

## A Roadmap for Effective Healthcare Investing: Navigating the Minefield

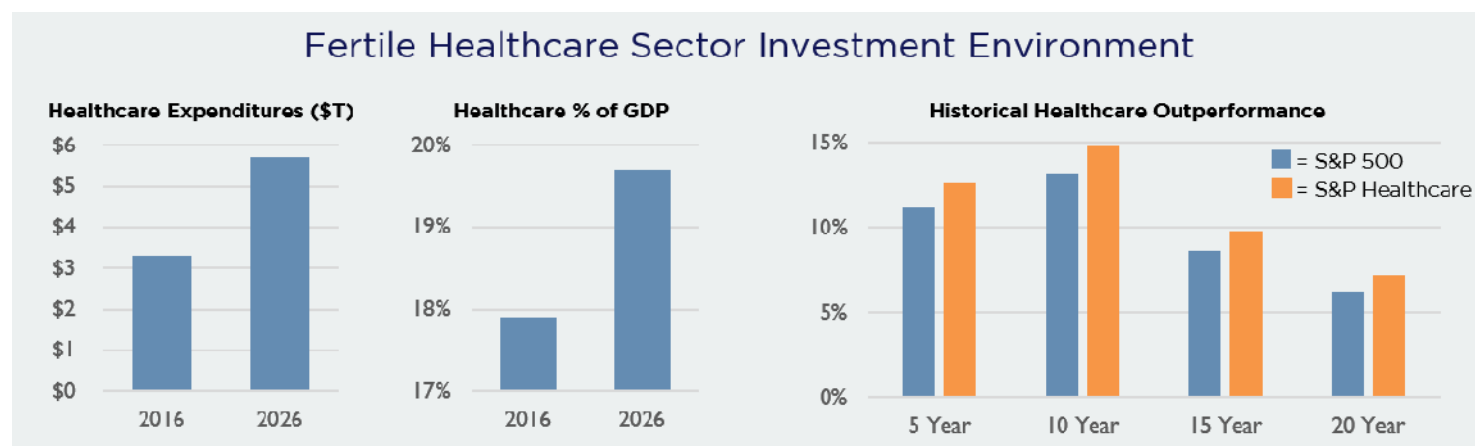
Healthcare is vital to each and every one of the more than 325 million people in the United States. **For investors, this large, diverse, and growing sector provides a fertile landscape across which to invest.** Indeed, there will be attractive opportunities to invest in healthcare for the foreseeable future due to:

- (a) Organic growth driven by the aging demographics of the U.S. population, particularly as “Baby Boomers” age into their prime healthcare consumption years.
- (b) The diverse and dynamic set of healthcare sub-sectors, which comprise a significant amount of total U.S. GDP.
- (c) The indispensable nature of healthcare products and services that are less prone to economic cycles.

We interviewed Pavadi Capital, a specialized healthcare fund manager, to provide a unique perspective on healthcare that goes against the grain when looking at the opportunity set within this sector. While healthcare exposure can add value to an investment portfolio, not all healthcare exposure provides investors with the same risk / return profile. For investors seeking to generate desirable returns without taking undesirable risks, one approach worth consideration is investing in a portfolio of profitable, publicly-traded healthcare companies, which can be beneficial for investors in multiple ways.

### The Healthcare Investing Environment

Healthcare is currently projected to grow to \$5.7 trillion and 20% of GDP by 2026. Stakeholders are vast and include both private and public companies. Currently, there are approximately 800 publicly-traded healthcare companies on the major U.S. exchanges, which account for approximately \$5 trillion of aggregate market capitalization. Importantly, investing in publicly-traded healthcare companies historically provided investors with an opportunity to outperform broader market indices, and healthcare’s *raison d’être* is ideally suited for the growing number of investors interested in impact investing and social responsibility.



### The Investors’ Organizational Framework

Organizational frameworks are important for investors. While healthcare can provide investors with the opportunity to generate investment returns over time, it is critical to understand not all healthcare investments entail the same types or levels of risks, both qualitative and quantitative.

