Evenlode Global Dividend Investment View

July 2023 – The health care option

The commentary below applies to the Evenlode Global Dividend portfolio which follows the Evenlode Global Income strategy. Market data is from FactSet and FE Analytics.

The Evenlode Global Equity strategy has just passed its third birthday, a fantastic milestone and we thank all of the clients who have supported the funds in their journey so far. This investment view is about its older sister, the Evenlode Global Income strategy, and something we're understandably often asked is what the differences between the two strategies are.

Fundamentally the Evenlode strategies share a common philosophy, seeking market-leading businesses that generate high returns on capital, cash flow that will grow into the future, and investing in them at sensible valuations. Our analytical and portfolio management processes are common across all the portfolios we manage and are designed around this philosophy.

The differences between the Global Income and Global Equity strategies come more in emphasis. The income-focussed strategy is not a high yield strategy, but we do balance receiving dividends today with growth in cash flow into the future. For Global Equity more cash is retained within the businesses, and the dividend payout ratio overall is therefore lower, but we expect cash flow growth to be a little higher. We expect the companies in both strategies to grow through time, but there may be some more mature companies in the Global Income strategy where there is a bit more yield, and the rate of growth lower.

A consequence of this is that you will find similar sectors in both portfolios, for example information technology or consumer goods. These are the sectors in which we find the most options that tick all of our investment boxes. Conversely there are some sectors that are very unlikely to be represented, say utilities, where returns on capital are structurally low. The different emphases of the two strategies do show themselves in the relative weights in different sectors however, and a particular one of those is health care. The health care sector makes up around 19% of the Evenlode Global Dividend portfolio but is much less for Evenlode Global Opportunities (which follows the Evenlode Global Equity strategy). In this investment view we'll take a closer look at this sector to see what is attractive from a global income perspective, and how it has performed for the strategy recently and over the longer term.

The health care sector in Evenlode Global Dividend

The delivery of health care varies in its model around the world, from the free at the point of delivery governmentally-funded NHS in the UK, to the private insurance-based system of the US, the world's largest health care market. Most countries have something in between. Whatever the funding model there is a multitude of elements that are needed to deliver the whole service, many of which are delivered by companies that are found within the Evenlode Global Dividend portfolio.

Perhaps the ones that most readily come to mind are the pharmaceutical companies that discover, develop, manufacture and market drug-based treatments, from relatively simple pain relief tablets to complex oncological therapies. Companies such as Switzerland's Roche and the UK's GSK take on risk as they put novel therapies through the research and development process and can be rewarded should their efforts prove to be efficacious. That a patient who is relieved or cured of an illness is likely to value the product is clear. However, often it is the health care system (government or insurer) that pays the for the therapy rather than the end user and so the benefits of keeping the population healthy and indeed out of the health care system itself are also motivators for the purchaser. Patent protection on the new treatments confers a period where the company can reap the rewards by selling it exclusively, but these are limited in time and the company must replenish its pipeline. The patent cycle is designed to spur on and reward innovation, whilst ultimately leading to treatments being able to be made at low cost, socialising the long run benefits of the developed technology. As such, the drug development business is not without risk – it is expensive to put a 'new molecular entity' (NME) through the phases of development, and if it fails then there will be no market for it at all. When successful, they can become 'blockbusters' like Sanofi's Dupixent, a wonder drug for allergic diseases which is forecast to have peak sales of EUR13bn per year. With that risk/reward profile in mind, we diversify the pharmaceutical risk both within and between companies – the three pharmaceutical developers in the portfolio (GSK, Roche and Sanofi) are themselves diversified and between them address multiple areas such as respiratory diseases, oncology, auto-immune diseases, and HIV. The pharmaceutical sector is the biggest of the fund's health care exposures, making up 32% of the underlying revenues of the sector within the fund, or around 6% of the fund as a whole.

So, pharmaceuticals make up a reasonable portion of the sector within the fund, but this is certainly not the whole story. The next largest portion is medical and surgical devices, at a quarter of the sector's revenue, or 5% of the fund. This covers another broad range of products, again from the relatively simple such as stents, to highly advanced surgical robots. The product development dynamics have similarities to the pharmaceutical sector in that approval must be given by health care regulators for new products, and there is a significant research and development requirement. Innovation is key although the reliance on 'blockbuster' products is less given vast product diversification. Medtronic, the fund's biggest holding in this space, makes products across multiple subcategories such as pacemakers, stents, defibrillators, spinal implants, insulin pumps and glucose monitoring systems to name just a few. There can be high switching costs for these products due to the training needs of the physician and patient familiarity, which extends product lifecycles. In the world of eyecare, EssilorLuxottica, formed when Ray-Ban owner Luxottica merged with French lens maker Essilor, sells to optometrists who know their products, and the lenses form an important part of the proposition to the end user who will usually be using the product day in, day out.

