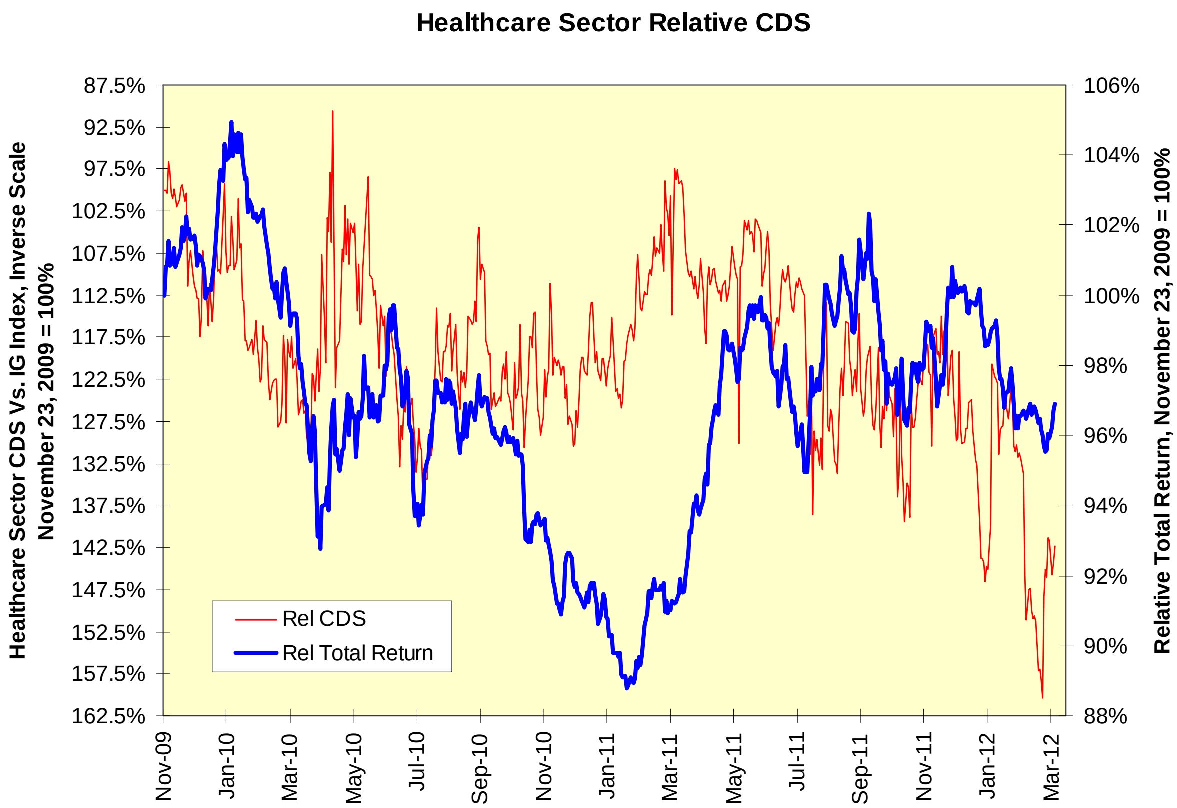
Healthcare Industry Risk Measures

A Risk Is Not A Risk, A Buy Is Not A Buy

You do not have to be Einstein to understand the difference between relative and absolute measures; consider this a quantum of solace. Yesterday's discussion of returns in the healthcare sector left out the broader question of how markets were or were not insuring against changes in the industry.

