Key Takeaways
• Throughout numerous business cycles and periods of extreme market volatility, health care has been one of the market’s most consistent performers. Looking ahead, the advent of new medical breakthroughs could contribute strongly to the sector’s near- and long-term results.
• Health care earnings growth was slightly negative for the third consecutive quarter, driven by patent expirations in the pharmaceuticals sector, which offset growth in other subsectors.
• Free cash-flow yield, one of several valuation metrics for the health care sector, continued to remain inexpensive relative to historical norms.
• Research Spotlight: The innovation cycle in health care appears to be improving, especially within biotechnology and health care technology. Companies in these industries create novel treatment modalities and will prepare consumers and payers for the transition of health care to a more value-based system.

Update on fundamentals
Macro backdrop
In Q1, equity markets—including the health care sector—largely shrugged off the lingering effects of the European sovereign debt crisis and U.S. fiscal woes, and rallied on the rebound in U.S. housing, improved consumer confidence, and the Federal Reserve’s ongoing accommodative monetary policy.

Despite the uncertainty over the global growth outlook, the health care sector continued to perform well on an absolute return basis. This further emphasizes that the demand for health care continues to be very stable through multiple economic cycles, as an aging population consumes more health care, both in the U.S. and around the world, and people survive longer with chronic diseases. Emerging markets have also contributed to the sector’s growth, responding to the growing demand for better health care from a burgeoning middle class. These secular trends should provide a similar investment backdrop going forward.

The combined earnings growth reported by health care companies fell slightly short of analysts’ expectations during the

Exhibit 1: Earnings growth in the health care sector slightly trailed analysts’ expectations in Q1 2013.
State of the Sector: Health Care
June 2013

first quarter of 2013 (see Exhibit 1, right). This was largely due
to the negative earnings growth in the pharmaceuticals industry.
Pharma is by far the largest segment of the health care sector,
representing more than 40% of the MSCI U.S. IMI Health Care
25/50 Index (the health care sector component of the broader
The next largest industry component is health care equipment,
at roughly 19%. Despite the sector’s lackluster earnings growth
in aggregate, health care was the market’s best-performing
sector on an absolute basis in Q1 2013, returning 15.7% and
outperforming the 10.6% return of the broader market, as
measured by the S&P 500.

Industry-specific highlights
A pattern of negative earnings results for pharmaceutical
companies persisted in Q1 2013. The primary culprit was the
ongoing expiration of valuable patents. Looking forward, much
of this headwind is now behind the industry and, as product
pipelines mature and expand globally, it should return the
industry to growth. Pharmaceutical stocks outperformed the
broader health care sector in Q1 2013, benefitting from large-cap
companies with shareholder-friendly capital allocation policies.
Certain pharmaceutical firms with high free-cash flow (FCF) and
attractive dividend yields also delivered respectable returns.

Biotechnology continued to perform well, thanks largely to a
strong and diverse pipeline of new treatments and the launch
of multiple novel products across many disease categories. This
potential high-growth theme is discussed in greater detail later in
this report (see Research Spotlight, page 3).

Health care technology stocks have also done well. As health
care payers begin to shift toward value-based purchasing and
abandon fee-for-service payments, hospitals are leaning heavily
on their IT systems to understand their cost structures and
revamp their care-delivery models. Moving health care into the
digital economy should drive productivity throughout the system
and ultimately lower costs.

Health care equipment and supply companies face a
difficult market in the U.S. due to an increased focus on cost
containment. However, these multinational companies have
enormous growth potential in emerging markets, as new
hospitals are built and the health care infrastructure expands to
accommodate millions of people who can now afford medical
care. Providing health insurance to this emerging middle class is
a national priority for many governments. Meanwhile, the health
care providers and services industry posted a 10% revenue gain
for the first quarter of 2013. However, mandatory spending cuts
due to the federal government’s budget sequestration could
potentially reduce Medicare reimbursements by 2%, which would
likely compress profit margins in the industry.

The Affordable Care Act, which begins its final phase of
implementation in 2014, could have a positive impact on health
care utilization, as approximately 30 million uninsured Americans
will gain coverage. While insurance companies will likely benefit
from an increase in enrollment, profitability may continue to
come under pressure. However, other parts of the health care
supply chain could see increased use of health care products and
services.

The expansion of Medicaid should also be a positive for
managed-care companies focused on the Medicaid population,
which is expected to grow to an estimated 84 million people by
2022. The rapid growth of Medicaid won’t necessarily translate
into free-cash flow for managed-care companies, so I view this
group with a certain amount of skepticism given how difficult it
will be to underwrite the Medicaid population and the industry’s
already slim profit margins.

Assessing valuations
Despite the strong performance in the first quarter of 2013,
valuations within the health care sector remained low by
historical measures on a free cash-flow yield basis. This method
of stock evaluation measures a company’s free cash flow
compared to its market price. A high FCF yield usually represents
a good investment opportunity, since investors would be paying
a small price and getting high earnings in return. A company
with a strong free cash flow has the ability to build its business
by launching new products, paying off debt, or other investor-
friendly measures. Currently, the FCF yield of the overall health
care sector is above its historical average, which is indicative of
strong investment value, but it has declined from recent highs as
the stocks have appreciated (see Exhibit 2, below).

EXHIBIT 2: Free cash-flow yield in the health care sector
remains high, but has fallen steadily since 2011.

<table>
<thead>
<tr>
<th>HEALTH CARE SECTOR: FREE CASH-FLOW YIELD</th>
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<tbody>
<tr>
<td>9%</td>
</tr>
<tr>
<td>8%</td>
</tr>
<tr>
<td>7%</td>
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<tr>
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<td>1%</td>
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</table>

Source: FactSet, as of May 31, 2013.

