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2014 Outlook: Health Care

Eddie Yoon, Sector Portfolio Manager

Fidelity sector portfolio manager Eddie Yoon provides his view on the most attractive investment opportunities and the major risks in the health care sector in 2014.

INVESTMENT OPPORTUNITIES IN 2014

Same themes, new year

I believe that the health care sector has the potential to continue to deliver stable, consistent performance in the months to come. From a macro perspective, the following investment themes for health care are largely unchanged, and will continue to be central themes for 2014.

- **The innovation cycle.** The innovation pipeline for the health care sector is full, especially in the biotechnology, medical devices, and life sciences industries. I believe these new products will lead to a greater understanding of disease and the development of new therapies and treatments. Looking ahead, medical breakthroughs could contribute strongly to the sector's near- and long-term performance.

- **Deflationary forces.** Many U.S. health care companies plan significant investments in software and technology platforms that can provide solutions to reduce the nation's rising health care costs, which, at 18% of current GDP, are on an unsustainable path.[1] The health care sector will continue to face cost and reimbursement pressure, but I believe there will be opportunities to capitalize on this trend through investments in companies that innovate and in so doing, help to lower expenses.

- **Recession-proof.** Throughout numerous business cycles and periods of extreme market volatility, the health care sector's "safe-haven" status often buoys its stocks through downturns or pullbacks compared to more cyclical or discretionary areas. Even through recessionary periods, most people will not forgo important health procedures or treatments. In the most recent past, the health care sector has also been able to outperform in up markets. This backdrop has the potential to present an ideal investing environment to compound returns over the long run.

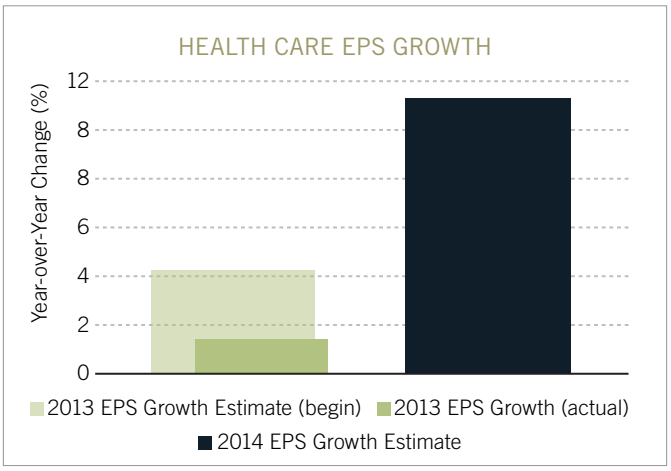
- **Health care consumerism.** The U.S. health care industry will see consumers evolve into the primary purchasers of health care benefits and health care services. Employers will continue to shift more of the health care cost burden to employees, introducing tools and services that provide consumers with more pricing transparency and quality data to help them manage their own health care choices.

- **Emerging markets growth.** Spending on health care in emerging markets will continue to rise even faster than the rapid economic growth of economies. Serving them and their burgeoning middle classes will require innovations in technology, health care delivery, and business models. This is a powerful tailwind for the medical equipment industry.

- **Consolidation among providers.** Industry consolidation has resulted in greater operational efficiencies and increased bargaining power with suppliers. M&A has been, and will continue to be, a prominent industry feature.

- **Outcome-based health care.** As the U.S. health care system evolves into one where value—rather than fee for service—is rewarded, the quality and efficiency of care should naturally follow suit. New businesses will form that help hospitals and physicians fundamentally rethink the way they approach medical care. Reimbursement will focus on performance and quality outcomes.

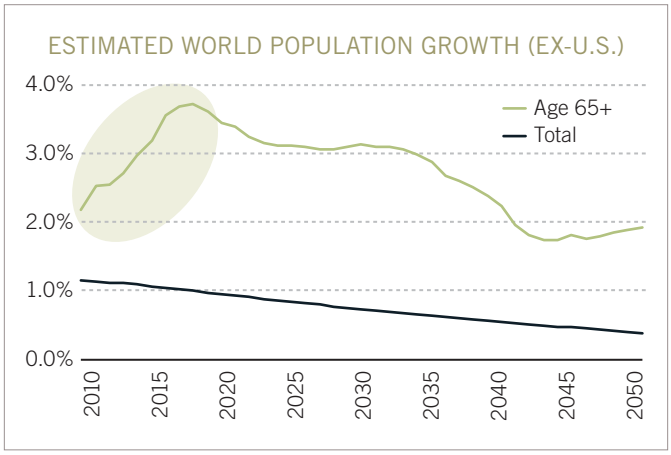
EXHIBIT 1: Earnings growth in the health care sector has fallen short of expectations in 2013, but analysts are forecasting higher growth in 2014.



