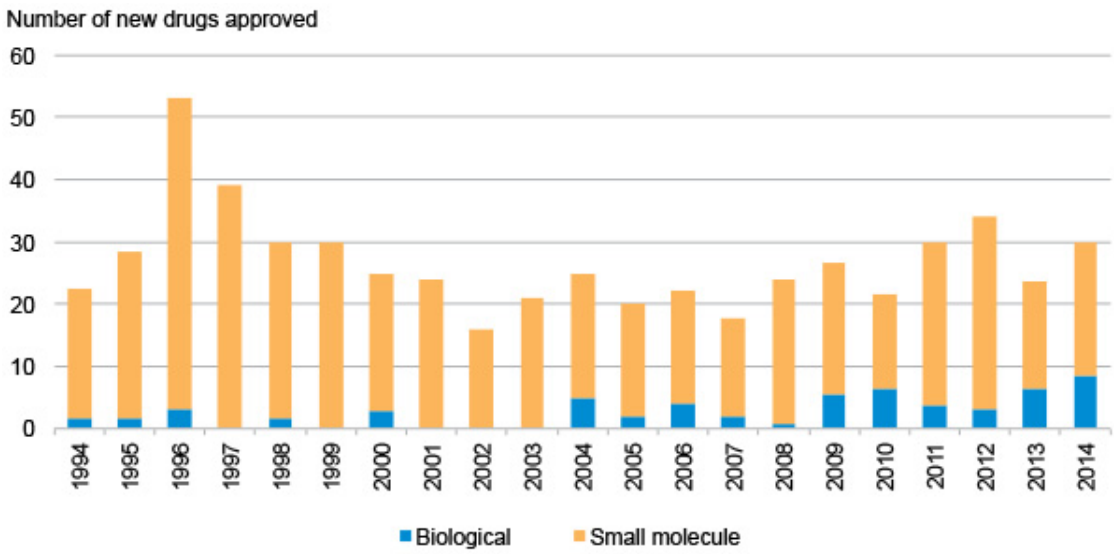
Healthcare: an innovation injection

John Bowler. Fund Manager, Global Healthcare

Healthcare has been one of the best performing global sectors year-to-date, which begs the question: how much further can it go? John Bowler argues that ongoing innovation from medical companies will continue to drive strong performance in the sector and highlights a few key areas where this is already occurring.

A key theme in the healthcare sector is the new technology cycle it has been enjoying for some time, which has been instrumental in driving past performance. The wider availability of research tools relating to gene sequencing and protein characterization, out of the specialised genome research centres and into mainstream academic laboratories, has helped drive significant progress in our understanding of diseases. This, coupled with more stringent investment criteria, is prompting improved productivity and I see 2014 as set to provide another year of important advances in drug development. Indeed, 30 new products have already been approved so far this year by the Food and Drug Administration (FDA) as can be seen in the chart below. This is the fuel that will sustain growth in the sector.

Chart 1: New drugs approved by the FDA



Source: Schroders, FDA as at 30 September 2014.

Importantly, the degree of innovation has improved, as indicated by the higher proportion of 'biological' drugs that can be seen in the chart. Biological drugs are defined as antibody or protein-based drugs and the growth in approvals of such medication highlights that industry is not only producing more products compared to the past decade, but also creating better quality products.

Last year I highlighted the exciting progress in cancer treatments such as immuno-oncology, which is a new treatment approach that has already shown a significant change in clinical outcomes in certain cancers. This innovation is set to change treatment standards and remains an opportunity that has yet to be fully reflected in analysts' estimates. The developments have captured the attention of investors and I would like to highlight that the innovation cycle affects a far broader area than just cancer.

Novartis recently published late stage clinical data on its new drug (LCZ 696) to treat chronic heart failure. The drug improved mortality rates by 20% on top of the gold standard, enalapril, and represents the first improvement in treatment standards since the early 1990s. Market forecasts for sales of this product have risen to $4.4 billion by 2020 which is meaningful even for a company of Novartis's size.

Continuing with cardiovascular medicine, both Sanofi and Amgen are at the vanguard of a new class of drug to lower cholesterol. Current therapy is dominated by the so-called 'statin' class of medicine which work by restricting the production of cholesterol in the liver. This class has already demonstrated its ability to save lives but is not effective in all patients.

