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Themes in the global healthcare sector

Healthcare is playing an increasingly important role in social and economic development around the world, and will be pivotal in meeting looming global demographic challenges. Innovation is an essential element in meeting the growing demand for effective healthcare treatments and, in our view, provides a variety of attractive opportunities for investors. In this article, we look at prospects for investment in the healthcare sector, and explain how our global thematic approach highlights companies with long-term investment potential.

The healthcare sector has, over the past decade, suffered from a decrease in share-price valuation (see Chart 1). The price-to-earnings ratio on the MSCI World Healthcare Index fell from 35.3 to 12.6 over the 10 years to 30 June 2010, while the same ratio on the MSCI World Index as a whole fell from 29.6 to 16.0.¹ This decline in market confidence has been fuelled by a number of factors: fears over the effects of approaching patent expiries, concern about the escalating costs of bringing drugs and services to market, a slowdown in the pace of new product launches, and the recent attempts, particularly of Western governments, to reduce expenditure in the sector in the wake of the global credit crisis. Investors must take account of these risks, but we believe that current valuations present opportunities for investment in a sector with broad potential for international expansion and revenue growth. Companies that are able to innovate sufficiently strongly to overcome the increasing costs of research and development activity appear particularly attractive.

**CHART 1 - HEALTHCARE SECTOR VALUATIONS: MSCI WORLD HEALTHCARE INDEX
10-YEAR PRICE TO EARNINGS RATIO**



Source: Thomson Reuters Datastream as at 08/07/2010.

1. Source: Thomson Reuters Datastream, July 2010.



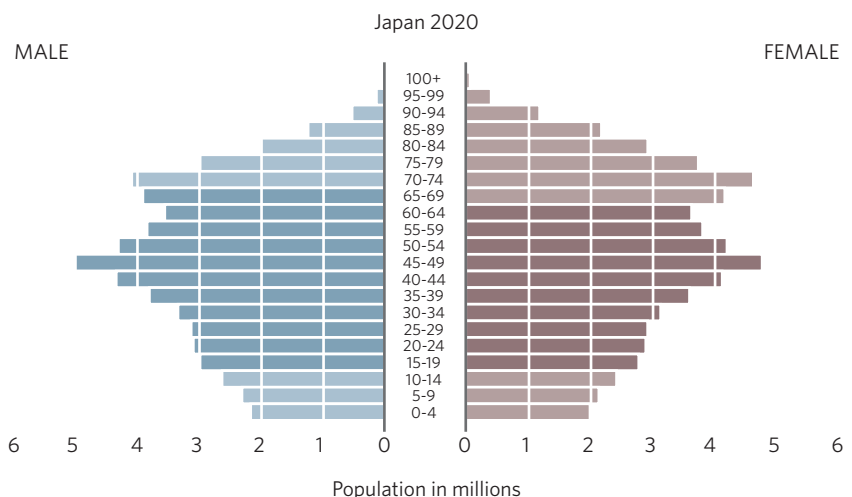
Applying global themes to the healthcare sector

At Newton, we identify key global themes which represent forces of change in global markets. Our theme-based investment approach affords us the perspective to identify long-term areas of investment opportunity and risk. Through analysis of individual companies in the context of our themes, we look for well-positioned companies with stable growth prospects. Given that the healthcare sector should benefit from the trends identified in a number of our themes, in particular *population dynamics*, *developing economies* and *medical technology*, it provides a broad range of attractive investment opportunities.

Our *population dynamics* theme has grown out of current and impending shifts in global demographics. As the average age of Western populations continues to rise, the need for treatment of diseases and illnesses associated with old age, and the desire to maintain an active lifestyle, are becoming more widespread. One consequence of ageing populations is that the burden on tax revenues from a proportionately smaller workforce grows, resulting in fewer available funds to cover rising demands. Improvements in existing healthcare provision, that lower governments' costs, are therefore desirable. Such improvements also give rise to strong opportunities for corporate revenue growth among companies who can create them.

In Japan, for example, it has been forecast that, by 2050, 36% of the population will be over the age of 65.² The burgeoning market for generic drugs holds significant potential for healthcare companies, such as Sawai Pharmaceutical, which have the resources to provide high-quality generic medicines at a lower cost.

CHART 2 - FORECAST POPULATION DISTRIBUTION, JAPAN 2020



Source: J.S. Census Bureau, International Database, August 2009 Analysis.

A key advantage of our global thematic process is that it enables us to compare trends across different regions, economies and industries. In the context of emerging markets, our themes paint a very different picture to that of the developed world, in terms of both the opportunities available and the attributes required of successful companies. Our *developing economies* and *global realignment* themes focus on the increasing expansion and influence of emerging economies, and the trends identified in those themes lead us to favour a number of healthcare companies with strong potential for growth in emerging nations.

