Industry Perspectives

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COVID-19 — Help or Hindrance for the Health Care Sector?

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Today, nearly everyone I know has become a pandemic armchair expert, with a zest for handwashing and a newfound interest in immunology and epidemiology. The potential for new, lifesaving therapies and vaccines has in turn spiked investor interest in health care. Under normal circumstances and compared to other sectors, demand for health care is relatively stable and less impacted by economic swings—there's only so long you can put off that heart bypass! Therefore, the sector has well understood defensive growth characteristics supported by aging demographic trends, growing demand in emerging markets and continued innovation, contributing to long-term sector growth potential.

However, in late March, almost every health care stock declined with the rest of the market. For long-term oriented investors such as ourselves, we recognized there was uncovered value in the health care sector even before the pandemic—COVID-19 created more volatility, providing disciplined investors with some interesting entry points, though not uniformly. Since this black swan event is a major public health care crisis, companies in the sector have seen both challenges and opportunities, causing divergent stock performance across the sector.

Companies exposed to COVID-19 testing rallied hard off the March lows, as did pharmaceutical companies that were quick to develop treatments or vaccines for COVID-19. Conversely, medical device companies have lagged because of the decline in elective surgeries, and dental-related companies have struggled as dental offices were shut down and only recently started seeing patients. We've seen health care insurers become more profitable as they continue collecting premiums despite fewer patients seeking treatment, whereas senior living facilities have struggled with sickness impacting their patient population. Hospitals have also been challenged providing critical care to COVID-19 patients while other profitable areas of their business, such as surgeries, dried up or were postponed.

If we had a crystal ball in 2019, we could have identified exactly how the pandemic would impact the stock market and invested accordingly. But without access to such devices, we've relied on our intrinsic value investment philosophy to guide our decisions. Take for example our investment in scientific supplies company Thermo Fisher Scientific, which was first initiated in early 2016. We liked the company's then excellent management team, leading product offering with a competitive advantage and its scale. At the time of initial investment, the stock was also reasonably priced, trading at a discount to our estimate of intrinsic value. Fast forward to 2020, and the company was ideally positioned to quickly develop a test for COVID-19, which has dramatically benefited near-term earnings. Additionally, they offer supplies commonly used in the research and development of vaccines, which means we had exposure to a key beneficiary of the pandemic by identifying and investing in a high-quality industry leader that is involved in several segments of the health care value chain. A key part of our process is staying true to our estimate of intrinsic value, so we recently sold our position after the dramatic stock appreciation pushed the stock past our valuation. Although the company is benefiting from the pandemic today, as long-term investors we recognize these excess revenues are likely to be transient.

We have also owned other stocks during the pandemic that have appreciated due to COVID-19. For example, Abbott Laboratories, a medical device, diagnostics and consumer products company has been a long-term holding. The company is a leader in diagnostic testing and was able to quickly innovate and produce several different COVID-19 tests, each useful in different settings. Stericycle, a medical waste disposal company, appreciated as the company was able to rapidly set up medical waste disposal systems for 1,000 new testing sites across the U.S. Pharmaceutical company Pfizer, another long-term holding, partnered with a startup to quickly develop a vaccine for COVID-19. While we didn't invest in these businesses because of the pandemic (we had already identified them as leaders in their areas of expertise with long-term sustainable advantages), each company was able to aid in the fight against COVID-19 and provide value to our portfolios.

Looking ahead to the end of the pandemic, which is looking more possible by the day with the progress being made by vaccine developers, we are also using our disciplined investment process to ensure that our health care investments are appropriately positioned for a more normalized world. Consider our investment in medical device contract manufacturer Integer Holdings. The pandemic forced discretionary surgical procedures to be cancelled or delayed, which meant Integer's customers saw dramatically reduced sales, leading to a slowdown for Integer as well. With the recent decline in the stock to a price below our estimate of intrinsic value, we added to the position in some portfolios and initiated a new position in others. We see Integer as a leading manufacturer in the medical device industry led by a strong management team and believe that once surgical volumes return to a more normalized level that the company's sales will rebound and the stock price will follow.

We've previously seen that intrinsic value investing has been a successful strategy over different market cycles, but with the last major pandemic having occurred in 1918, we haven't seen the effect of this philosophy in a modern pandemic until now. We believe there is now evidence that despite this black swan event, patient investors with a valuation discipline are still able to find opportunities and protect their portfolios appropriately during a pandemic. Looking ahead, we would argue that long-term investors are able to use this same philosophy to find additional areas where the market remains mispriced.

As of November 30, 2020, Diamond Hill owned shares of Abbott Laboratories, Integer Holdings Corp., Pfizer, Inc. and Stericycle, Inc.