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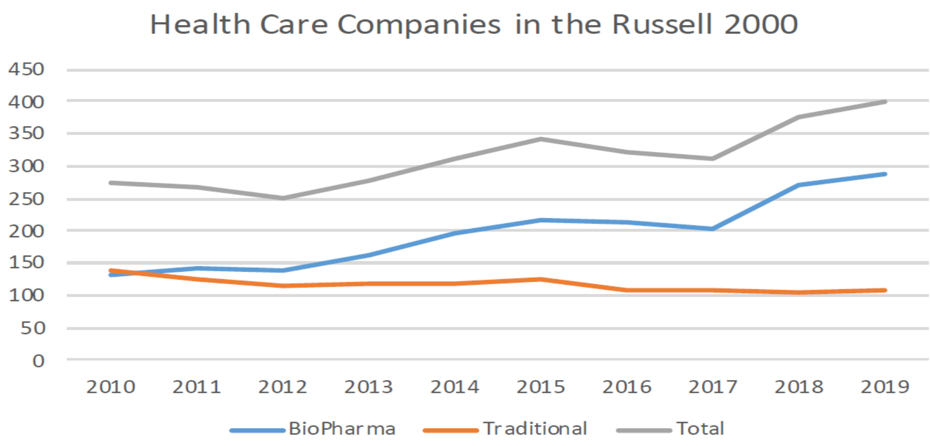
Small Cap Health Care: How Biotech is Influencing the Sector

The presence of biopharmaceutical companies within the investing landscape has showcased an impressive upward representation over the past decade, particularly as it relates to small cap investing. Biotechnology companies typically create drugs from living organisms, a method which contrasts with that of traditional pharmaceutical companies who create and sell drugs made from chemical-and plant-based compounds. From the standpoint of the investor, taking a stake in these companies is different than that of a more traditional health care company (a medical device company, for example). For starters, the outcome of success differential is more finite (binary, in some cases) for the former yet outcomes for the latter present a continuum, generally speaking. According to a 2018 study conducted by the MIT Sloan School of Management, just 14% of all drugs in clinical trials eventually win approval from the FDA, underscoring the "1/0" success/failure outcome, particularly for biotechnology and pharmaceutical companies with only one or two compounds in development. Contrast this with health care companies in the medical device, medical services, hospital and managed care areas, whose products and services have outcomes that resemble more of a normal distribution with associated risks and whose tails are more constrained. What we have observed is a bifurcation of the small cap Health Care sector, with demonstrative changes in its makeup and resultant behavior in its risk and return characteristics. One reference point can be found in our Winter 2020 Isthmus Insights whitepaper titled "*Dissecting Beta – A Time Series Analysis*" where we analyze how sector betas have changed over time. In particular, we showed that small cap Health Care's beta increased from 0.76 in 2010 to 1.03 in 2018, a 36% increase. We believe that this increase was largely due to the increasing presence of biopharmaceutical companies in the sector. This observation prompted us to probe further to quantify additional aspects of this shift, such as the constituent number, market value, performance and cash flow differences between the two groups. What follows is an analysis of these elements dating back to 2010.

We started by using FactSet's Portfolio Analysis tool to pull constituents from the Russell 2000® Index using the ETF as a proxy. We drilled down into the Health Care sector and segregated the companies into two groups, which we will call BioPharma and Traditional Health Care, using FactSet industry classifications. The BioPharma group includes the following FactSet industries: Biotechnology, Pharmaceuticals: Generic, Pharmaceuticals: Major, and Pharmaceuticals: Other. The Traditional group consists of Medical Specialties, Services to the Health Industry, Medical/Nursing Services, Managed Health Care, Medical Distributors and Hospital/Nursing Management.