#### For Example: By Investment Product

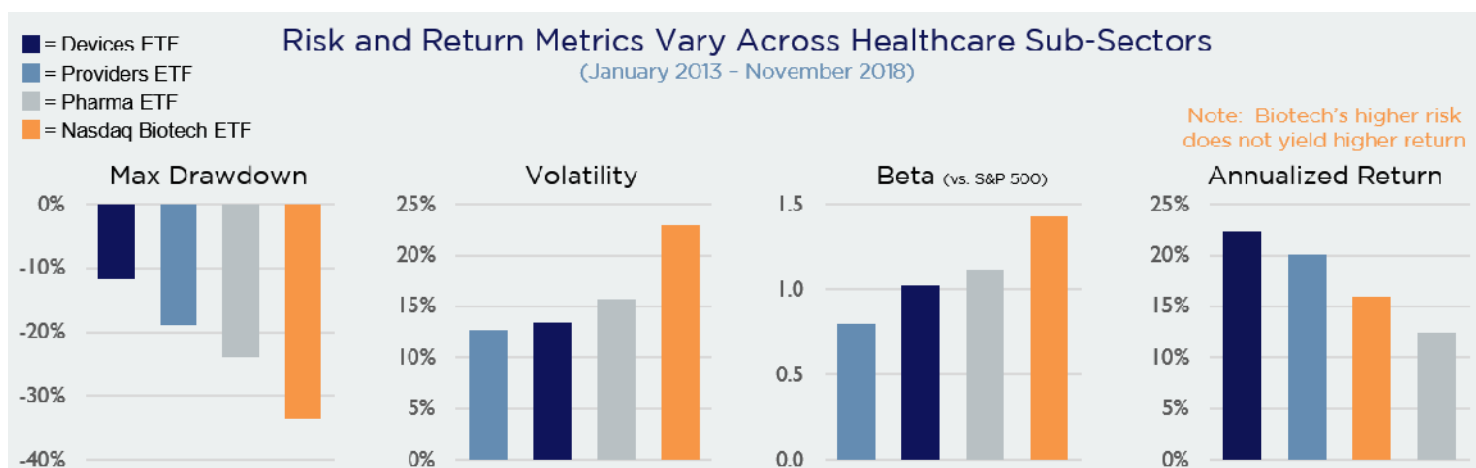
For investors seeking exposure to healthcare, there is a \$250 billion asset management landscape comprised of mutual funds (\$110B / 44%), healthcare specialist private funds (\$90B / 36%), and ETFs (\$50B / 20%).

#### For Example: By Segments

Given healthcare’s sheer size and inherent complexity, there are many different ways to organize the sector into smaller, more manageable segments, e.g., by sub-sector, by market capitalization, or based on other differentiating characteristics.

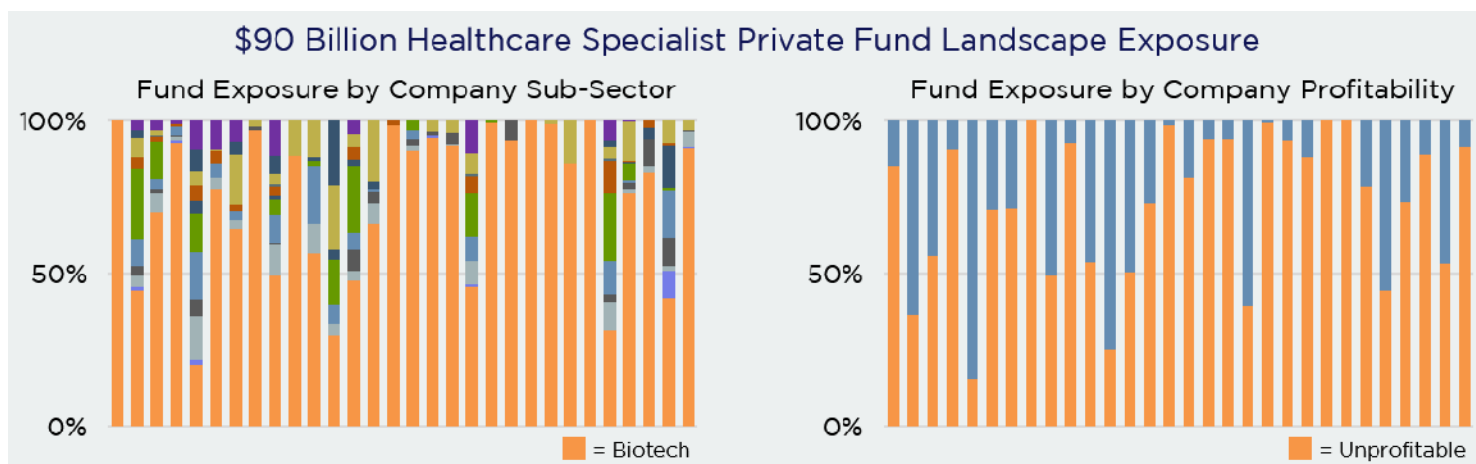
### Case Study: Risk and Return Metrics for Biotech Sub-Sector

