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Healthcare: The 21st Century Juggernaut

By Randy Zaharia

Healthcare costs are looming ever larger as we move further into the 21st century. In October 2003, Southern California was hit by a series of union job actions, primarily called over healthcare costs. The supermarket workers' union and the Los Angeles County transit mechanics' union both initiated strikes over employer healthcare proposals that cut back benefits and/or increased costs to the workers. In addition, LA County sheriff's deputies called a sick-out due to a contract dispute over health benefits. Healthcare benefits are critical to most people, but exploding costs for health insurance with increases averaging 13% annually over the last few years, according to the Kaiser Family Foundation, are jolting the bottom lines of businesses and organizations (see CPI/ health care inflation graph and insurance costs graph on page 2).

The reasons posited for increasing healthcare costs are numerous and diverse. Some have argued that the lack of a single payer national health plan is the main cause. Others counter that the use of third party payers has removed any incentives to shop for the least expensive providers. Another reason blames pharmaceutical companies and their escalating drug prices and restrictions on generics. Others argue that massive amounts of paperwork along with expensive lawsuits and malpractice insurance, all piled on top of doctors and hospitals, have pushed up the costs of both. However, this analysis takes a step back to get a larger perspective.

Over the last several decades, a major focus by investors was to consider the longer term, future impact of the "baby boom" generation (those born between 1946 and 1964). In the 1970s and 1980s, there were huge impacts on the real estate markets as "boomers" reached house buying age, and in the 1990's, there was a huge impact in the financial sector as they reached wealth building years. Looking forward into the 2000's and 2010's, these "boomers" will be reaching middle-age and retirement, and will impact healthcare demand. Currently, most "boomers" are in their 40's and 50's, and beginning to reach those years where health problems become more common. As a result, over the next 20 years, the demand for healthcare from "boomers," an extraordinarily large demographic group, added to that of the general population whose growth is supplemented by a continuing influx of immigrants, will be placing significant burdens on the health care system.

Given demand, what about the supply of healthcare professionals? According to the Association of American Medical Colleges, there appears to be uncertainty over whether enough doctors are being trained to handle the growing healthcare needs. Dr. Whitcomb, senior vice president of the AAMC in 2001, noted that any miscalculations that produce too few doctors could severely restrict medical care in the future (AAMC Reporter, July 2001). In addition, according to Standard & Poor's (S&P) June 2003 Healthcare survey, there are severe shortages of many healthcare professionals including lab technicians, pharmacists,

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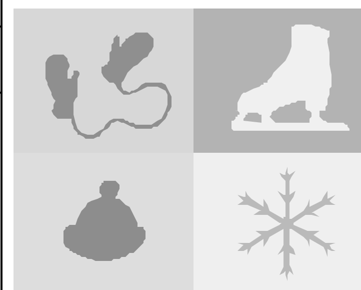

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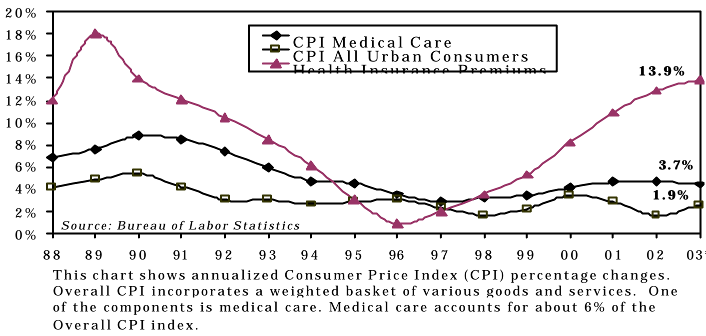
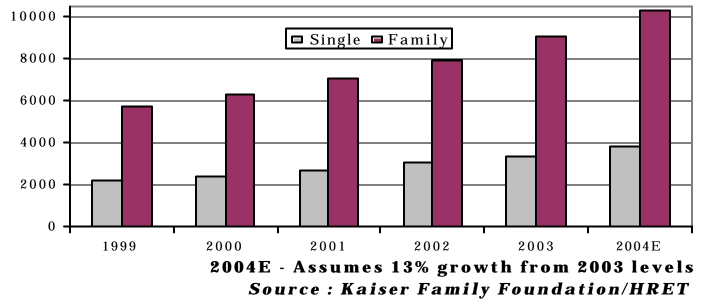


This chart shows annualized Consumer Price Index (CPI) percentage changes. Overall CPI incorporates a weighted basket of various goods and services. One of the components is medical care. Medical care accounts for about 6% of the Overall CPI index.



and most especially, nurses. S&P quoted Bureau of Labor Statistics projecting the need for an additional 5.3 million healthcare professionals (3.1 million for new positions) by 2010. The bottom line is that sharply increasing demand for healthcare is meeting a relatively stable supply of healthcare services, and the result will probably be sustained increases in healthcare costs.

As noted above, the healthcare arena will be growing in size and importance over the next several decades, and, as a consequence, may grow in size in our markets. As of the end of 2003, the healthcare area accounted for roughly 13% of the value of the S&P 500 Index , and about 15% of the US Gross Domestic Product. Many of today's healthcare companies could grow significantly in size, while others, buffeted by the pressures to lower costs, may actually experience little growth.

