ANDRESEN
AND ASSOCIATES
FEE ONLY INVESTMENT ADVISOR
WWW.ANDRESENASSOC.COM
(831) 758-1575

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HEALTH CARE MUTUAL FUNDS: GOOD MEDICINE?

If you are a client of Andresen and Associates, you are aware of our interest in health care stocks. Recent market turbulence has caused us to re-evaluate our overall positions in the stock markets in general and in health care mutual funds in particular. Here's what we found.

As of late 2005, health care stocks represent a classic "value investing" opportunity. "Value investing" is the strategy of buying undervalued investments. You could call it bargain hunting.

When you buy an underpriced house, there's always a reason. Maybe it floods once a decade, or the roof is rotten, or the ghost of Aunt Frieda lives in the closet. Likewise, a bargain-sale car is usually cheaply priced for a reason. Perhaps the transmission is bad or the pink and purple paint job is simply out of fashion.

So it is with stocks. When a stock is underpriced, there's a reason. The art of value investing is the ability to perceive which reasons will last forever, and which reasons will pass away with time.

The most common yardstick for measuring valuation in stocks is the "P/E Ratio". It is a simple number: how much are you paying for a dollar's worth of earnings? For example, the Standard and Poor's 500 Index of 500 giant corporations now has a P/E of about 16. That means if you buy an index fund, which is a computer-generated basket of these 500 stocks, you are paying about $16 for $1 in earnings.

A smaller P/E number means the stock is priced more cheaply. A higher number means that the stock is more richly priced. The challenge is to figure out why the stock is priced as it is.

A classic value investor would say that the lower the P/E, the better. I would tell you that some stocks have very low P/E's because they are genuinely bad investments. To be a successful value investor, you need to know the difference.

Right now, health care stocks are cheaply priced relative to the S&P 500. Pfizer (symbol PFE) is a giant medicine manufacturer, and it has a bargain basement P/E of 12. It yields about 3% in dividends, which is better than most bank deposits.

Another pharma giant, Merck (symbol MRK), has a P/E of 12, a yield of 5%, $13 billion in cash in the bank, and $2 billion in free cash flow a year. Merck also has a $253 million lawsuit judgment against it, awarded to the family of a man who died after taking its arthritis painkiller Vioxx. Other former Vioxx users are also filing lawsuits. The potential legal liability for medication side effects is gigantic. The fear in the investing world is that all these stocks will be ground into dust by a blizzard of injury and wrongful death lawsuits.

Pharmaceutical stocks are also losing market share to makers of generic drugs. Side by side with this erosion, the new Medicare drug program will obviously favor generic medications, and create tremendous cost-control pressures on the industry.

A final reason for the depressed prices of health care stocks is that managed care lobbyists are winning the battle for the hearts and minds of Congress. A system which siphons off cash flow from both doctor and patient, only to deliver that skimmed profitability to third party shareholders, does not seem maximally efficient to me. However, as an investment advisor, that is not my problem. My challenge is to become a shareholder and reap the benefits of political preference. One example of this kind of stock is Health Management Associates (symbol HMA), which runs rural hospitals, and therefore is able to extract monopolistic prices.

Meanwhile, we are certainly in an unprecedented health care revolution. New medications are raising the global standard of care all over the world. For example, Biocryst Pharmaceuticals (symbol BCRX) is coming out with its antiviral drug Permavir, just in time for the Avian Flu panic.

A swarm of new inoculations are transforming the world. Merck will soon be introducing a new host of virus vaccines, including Zostavax, to prevent shingles. Merck is also about to release a new vaccine which, in tests, has been 100% effective in preventing cervical cancer. Barring any unforeseen side effects, I would expect virtually all women to receive this inoculation within a few years.

In an environment where the profits are theoretically huge and the risks are unquantifiable, you can see both the promise and the danger of investing in health care. But that is what value investing is all about: a disagreement about what the future may hold.

What's more, the great minds of value investing cannot even agree. The managers of the superb Longleaf Partners mutual fund do not hold any health care stocks because they perceive that they cannot quantify the risks. However, the managers of the equally phenomenal Dodge and Cox Stock Fund hold about 16% in health care because they feel that these stocks are just too attractively priced.

