Healthcare Industry Investment Opportunities- March 2014

After a spectacular 2013 for both the overall market and the healthcare sector in particular, we anticipate increasing volatility for Healthcare in general and a diversion of returns for particular sectors within the healthcare segment. In 2013, the healthcare industry outperformed all other major sectors with the exception of Consumer Services. Investment performance returns for Healthcare was 41.28% versus the S&P 500 Index at 32.31% and Consumer Services at 41.45%. Healthcare performance was significantly aided by Biotech (65.47%) and Pharmaceuticals (41.28%). We do not believe that this level of performance for Healthcare, particularly Biotech, is sustainable for 2014. However, given the Healthcare weighting in the S&P 500 (about 13.5%) we feel that we must at least own a hedged piece of the Healthcare industry.

With the exception of the January pullback, the Healthcare Sector continues to make new highs. We are concerned about the lofty valuations of healthcare overall, but believe the sector will continue to rally due to the continued Quantitative Easing (QE) by the Federal Reserve and the an anticipated acceleration of the economy as a whole as 2014 unfolds.

Generally we see a Healthcare industry pullback after the J.P. Morgan Healthcare conference in January in San Francisco. This year there were four factors coming out of that conference which pushed the healthcare industry investment returns lower.

1) Profit taking after strong 2013 performance,
2) Near term over-valuation
3) Lack of near term catalysts
4) Relatively conservative company guidance for 2014.

We are selecting funds for our clients which have an exposure to healthcare, excellent historic performance over multiple market cycles, and can generate better returns through superior stock selection. In short, we are recommending ETF's with Healthcare exposure but with less risk of near term volatility. With our clients, we recommend exposure to diversified healthcare industry holdings in two ways: the Emerald Small Cap fund (HSPGX) and the Consumer Staples ETF (Symbol- XLP). We like the Emerald Small Cap Fund (Healthcare weighting of about 22%) due to the consistent outperformance of the fund over multiple market cycles.

We recommend exposure to healthcare thru the XLP Consumer Staples ETF for two reasons.   If the stock markets were to pull-back, we believe that the Consumer Staples stocks would decrease less than the general market since consumers generally continue to spend on basic stables like shampoo and medications rather than discretionary expenditures such as eating out at restaurants. Secondly XLP provides exposure to the Healthcare sector by way of Pharmacy Retailers including CVS *(@ 5.4% of the fund)* and Walgreens *(@3.9% of the fund)*. Through the fund's pharmacy holdings, investors get the opportunity to own an indirect position in the more volatile pharmaceutical stocks while also participating in the less volatile consumer products staples industry.

Long Term Fundamentals

Longer term, the Healthcare industry remains extremely attractive as an investment for the following reasons;

1) HealthCare represents more than 1/6th of the United States economy.

2) Strong demographics favor the industry.
3) Innovation
4) As an industry, HealthCare is a defensive investment with a significant growth component.
5) Healthcare generally continues to have strong profit margins.
6) The period of significant patent expirations is over, so investors can now look forward to revenue growth off a lower base from new product launches

Therefore, we believe investors should have exposure to Healthcare. In addition, while many company's stock prices move in lockstep with the balance of the industry, a good stock picker, can always identify unique catalysts which provide opportunities to out-perform the healthcare industry.

Lastly, regarding the Affordable Care Act (ACA). With a majority of the implementation beginning in 2014, we believe significant uncertainty remains on how the ACA will affect specific sectors in the Healthcare Industry. In our opinion, the sectors most affected by the ACA, in the near term, will be Hospitals and Insurance companies. We believe uncertainty provides short term stock price inefficiencies and we will look to take advantage of any buying opportunities.