LPL RESEARCH

WEEKLY MARKET COMMENTARY

KEY TAKEAWAYS

The upcoming ACA Supreme Court decision may create a buying opportunity for the healthcare sector.

We believe the odds favor the status quo, meaning that any selling pressure related to the risk of losing insured patients may present a buying opportunity.

A ruling declaring the ACA subsidies illegal remains a possibility and may create an even better entry point for the sector.

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ACA RULING COULD MAKE HEALTHCARE SECTOR MORE AFFORDABLE

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The upcoming Supreme Court decision regarding premium subsidies for the Affordable Care Act (ACA, aka Obamacare) may create a buying opportunity for the healthcare sector. We believe the odds favor the status quo (all subsidies legal regardless of the state), meaning that any selling pressure related to the risk of losing insured patients may present a buying opportunity. However, a court ruling in favor of the challenger (against the administration), which would likely be met with even more selling pressure and remains a possibility, may create an even better entry point for the sector.

CONTEXT

Later this month, in the case of *King v. Burwell*, the Supreme Court will rule on whether ACA premium subsidies (via tax credits) are legal for individuals with Obamacare policies in states that chose to use federal health insurance exchanges rather than setting up their own state-run exchanges. When the law was written and subsequently passed in 2010, the hope in Washington was that all states would set up their own insurance exchanges for their citizens. Were this achieved, it would have eliminated the question of whether any subsidies that made insurance premiums more affordable were legal. The law is quite clear about the legality of premium subsidies in states with exchanges. However, the law is ambiguous about states that opted not to set up exchanges, which is the crux of this case.

WHICH WAY WILL IT GO

Our sources in Washington see 60% odds of the status quo (a ruling in favor of the administration), while we believe, based on the points below, that the odds may even be a bit higher.

A favorable ruling for the administration could be based on three potential arguments:

1. The court may think the intent of the law and the broad context—including consideration for the conditions under which the law could reasonably function economically—are enough to essentially prove the IRS's intention and uphold the status quo. The section of the law that allows for the federal government to set up an exchange if a state does not, points in this direction.

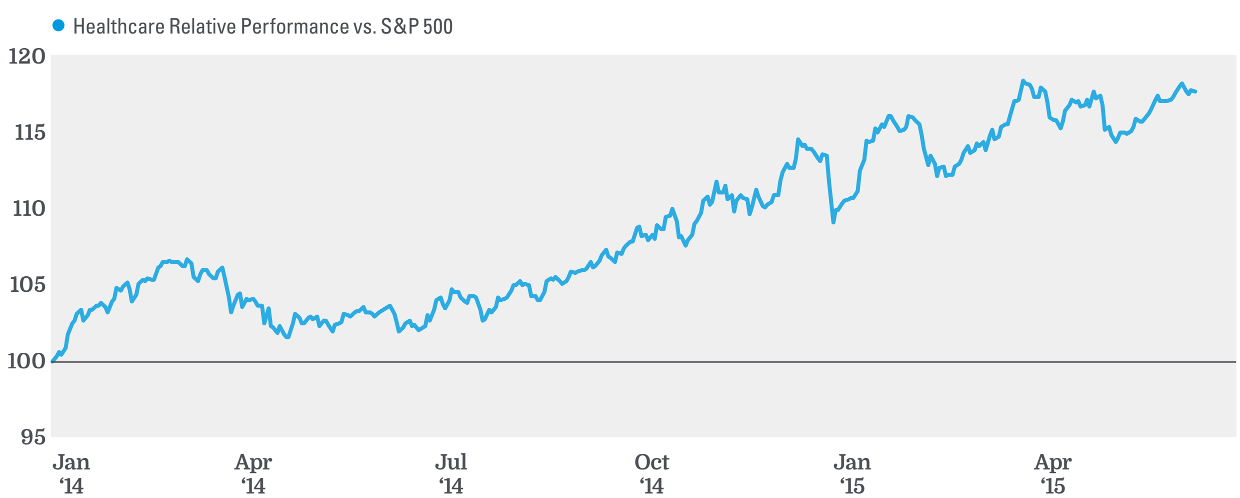
2. The court may determine statutory ambiguity and defer to the interpretation of the IRS. In this case, the premium subsidies would remain in place.
3. The court may agree with the challenger based on the "letter of the law" but allow the subsidies to remain in place so as to not inflict financial harm on the states. The states, in theory, would have known their residents could not receive subsidies and that removing the subsidies would hurt their individual insurance market.

