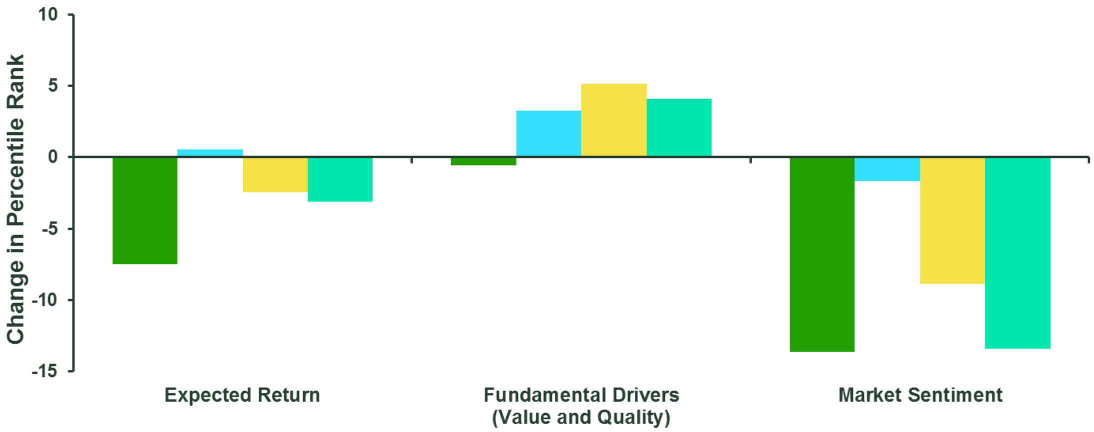
Fundamental drivers of return – value and quality

By our assessment, fundamental attributes for the underlying health care industries remain the same, or are even more attractive, post-selloff *(see Figure 1)*. Most valuation multiples (measured with respect to, for example, earnings, cash flow or enterprise value) have improved, although there has been a deterioration in capital management among health care providers. Meanwhile, the drivers of internal growth that indicate quality, including margin improvement and debt, remain strong and have improved in many cases. US health care companies have also kept asset growth under control — another sign of good quality. Furthermore, employment growth and other drivers are pointing to continued solid fundamentals for many companies in the sector.

Figure 1 Fundamental attributes for most health care segments remain the same, or are even more attractive, post-selloff, but market sentiment has deteriorated



Source: State Street Global Advisors analysis

Figure 1

Change in aggregate rank between 31 January 2019 and 30 April 2019.

Based on State Street Global Advisors' proprietary measures of value, quality and sentiment for US stocks in the Health Care GICS sector.

Legend

- Health Care Providers
- Health Care Equipment
- Pharmaceuticals
- Biotechnology

Using our assessment of fundamental drivers to compare various health care segments, health care providers and services continue to be most preferred, followed by pharmaceuticals (based on valuation) and biotech on (based on quality). Health care equipment is least preferred by these measures, because it is in aggregate much more expensive than other health care segments.

Market sentiment as a driver of return

We take a multi-dimensional view of market sentiment, including price movements, changes to earnings and sales forecasts, hedge fund positioning. By these measures, market sentiment in aggregate has declined across US health care firms, but only with respect to price movements. Earnings forecasts still look strong and are improving in most segments, and hedge fund positioning is very positive in the sector.

It's also worth noting that, despite this overall decline in sentiment, the health care equipment and pharmaceuticals segments still have strong sentiment indicators, particularly with respect to hedge fund positioning and earnings-forecast improvement, which each provide insight into the aggregate views of informed investors and market observers.

Risk forecasts

In addition to forecasting returns, we believe that it's important to forecast risk in order to size positions in a risk-aware portfolio. Where expected returns are equal, we prefer companies that bring less volatility to the portfolio over those that bring more volatility.

There are many aspects of portfolio and market volatility: beta estimates, risk models that aggregate risk into stock specific risk, common factor risk, correlations among industries and among countries, and more.