While this analysis may initially appear dour, American ingenuity has always found ways to deal with challenging situations. As the old saying goes, "from chaos comes opportunity." The key concepts going forward will be cost containment, preventative healthcare, and productivity improvements, especially through technology. According to a series of Blue Cross Blue Shield Association studies (published in October 2002, and reported in the June 2003 S&P Healthcare study), hospitals were the biggest drivers of overall healthcare costs, in addition to pharmaceuticals and outpatient spending. While many hospitals may have secured higher revenues from insurers, will long term cost containment pressures make hospital facilities and managed care facilities "undesirable" long term investments? Hard to say, but these are the difficult questions for this sector. The art and skill in dealing with these questions will be in not only looking for profitable companies now, but for companies which will take advantage of the challenges and opportunities facing healthcare in the future.

For example, many of the medical device makers and pharmaceutical companies are providing products that will substantially help reduce long term costs to the health care system, as well as provide preventative health benefits. Companies like Guidant, Johnson & Johnson, and Medtronic are providing products designed to reduce the stay necessary in a hospital, as well as reduce the need for expensive healthcare resources. Similarly, companies such as AstraZeneca and Pfizer are providing pharmaceutical products which may help speed healing, reduce hospital stays, eliminate bacterial infections, and reduce cholesterol levels. In addition, some of these companies, as well as others, are involved in advanced biomedical research which could breakdown significant barriers to dealing with many diseases such as AIDS, cancer, and others. This biotechnology – advanced drug therapies, genomic research, etc. –may eventually hold keys to allow the current healthcare system to handle the looming demand, as well as prevent some of the diseases that tax the system now.

From another aspect, the aging of the population will continue to provide demand for "replacement" products and services. For example, some of the fastest growing medical device companies include the orthopedic companies such as Biomet, Stryker, and Zimmer. As more baby boomers reach their 50's and 60's, the demand for replacement knees, hips, spines, and other joints will escalate as "boomers" want to maintain their quality of life.

Critical to the success of many of these healthcare companies is the ongoing co-operative research with major universities. In many cases, it may make the difference between a well accepted product and one less utilized. As a result, we review and analyze the research and development of the company, the depth and breadth of its management, the pipeline of products in the company, and the connections that the company has to the medical university establishment. These aspects are all part of the analysis that goes into not only the background review for healthcare companies, but into the background review for all of the companies that Clifford researches. This is part of "how we do our homework."

From a productivity standpoint, the healthcare sector has long lagged the rest of the economy. In a November 11, 2003, *Wall Street Journal* article, it was noted that healthcare productivity finally went from a decline in the 1987-1995 time period to a slight increase in the 1995-2001 time pe-

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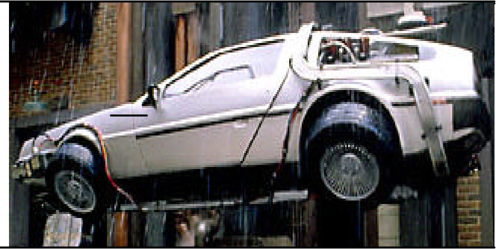
Back to the Future - 2004 Understanding the Mutual Fund Scandal



By Terry Price

Back in the mid 1980s, Universal Studios released the first of three hit movies titled *Back to the Future*. These clever stories revolved around a somewhat eccentric scientist who invented a time travel machine installed in a DeLorean automobile. Then together with the movies' main character, Marty McFly, the two proceeded to travel back and forth between the past, the present, and the future.

Part of the storyline of those films centered on the oddball scientist's insistence that Marty McFly never bring back anything from the future from which he might personally profit. In discussing this with his young protégé, the professor explained the obvious financial rewards Marty would receive from having pre-knowledge of the future. But he also clearly explained such personal gain would be detrimental to society as a whole. And in true Hollywood style, history would be ever-after altered, and the future of all mankind would never be the same.

Well, as revealed this past September by New York's Attorney General, a few unscrupulous firms have recently been riding in their own version of a financial DeLorean time machine. Gleaning future information, some individuals have been profiting illegally in the present through what has come to be known as the mutual fund late-trading scandal. Here's how it worked.

Under federal regulation, mutual funds are only allowed to price their shares once each day at 4:00 pm Eastern Time. Unlike other securities which trade during the whole business day at ever-fluctuating prices, mutual funds are only bought and sold based on that once-a-day 4 o'clock price. If an order is placed before 4 o'clock, it is executed. If it's placed after 4:00 pm, it's traded the next day at tomorrow's price.

An exemption has been granted to certain pension administrators who accumulate purchase orders throughout the day and then submit one combined order after the close. It's that simple. However, certain parties, mostly hedge funds, were able to disguise themselves as pension administrators and trade after the 4:00 pm deadline at that day's share price. So why the big fuss?