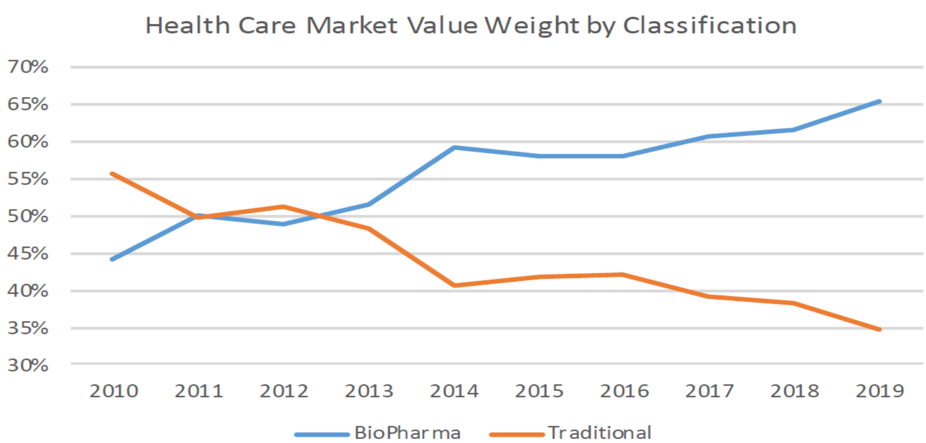
It is pretty striking to see the shift in the makeup of the Health Care sector between these two groups over the last decade. In 2010, there were 273 companies in the Health Care segment of the Russell 2000® Index. One hundred forty of them, or 51% of the total, were Traditional Health Care companies. These Traditional Health Care companies not only were more numerous than the BioPharma companies, but also held a greater combined market value. In that same year, they accounted for 56% of the market value of the Health Care sector in the Index. As seen in the chart below, the number of these so-called Traditional Health Care companies in the Russell 2000® Index has steadily declined over the last decade, juxtaposed by the rapid increase in the quantity of BioPharma companies. As we shift to the end of last year, only 109 of the 398 Health Care companies in the Index fit into the Traditional classification. By contrast, the number of BioPharma companies has increased from 133 in 2010 to 289 last year, an increase of 117%. That group now accounts for 73% of the companies (and represents 65% of the market value) in the Health Care sector. The acceleration has been even more pronounced in the last two years as the number of BioPharma companies in the Index increased from 203 in 2017 to 389 at the end of last year.

CHART 1



Source: FactSet Research Systems Inc.

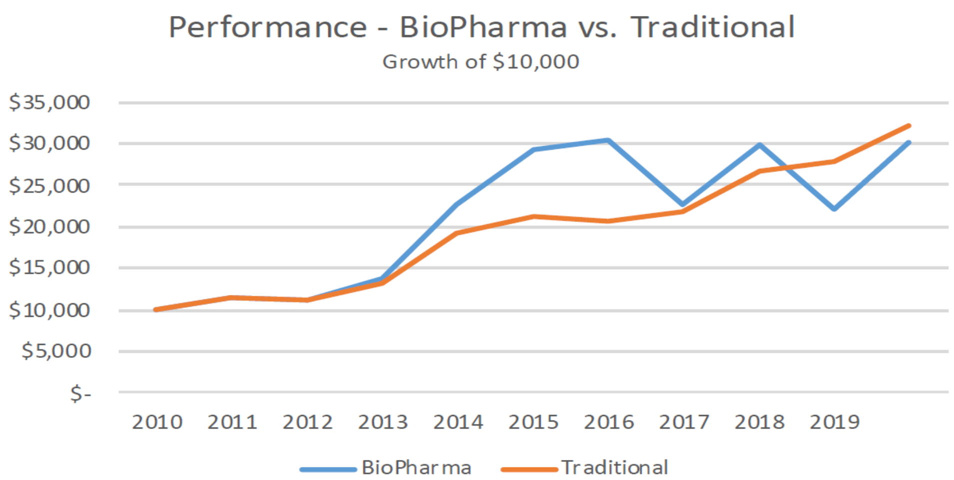
CHART 2



Source: FactSet Research Systems Inc.