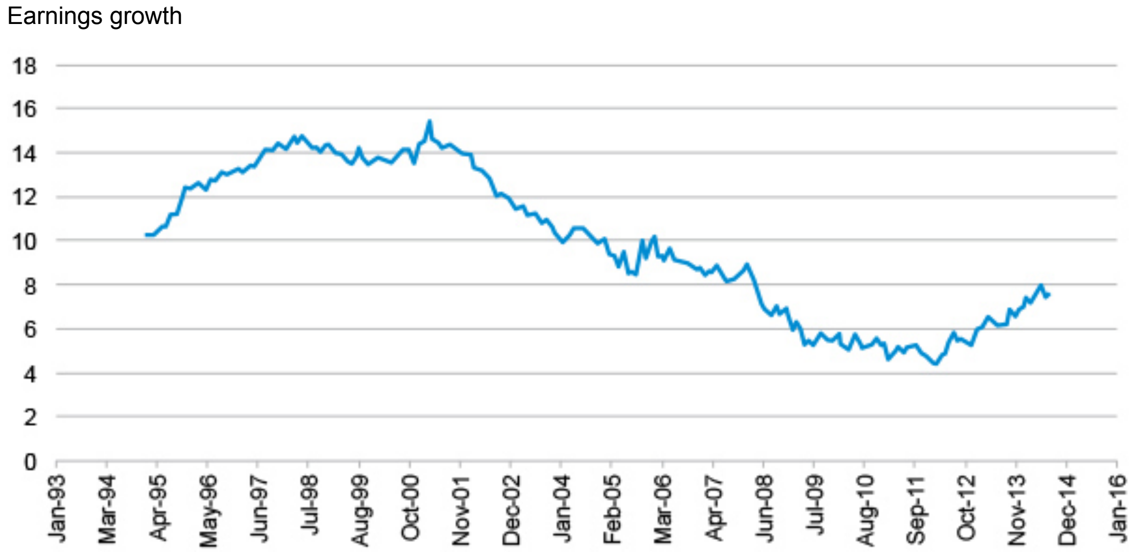
The medical world is therefore very excited about the use of certain antibodies that allow the liver to remove cholesterol from the blood. Treatments such as Amgen's evolocumab and Sanofi/Regeneron's alirocumab have both presented successful late stage clinical data that demonstrates the potency of this new class in even the hardest-to-treat patients. It took the statin class several, ten thousand-patient clinical studies, monitored over years, to prove that lowering cholesterol could save lives. By contrast, in a patient 'safety' study conducted in only 2000 patients who were monitored for 12 months, alirocumab has already shown a statistically significant reduction in heart attacks. To show a statistically significant response in a small group of patients over a relatively short period of time supports the view that this class of drug has greater potency than the statin class.

The innovations described above, the heart failure drug and the cholesterol-lowering antibody drugs, will launch next year and should help illustrate that there are still companies in the sector that can benefit from a new product cycle.

Attractive value and growth prospects

From an investment perspective, the below charts are key to understanding the sector's value and growth prospects. Chart 2, which shows the long-term earnings growth forecast for the MSCI World Pharmaceutical Sector, demonstrates that the benefits of this innovation cycle have already begun to be reflected in long-term growth expectations. However, it also illustrates that we are some way from reaching the level and duration of the previous innovation cycle of the late 90s.

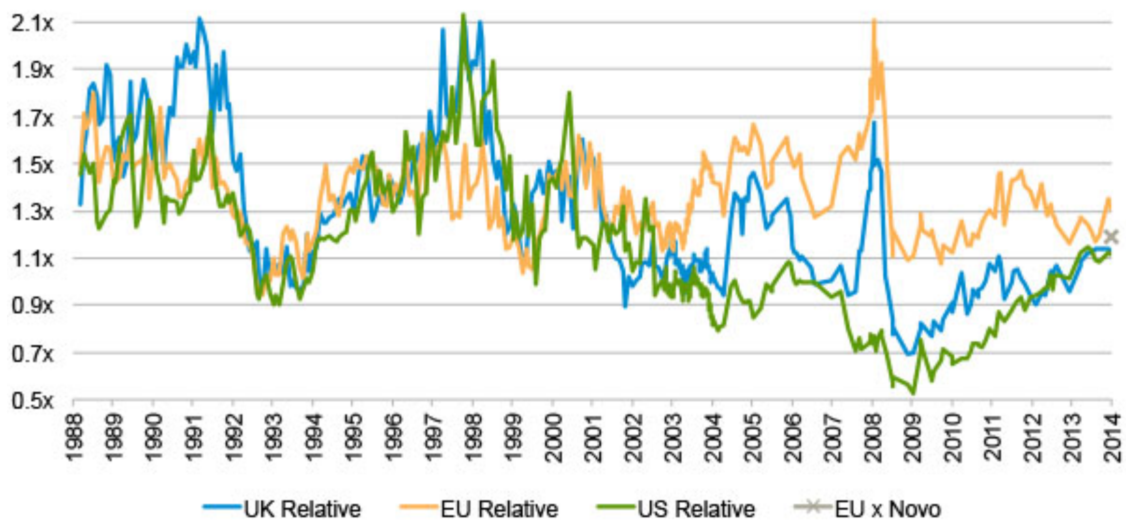
Chart 2: Long-term earnings growth forecast



Source: IBES, Datastream. Data as at 1 September 2014.

Chart 3 shows that the large cap pharmaceutical sector's relative price-earnings ratio (PE) has re-rated from its historic low in 2009. Despite the increase in long-term growth expectations, however, valuations have only just returned to their historic average and are certainly not stretched versus history.

Chart 3: Pharmaceutical price-earnings relative to local market



Source: Bloomberg consensus estimates to 31 October 2014.

Please note that stocks and sectors are mentioned for illustrative purposes and should not be viewed as a recommendation to buy/sell.

Past performance is not a guide to future performance and may not be repeated.

The forecasts included should not be relied upon, are not guaranteed and are provided only as at the date of issue. Our forecasts are based on our own assumptions which may change. We accept no responsibility for any errors of fact or opinion and assume no obligation to provide you with any changes to our assumptions or forecasts. Forecasts and assumptions may be affected by external economic or other factors.

Related articles innovation healthcare John Bowler Global Equities