November 2010 Commentary
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Now that we (and everyone else) have had time to digest the results of the mid-term elections we can now perhaps make some educated guesses on the direction reform will take and its subsequent impact on the shares in the sector. We would note that we had the great privilege of giving a keynote address at the Columbia Business School Health care conference on the subject and what follows is an elaboration of questions that arose out of these sessions.

At the very highest level what can a House of Representatives controlled by the Republicans do? In our view relativity little as the senate is currently majority-controlled by Democrats and there is Democrat president with veto power. So in order for House Republicans to make major changes these laws will have to be moved through conference committee and than not get vetoed; a prospect we find unlikely.

That is not to say we the House will be completely inactive. Republican leaders have said (to the extent one can believe any rhetoric) that they intend to hold many hearings/investigations into health care reform so we would expect numerous trips for top HHS (Health and Human Services) officials like Kathleen Sebelius, Donald Berwick (CMS- Centers for Medicaid and Medicare services) and Joshua Sahrfsstein (FDA) to congress. The use of hearings as a policy tool has been used by Republicans before -- in the mid-90’s and we expect that this Republican strategy will not change. The impact of these hearings may slow down the implementation process but we do not expect this to be meaningful for health care shares other than possible noise which can be short-term trading catalysts but not long-term material.

On defunding: There has been some rhetoric regarding using appropriations bills to try to “defund” the reform law. We think this is unlikely though not out of the question. We would point out that the last time the Republicans used this tactic it led to a government shutdown (circa 1995), but remember at that time Republicans controlled both House and Senate- it is possible that this time the Senate would just pass some continuing resolutions to keep the government running. Even if the House republicans tried a more surgical strike like “just” shutting down HHS via appropriations bills- this would be in our judgment a very foolish political tactic as HHS contains many programs constituents like (i.e. Medicare, FDA, NIH)-- shutting these down would be unpopular with voters and politicians are loath to make constituents unhappy. In short, we think defunding is off the table.

However even the Democrats have suggested there will be “tweaks” to the bill. In our view while the tweaks will not be material to health care shares it will be interesting to see which tweaks occur to get sense of the power dynamic in Washington. We anticipate the tweaks will generally be the more unpopular parts of the law and those include changes to the 1099 statutes (collecting taxes on goods), the IPAB (independent payment advisory board).

The Attorneys General Lawsuit: As most investors are aware the Attorneys General of now 19 states have filed (with amicus briefs being filed from all over the place) to overturn the law on constitutional grounds. In our view it’s almost inevitable that this suit will wind up in front of the Supreme Court in 2012 or 2013. The Supreme Court is
difficult to quantify but we believe whatever decision emerges on this issue will be 5/4 (assuming the court composition stays the same),-- we just can't tell which way the majority will rule. We would point out that mandates (generally the subject of the case) are originally a Republican idea. Of course if the court rules against reform in 2013 (6 months before the law goes into effect) we anticipate a high level of dislocation and this will not be a good thing for society (probably) -HC stocks may do ok though.

One apparently overlooked part of the election was the wins of the Republicans at the State level. Recall that implementation of health care reform in many ways will take place at the state level and this includes development of the exchanges and scrutiny of MLRs (medical loss ratios). As an aside HHS said on Nov 12, that the MLR rules would be completed by the need of November but since they have missed every other deadline they set we have low confidence in this latest pronouncement.

Nevertheless, we expect the Republican state houses to ameliorate much of the presumed negative impact of some of the federal rules. Some states will just ask the federal government to design the exchanges and associated rules and some states will ask for waivers (this also includes large corporations who have “mini-med” plans). At this time we do not see a “race to the bottom” where states compete for the most lax rules though there is always the possibility of the outcome. We do believe however that this environment though uncertain is a step-change improvement for managed care companies who were previously facing a certainty of an unfriendly environment. In our view the worst case scenario is if the rules become too difficult they will exit geographies and/or product lines. We believe states are fearful of market disruptions in the near-term and therefore will do what they can to encourage insurers to remain in the states. It is our understanding that investor concerns are very high about adverse selection (insurers forced to insure patients while having prices capped) we think market exit potential should alleviate some of these concerns. We have also heard investor concerns about corporations “dumping” their employees into exchanges- on this we will have to see in 2014 but we don’t anticipate that Republicans want this (major market disruption) outcome any more than Democrats.