(continued on page 4)
Biotechnology delivers inventive approaches to treating disease

Unlike pharmaceuticals’ iterative approach to innovation (e.g., combining doses into a single pill or tweaking the formulation of an existing drug) biotech firms target diseases in fundamentally different ways, creating novel categories of drugs with entirely new mechanisms of actions—all at a rapid-fire pace. The innovation cycle in biotech is potentially hitting its sweet spot and has driven strong results.

The FDA approved 18 new biopharmaceuticals in 2012, and recent clinical trials in multiple disease categories have been promising. More than 40% of new drugs in development are biopharmaceuticals instead of conventional drugs. Biologics already on the market have done well, underpinning biotech companies’ sales, earnings, and free-cash flow. These drugs include Avastin, Herceptin, and Rituxan, which are among the world’s top-selling cancer drugs. Biologics now comprise nearly one quarter of the $320 billion spending on pharmaceuticals in the U.S. each year.

Products from biotech companies have become major game-changers in medicine. Pending approval from the FDA, a new drug will be launched this year that boosts cure rates for chronic hepatitis C. Other breakthrough therapies include those that treat several types of cancer, multiple sclerosis, and cardiovascular disease. These innovations fundamentally change the life expectancy and quality of life for patients with these diseases.

Biologics cannot be copied identically in a generic form, so these complex drugs currently don’t face the same competition from generics that conventional drugs do. While this may change in the future, regulation continues to muddle its way through the political process. In addition, a considerable portion of research at biotech companies is funded with private market capital, making discoveries less vulnerable to federal cutbacks from the National Institutes of Health.

Biotech innovation involves more than creating new modalities to treat disease, however. The industry is also taking advantage of our newfound understanding of the human genome. Ten years ago, the first human genome was sequenced at the cost of $3 billion. Today, sequencing a subset of an individual’s genes costs as little as $5,000. This is providing biotech companies with a better understanding of the underlying causes of disease, which will eventually lead to smarter, more efficacious medicines.

DNA-based diagnostic tests are on the horizon that will determine which patients will respond to a particular therapy, thus eliminating costly and ineffective drug regimens. Molecular diagnostics may soon be able to screen for specific genetic mutations that cause one drug to be harmful and another safer for an individual. Such patient-centric medicine will save the health care industry billions of dollars a year and provide better and safer care.

Technology helps drive innovation

As patients look forward to customized treatments based on their genetic makeup, they are also being given greater responsibility for individualizing their care. With employers moving employees into high-deductible health care plans, consumers will have to make more decisions about how to use their health care dollars effectively, since they will pay for a greater share of medical care out of pocket.

Companies that can help consumers get the most value for their health care dollars will be at the forefront of a powerful new trend toward consumerization of health care. Employers are looking to tech companies to give their employees the right tools to manage their health benefits (see Exhibit 3, below). Imagine going to an Amazon.com-like portal and being able to compare costs for knee-replacement surgery among different doctors.

Employers and other payers are also demanding more data on safety and outcomes from hospitals, and will require hospitals to share risk with providers through accountable care organizations. Hospitals look to health care tech companies to move them from the analog to the digital world to meet these data demands and to benefit from—rather than suffer the financial consequences of—a rapidly shifting payment model. Today, few software vendors can offer hospitals the solutions they need to adapt to the new world of payment reform, making these companies a potential sweet spot for investment.

EXHIBIT 3: Employers want today’s health plans and providers to arm employees with the best tools and services available.*

<table>
<thead>
<tr>
<th>ACCESS TO PRICE AND QUALITY INFORMATION ON THE RISE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provide price/hospital quality transparency tools purchased through specialty vendor(s)</td>
</tr>
<tr>
<td>Require vendors to share data for employee outreach &amp; integrated reporting</td>
</tr>
<tr>
<td>Encourage plans &amp; providers to offer patient access to online medical information</td>
</tr>
<tr>
<td>Provide employees with healthcare service unit price information</td>
</tr>
<tr>
<td>Provide price/hospital quality transparency tools purchased through 1+ health plans</td>
</tr>
</tbody>
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Outlook for health care stocks

The health care sector has the potential to continue to deliver strong performance in the months and years to come. Key investment opportunities will focus on companies that can provide innovative solutions to reduce the nation’s rising health care costs, which, at 18% of current GDP, are on an unsustainable path. These companies typically have disruptive business models that can exert deflationary forces on spiraling health care costs.

As the U.S. health care system evolves into one where value—rather than overuse of medical care—is rewarded, the quality and efficiency of care will 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. Consumers will be asked to make more-informed decisions regarding their own health care, and technology companies will provide these enabling tools. For example, we may see pediatric clinics staffed around the clock, commanding higher reimbursement rates from payers who would rather have patients treated in clinics than in hospital emergency rooms. Families could find these clinics, read reviews, and see prices on their smart phones. This is the type of evolution I expect to see in the modern health care delivery model.

Views expressed are as of the date indicated, based on the information available at that time, and may change based on market and other conditions. Unless otherwise noted, the opinions provided are those of the author and not necessarily those of Fidelity Investments or its affiliates. Fidelity does not assume any duty to update any of the information.

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

Past performance and dividend rates are historical and do not guarantee future results.

Investing involves risk, including risk of loss.

Diversification does not ensure a profit or guarantee against a loss.

Stock markets are volatile and can fluctuate significantly in response to company, industry, political, regulatory, market, or economic developments. Investing in stock involves risks, including the potential loss of principal.

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.

Indexes are unmanaged. It is not possible to invest directly in an index.

Endnotes

1 Source: Congressional Budget Office estimate, Feb. 21, 2013.

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