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Time for a Health-Care Fund?

Rob Wherry October 2006

THIS YEAR INVESTORS HAVE had a hard time making sense of the reams of economic data on interest rates, housing starts, unemployment and consumer spending. Even the record highs of the Dow Jones Industrial Average have some people scratching their heads. The general consensus though: Be prepared for a period of slowing earnings growth going forward.

If that's the case, one sector will look pretty good.

Companies that cure the aches and pains of millions of sick Americans perform well in flat markets — and in the months after the end of a Federal Reserve tightening cycle, according to Barrington Research. In other words, right about now. "It has been more of a defensive and recession proof sector," says J.C. Waller, manager of the **ICON Healthcare fund** (IHCX¹).

Investors in this sector have had to be patient up to this

point. The average health-care mutual fund returned 8.9% annually over the last three years, according to Morningstar. During that same time period the Standard & Poor's 500 index returned 11.3%. Now, however, Zacks estimates the S&P 500's five-year growth rate at 8% while the health-care funds on our list are expected to grow at twice that amount.

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- Gary Webb

Health care has been under the weather over the past few years for several reasons. Sure, there were perennial problems like pricing pressure, patent expirations, weak pipelines and the harbinger of increased

government regulation. But what really scared off investors were lawsuits, like those surrounding **Merck's** (MRK²) painkiller, Vioxx. It also didn't help that investors flocked to dividend-paying value stocks in recent quarters.

Health care, however, has one undeniable fact going for it: Baby boomers are hitting retirement age. This generation will help push spending on medicines, treatments and equipment to over \$3.1 trillion by 2011, up from \$2.2 trillion this year. And as drug companies win some lawsuits, investors have started taking a second look. Merck's stock, for example, is up 62% to \$42 a share since it hit bottom this time last year. Also, when the earnings of the S&P 500 slow, investors tend to flock to stocks that have above-average growth prospects.

Getting exposure to this industry used to be an easy call. Edward Owens has an

impressive track record running **Vanguard Health Care** (VGHCX³). Over the last decade the fund's average annual return was 17% vs. half that for the S&P 500. No health-care manager has done better over that time span. But alas, as the fund bulged to \$27 billion in assets Vanguard closed it to new investors.

A decent alternative — and one of our top performers — is the **T. Rowe Price Health Sciences** (PRHSX⁴) fund. Manager Kris Jenner, a former physician, has a great bedside manner: His entire retirement account, just under \$500,000, is invested in the fund alongside his shareholders. Jenner is warming up to the industry's biggest players. He thinks changes in the corner office at **Pfizer** (PFE⁵), **Bristol Myers Squibb** (BMY⁶) and Merck, industry cost-cutting measures and cheap stock prices have all been positives. "I think the doldrums for large cap U.S. pharma are largely over," he says. But he does sound one warning. "A political sea change in Congress [next month] will be viewed as a negative," he says. "There will be a reflexive knee-jerk reaction in the short term.

Jenner's go-anywhere style mixes aggressive positions in

small biotech outfits like **ResMed** (RMD⁷), a specialist in sleeping disorders, with drug industry stalwarts like **Wyeth** (WYE⁸), **Genentech** (DNA⁹) and insurer **WellPoint** (WLP¹⁰). That combination has worked to his advantage. His fund has returned an average 9% over the last five years, 25% better than the S&P 500. And he's done it with a relatively low 56% turnover rate.

Waller's ICON Healthcare is the only quantitative mutual fund on our list. Its computer algorithms screen health-care sectors on earnings growth and stock price volatility and momentum, among other things. The idea is to move between sectors — equipment makers, insurance or pharma, for example — that are trading cheap but showing signs of heating up. That might sound like an aggressive stance. But Waller's turnover is on par with the T. Rowe Price fund. (Although his expense ratio of 1.22% is 34% higher.) The fund is in the top 10% of its peer group over the last five years.

But just as you take your medicine in prescribed doses, so should you earmark only a portion of your portfolio to this sector. Health-care stocks can be extremely volatile,

especially if an upstart firm misses an earnings estimate or a drug company gets sucked into a lawsuit — something that happens frequently. For example, **Fidelity Select Medical Delivery** (FSHCX¹¹) got whacked earlier this year when one of its top holdings, **United-Health** (UNH¹²), was accused of allegedly backdating stock options. The shares are down 20% this year, helping the fund plunge to its recent place in the basement of its category.

"If you cannot take the bumps you should not be investing in this industry," says Gary Webb, head of Webb Financial Group. "Use a health-care fund as a small complement to your large core holdings. And pick one that has broad exposure not only to Big Pharmaceutical, but also to equipment makers, hospitals, insurers or biotech."

The Criteria

This week we limited our search to no-load mutual funds with a health care or biotech bent as labeled by Lipper. We narrowed our choices by requiring three- and five-year performance in the top 25% of the category. Finally, we knocked out any fund with an expense ratio higher than 1.45%, the average for a U.S. domestic equity fund