Coincidentally (most likely not) the “deficit commission” (the National Commission on Fiscal Responsibility and Reform) released its report last week. As math would have it health care is one of the biggest deficit problems for the U.S. The commission had many proposals including strengthening the IPAB (the thing we mentioned above everyone wants removed from the reform law), a public option (which didn’t make the law due to political unpopularity), means-testing Medicare (which we advocated in our book – Health Care Investing), malpractice reform and perhaps the hottest item fixing the Medicare “doc fix” aka the Sustainable Growth Rate (SGR) formula (which ironically is probably not sustainable). We did not see our preferred antidotes to market failure to help costs: re-aligning of incentives; fixing the lack of information transparency problems; no focus on the Pareto problem (chronic care accounts for a big part of spending); no solution for un-necessary variations of care; no changes in the misaligned resources in the commission report. Since the commission’s recommendations are not binding we do not see near-term fall out onto the shares of health care companies- however it does serve as a reminder that the problem is not going away.
The Bottom Line
The key takeaway from these elections for us- the 2012 election is going to be more important than this one. Also it would appear (from polls) the economics, and employment in particular, were more important concerns to voters than health care reform. If these polls are correct than the message to draw from this election is that if the employment situation does improve by 2012 repealing (and replacing) HC reform may not be the winning issue that some Republicans believe it is.

The takeaways for the sectors in our opinion:

For managed care: the result was a slight positive at least from psychology and possible implementation of exchanges and MLRs-though we are still waiting on this one.

For medtech: A negative as it looks like the tax is still in place to go into effect in 2013 despite protests from Minnesota senators.

For pharmaceuticals: A neutral unless the Republicans want to “re-litigate” the law. Pharma in our judgment signed a really good deal filling in the donut hole versus getting 30 million more customers. If the law opens up again areas that pharma does not like (for example larger rebates, and re-importation) may be re-introduced.

For life-science tools and early stage biotech the outcome is probably a negative as biomedical spending looks likely it is going to be cut or at least not increased.

For hospitals and biotech: Probably no change as they are not at near-term risk.

Health Care Sector Commentary
As the third quarter earnings season is mostly over we think we can make some general observations. As opposed to 2Q where there were many mostly negative surprises particularly as it related to guidance, 3Q (possibly because of the lower prior guidance) was not as volatile with respect to share price action. In fact, there were some cases where the expectations were so low that even an “in-line” report with “in-line” guidance lead to a pop in the stock. On the short the story was much the same with companies that have seen significant shareholder value reduction continue to have fundamental problems.

Three themes emerged from the conference calls. 1) Uncertainty about health care reform. As we discussed above there is still some uncertainty but in general with the exception of managed care which still awaits MLR rules and a few bio/pharmas awaiting FDA decisions (which seem to have slowed this year). Therefore we think from a fundamental standpoint companies can budget and plan better and the psychology surrounding the sector should improve with greater certainty.

2) The economy. With the 2nd quarter reports it appeared that many investors were “surprised” by the linkage between the economy and health care utilization. We flagged this problem in our book on health care investing a few years ago as co-pays deductibles, COBRA and the general lack of insurance all have a role to play in the changing environment. The message we heard emerging from the companies is that the economy has stabilized at a lower than optimal level. Our channel checks suggest this
is true but also suggest that companies have been engaging in price cuts which at least for some of them, may impact margins.

3) There is a lot going on outside the U.S. (OUS). For those companies with international operations the message we heard was generally positive. Asia is growing at a significant pace for many companies. Latin America is also growing quite fast. Investors were fairly concerned about austerity measures in certain European nations impacting results. In general this was not the case for most of the companies. We were recently over in Europe and our impression is that beyond some notable exceptions (Greece, Ireland - which are small markets) European health care systems (which are generally stingy anyway) are relatively healthy and spending at normal levels. We were happy to finally hear companies making distinctions between countries in emerging markets as all of the countries are different.

Market Commentary
After a very strong 3Q the market has hit a bit of a stall. We attribute this to the election as well as announcements like Quantitative Easing (QE2) and rhetoric from foreign central bankers. The economic indicators that we look at (employment (U3-U6, money supply, retail sales, inflation, equity volatility, equity valuation, GDP) have all either improved or have continued to get worse at a slower rate than recent prior periods which would be consistent with a stabilization albeit at a glacial pace;-- also consistent with what our companies have been saying.

It seems to us that the market anticipated some stabilization in 3Q essentially borrowing some returns from 4Q. Aside from some improvement in retail investment sentiment, which seems to be a volatile series anyway, we still do not hear any bullish comments from the pundit class. We generally hear three messages from the Pros: We are super bearish (this malaise could go on 7-10 years or more), we are short term bearish (the next year or two will be bad than improve) and we are bearish, but, -- usually some form of we are bearish but we don't want to fight the Federal Reserve. Its true there is not a lot to be joyful about in terms of economic growth in the U.S. (contrasted to the rest of the world). We are certainly glad we have the ability to hedge in the fun as we expect the next few quarters to be rocky in terms of economic performance as well as equity performance. The happy news (if one can call it that) is that markets like economies tend to be cyclical; the situation seems to be improving and if words match actions and valuation a lot of negative news is priced into to shares. We remind investors “Fat Tails” (unexpected events) can work in both directions (both upside and downside) though investors don’t seem to mind the upside surprises and with everyone looking for bad news…

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