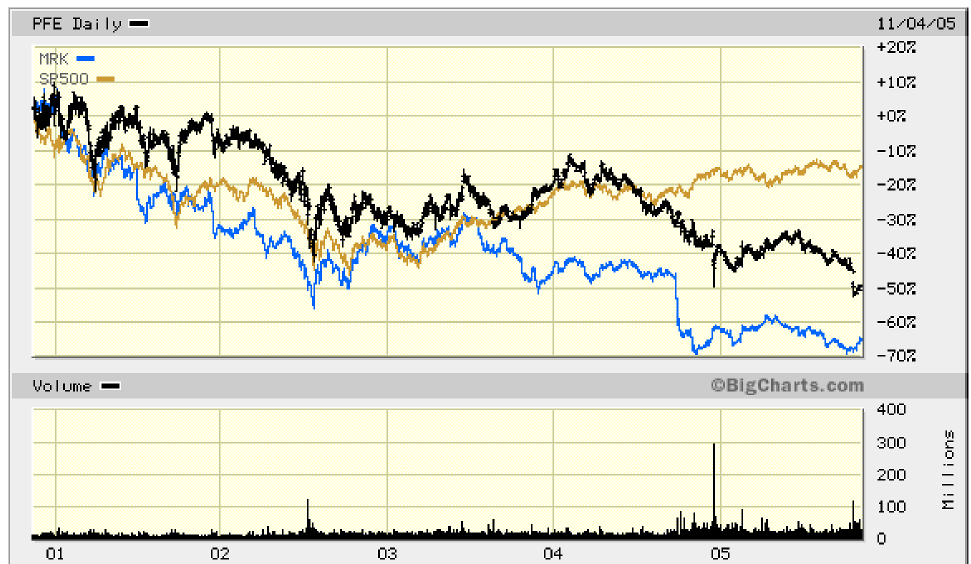
GRAPH 1: These large pharmaceutical stocks have fallen for years.

GRAPH 2: At current valuations, these large pharmaceutical stocks are a buy, but with big risks.

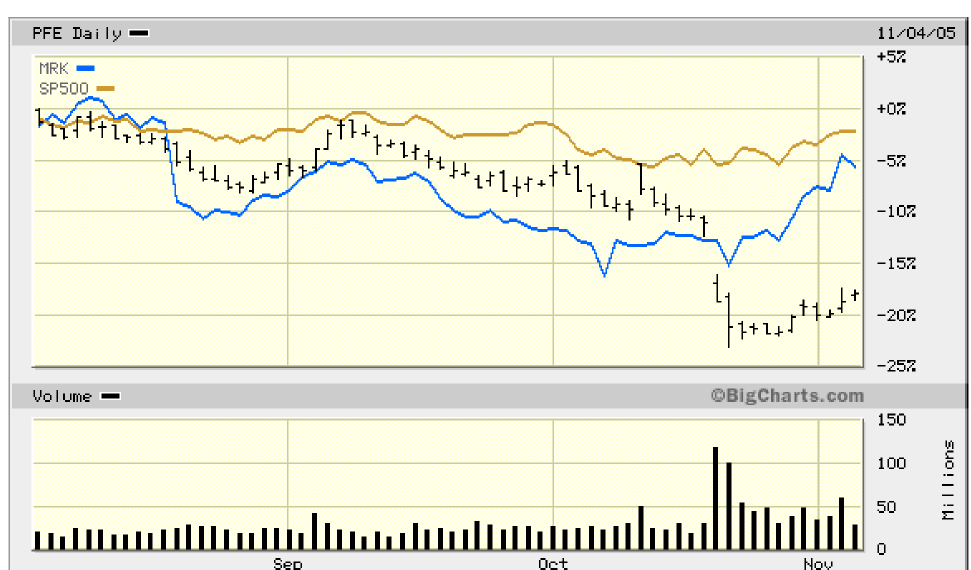
This confusion was expressed very strongly this week when I spoke with Conner Browne, Associate Portfolio Manager of the Thornburg International Value Fund. He finds health care stocks very attractive, currently trading at very low valuations, but the pace of change in the health care arena has made him reluctant to invest. The inability to quantify the legal and political risks has made him very timid in the American markets. As a result, most of Thornburg's health care investing has taken place in international markets, which are less vulnerable to the US legal system's irrational frenzies.

After lots of study, Andresen and Associates decided earlier this year that health care is an attractive investment. Our recent week's research has confirmed both the opportunities and the risks. I have decided to overweight our portfolios in health care because I believe that current fears are overstated. To me, health care looks a lot like energy and gold in 1999. If you recall, there were plenty of reasons why they would not recover either.