One way to illustrate this insight is to evaluate different healthcare sub-sector ETFs and compare their risk metrics, which highlights biotech as the sub-sector that is quantifiably riskier across multiple metrics. For an even broader perspective, an analysis of the 100 largest ETFs globally reveals that biotech's volatility and beta are among the highest (riskiest).



### Risk Highlights – “The Minefield”

Despite material differences in risk across healthcare sub-sectors, with biotech being meaningfully and quantifiably riskier across multiple metrics, the majority of healthcare specialist investment funds are in fact concentrated in **biotech**. In addition to biotech, healthcare specialists also have substantial exposure to **unprofitable companies**. This significant exposure to unprofitable, often development-stage biotech companies, **which tend to have frequent binary events, higher volatility, higher beta, deeper drawdowns, and less liquidity**, is a challenge for healthcare investors seeking to generate desirable returns without taking undesirable risks. When investors compare investing in healthcare to navigating a minefield, these aforementioned risks come to mind. A key question for such investors is how to most effectively derive value from investing in the large, diverse, and growing healthcare sector. *How can one effectively navigate or avoid the minefield?*



### Why Invest in Profitable, Publicly-Traded Healthcare Companies

For investors looking to successfully traverse the intricate healthcare landscape, one tactic is segmenting healthcare companies into those that are profitable and those that are unprofitable.

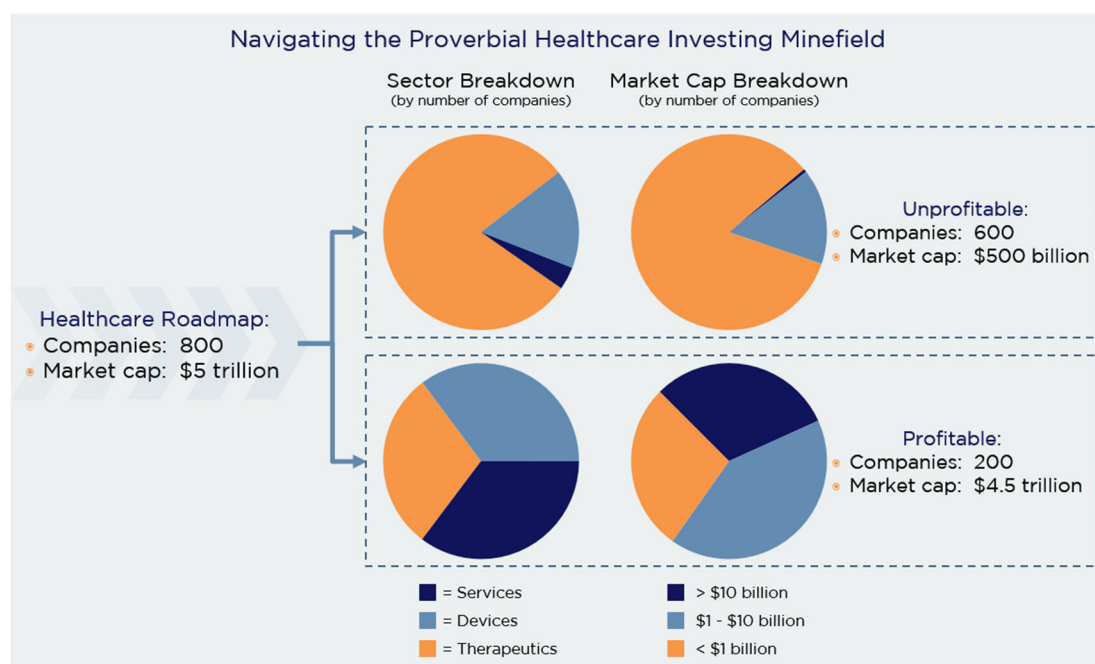
This relatively straightforward starting point enables investors to operate within an investment universe comprised exclusively of profitable companies, which can provide numerous benefits.