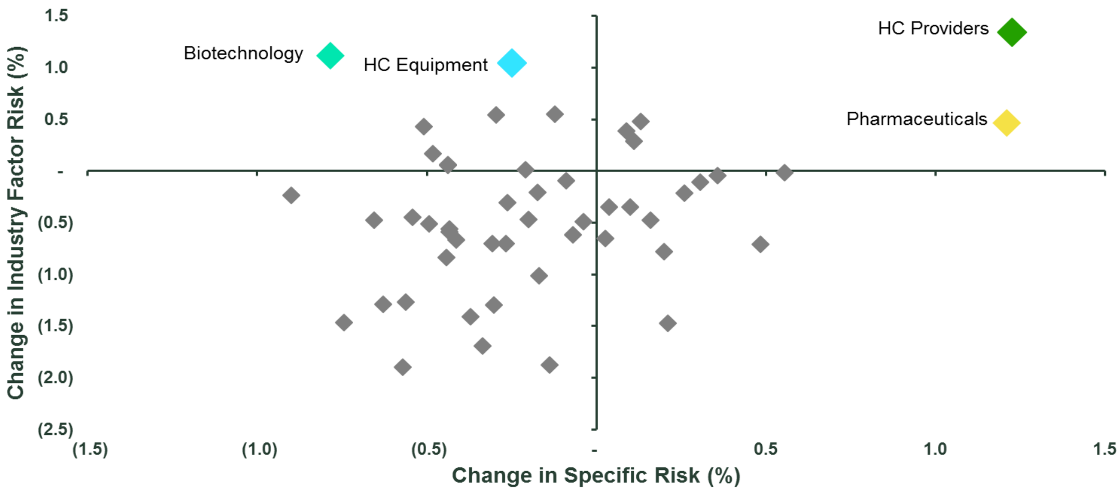
Glossary

Market sentiment- Market sentiment refers to the overall attitude of investors toward a particular security or financial market.

GICS- the acronym for Global Industry Classification Standard

Volatility derived from industry exposure (often called “industry factor risk”) has risen in all the main health care segments *(see Figure 2)*. Within health care providers and pharmaceuticals, the risk derived from idiosyncratic or stock-specific characteristics has also risen.

Figure 2 **Industry-factor risk has risen in all of the main US health care segments; stock-specific risk for health-care providers and pharmaceuticals is also up.**



Source: Axioma World-Wide Medium Horizon Fundamental Risk Model

Figure 2

Industry Factor and Stock-Specific Risk Change between 31 January 2019 and 30 April 2019

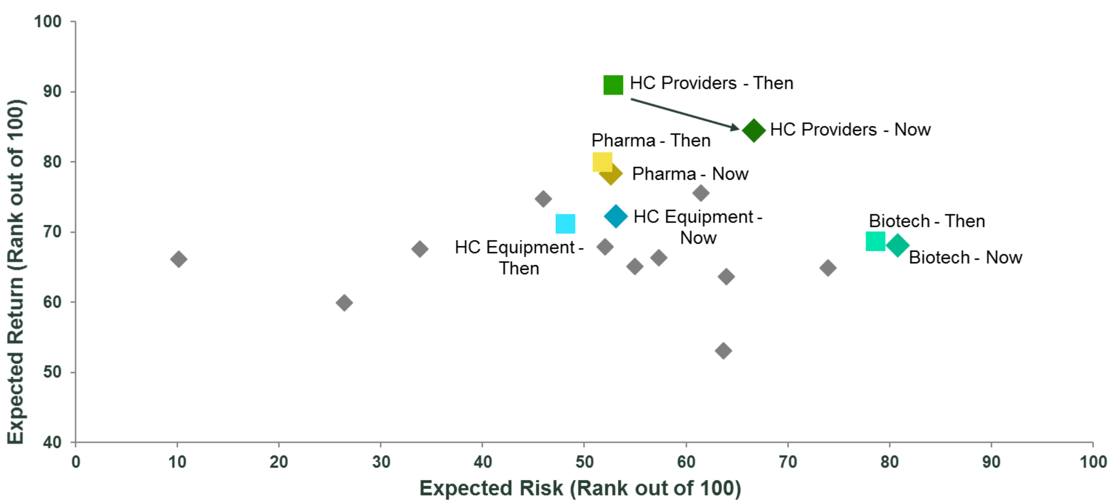
Legend

- Health Care Providers
- Health Care Equipment
- Pharmaceuticals
- Biotechnology
- Other GICS Industries

The bottom line

Based on our proprietary measures, health care stocks have experienced a decline in expected return and an increase in expected risk in recent months *(see Figure 3).* Nevertheless, fundamental drivers of performance remain strong in the sector, and according to our measures, health care providers and pharmaceuticals are still among the more attractive industries across the US equity market. We believe that the change in return and risk may warrant a reduced position size, but at these levels, we will likely retain some exposure to the pharmaceutical and health care provider segments.

Figure 3 **In recent months, expected return has declined and expected risk has increased in the US health care sector.**



Source: State Street Global Advisors analysis

Figure 3

Expected risk and return for health care stocks in the US equity market compared to other segments.

As of 30 April 2019 (“Now”) and 31 January 2019 (“Then”)

Legend

- Health Care Providers
- Health Care Equipment
- Pharmaceuticals
- Biotechnology
- Other GICS Industries (Now)

To reach this conclusion, we focus on measurable and tangible aspects of our investment process, which is designed to respond to changes in market sentiment as they arise for any reason. We believe this approach allows us to make better investment decisions than the alternative – spending our time arbitrarily assigning probabilities to highly uncertain future political events and their subsequent outcomes.

Marketing communication

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