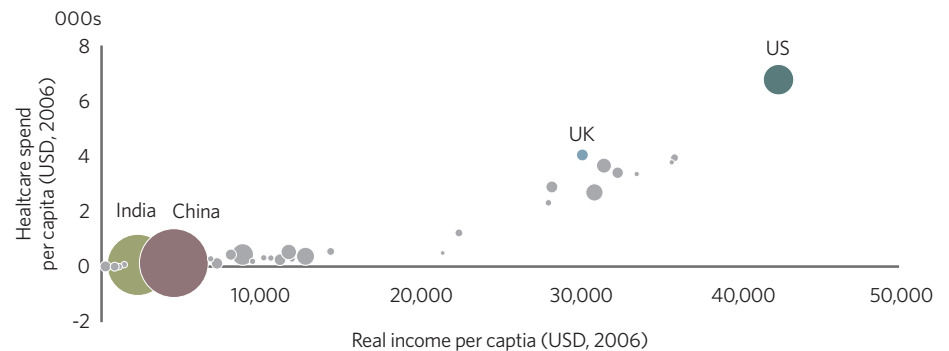
2. <http://www.japanfocus.org/-Vaclav-Smil/2411>, accessed on 14/07/2010.

In such nations, rises in GDP are leading to increased individual wealth, and consequently to higher levels of spending on healthcare. The increased 'Westernisation' of both lifestyles and diets may present further growth opportunities for companies that are able and willing to expand their horizons. We are increasing our exposure to the global opportunities that are presented by expanding emerging markets, for example through Pharmastandard, which has strong exposure to Russia, and Hikma, a market-leading medicines company in the Middle East which has succeeded in overcoming many of the stringent barriers to entry in these markets to command a dominant market share in the region.



Our *more government* theme identifies that, in contrast with the significant financial constraints of their counterparts in many developed economies, emerging-market authorities should be able to intervene positively in their economies to stimulate domestic spending. Among areas of greater expenditure should be the healthcare sector, and the drive of authorities to improve access to basic medical care represents a significant opportunity for companies with a firm presence in emerging economies. One such company is Fresenius Medical Care, which specialises in products and services for the treatment of kidney disease. Fresenius Medical Care is building a substantial presence in China, where the number of dialysis patients is expected to surpass 500,000 by 2018, having grown from 120,000 at the end of 2009.³ Around 50% of newly installed dialysis machines in China are currently supplied by Fresenius Medical Care, and the company is well-placed to take advantage of the growing demand for its services.

CHART 3 - CORRELATION BETWEEN INCOME GROWTH AND HEALTHCARE SPENDING



Note: Circles are sized in proportion to population.
Source: Newton, Gapminder.org, March 2010.

In China, the government has announced plans to spend 580 billion yuan (€87bn/\$125bn) over the next three years, to provide basic medical care to 90% of the rural population, and to build 2000 hospitals with training for 1.4 million medical staff. The healthcare industry has grown unevenly in many emerging economies, with pronounced variations between urban and rural districts in the quality of care and services provided. The combined influence of higher public spending and new competition from foreign private providers is likely to balance out these regional variations, and to create attractive opportunities for investment.

Meanwhile, the increase in individual wealth in emerging economies is leading to a rise in expenditure on private healthcare services. The influence of reputable healthcare companies in emerging markets promises additionally to raise the quality of care. Increased individual disposable income also paves the way for 'medical tourism', which involves individuals

3. Fresenius Medical Care Report, 'A Huge Task for a Vast Country', 2009.

travelling to buy healthcare from private hospitals beyond their immediate vicinity. Parkway Group, as an established healthcare provider in a number of growing Asian economies, is one beneficiary of this trend.

Our *medical technologies* theme looks at the benefits of technological advances that can improve both the quality and efficiency of medical treatment. In major Western economies, where a strong emphasis upon efficiency is necessary in order to meet growing demand without increasing costs, the scope to develop successful, cost-effective medicines, devices and services affords valuable pricing power to certain companies. For example, Medtronic, a US healthcare equipment and services company, has developed a pacemaker which is safe to use in MRI scans. This is a significant invention, given the correlation between ageing populations, the number of pacemaker recipients and the need for MRI scans in later life. Swiss pharmaceuticals and biotechnology company Roche develops innovative cancer drugs which target specific types of the disease; this innovation harnesses new technology in order to meet the growing demand for effective treatments, leading to attractive long-term growth potential.

Despite the apparent challenges facing the healthcare sector, we believe that there are a number of companies which are well-positioned to benefit from the more favourable trends that are influencing the sector's long term growth prospects. Our thematic approach, and our fundamental global research, should continue to help us to identify both the risks in the healthcare sector that, on behalf of our clients, we wish to avoid, and the significant opportunities that should help us in seeking to fulfil our clients' investment objectives.

All data is sourced from Bloomberg unless otherwise stated.

Past performance is not a guide to future returns. The value of investments and the income from them can fall as well as rise and investors may not get back the original amount invested. The value of overseas securities will be influenced by fluctuations in exchange rates. If part of the portfolio is invested in sub-investment grade bonds, which typically have a low credit rating and carry a high degree of default risk, then please be aware that this can affect the capital value of your investment. If the portfolio has exposure to hedge funds, gold, private equity and property via publicly quoted transferable securities, then there are additional risks associated with these sectors. The information contained within this document should not be construed as a recommendation to buy or sell a security. It should not be assumed that a security has been - or will be - profitable. There is no assurance that a security will remain in the portfolio. This presentation is for professional investors only. The opinions expressed in this presentation are those of Newton Investment Management and should not be construed as investment advice. In addition the information contained in this presentation should not be construed as a recommendation to buy or sell a security. 18821 07-10



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