Vaccine Hopes Shouldn't Drive Healthcare Investing Strategies

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by Vinay Thapar

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Healthcare stocks are once again in focus as a result of promising news of COVID-19 vaccines. But investors shouldn't hunt for the pandemic's panacea. Focusing on business fundamentals is a much better way to find healthcare stocks with long-term potential than searching for the next big drug.

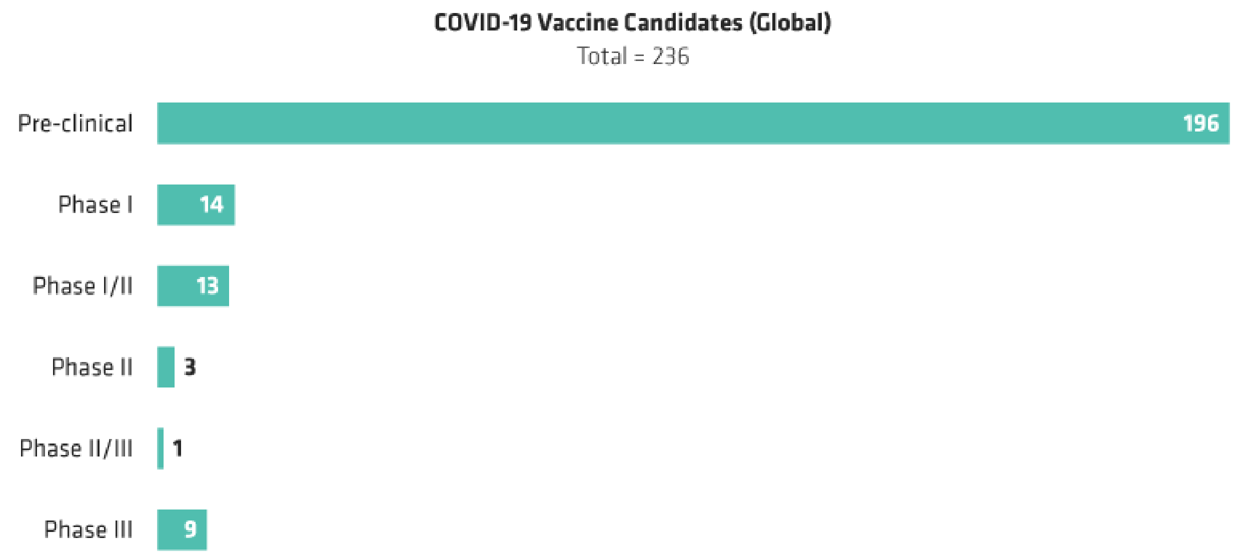
Investors have been captivated by strong trial results for COVID-19 vaccines from Pfizer and Moderna this month. As shares of both companies surged on the news, and two additional vaccine candidates reported encouraging trial results, investors might be tempted to look for blockbuster drugs for COVID-19 or other diseases when searching for healthcare stocks.

Yet the MSCI World Health Care Index has actually underperformed the broad global benchmark since Pfizer's announcement on November 9 through November 20. And in fact, the recent successes reinforce why we think equity investors should focus on business rather than science to identify promising healthcare stocks.

Competition Could Erode Vaccine Profitability

For vaccine frontrunners, it's still early days. More data is needed to validate the efficacy of the drugs, and vaccine safety is still under scrutiny. Historically, vaccine success rates are 33% from phase 1 trials to approval. While the current candidates look promising, about 70 companies worldwide are working on more than 200 novel coronavirus vaccines (*Display*). Most are still in very early development stages, and it's still hard to predict which will make it to the finish line.

