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Is Good Health Worth the Cost?

Dear fellow investors,

"The future is never clear, and you pay a very high price in the stock market for a cheery consensus. Uncertainty is the friend of the buyer of long-term values."
— Warren Buffett

During the season opening baseball game for the Seattle Mariners, the Make-a-Wish® Foundation blessed a young boy who has fought cancer at Seattle Children's Hospital for years with a run around the bases. The Fred Hutchinson Cancer Research Center also honored a lady who successfully used recent treatments to beat cancer. It was heartwarming and a reminder of what fantastic things are being done in medicine in the US.

What they didn't do that night was flash the cost up on the big screen of the young boy's medical care at Children's Hospital or the money spent at the Fred Hutch to put this lady's cancer into remission. The President didn't tweet anything about how high the drug prices were. Amazon didn't make any new announcement attacking the healthcare industry. Why are we happy about good outcomes, but turn right around and beat up the companies which are making these wonderful breakthroughs possible?

To quote Buffett, "the future is never clear" about the healthcare industry. We believe the uncertainty in this part of the stock market is producing behavior that is "the friend of the buyer of long-term values." Let's consider what we've known historically and what we know right now:

Healthcare normally carries a great deal of good will

Investors in pharmaceutical and biotech companies have historically carried a bit of a halo. Peter Lynch argued to watch what goes on around you and invest in things you understand. If you are taking a prescription which is making you feel better or get medical treatment which improves your life, it is pretty easy to think that thousands of other people are gaining the same benefit.

Healthcare companies overcome great risks to succeed, but can gain incredibly profitable businesses in the process.

It takes over one billion dollars to create a blockbuster drug through chemistry or biotechnology. Most of the development ends in failure. The highest research and development budgets in the US are attached to the major pharma/biotech companies. Success breeds success, because the money you make on prior successes funds the R&D budget to find future successes. Does the government want to come up with the billions of dollars needed to improve our health or do they wisely want it done in the for-profit sector?

Relative to the S&P 500 Index and to the average stock, we believe these stocks are bargains

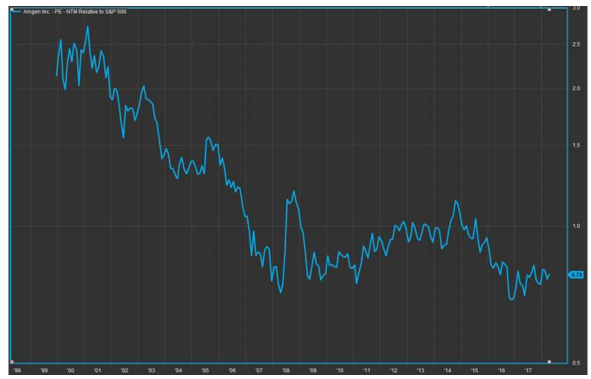
The healthcare companies we are researching have better histories of profitability, stronger balance sheets, better free cash flows, more shareholder friendliness and have seen stronger insider ownership in the large-cap sector of the US stock market than other sectors. It is rare for these companies to be avoided by investors who focus on quality and future growth.

We will use Amgen (AMGN) as a poster child for what is going on. Amgen is trading around $166 on April 3, 2018 on trailing earnings of $12.58. This makes a P/E ratio of 13.28x versus a trailing P/E of over 20x for the S&P 500 Index (source: Thomson Reuters). They have a long history of researching and creating successful medical remedies. The company has a stellar balance sheet with more cash than debt. Insiders have sold very little stock in the last 12 months. Amgen's net profit margin was 40.4% and generated an unleveraged return on equity of 33.5% in 2017.

Amgen has one of the most exciting new biotech products called Repatha. Taken in tandem with a statin, this biologic reduces the bad cholesterol in a group of 27,000 high risk patients by 70% on average. Repatha dramatically lowered the risk of heart attack and stroke in this large population of people whose high bad cholesterol threatens their life. They were in the study because statins by themselves had not solved the high bad cholesterol dilemma.

However, it has become politically attractive on both sides of the spectrum to take shots at companies developing these drugs and Repatha has been no exception. The list price for a year of Repatha is $14,000. To cater to the body politic, health insurance companies have balked at paying that price and have slowed the adoption of its use. Since its widespread use is being delayed, earnings estimates are expecting small growth in Amgen earnings to $13 - $13.50 per share in 2018.

In effect, this slow adoption will prevent thousands of high cholesterol Americans from running around the bases at next year's opening game or being honored as one of the 'Hutch Heroes'; who have recovered from the disease in their body which is trying to put them in their grave. In the short run, just about anything can happen and the present cultural attitude could continue. In our observation, change is the only guarantee which exists in the investment business and attitudes tend to return to normal. Below is the chart of the P/E ratio of Amgen compared to the S&P 500 going back twenty years:[1]



Peter Lynch argued that over long stretches of time, earnings and stock prices are highly correlated. We are very excited to collect the current annual dividends of $5.28 (3.2% yield) and wait for the investment markets to be as excited as we are about Amgen and other businesses which are creating life-saving medicines for people whose lives are being prolonged.

Warm regards,

William Smead

Source: Bloomberg.

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