However, this case is no slam dunk and there are arguments that favor the challenger. The "letter of the law" clearly specifies that premium subsidies go to those qualified individuals living in states that have set up insurance exchanges. The court's job is to interpret the law, not clean up errors by the law's authors or make loose assumptions. This text may have been intended to create an incentive for states to set up exchanges as the administration wanted, meaning that section of the law was written strategically, rather than in error.

SECTOR IMPLICATIONS

The healthcare sector has performed well (as measured by the S&P 500 Healthcare Sector Index), partly due to the increase in the number of individuals with health insurance in the United States under the ACA. Year to date, the sector has returned 8.9%, compared with the 2.6% return for the S&P 500 Index, after a very strong 2014 in which the sector's 25.3% return nearly doubled the S&P 500's. So might the sector's strong relative performance over the past 18 months, shown in Figure 1, and the uncertainty and potential impact of this decision, mean the sector is due for a fall?

1 HEALTHCARE HAS SIGNIFICANTLY OUTPACED THE S&P 500 INDEX SINCE THE START OF 2014



Source: LPL Research, FactSet 06/05/15

Because of its narrow focus, investing in a single sector, such as energy or manufacturing, will be subject to greater volatility than investing more broadly across many sectors and companies.

Indexes are unmanaged and cannot be invested in directly.

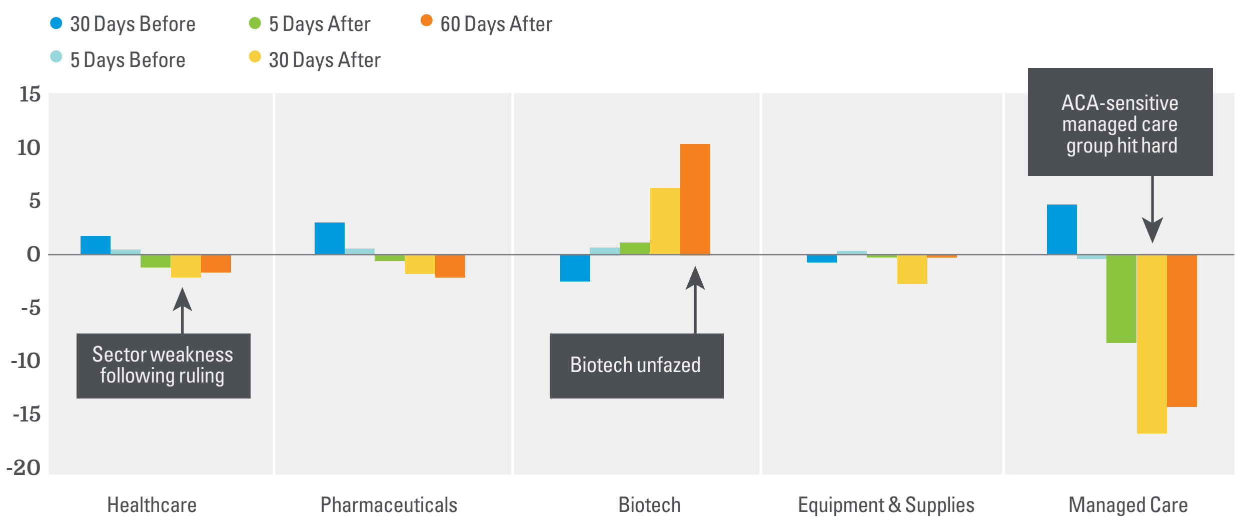
Past performance is historical and is not indicative of future results.

Uncertainty surrounding the upcoming decision may drive increased volatility in the sector over the next several weeks. Should the group follow the pattern that it did during the Supreme Court ruling in 2012 (issued on June 28 of that year), then the healthcare sector may underperform the S&P 500 if the court rules in favor of the plaintiff (challenger). In the 2012 decision, the Supreme Court ruled in favor of the individual mandate, but weakened the law somewhat and confused markets for a period of time.

Figure 2 shows the relative performance of the healthcare sector and the primary industry groups compared with the S&P 500 shortly before and after that June 2012 ruling. As the figure shows, one was better off not owning the sector for the two months after the ruling (except for biotech), particularly managed care stocks. The sector produced gains during these periods, but trailed those gains produced by the broad market. We also see that biotechs were unfazed by the ruling and charged ahead.

After the initial negative response, beginning on September 13, 2012, the sector subsequently outgained the S&P 500 by 30 percentage points cumulatively through June 5, 2015. While we do not expect that magnitude of outperformance over the next several years, we may see a repeat of this general pattern; and in the event of an unfavorable ruling, we could be presented with an opportunity to buy healthcare on weakness.