Relative CDS

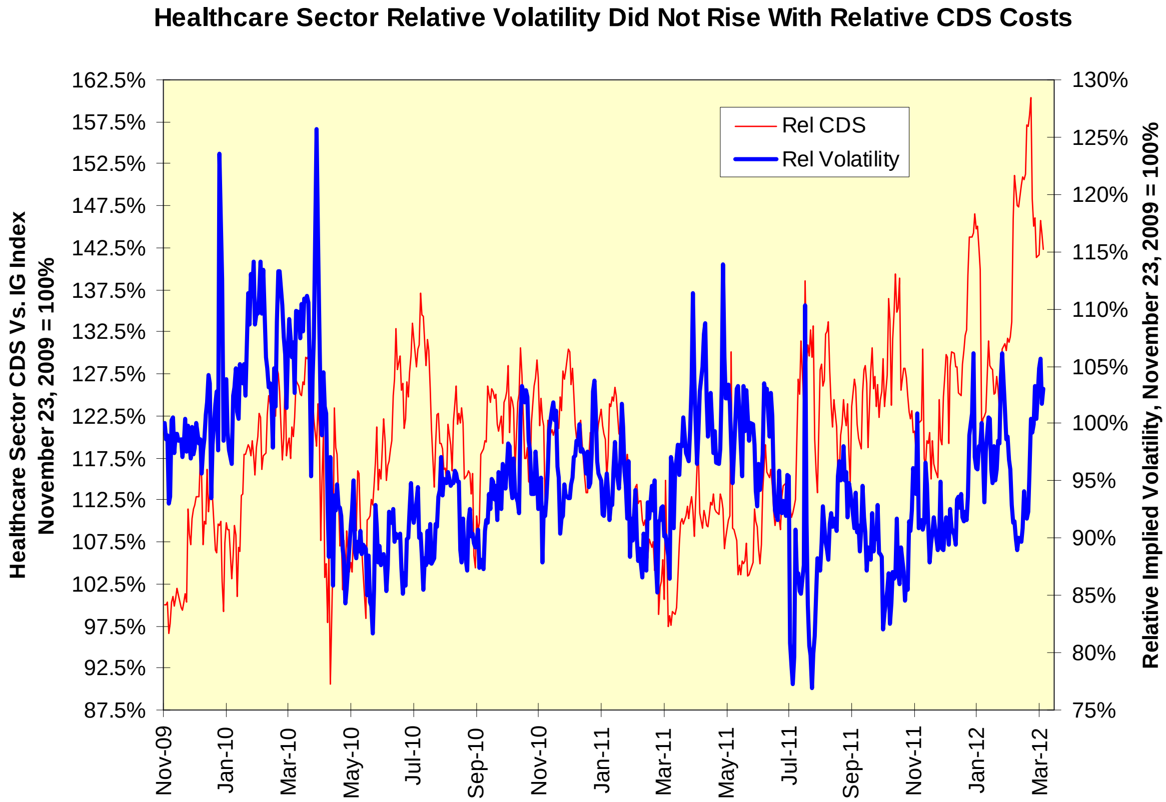
First, let's compare an index of five-year credit default swap costs for firms in the healthcare sector such as Community Healthcare (CYH), Hospira (HSP), Baxter International (BAX), Tenet Healthcare (THC), Cardinal Healthcare (CAH), Boston Scientific (BSX), Medtronic (MDT), Universal Healthcare (UHS) and Quest Diagnostics (DGX) relative to a broader index of investment-grade CDS. This relative CDS index started rising at the end of March 2011 even though the defensive healthcare sector outperformed the broad market going into the October 2011 low. It then continued rising into mid-March 2012 and then narrowed sharply over the past two weeks.



The relationship between relative CDS costs and relative stock market performance is too erratic to be called deterministic; you cannot have a relationship that oscillates in and out of correlation over this short of a period.

Relative Volatility

As many so-called correlation traders look at the relationship between equity option volatility and CDS on the sound logic both represent risk measures for the firm, let's compare the same relative CDS measure noted above to the relative volatility of the Healthcare Select SPDR (XLV) and the SPDR (SPY) itself.



Once again, this is an on-again/off-again affair. It diverged badly after the broad market re-entered a bullish phase in November 2011. The reason is relatively simple: The underperformance of the healthcare sector was not associated with absolutely negative performance at all. The sector has returned 11.88% since November 30, 2011; yes, this is less than the 12.88% for the S&P 1500 Supercomposite, but it hardly invites preemptive option insurance buying, does it?

Can these industry risk measures be used to handicap the Supreme Court decision? In theory, a jump in relative CDS costs and in relative volatility would tell us the industry's economics are about to get jumbled, but you will get the same information from relative stock market performance. Simply doing relatively worse than the broad market if absolute performance continues to gain will not give you a head start on the Court's ultimate decision.