**Benefit #1. Demarcation of a Discrete and Sizeable Investment Universe:** Of the approximately 800 publicly-traded healthcare companies, roughly 200 are profitable and 600 are unprofitable. If the objective is to construct a concentrated portfolio of

longer-term holdings, 200 profitable companies makes for a well-defined and manageable universe of companies across which to invest.

**Benefit #2. Preservation of the Vast Majority of Healthcare's Investible Market Capitalization:**

Of healthcare's approximately \$5 trillion of investible market capitalization, the roughly 200 profitable companies account for \$4.5 trillion, or 90% of the total capitalization. The remaining 600 unprofitable companies account for the remaining \$500 billion, or 10%. As the sector continues to grow, the \$4.5 trillion of profitable company market capitalization should likewise continue to grow.



**Benefit #3. Diversification across Healthcare Sub-Sectors:** A further analysis of the profitable subset of companies reveals that they are spread fairly evenly across the therapeutics, devices, and services sub-sectors. In contrast, the vast majority of unprofitable companies are components of the therapeutics sub-sector, particularly biotech.

**Benefit #4. Diversification by Market Capitalization:** A further analysis of the profitable subset of companies reveals that their market capitalizations are spread fairly evenly across large-, mid- and small-caps. In comparison, the vast majority of unprofitable companies have market capitalizations below \$1 billion.

**Benefit #5. Scalability and Liquidity Implications:** Because the 200 profitable companies account for \$4.5 trillion of market capitalization and include many mid- and large-cap companies with deep underlying liquidity, an investment strategy focused on constructing a portfolio of such companies has multi-billion dollar scalability with ample liquidity. In comparison, a portfolio of unprofitable companies can often have capacity constraints and significant illiquidity risks, which become exacerbated as assets in those strategies scale.

**Benefit #6. Qualitative and Quantitative Risks:** Importantly for risk-conscious investors, the key considerations and variables impacting investment performance can be vastly different for profitable, commercial-stage companies compared to unprofitable, often development-stage companies. Most notably, the due diligence process for many unprofitable companies is centered around predicting the outcome of unknowable binary events, which are often many years and tens or hundreds of millions of dollars from becoming knowable. Beyond qualitative risks, portfolios of profitable companies tend to be quantitatively lower risk than portfolios of unprofitable companies across multiple metrics.

**Benefit #7. Compelling Corporate Missions and Value Propositions:** From the universe of profitable companies, one can find fundamentally sound companies with strategic priorities and core competencies that dovetail with key trends propelling the dynamic healthcare sector forward. Examples of such trends include:

- the foundational shift from a volume-based to value-based system;
- the increasing number of healthcare services being provided in lower-cost, higher-quality outpatient settings;
- the burgeoning influence of the healthcare consumer and associated demands for, amongst other things, more choices and transparency;
- the pervasiveness of technology and interoperability;
- the growth in government-sponsored healthcare via Medicare and Medicaid; and
- the import of operating scale and purchasing power across sub-sectors.

