Relative Healthcare Risk Greater For Sector's Bonds

One of the great things about our republic is its resilience in the face of head-scratching judicial decisions. If you watched the All-Star game last night, you had the privilege of watching some stupendously well-compensated baseball players. I hesitate to say, "Overpaid" as that judgment can exist only in the mind of an owner faced with cutting the check.

We are forty years into baseball's free-agency era. Prior to that, players were bound by the reserve clause keeping them bound to a single team until traded or released. The Supreme Court upheld that clause in the 1922 case of *Federal Baseball Club v. National League*. The Supreme Court – no one referred to them as SCOTUS then – held baseball to be exempt from the Sherman Antitrust Act on the grounds baseball was a sport and not a business.

Later incarnations of the Supreme Court have weighed in that a penalty is a tax and actions by the federal government could be substituted for actions to be taken by a state if that was what was necessary for a law to remain constitutional.

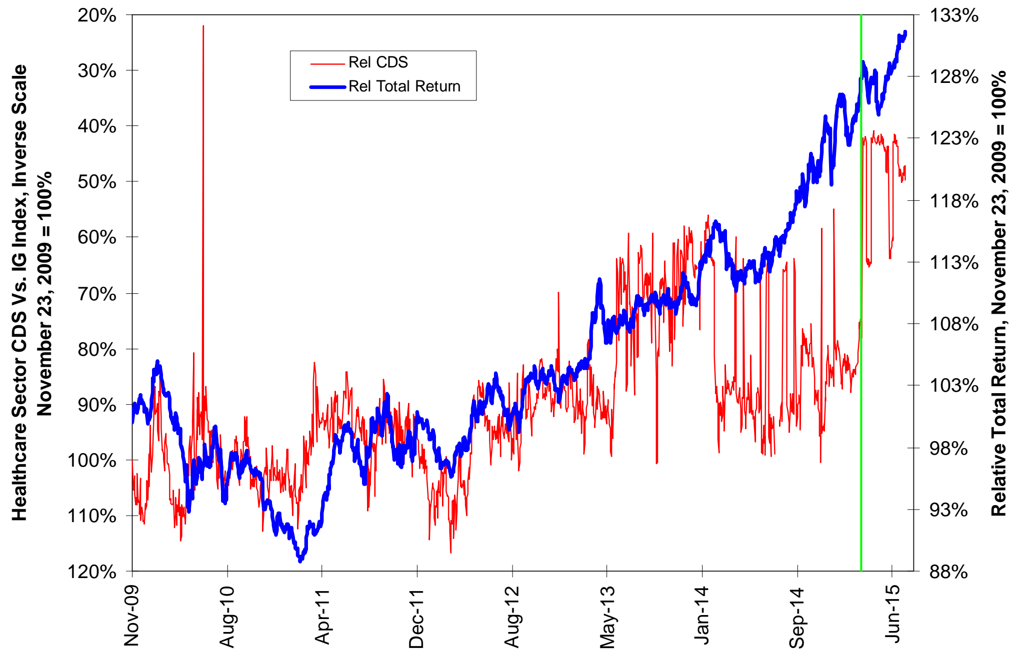
What is and has been unassailable is how the healthcare sector has outperformed the broad market since the November 2009 date when the Affordable Care Act became inevitable via some legislative fancy footwork and all-around razzle-dazzle. The S&P 1500 Healthcare sector has outperformed the Supercomposite itself by 31.3%.

I should note, so I will, the strongest performing industry groups within the sector since the October 2014 panic low have been Managed Care and Healthcare Facilities. The intellectual property-dependent groups such as Healthcare Technology, Life Sciences Tools & Services, Pharmaceuticals and Biotech have outperformed the broad market but have underperformed their rent-capturing brethren.

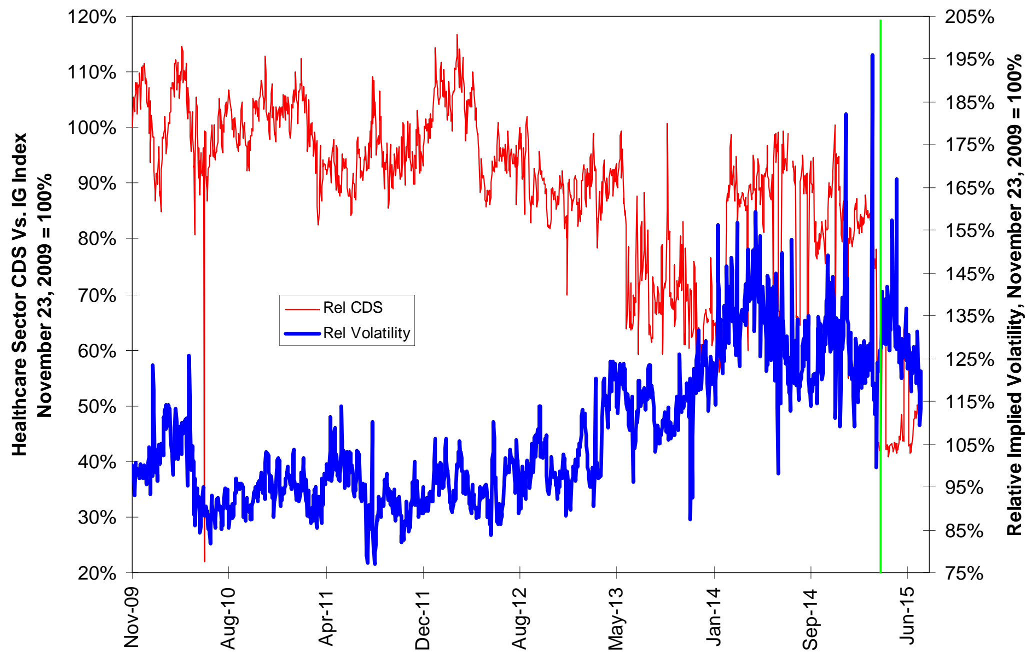
The industry has been consolidating rapidly into an oligopolistic structure designed to capture the flow of mandated-insurance money and cost-plus pricing structures. As in the case of finance, the increasing regulatory burden is borne more easily by large, bureaucratic structures than by risk-taking innovators. One day these industry arteries will harden and we will be stuck with the consequences, but we get both the government and the healthcare industry we deserve.

Risk And Return

Management in most industry has an incentive to reward shareholders and the expense of its creditors. We can see this in the healthcare sector by mapping the sector's relative equity return against its relative five-year credit default swap costs (plotted inversely). Even though relative equity returns have continued to push higher since March 2015, relative CDS costs have stopped narrowing. The sector's bondholders are becoming nervous even as shareholders continue to charge forth.



If we map the sector's implied volatility against these same relative CDS costs, we see shareholders are viewing the sector as being decreasingly risky vis-à-vis the broad market at the same time bondholders have started to ask for greater credit risk protection.



A sector's stocks cannot become decreasingly risky while its bonds are becoming increasingly risky, especially when the sector's gains have been skewed toward its less-innovative industry groups. Baseball may not be a business, but healthcare most certainly is and one thing that is true now has been and always will be true, and that is profits, unlike the salaries of .250 hitters, eventually stop growing.