EPS Growth Estimate for 2013 was as of Dec. 31, 2012. Actual 2013 data include estimates for Q4 2013. EPS: earnings per share. Source: FactSet, Fidelity Investments, as of Oct. 31, 2013.

Fidelity INVESTMENTS

EXHIBIT 2: Aging demographics will lead to more procedures and therapies. This is a global phenomenon.



Source: United Nations and Haver Analytics.

- **Aging populations.** The health care sector has global tailwinds stemming from aging populations around the world which spend more on health care than younger populations (see Exhibit 2, above). By 2030, one in five Americans will be over age 65, compared with only one in eight today.[2]

Where the ideas are: Seeking diversity in cap size and industries

A major benefit when constructing a health care portfolio is the diversity of the industries in the health care sector. Health care spans a wide range of industries globally, each with a unique set of opportunities. While the sector continues to play a defensive role in investment portfolios, many of its industries also offer companies with compelling long-term growth potential that, if selected properly, can keep pace with more cyclical parts of the economy.

In 2013, the best investment ideas were concentrated primarily in the biotech industry. In fact, the S&P 500 biotechnology index is up 60% just this year—more than any other part of the health care sector.[3] However, in 2014 I believe investment opportunities will be more balanced across other industries. Presently, I am exploring opportunities across the cap spectrum in the medical device, specialty pharmaceutical, and life sciences industries. I am looking for stable companies with open-ended growth opportunities, attractive revenue models, competitive advantages, and talented management teams. I will continue to invest in large-cap biotech stocks but I have reduced some exposure to parts of the biotech market, such as the small-cap segment where valuations are generally more expensive on a risk-adjusted basis compared to where they were earlier in 2013.

RISKS: WHAT TO WATCH IN 2014

Uncertainty about U.S. health care reform

Much is being written about investment opportunities related to the Patient Protection and Affordable Care Act (PPACA) and the federal and state online health care exchanges, which opened for business October 1, 2013. Over the longer term, as the Affordable Care Act takes effect, we anticipate that millions more people will have access to health insurance, which should modestly boost utilization. Over time I believe that health care reform will be seen as the catalyst that brought market forces into the health care economy and enabled consumerism.

In the near term there are many unknowns and challenges, not the least of which is investor uncertainty about cuts in government spending on health care. For the most part I am staying away from investments in managed care organizations, hospitals, and providers, and from policy-centric investments in general.

Investment implications

Despite being in an industry that is becoming more regulated, and amid considerable uncertainty regarding the impacts of the PPACA, health care overall is a sector featuring rising demand that is poised for growth. It is important to point out that of the three trillion dollars we spend in health care as a country today, only 10%–15% of that money is spent on biopharmaceutical products and medical devices.[4] Because of this fact, changes in policy have a muted impact on the investable universe. The health care sector has historically been characterized by steady returns over the long term, and I expect to see this pattern continue. Health care is a unique sector in the market. With an inflecting innovation cycle, and new therapeutics coming on the market that can treat unmet medical conditions, there remains a lot to be excited about.

This leads me to a secular outlook for the health care sector that is mostly favorable, and which should continue to be less correlated to the broader equity market. The health care sector provides both growth and defensive characteristics. Company fundamentals in many industries, such as the ones I have cited under the opportunities section of this outlook, look attractive today, and I expect these fundamentals to remain attractive into 2014.

Author

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Eddie Yoon is a portfolio manager and research analyst for Fidelity Investments. He currently manages several health care sector portfolios and subportfolios. Mr. Yoon is responsible for covering medical equipment within the health care sector. He joined Fidelity in 2006.

Fidelity Thought Leadership Vice President and Managing Editor Teresa Houser provided editorial direction for this article.

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Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.

Past performance is no guarantee of future results.

Neither asset allocation nor diversification ensures a profit or guarantees against a loss.

Because of their narrow focus, investments in one sector tend to be more volatile than investments that diversify across many sectors and companies.

The health care industries are subject to government regulation and reimbursement rates, as well as government approval of products and services, which could have a significant effect on price and availability, and can be significantly affected by rapid obsolescence and patent expirations.

Stock markets, especially foreign markets, are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Foreign securities are subject to interest rate, currency exchange rate, economic, and political risks, all of which are magnified in emerging markets.

Endnotes

[1] Wallstreetjournal.com/U.S. Health Spending: One of These Things Not Like the Others/July 25, 2013.

[2] Brookings.edu/research/testimony/July 30, 2013.

[3] S&P 500 Index.

[4] FDA.gov/U.S. Food and Drug Administration: A Special Report-Pathway to Global Product Safety and Quality.

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