Healthcare Sector Risks Rising

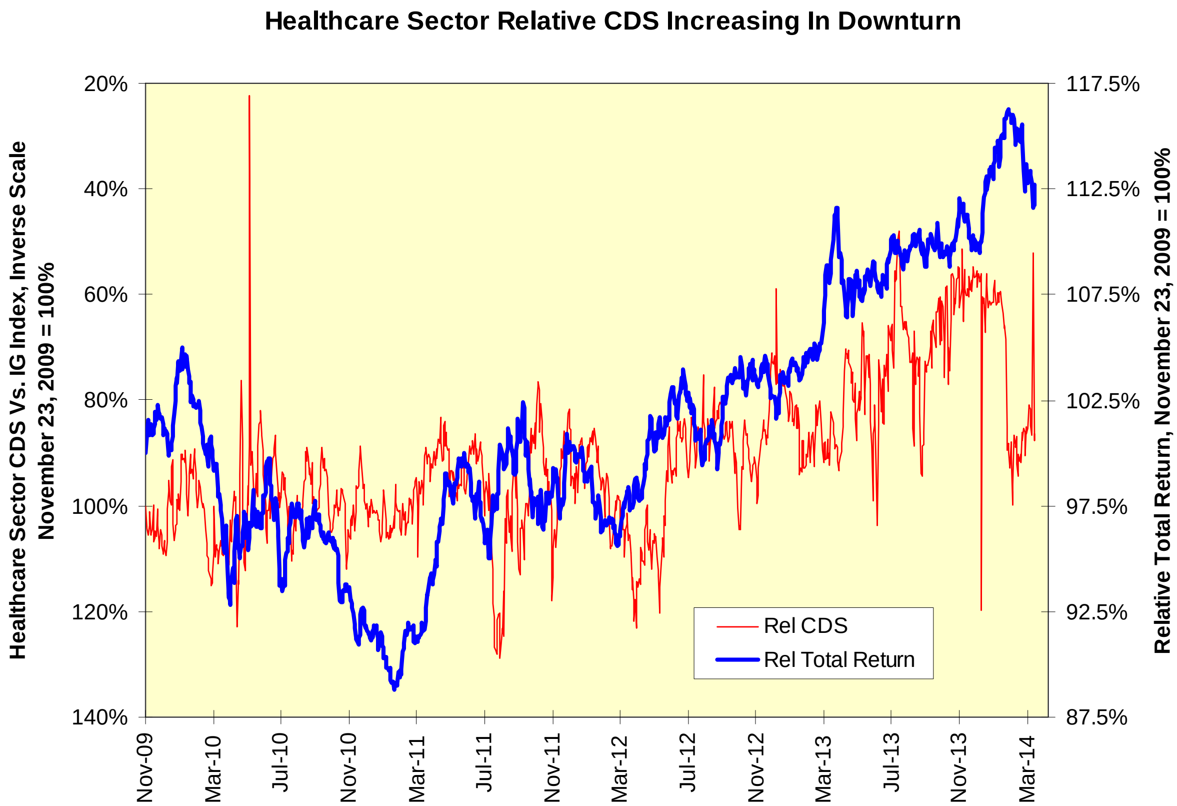
One of my favorite pastimes since the passage of the Affordable Care Act (ACA, aka ObamaCare) has been tracking winners and losers within the health care sector every time something in the law gets changed, postponed, delayed or ignored. But one thing did not change between February 2011 and February 2014, and that was the sector's outperformance of the broad market, something you could have played quite easily with the Health Care Select SPDR (XLV).

We all know trees do not grow to the sky, but knowing it and acting on it are two different things. It often takes a triggering effect to hit us over the head with the proverbial two-by-four to get our attention. This happened in the biotechnology group way back in March 2000 when then-president Clinton and then-prime minister Blair together questioned patenting genetic-based therapies.

