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ADVISER FUND UPDATE

Market Summary and Commentary for Individual
Investors from Adviser Investments



September 17, 2009

A Healthy Discussion

Though famous for index funds, one of Vanguard's best funds is actively managed and invests in just one sector of our economy, making it the antipathy of an index fund. But, Ed Owens, manager of Vanguard's Health Care fund feels his value approach to investing in a globally diversified portfolio of companies tied to this "sector" is probably one of the best ways to reduce, rather than increase, risk in one's portfolio. Owens doesn't grant many interviews, so when he said he was willing to speak with CEO Dan Wiener on the record, Dan jumped at the opportunity. Vanguard's Health Care fund (and the Hartford Global Health fund run by Owens's health research team) appears in many of our clients' portfolios, so his insights are of great interest to us. Here is a snippet of Dan's comprehensive interview with one of the greatest health care stock pickers today.

Dan Wiener: How has the health policy debate affected the way you run your portfolio?

Ed Owens: In many respects, not very much. My assumption is that like companies are going to be similarly affected by any changes, so that it's always the search for the best value among similar companies. I like to say, "the closest comparable," so if you look at a group of 10 companies that are closely comparable, I try to be invested in the most attractive half of them with weightings skewed to the most attractive of them all. That process doesn't really change, depending on what comes out of Washington.

Now, different sub-sectors could be affected differently; our weightings in sub-sectors could be affected by Washington's outcome. As an example, early in the year, when maybe the worst was being feared, the managed care companies and big pharma were beaten down worse than other sectors in health care, so we added to them.

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So it was a price change more than a judgment about what would happen that would drive the investment process for us. As you know, we are value investors and we believe that prices change more than fundamentals change, normally, so we're always looking for price changes that would create investment opportunity, the opportunity to increase the weighting of a stock or to reduce the weighting.

DW: Where are the breakthroughs coming? Are we on the verge of another golden period for advances in the health arena, and if so, how are you positioning the fund for it?

EO: I think the golden period is maybe pushed out a little. The tougher FDA the last couple of years has removed some of the bridge to continuous earnings growth through a period of patent expirations in the next couple of years. But the biotech revolution, all the knowledge derived from the genomics revolution, which peaked in terms of decibel level in 2000, the lag between basic science research and commercial products is typically 15 to 20 years, so I think that there is the potential for a tremendous period of growth in the second half of the decade of the teens. That should result in multiples expanding ahead of that time period.

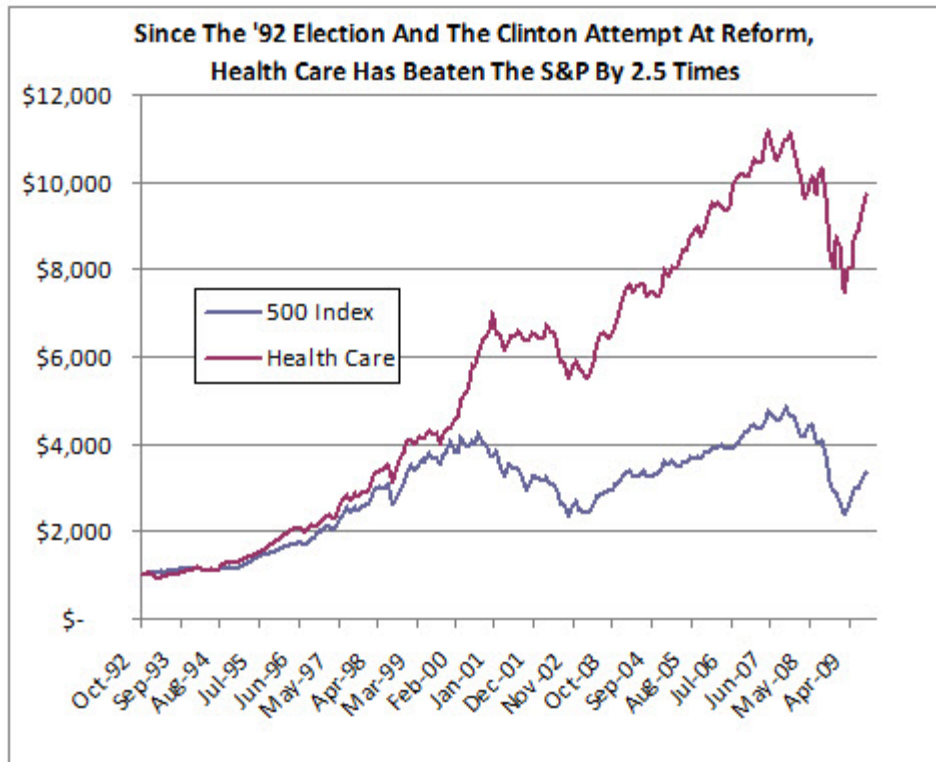
Our health care group's maybe six years of underperformance versus the overall market should end certainly by 2012 and hopefully sooner. [Note: While the health sector has underperformed the overall U.S. stock market over the past six years, up 14% versus 18%, Owens has more than doubled the market's performance and tripled the sector's performance with a 43% gain.] It's an industry that has many facets, and has been well served by our approach to diversification across all sectors and geographies of health care—not making huge bets normally, but constantly shifting the weightings among the stocks as the prices change. I think we are firmly in that kind of period now. In the last year, we did put on one really big bet, Schering-Plough, and that, fortunately, worked out when they acquired Merck in a reverse merger, with Merck paying them a really nice premium. So Schering-Plough was really our shining star the last year. It's still the largest position in the fund, but right now I'm trying to come up with what's next in terms of making a big bet in the fund. Right now, it's still Schering-Plough and the Schering-Plough-Merck combination.

DW: The twin pillars that you always talk about are biotechnology (which I consider to be a proxy for innovation or R&D) and demographics. The demographics side is definitely continuing to bolster the case for health care, but what about the innovation piece? And how does that manifest itself in the fund?

EO: I guess it's hard to point to individual names and say, "This is one of those pillars," but those pillars are basically the key growth drivers of health care. That's why, given a free market system, health care will grow faster than the economy, and health care stocks will outperform all equities. Each of those pillars has counterpoise trying to hold it in check (or potentially holding it in check). The innovation side is temporarily in check with the FDA, going through a period of increased focus on safety. So they are not approving products that in a different period, where they were more focused on innovation, more products would be approved.

In terms of demographics, the counterpoise there is that demographics are so favorable to products consumed by the elderly, that society in the form of Congress is now pushing back in terms of health reform. This health reform, in its most severe manifestation, will be one of rationing—rationing through designing protocols or rationing through creating long waiting lines that deter people from seeking care. In both of those cases right now, we're in a period where the push-back is visibly affecting the growth of the sector. It's a situation, where having pushed back on both the pillars, it can't last forever, so we are approaching a period where I think that long-term investors will be well rewarded as we leave a period of six years now when health care has underperformed the greater market overall.

Of course, my job is really divorced from those two pillars. It's to try to do better than what the market does in that sector. I think what I have done is come up with a simple formula that's kind of mechanical and it's just called "value investing." Most other players in the health care sector focus on price or momentum investing, and I think that, over time, it's been shown that value investing is a superior long-term investing strategy. Hopefully I can continue to just keep plodding away with a low turnover strategy and keep it working. It is a challenge.



Source: Adviser Investments

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