The significant acceleration of the weight in the Health Care sector represented by BioPharma companies has certainly been driven by the pure number of those companies included in the index. However, we wanted to see if performance between the groups has also been a driver. Per FactSet, the average return of the BioPharma group has outperformed the average return in the Traditional group in seven of the last ten years. That does not tell the whole story, however. The high volatility nature of the BioPharma group has led to some years of significant underperformance. The following is a chart showing the growth of a $10,000 investment ten years ago in both groups, with the investment spread evenly among the constituents.

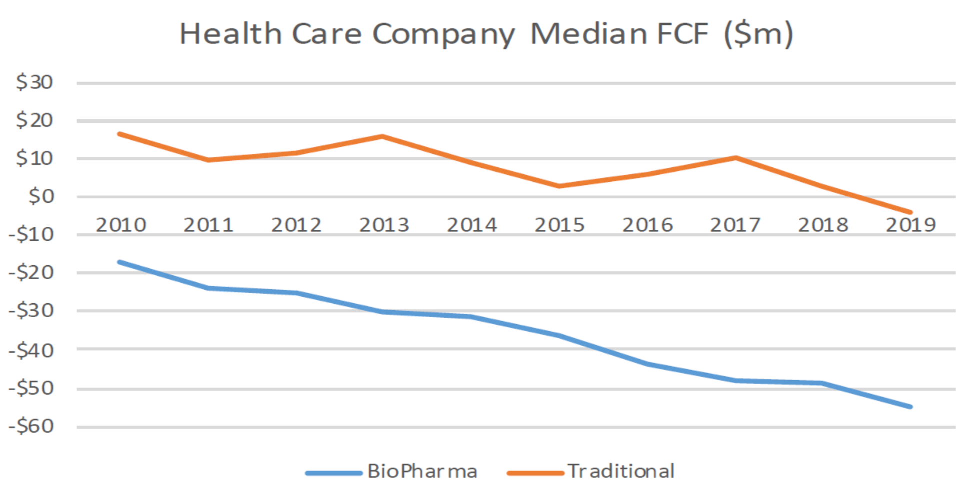
CHART 3



Source: FactSet Research Systems Inc.

It is often said that "Cash is King", so we wanted see if the performance trends in the Health Care sector were driven by cash flow generation. We discovered that the BioPharma group has not generated positive Free Cash Flow, defined as Cash from Operations minus Capital Expenditures, in any of the last ten years on either a cumulative basis or using the median of the individual companies. Moreover, the trend has shown a steady decrease in the median Free Cash Flow of the BioPharma companies every year since 2010. It appears that for the BioPharma companies, cash isn't king! The Traditional group has generated positive Free Cash Flow each year as a group, through there has been a general decrease in the median level over time including a negative year in 2019.

CHART 4



Source: FactSet Research Systems Inc.

Conclusion

We conclude by confirming that the Biopharmaceutical industry has reinforced itself as a major influence within the small cap portion of the Health Care sector. It is plausible that the industry's increasing representation is seen as a diversifier for some investors; maybe this is why, in the absence of cash flow and in the presence of the potential for outsized home runs, that a position in Biopharmaceutical fits within the context of a fully diversified portfolio. In an absolute sense, we are reassured that cash flow does matter, given the lack of demonstrable outperformance of BioPharma versus Traditional over the long-term in our analysis. We have, however, seen recent outperformance from the BioPharma group; in 2019, the average BioPharma company returned 36% versus 16% for Traditional, and year-to-date through 6/30/2020, this outperformance persisted (18% for BioPharma versus 7% for Traditional). As an active manager that centers on owning companies with proven histories of producing consistent free cash flow, we are often led to the Traditional part of the Health Care sector, given that this group characteristically possesses this attribute. We believe that on a long-term basis, this approach serves investors well, in that one may capture like-sized performance versus BioPharma with less short-term volatility, 2019 and 1h20 notwithstanding.