Competition for COVID-19 Vaccines Could Erode Profitability



For illustrative purposes only

As of November 20, 2020

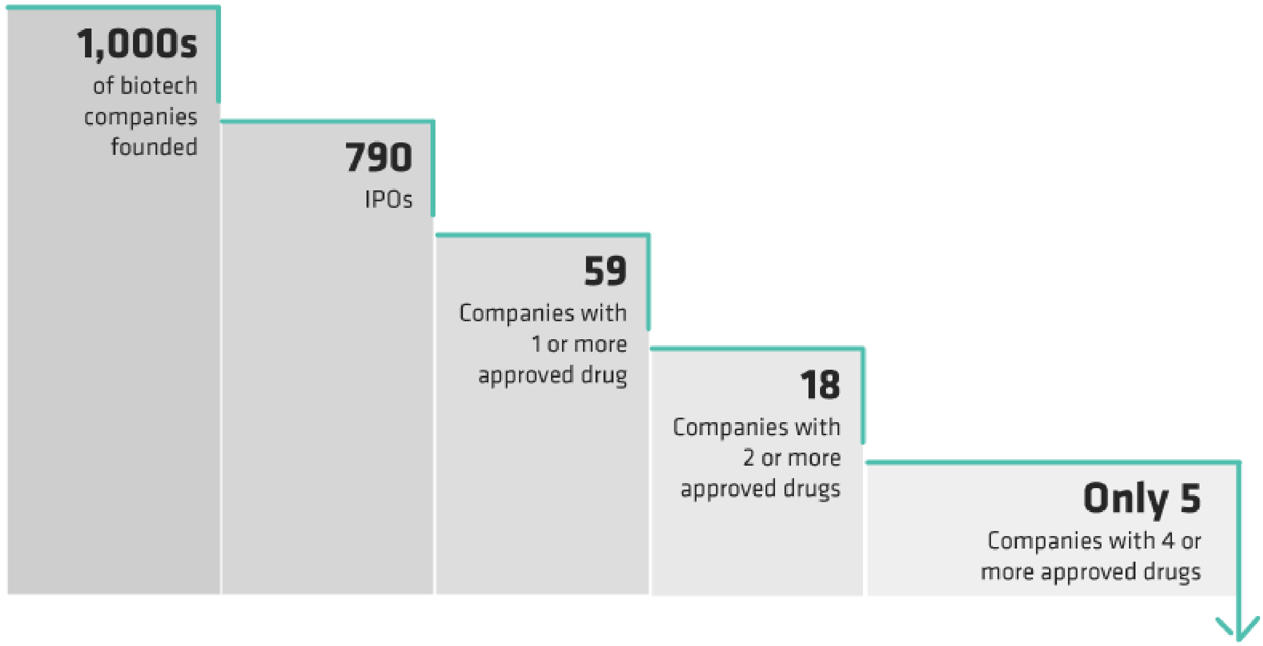
Source: Milken Institute and AllianceBernstein (AB)

Given the huge amounts of money being invested, it's likely that more than one coronavirus vaccine will make it to market. Demand will be massive, as every country on the planet seeks to procure enough doses for their populations. However, given the expected competition among several products, we don't think COVID-19 vaccines will be very profitable products.

The race for a vaccine is understandably alluring. Everybody wants to be part of the drug that will save the world from the pandemic, just like everybody wants to invest in the cure for cancer, Alzheimer's disease or countless other illnesses. But it's notoriously difficult to predict successful drugs in development. The failure rate for drugs that enter human trials is about 90%. Among thousands of biotech companies founded since 1976, only 59 have more than one approved drug, while only five companies had more than four approved drugs, based on industry data through 2017 (*Display*).

Consistently Successful Drug Development Is Hard

Drug Development Since 1976



For illustrative purposes only
As of December 31, 2017
Source: EvaluatePharma, GlobalData, Morgan Stanley, Pharmaprojects and AllianceBernstein (AB)

To be sure, select companies that develop drugs may be good investments. But an investment thesis shouldn't be based on the science behind a COVID vaccine or any other treatment, in our view.

What Defines a Solid Healthcare Business Model?

Identifying healthcare companies with strong business models is a much better strategy. We believe that this approach leads to a far more consistent and explainable path of performance and long-term returns.

Strong healthcare businesses have similar features to good businesses in other sectors. In particular, we think high or improving returns on capital and a strong reinvestment rate signal a business advantage. When a company generates profits above its costs of capital, and reinvests those profits back into the business, our research suggests that the underlying business model typically has staying power.

Medical Themes Worth Watching

Several healthcare themes underpin solid business dynamics for healthcare companies. Improvements in diagnostics are accelerating because of advances related to human genome sequencing. Minimally invasive therapies and robotics are helping hospitals increase patient turnover and saving costs for healthcare systems. Telemedicine has received a boost during the pandemic as more patients seek to consult with doctors virtually.

Companies in these areas can provide access to promising growth potential that's easier to forecast than a hot drug prospect. For example, Illumina is a leading supplier of instruments and reagents to sequence DNA, which is used for clinical diagnostics in areas such as oncology, and has demonstrated advantages in accuracy and cost versus competitors. Edwards Lifesciences manufactures aortic valves that can help heart patients avoid open-heart surgery—a benefit for hospitals and patients in normal times, especially during a pandemic.

For Solid Businesses, Blockbuster Drugs Are a Bonus

Some attractive healthcare companies have faced a disruption to demand as COVID-19 led to a reprioritization of medical procedures for individuals and hospitals. However, in our view, products and services that create efficiencies for patients and healthcare systems will prevail over time, especially when conditions in the industry normalize in a post-COVID world. And the business benefits created by these companies can be identified and analyzed today.

When a COVID-19 vaccine comes to market, we will welcome its success as much as anyone, hoping for a return to normalcy. But equity investors shouldn't be distracted by headlines and dramatic stock moves of vaccine winners. Healthcare portfolios should focus on companies with long-term business advantages, and if one happens to come up with a COVID-19 vaccine or another blockbuster drug, consider that a bonus for an otherwise solid position.

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