

## Viewpoint

Baird Investment Management (BIM) manages high-quality portfolios for high-net-worth individuals and institutional clients.

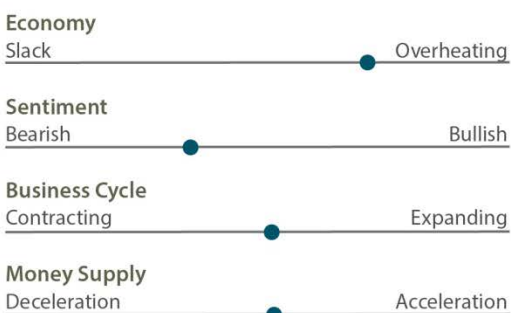
**BAIRD**

 Baird Investment  
Management

*"I have wondered at times what the Ten Commandments would have looked like if Moses had run them through the U.S. Congress."*

– Ronald Reagan

### Market barometer



Source: MTI, Investors Intelligence, Bloomberg

### Market update as of 7/31/13

	MTD	YTD	Trailing 12 Months
Dow Industrial Average	4.1%	20.0%	22.4%
S&P 500	5.1%	19.6%	25.0%
Russell 1000® Growth	5.3%	17.7%	21.6%
Russell MidCap® Growth	6.2%	21.8%	30.7%

Source: Russell, APL

## The Never-ending Story of Health Care Reform

Health care reform has been a popular topic among investors for more than four years now, and for those of us who invest in the health care sector, it feels more like 40. Despite congressional and presidential elections, endless lobbying and political maneuvers, and a decision from the Supreme Court, "Obamacare" (e.g. Affordable Care Act or ACA) will finally come to fruition in 2014. We expect the almost daily updates around health care reform to continue throughout the rest of the year, particularly around the early months of health care exchange enrollment and the mid-December deadline. Despite the importance of a significant change to the U.S. health care system, we believe the majority of the political developments and early experience with the new law will prove to be mostly noise. However, that doesn't mean there won't be volatility among health care stocks as investors wrestle with biases associated with anecdotal evidence, politics and historical interpretation as they make investing decisions.

### Anecdotal Evidence

Often during drug development, you hear anecdotal reports about a miracle drug that may have saved someone's life. Or sometimes, it's the opposite – a new drug creates a serious complication, or possibly even a patient death. These anecdotal reports can often influence consumers or even doctors, yet they have no real bearing on the actual efficacy. In reality, drug companies undergo clinical trials involving hundreds or thousands of patients, often in several countries, to generate data that can truly be analyzed.

We see similarities with health care reform, where anecdotal evidence temporarily serves as fact – particularly, around the enrollment of people in the state-based health care exchanges. We expect examples to be made of the first people who can't get through on the phone, who don't properly sign up, or who miss a deadline due to complexity. We anticipate such examples will likely find their way into a mainstream media story, or perhaps get picked up by social media and spread. Nevertheless, the real test will be to see how these exchanges fare with greater numbers of participants over the first year of operation.

### **Political Bias**

If there's one major takeaway from the health care reform marathon of the past four years, it's that politics is the most powerful force. Economics, science, medicine, etc. were not of concern regarding the creation of the law – all that mattered was whether the idea came from a Republican or a Democrat, so then it could be qualified as either "good" or "bad." We believe this thinking continues, particularly in this political climate, and that those in Republican states will have a vastly different perspective on the enrollment and implementation of health care reform compared to the White House or Democratic states.

Adding to the complexity are political changes and the ramifications of those decisions. For example, the Obama administration recently delayed the timing of the employer mandate by one year to 2015. Further, consider that Republican governors in Arizona and Florida initially did not favor exchanges, yet ultimately supported them given the economic realities. They, in turn, faced state legislature led by Republicans who were still against it. Both states did finally pass the bills, but with great challenge.

In our view, these political maneuvers have and will continue to alter the timing of implementation, but not cause the law to implode. We expect to see investor expectations altered and re-altered multiple times in 2014 and 2015.

### **Historical Perspective**

Although we are not political scientists or experts in American history, there have been several interesting articles written in the press in the last few months about previous changes to the U.S. health care system. Two prominent examples would be the addition of the prescription drug benefit added to Medicare a decade ago, and the launch of Medicare itself fifty years ago. The prescription drug benefit, which was passed with Republican support in a Republican presidency, was even more unpopular in opinion polls at the time than Obamacare is today. It ended up being a very popular benefit, and the cost estimates ultimately came in lower than expected. In the mid-1960s, the U.S. government was frantically trying to enroll seniors in Medicare, while the American Medical Association was lobbying extensively against the program calling it the beginning of "social medicine." Have we heard that before?