Let's say we own a mutual fund of healthcare stocks which today at 4:00 pm was priced at $10 a share. At about 5:00 pm today, a large drug company in our fund announces the discovery of a cure for all cancers. At 6:00 pm a medical device company announces their brand-new artificial heart, guaranteed to beat for 50 years on a single battery. And shortly thereafter, a medical supply company announces their discovery of artificial blood, eliminating the need for all blood donations in the future.

We suspect our healthcare mutual fund would likely rise briskly in value the next day as those individual stocks take off. However, if someone could buy shares back at today's closing price of just $10, odds are they would almost guarantee themselves a future profit while taking very little risk. Now, we are not sure the consequences of such illegalities are as dire to all mankind as predicted in the movies. But they certainly do hurt existing shareholders because of dilution from the additional shares outstanding that were purchased at a lower price than would be fair under ordinary circumstances. Also, the purchases unfairly benefit those who use mutual funds in this manner for their personal gain without assuming risk equal to that of existing holders. We also suggest a much broader cost of such illegal activity will likely affect all those investing in mutual funds in the future.

Recent articles have discussed increases already seen in mutual fund insurance premiums as well as legal and administrative expenses. These increasing expenses are generally tied to the enforcement of stricter regulatory rules now being applied to all mutual fund companies, not just the few which have been found guilty. It is expected many of these costs will be passed on to shareholders. According to Morningstar, the average stock mutual fund already charges 1.14 percent annually. One fund consultant estimates additional mutual fund expenses will rise between 0.05 and 0.10 percent of assets. If passed through to all fund shareholders, those additional costs may drive the average stock mutual fund fees upward into the area of 1.20 to 1.25 percent annually.

In the "Back to the Future" movies, things generally worked out well for the main characters. The difficulties and cir-

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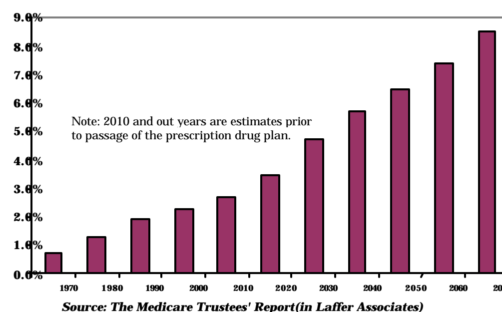
riod. According to the article, computers were beginning to help in this sector. For example, the Food and Drug Administration is proposing to require bar coding on prescription and some over the counter medication; a private company in St. Louis, Missouri provides many of the technology tools (printouts, inks, software) to accomplish these barcode tasks. Some doctors have given up their massive Physician's Desk Reference tomes for a Palm or Sony personal digital assistant, allowing them to look up drugs in seconds rather than minutes. These are just a hint of the potential yet to come in improving productivity in the healthcare sector.

One critical final variable to factor into all of this is the US federal government, the proverbial "800 pound gorilla." Medicare health plan outlays continue to explode with estimates that the trust fund might run out of cash before the end of the 2010s. Late in 2003, Congress passed, and the President approved, a major expansion of Medicare with an added prescription drug benefit estimated to cost an additional $400 billion over the next 10 years and possibly another $1 to $2 trillion in the decade after that. While we believe this prescription drug benefit plan may be advantageous to the pharmaceutical companies in the near term, in the longer term it may allow intrusion by government into the pricing arena. Already, the FDA is battling numerous cities and states over the importation of drugs from Canada. Potentially, this pressure may burst and overflow into the

Medicare Spending as a Percentage of GDP



pharmaceutical sector, ultimately reducing these companies' attractiveness.

While more and more resources will be diverted to healthcare and the value of healthcare companies probably will rise as a consequence, there will be significant challenges and opportunities in identifying who the winners and who the losers will be as we go forward. If there ever was a sector that required the utmost research, care, and consideration, this is it. At Clifford, we have remained clear-eyed and realistic.We are convinced that with so many varied crosscurrents in this sector, there are a multitude of opportunities for companies both inside the healthcare sector and outside; technology companies, consulting companies, and possibly others may become critically important to the healthcare arena. The possibilites for human ingenuity and productivity in healthcare the next 20 years are staggering.

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cumstances they experienced along the way made for great Hollywood fun. Unfortunately, we do not see such an enjoyable outcome for present-day investors. Overall confidence in the mutual fund industry has been reduced. The public has demanded and received more and more regulation. However, regulation has its costs and is likely to increase the fees charged to all who use mutual fund investments in the future.

We wish we had a magic DeLorean at our disposal. We'd take a ride back from the future with the hope of fending off the misconduct of what has already occurred in the past. But we don't. So going forward we are left with the words of our founder A .M. Clifford written in 1925, ". . . all investments are risks, differing only in degree of risk, while the investment yield should be proportionate to, and compensate for, the risk assumed–otherwise the investment is not a good risk, quite irrespective of its final outcome." As investment counselors, we are committed to this philosophy. Rather than illegally gaming the system, we understand our responsibility to properly analyze investment yield and risk and will continue to advise our clients accordingly. As it has for nearly 90 years, we expect this philosophy to continue serving our clients well as they look back at their portfolios from the future.