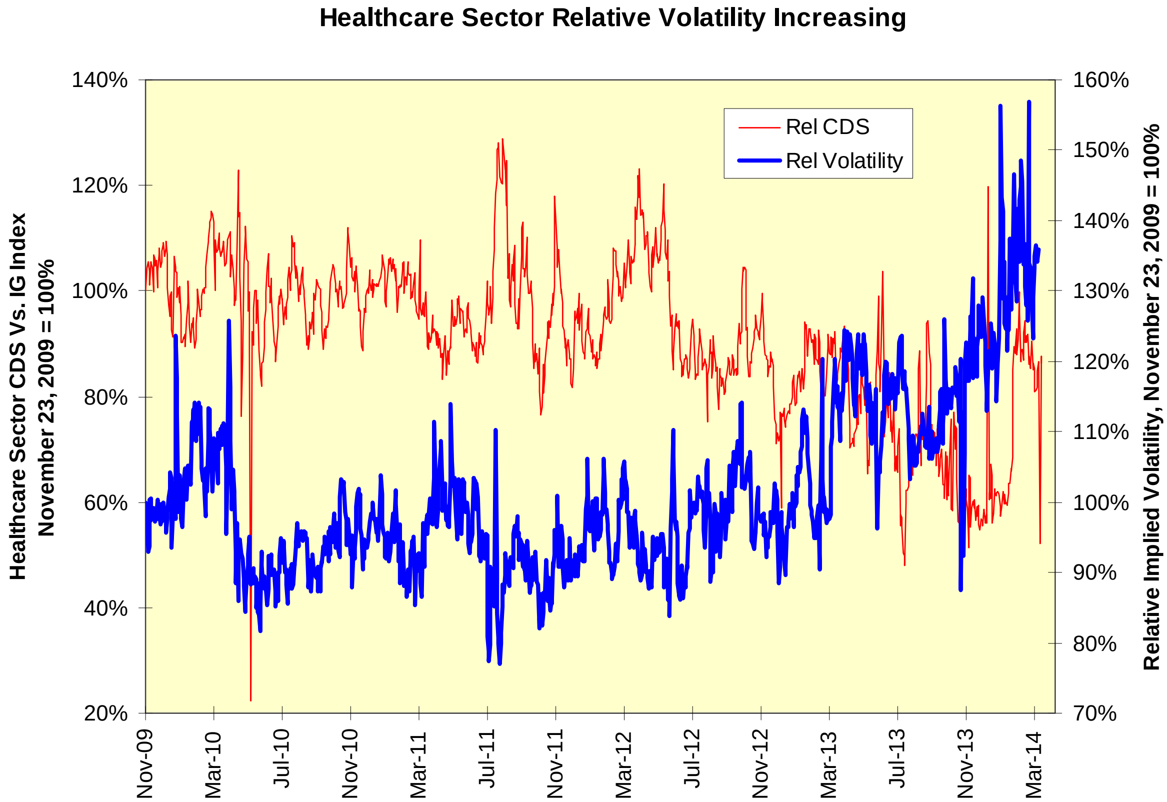
This happened just after the NASDAQ hit 5,000. One of my colleagues at the time said, "I think it all begins today." I rejoined this was the third major selloff in the NASDAQ that year, to which he shrugged and repeated his sentiment. As events had it, he could not have been more correct. I thought about this when various Congressional sources helped push a firm like Gilead Sciences (GILD) over the cliff last month.

Risk And Return

An average of five-year credit default swaps relative to the iBOXX five-year investment-grade CDS index has increased while relative performance has declined. The opposite had occurred for much of the sector's long streak of outperformance; relative CDS costs, here plotted inversely, fell as relative performance rose. This is as it should be.



Now let's compare the same relative CDS measure to the relative volatility of the XLV and the SPDR S&P 500 Trust (SPY) itself. We should expect the two measures of uncertainty to move in a related fashion, and they do. The relative implied volatility of the health care sector had been rising for the better part of a year and then jumped as relative performance peaked. Once again, this is as it should be.



The risk is obvious. Investors were willing to ignore higher relative implied volatility during a long period of outperformance and were equally willing to sell credit protection on the sector's bonds. Higher relative returns have a way of making you think the trees can grow just a little bit taller or, failing that, the sky can be lowered. This will not be the case during a relative performance correction as investors in a risk-reduction mode are going to be forced into shedding higher-volatility assets. That will create a self-reinforcing loop, especially for the sector's (formerly) high-flying biotechnology group. The weekly return on the iShares NASDAQ Biotechnology ETF (IBB) since September 2011 has been over 125%. Investors tend to cash winners in before they bite the bullet on their losers.