Medical services make up 21% of the sector's revenue for the fund, or 4% of the fund's total. Multinational Australian business Sonic Healthcare and US-focussed Quest Diagnostics operate the laboratories where samples from patients are analysed. If you're in the UK and had a PCR test for COVID-19, it may well have been sent off to a Sonic Healthcare facility for analysis, and they report back the results. Quest Diagnostics rolled out similar facilities in the US. In the world of diagnostic testing scale and reliability are key – UK-based readers may remember the understandably negative headlines about 43,000 incorrect test results from a covid testing laboratory. The pandemic perhaps served to underline the importance of medical testing and presented an acute load on the testing system, but during normal times these companies have shown the value of specialising in high throughput analysis that can be done quickly, accurately and at a cost that makes sense. In the US historically much testing was done in-house at hospitals but often these labs were uneconomic as they lacked scale. There is a therefore growth opportunity for medical testing businesses from both the increased use of such services in general and in consolidating smaller, less efficient laboratories into more efficient and reliable operations.

Pharmaceuticals, devices and services thus make up the majority of the fund's health care allocation. The portfolio also has some exposure to the companies that make the diagnostic machines that do the testing in practice. Roche and Siemens Healthineers are two of the three main global diagnostic device makers, and both have automated solutions that can analyse impressive numbers of samples. The Atellica analyser from Siemens Healthineers can manage up to 1,800 test per hour[i], and just as speed and reliability are the watchwords for the lab operators, so they must be for the machine makers. Another one is flexibility; labs come in many shapes and sizes so the machines are modular and can be adapted to different physical spaces. Siemens Healthineers are also big in the world of imaging devices, typically sold to hospitals or hospital chains. Again, if you've had an MRI or CAT scan, you might well have been in one of their machines. The fidelity of the technology has been improved vastly through time via the hardware and the image processing software that can be applied to the task. It will probably come as no surprise that artificial intelligence is being touted as the next big thing here. Given the potential for linking diagnostic imaging with treatments, particularly for cancer, this in time is likely to prove to be more than just hype and has the potential to improve outcomes for the most serious of diseases.

The balance of health care sector exposure for the fund is in vaccines and consumer health products. The catch all term of 'health care' can be seen from this overview to be quite diverse under the bonnet, and whilst patient outcomes and the efficiency of the health system are common driving forces across its different elements, there are different motivations and multiple ways for businesses to add value. Health systems don't have unlimited budgets, so it is important that there is a strong value proposition from any therapy, device or service being brought to the market. Total budgets might grow roughly in line with the global economy, perhaps a little more if health expenditure continues its trend of rising as a percentage of GDP[ii], or a little less if it reverses.

Value for investors?

The goods and services provided by portfolio health care companies are valued by the patients and systems they serve, but are they valued by investors? Over the last five years of the Evenlode Global Income strategy the sector has performed pretty much in line with the broader fund delivering around 60% on a total return basis[iii],which is not bad for what should be a steady rather than spectacular sector. However, over the last year the sector has underperformed the fund, being flat versus a rising market. The main culprits for this are the pharmaceutical companies Roche and GSK, which declined over the period. Roche has one of the more diversified pharmaceutical portfolios of any of the large integrated players and has navigated its patents cycle pretty well, but longer-term worries about the future pipeline have weighed on the stock price. As noted above, developing drugs involves risk and the company did have some negative readings in trials in the pipeline of new therapies, but the company still has good medium-term visibility from its existing portfolio across oncology (the largest), MS, haemophilia and ophthalmology. GSK has been an underperformer from a business perspective for some time, with historically limited productivity from its research and development effort, but in recent years has turned this around. However, last year the potential for damages from a litigation around a legacy heartburn medicine, Zantac, surfaced as an issue that sent the stock price downward. The purported link to cancer seems relatively weak, but we analysed the potential impact nonetheless and it seemed to be rather less than the share price reaction implied. The issue is now being worked through after having been dismissed by US federal courts and the first settlement in California.

Sentiment has also cooled to the medical testing service and equipment companies following the pandemic, which was a benefit during those years of heavy testing. We do not bake those temporary boosts to revenues into our valuation models, preferring to take a longer-term look through and on that basis a return to pre-pandemic levels of non-covid testing is a good sign. Elsewhere in medical devices Medtronic is down slightly over the last year as supply chain issues impacted sales and there was a disappointing medical trial for a kidney 'renal denervation' device, used to treat hypertension.

To generalise then, there are some company-specific matters that have led to the sector taking a pause on contributing to returns over the last year. Each of those matters presents a different challenge and we believe that they are surmountable over time, managing risks as we always do through diversification, position sizing and through our valuation management framework.

Near term concerns often turn up opportunities and looking at the valuations of the companies in the sector see some evidence of that. The free cash flow yield of the health care companies in the portfolio is 5.8% on average, and dividend yield 2.8%[iv], both above the average for the fund and broader equity market. The free cash flow is flattered somewhat by the tail end of the covid testing boom, but nonetheless the figures are attractive for income seekers, and the total return potential is backed up by our discounted cash flow valuations as well.

Coming back to the differences between Evenlode's Global Income and Global Equity strategies, the higher yield and steadier growth profile than other sectors make health care tilt towards the income story but fits with our stated desired characteristics all the same. The sector's solid longer-term performance in the Global Income strategy shows that has not just been about taking the dividends; capital growth has been forthcoming, and we will certainly accept the dividends as they arise.

Ben, Bethan, Chris, Rob and the Evenlode team

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i The Atellica analyser

ii Source: World Health Organisation. Explore the data here.

iii Source: Evenlode Investment, FactSet, FE Analytics. To end-June 2023 the fund B Acc units had returned 58% in sterling terms, and the sector approximately 60% excluding fees and transaction costs.

iv Source: FactSet, Evenlode.