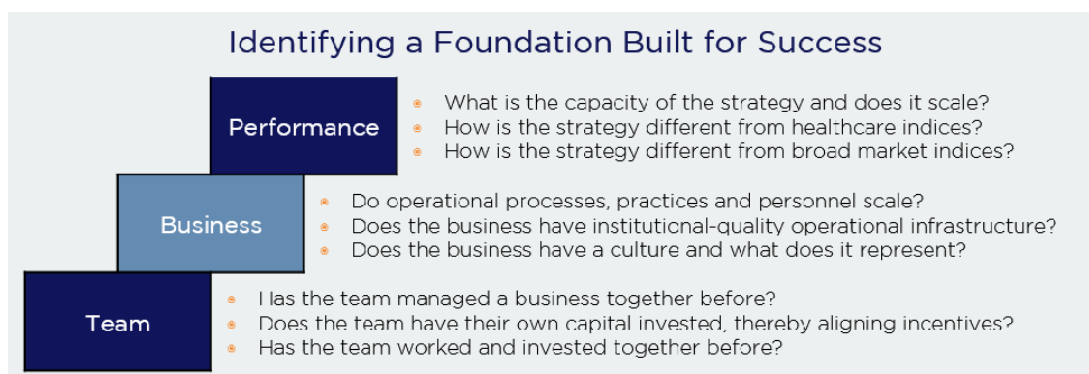
**Benefit #8. Large Market Opportunity:** The addressable market opportunity for certain profitable companies is in the hundreds of billions of dollars. For example, managed care plans for Medicare beneficiaries (principally Americans age 65 and older), commonly referred to as Medicare Advantage plans, continue to provide value to the Federal government and consumers. Beyond Medicare, Medicaid (covering low income, disabled and other vulnerable populations) is now a “third rail” in national politics. This reality, coupled with states’ continued focus on reducing their “fee-for-service” Medicaid outlays, provide Medicaid Managed Care companies with a significant and growing opportunity. Together, Medicare Advantage and Medicaid Managed Care represent a market opportunity totaling in excess of \$500 billion.

**Benefit #9. Utilization of Tried-and-True Valuation Multiples:** Profitable companies, unlike unprofitable companies, have valuation multiples that are measurable, meaningful, and can serve as an adjunct throughout an investment process. One key determinant in the realization of investment gains versus losses is the price paid at the investment’s inception. Effectively incorporating tried-and-true valuation multiples into an investment process can facilitate finding attractively-valued companies and entering investments potentially closer to trough, rather than peak, valuations.

**Benefit #10. Differentiation:** An investment portfolio comprised exclusively of profitable, publicly-traded healthcare companies is different from most healthcare-focused investment portfolios. In investing, doing something different in a methodical, repeatable, and scalable manner is often a key ingredient in constructing long-term, uncorrelated outperformance.

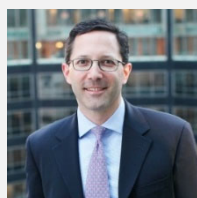
### Other Critical Factors in Healthcare Investing

Beyond portfolio construction and management, there are other critical success factors that should be considered by investors looking to add healthcare exposure to their investment portfolio. Management team dynamics and business strategy subtleties can enhance value or accelerate its demise.

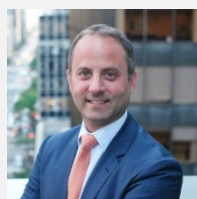


Beyond the pursuit of investment returns, investing in healthcare companies can also have a positive and far-reaching societal impact. The current healthcare system faces persistent and evolving challenges, and it can be rewarding to invest in companies actively engaged in addressing such critical issues. Ultimately, the objective for all of the healthcare sector’s stakeholders, including investors, should parallel the mission of the largest healthcare company: “To help people live healthier lives and to help make the health system work better for everyone.” And if this objective can be achieved with minimal traversing of the proverbial minefield, so much the better.

### Special Thank You To Our Co-Contributors:



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### PAVADI CAPITAL LLC

*patience • value • discipline*

- Pavadi Capital LLC manages investment funds focused on finding underappreciated, value-oriented investment opportunities across the large, diverse and growing U.S. healthcare sector.
- Pavadi's distinct focus is the culmination of efforts to identify a durable way to generate returns and manage risk by investing exclusively in profitable, publicly-traded healthcare companies.