### **Investing Challenges**

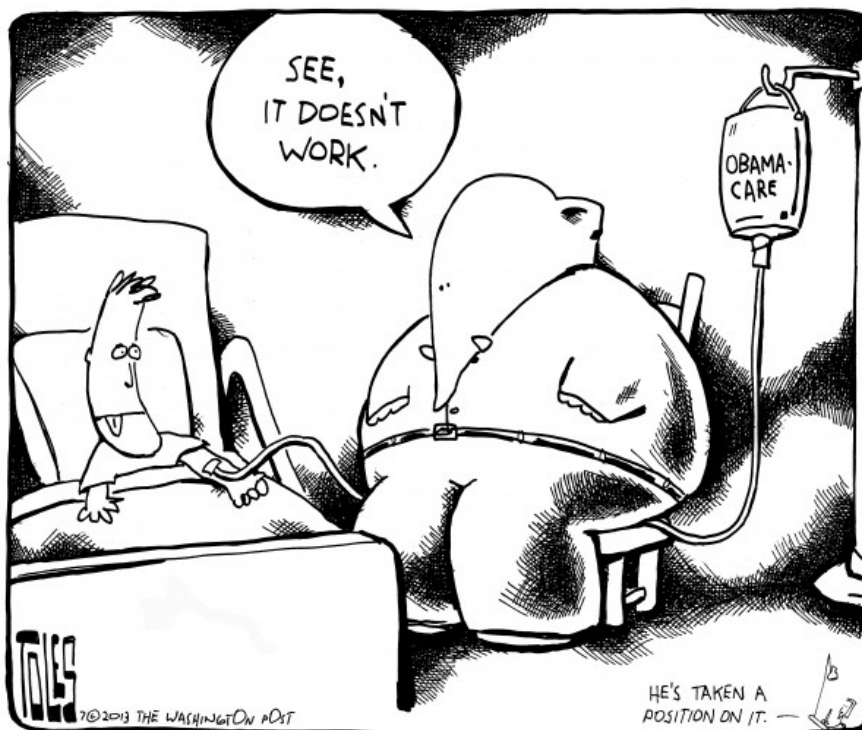
We believe many investors are gravitating to the two subsectors with the most sensitivity to Obamacare - hospitals and HMOs. The challenge is that these decisions may be based on one or a combination of the above biases, with some believing that as Obamacare is rolled out, an increase in insured individuals will lead towards greater hospital volume. As a result, hospitals have rallied over the past year. However, many also have the view that the legislation will not be fully implemented, and that the overall change to the insured population will be minimal over the intermediate term.

The problem we see with this investment approach is that there is limited ability to research and analyze given the associated complexity (and the regular stream of unforeseen changes), and the potential to become too binary (and leads to significant volatility).

## Our Approach

We invest with a time horizon much longer than a few weeks, months or quarters. We want to own companies in all sectors with strong fundamentals, ideally with double-digit, top-line growth and expanding margins. That has been difficult to do in health care for the past few years, so we tend to focus on companies with new product cycles, or companies that help address the rising costs of health care, often in health care services. Furthermore, we look for companies in health care subsectors that aren't strictly sensitive to Obamacare, such as genetic sequencing, health care IT and orphan and generic drugs.

For example, Illumina has developed market-leading instrument platforms for both research and clinical use to sequence human genes. The company currently faces minimal competition and is seeing increasing adoption in more clinical applications which represents a very large market opportunity. Alexion has an orphan drug that has experienced very strong sales growth the last several years due to its expansion in new geographies, as well as for new indications. On the cost savings side, Catamaran is a pharmaceutical benefit manager (PBM) that helps companies, insurance providers, and local governments reduce spending on drugs. We think these companies will continue to gain market share in the next few years, and we believe they should continue to grow regardless of what happens with health care reform in the next twelve months.



**To learn more about Baird Investment Management (BIM) and our products, please contact us at 800-792-4011 or 414-765-7246. Visit us online at [bairdinvestmentmanagement.com](http://bairdinvestmentmanagement.com).**

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