GRAPH 1

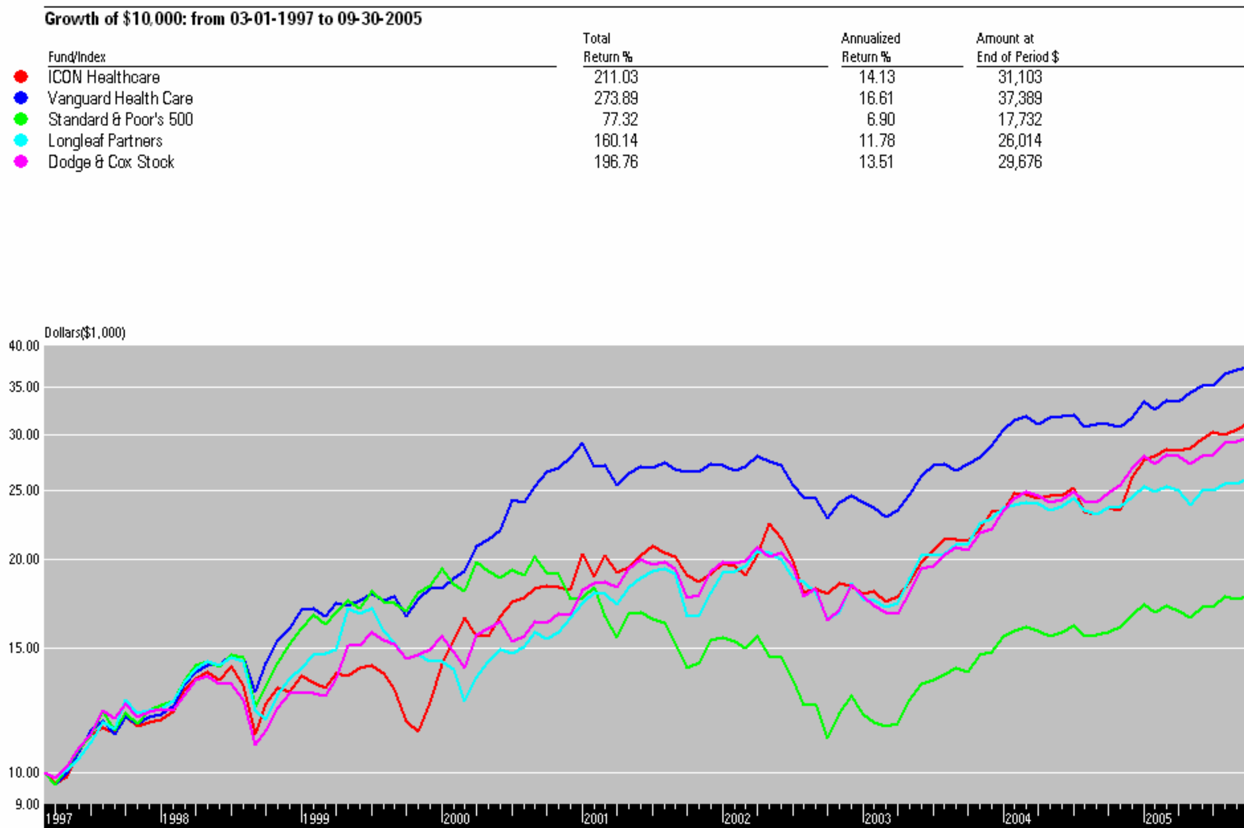


GRAPH 2



We are reducing the individual stock by stock risk—the risks of any individual company—by using mutual funds. With a health care mutual fund, you should be fairly well diversified against the kind of individual corporate blowout that Pfizer and Merck recently experienced. Yet we still have to do our homework. There are many more health care stocks than just the giant pharmaceuticals, and many health care mutual funds invest differently than you might expect.

GRAPH 3: PERFORMANCE 3-1-1997 to 9-30-2005
Meanwhile, the diversification provided by health care mutual funds has provided market-beating returns.



Growth of $10,000: from 03-01-1997 to 09-30-2005

Fund/Index	Total Return %	Annualized Return %	Amount at End of Period $
ICON Healthcare	211.03	14.13	31,103
Vanguard Health Care	273.89	16.61	37,389
Standard & Poor's 500	77.32	6.90	17,732
Longleaf Partners	160.14	11.78	26,014
Dodge & Cox Stock	196.76	13.51	29,676

During our research this week, I also spoke with JC Waller, the marathon-running former US Army Ranger who manages Icon Health Care. While Vanguard Health Care and Schwab Health Care emphasize the larger stocks, Icon tends to wander its own path. JC feels that Pfizer is at a whopping 50% discount to fair pricing, but that is not where he is putting his money. Instead, he is loading up on manufacturers of generic drugs, to take advantage of current political trends. He is also buying lots of infrastructure stocks like Quest Diagnostics, Lincare, and pharmacy benefit management stock ESRX. These are much smaller stocks than the gargantuan pharmaceuticals, and they illustrate the tremendous diversity in the health care stock universe. So far, JC must be right: his fund is up 12% per year over the past half decade.

While I am seeking to invest our money in smaller health care stocks, I am also seeking overseas venues. Swiss Helvetia (SWZ) is our Swiss entrée to the large research and development interests in that country. The managers of Vanguard Health Care have led the way overseas. This fund has so much international exposure that we count it as one of our international mutual funds.

I do not expect our investment in health care to be easy or seamless. I expect our investment in these mutual funds to bring us some stressful, soul-searching times as the political winds blow our holdings back and forth. This year, all of these funds have substantially outperformed the S&P 500, but there will be times when they do not. My goal, and my expectation, is that within three years we should obtain substantial gains from these investments, or we should be gone.

The bigger question is whether you, as an investor and as a client, are willing to face indeterminate risk to obtain possibly large future returns. Your willingness to invest in the health care sector depends on your own levels of risk tolerance, and your own long-term financial goals. Please call me with any questions or comments concerning your own portfolio.