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# Fund managers boost bets on health care even amid high prices

NEW YORK | By David Randall

Last July, when Federal Reserve Chair Janet Yellen spurred a sell-off in healthcare stocks by saying that valuations in shares of biotech companies looked "stretched," portfolio manager Graham Tanaka saw an opportunity.

After a year-long buying spree, he now has more than a quarter of his $17 million Tanaka Growth fund portfolio in healthcare companies such as Gilead Sciences Inc, up from just 5 percent at the start of last year.

That bet is paying off: his fund is beating the S&P 500 by about 13 percentage points since the start of the year, putting Tanaka in the top 1 percent of equity fund managers tracked by Morningstar. Even with his big bet on healthcare, he's planning on adding more.

"With aging demographics in the US and the developed world, healthcare needs are going to grow dramatically faster than GDP," Tanaka said.

In the eleven months since Yellen's warning, other fund managers have benefitted by shaking off concerns about high valuations and increasing their holdings of healthcare companies. The average U.S. large cap equity fund run by a stockpicker now holds 15.8 percent of its portfolio in healthcare stocks, a position higher than any of the last 3 years, according to Lipper data.

With a 10 percent rally in the sector so far this year, that outsized bet on healthcare is helping fund managers post their best performance relative to the S&P 500 since 2007, the year before the financial crisis. Should the rally in healthcare continue, funds may finally be able to turn around a six-year skid in which stockpickers have struggled to outperform benchmarks.

Yet some market strategists and analysts said that the move to healthcare after its significant outperformance reminds them of the tech bubble of the late 1990s, when stock funds piled into the hot sector just before the dot-com crash.

"Being negative on pharmaceuticals and biotech has not been the right move thus far in 2015, but almost all the objective data suggests that underperformance is likely in the months ahead," said Tobias Levkovich, chief U.S. equity strategist at Citigroup, in a note to clients Tuesday, citing a declining number of upward earnings revisions. "Few investors are willing to back off what has been a very rewarding strategy, which also means that when they back away it could get somewhat messy."

Still, because health spending is becoming a larger part of the economy, a broad selloff in healthcare companies akin to the popping of the tech bubble is unlikely, said Randy Gwirtzman, co-portfolio manager of the $95 million Baron Discovery fund, who more than doubled his holdings of healthcare companies over the last year.

Healthcare is expected to rise to 19.9 percent of U.S. GDP by 2022 from 17.1 percent in 2013, according to the Office of the Actuary at the Centers for Medicare and Medicaid Services. GDP itself is expected to grow 2.4 percent this year, according to a Reuters poll of economists.

Gwirtzman is looking for companies that can help cut costs, rather than biotechs that offer the promise of new drugs, he said.

His top holding, Foundation Medicine Inc, offers a form of cancer testing that allows doctors to offer targeted therapy more effectively. Shares of the company are up nearly 60 percent for the year after Swiss pharma giant Roche took a majority interest in the company in January.

"There's a lot to like in healthcare other than biotech," he said.

If there is a pullback in the healthcare sector, it could be sharp, analysts such as Levkovich said. The Nasdaq Biotechnology index fell nearly 6 percent in three days after Yellen noted high valuations in July. After a subsequent rally, the biotech sector is now trading 43 percent higher than it was before she noted the high valuations.

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While few big-name funds are significantly reducing their healthcare holdings, some top-performing funds are becoming more cautious because of the extent of the rally in biotech and pharma companies. The Nasdaq Biotechnology index is up 52 percent over the last year, while the S&P Pharmaceuticals index is up 33 percent over the same time.

Those high prices are making it harder for fund managers to find attractive places to put their money. T. Rowe Price closed its $14.1 billion Health Sciences Fund to new investors Monday after receiving $1.1 billion in new investor dollars over the first four months of the year.

"We've seen extraordinary returns from stocks like Gilead, but we haven't been taking on any new positions until we find extraordinary discounts," said Rafael Resendes, whose Toreador Core fund has bested 98 percent of other large cap funds over the last three years. Shares of Gilead are up 19 percent for the year to date, and nearly 40 percent over the last 12 months.

Resendes, who still holds Gilead, expects to pare down his holdings of healthcare stocks this year because they no longer offer attractive prices.

Other managers are sticking with healthcare, but branching out beyond its hottest sectors. Matthew Kaufler, a portfolio manager who oversees the $997 million Federated Clover Value fund, has been buying healthcare services companies as more baby boomers age. Kaufler owns shares in companies such as Brookdale Senior Living Inc, which runs upscale assisted living and retirement centers. Shares of the company are up 2.8 percent for the year to date.

Healthcare companies overall in the S&P 500 are expected to post an average earnings growth of 11.4 percent in 2015 compared with just a 0.6 percent gain among the index overall, according to S&P Capital IQ.

(This version of the story corrects spelling of 'Gwirtzman' in 11th paragraph.)

(Reporting by David Randall; editing by Linda Stern and John Pickering)