2 HEALTHCARE UNDERPERFORMED FOLLOWING ACA SUPREME COURT DECISION IN 2012



Source: LPL Research, FactSet 06/05/15

Data are relative performance (total returns) of S&P sector and industry groups, represented by S&P 500 healthcare subindexes, relative to the S&P 500 during these various time periods relative to the ACA Supreme Court decision on June 28, 2012.

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Healthcare valuations were cheaper in 2012 when that prior court decision was reached, providing some cushion against losses. Today, even at a 5% premium relative to the S&P 500 on a forward price-to-earnings ratio (PE) basis [Figure 3], we find the sector reasonably valued. Healthcare has been producing some of the fastest earnings growth among all sectors, while biotech companies continue to enjoy very strong revenue growth prospects, in our view.

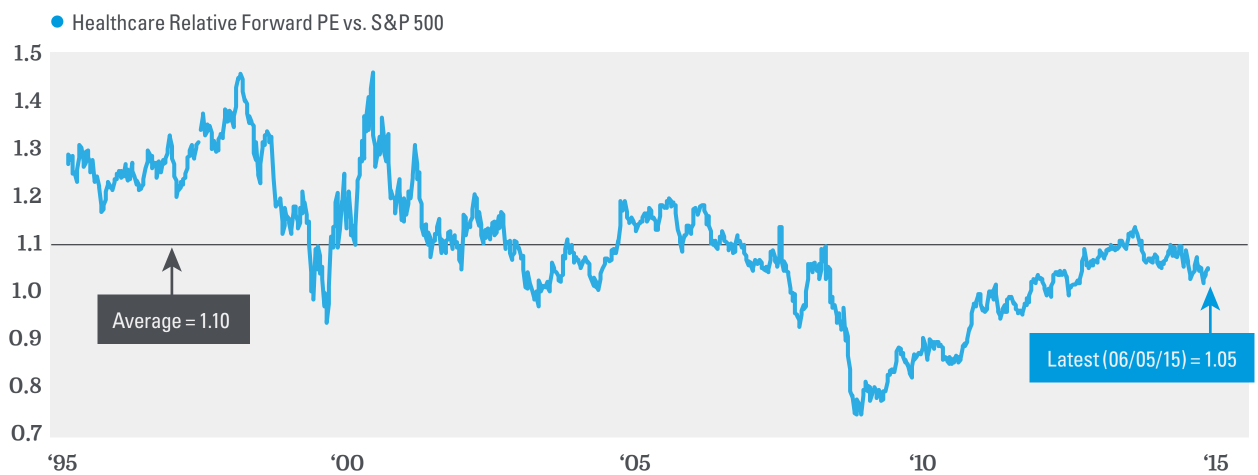
POTENTIAL FALLOUT

An adverse ruling for the administration (against the status quo) could potentially lead down several paths but would likely have significant impact. (There are 6.5 million Obamacare enrollees in 34 states that did not set up exchanges, out of 10.2 million paid subscribers in total.) At a high level, if the subsidies are eliminated, healthy patients may drop coverage due to the higher cost, creating a sicker—and therefore more expensive—insured pool.

A ruling in favor of the challenger could require states that still choose not to set up exchanges (perhaps 25–30) to take some steps in that direction to maintain eligibility for the subsidies. The administration may water down the requirements to encourage more states to set up exchanges.

A ruling in favor of the challenger may require Congress to come up with a fix that, given the intense partisan views on this law, would be extremely difficult. President Obama views this legislation as a signature achievement. He is not likely to give up the individual mandate or any other significant part of the law to get a deal done with the Republican Party. It is not clear what a fix would look like, which could create significant uncertainty for healthcare companies with regard to their base of insured customers.

3 **HEALTHCARE RELATIVE VALUATIONS REMAIN REASONABLE**



Source: LPL Research, FactSet 06/05/15

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CONCLUSION

Until now the healthcare sector has shown little concern about the upcoming ACA Supreme Court ruling. But that may change. The odds of a ruling that potentially eliminates subsidies for more than 6 million Obamacare enrollees are not insignificant and may contribute to sector volatility as the decision approaches. Tactical investors may want to consider reducing healthcare exposure ahead of that potential volatility. If the Supreme Court rules the ACA subsidies in states with federal exchanges are illegal, more pronounced selling may create an attractive buying opportunity. This one will be very interesting to watch. ■

DEFINITIONS

Forward price-to-earnings is a measure of the price-to-earnings ratio (PE) using forecasted earnings for the PE calculation. While the earnings used are just an estimate and are not as reliable as current earnings data, there is still benefit in estimated PE analysis. The forecasted earnings used in the formula can either be for the next 12 months or for the next full-year fiscal period.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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