Medical Xpress

Can health-care stock funds stay on top?

October 16 2014, by Stan Choe

(AP)—When swings in the stock market cause anxiety to spike, like it is now, many investors aim to get healthy.

Stocks don't come with guarantees, but health care stocks have held up better than others during past downturns. People get sick regardless of the economy's strength, after all, and an aging population around the world means more demand for prescription drugs and hospital care. That has brought more attention to health care stock funds, as worries about a weak global economy have sent stocks sinking in recent weeks.

Health-care stock funds have returned an average of 19.1 percent annually over the last five years, more than any of the other 101 fund categories tracked by Morningstar. The strong returns are luring more dollars: Investors put more into health care funds last month than they pulled out, contrary to the trend for stock funds in general. But it's important to keep in mind that conditions are much different for the sector than they were five years ago. Here's a look at some questions to consider before buying a health care fund.

— ARE HEALTH-CARE STOCK FUNDS REALLY SAFER INVESTMENTS?

Everything is relative, but they have been in the past.

"We're investing in demand for health, and that comes in drugs, devices and hospital services," says Jean Hynes, manager of the Vanguard Health Care fund (VGHCX), whose $40.9 billion in assets makes it the largest fund in the category by far. Demand for those tends to be more stable than it is for, say, electronics or other non-essentials.

Consider how the financial crisis dragged the Standard & Poor's 500 index to a loss of 37 percent in 2008, even after factoring in dividends. That year, health care stock funds lost an average of 23.4 percent.

Many of the big pharmaceutical companies and insurers in the sector also pay dividends, which can help offer a smoother ride. Johnson & Johnson, Pfizer and Merck are the three largest health care stocks in the S&P 500, and all have a higher dividend yield than the index.

— WHAT SHOULD I LOOK FOR IN A HEALTH CARE STOCK FUND?

Even within the health care sector, some types of stocks are safer than others. On the more volatile end are biotechnology stocks, which can be boom-or-bust investments depending on how much excitement their drugs under development are generating.

Puma Biotechnology, for example, has more than doubled this year, but that includes some extreme swings. This summer, it posted a one-day loss of 25.3 percent and a one-day gain of 295.4 percent.

Investors hoping for a smoother ride should look for funds with a smaller percentage of their assets in biotechnology stocks, says Eddie Yoon. He manages the Fidelity Select Health Care Portfolio fund (FSPHX), which has a four-star rating from Morningstar.

Yoon has been paring back on biotech stocks: They make up 25 percent of his fund's assets, down from 28 percent two years earlier. That's even as surging prices for biotech stocks have made them a bigger part of the sector: They make up 22 percent of the index that Yoon benchmarks his fund against, up from 16 percent two years earlier.

— WHY DID HEALTH-CARE STOCK FUNDS DO SO WELL OVER THE LAST FIVE YEARS?

Health care funds were available at bargain prices five years ago. That's when Congress was debating how to reform the health care system, and some investors worried that new regulations could hurt profits.

Pharmaceutical stocks were hurt by worries about a slowdown in government approvals for new drugs. There were also concerns that a raft of patent expirations for high-profile drugs would send profits for large drugmakers off a cliff.

"Fast forward to now, and we have a system where we at least understand what the system is going to look like," Hynes says. "Companies have gotten through the patent cliffs in a way that was very predictable, and we are in a new and exciting product cycle."

The Affordable Care Act has meant more people have health insurance, which analysts expect will lead to higher demand for health care. That means investors are willing to pay higher prices for the sector: Health care stocks in the S&P 500 trade at 20 times their earnings per share over the prior 12 months. Five years ago, they had a price-earnings ratio of 12.

— SO THE NEXT FIVE YEARS WILL BE JUST AS GOOD, RIGHT?

Unlike five years ago, health care stocks are no longer cheap. Many are close to their average price-earnings ratios over the last few decades. Biotechnology stocks in particular can look expensive, as demand for their strong potential growth has inflated price-earnings ratios. That makes it tougher for health care funds to replicate their returns.

But prospects for companies' earnings look better today than five years ago, Hynes says. Long-term trends are encouraging for the sector.

Demand for health care tends to spike once a person gets past the age of 70. A similar leap occurs when someone enters the middle class. Both trends are occurring around the world, as the Baby Boom generation enters retirement and developing economies in China and India vault millions of families into the middle class.

"That tail wind is there regardless of whether the economy is expanding or contracting," Fidelity's Yoon says.