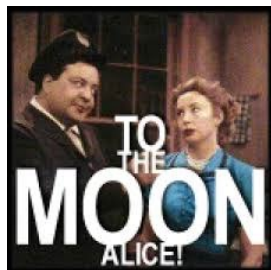


## Healthcare Spending



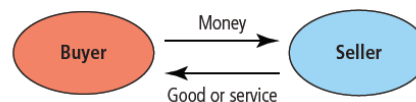
In 1960, healthcare spending was just 5% of our Gross Domestic Product; this year, it is projected to be over 18%. Yes, healthcare spending in our country has gone “to the moon”. The rise in healthcare’s share of our economy is of interest for at least two reasons. First, according to Fidelity Investments, the average couple will need over \$285,000 in today’s dollars for medical expenses in retirement, excluding long-term care. Whew. Second, with healthcare stocks comprising approximately 15% of the U.S. stock market, healthcare industry trends are likely to have a meaningful impact on your savings and investments.

While healthcare spending spans across a wide array of categories, today we are going to focus on a topic that you’ve likely seen a lot in the headlines lately: prescription drug trends.

Prescription drugs account for 10% of total U.S. healthcare spending today, which is up from 6.6% in 1992. While there are multiple factors driving this increase, perhaps the most important is that the U.S. effectively subsidizes research and development (“R&D”) of drugs for the rest of the world. While the U.S. Food and Drug Administration has implemented regulations and protections across the industry, our healthcare market continues to be more open and entrepreneurial than other developed countries. On average, pharma and bio-pharma firms invest approximately 15% of their revenues back into R&D – and in 2017, R&D spending in the pharmaceutical industry totaled \$165 billion globally. While the majority of research fails, the successes have led to a sustained output of innovative drug therapies benefiting us all. For example, in 1992, AIDS was a death sentence; today, its origin HIV is a manageable disease. Lipitor – the first of the statin-based anti-cholesterol compounds – has revolutionized cardiology and the lives of its patients. Advances in the bio-pharma sphere have been transformative: Rheumatoid Arthritis, Crohn’s Disease, and other autoimmune maladies have become meaningfully more manageable. Up until now, pharmaceutical companies have compensated for these large R&D expenses by setting their own prescription drug prices.

The rise in prescription drug spending is a function of both price and utilization increases. The health insurance market – the primary payor – is the next factor to review. The majority of drug costs are paid through health insurance plans, which can foster demand (utilization) at a high rate. Exhibit A illustrates the difference between a typical market versus the market for health care, and how introducing a third party changes the messaging power of markets. In this diagram, the patient takes a prescription from their physician, makes a copay to their pharmacist, and then the pharmacist makes a payment claim to the insurer. Unfortunately, this creates what is known as a moral hazard. Since in most cases patients do not know the true cost of their prescriptions, they have no incentive to “engage in behavior that will keep spending at a reasonable level” (Mankiw, 2017). As a result, insurers have begun to offer incentives in the form of lower premiums for higher copays. Americans with High Deductible High Copay Plans have certainly noticed the trends in prescription prices and have signaled their displeasure.

(a) Model of the typical market



(b) Model of a healthcare market with an insurer

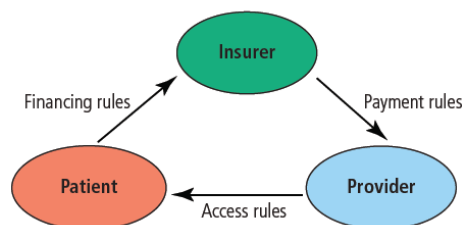


Exhibit A: How an Insurer Changes a Market.  
Source: Mankiw NG. The Economics of Healthcare. 2017.

While there are many other factors contributing to the rise in pharma spending, we will mention just one more here. According to BlueCross BlueShield, individuals are not maximizing the health benefits prescribed by their doctors: nearly three out of four people report they do not always take their prescription medicines as directed. As a result, acute cases are increasingly migrating toward chronic cases – which are exponentially more expensive to address.

Since 1992, the primary issue in the U.S. has been providing access to good care, including prescription drugs. Rising costs cannot go much past the moon; they are the more pressing issue today. Value Based Care – which focuses on outcomes as opposed to volume of services – is a promising concept that has the potential to meaningfully reduce costs. While it is facing roadblocks since it threatens the status quo, there are an abundance of incentives to this model. Physicians could seek the best, most effective drug therapies at the lowest costs, and would be incentivized to educate patients to take the drug as directed. Educated patients would have incentives to lead healthier lifestyle where possible – which would lead to fewer prescriptions and for less duration. The system would be incentivized to promote development of and access to generic drugs, while discouraging ‘patent extensions’ beyond the original term when the compound was discovered.



One of the most distinctive features of a classic New York City brownstone is its stoop. In the late 19<sup>th</sup> century, the Dutch built stoops to raise their parlor floor above flood waters; some posit that these stoops were built to raise the parlor floor above a “sea of horse manure” that was certain to come if trends continued as the city grew. In this case the trend self-resolved. We believe it is in the healthcare industry’s enlightened self-interest to resolve the spiraling cost curve before sentiment demands a government solution.

As the 2020 election season unfolds, it is a sure bet that the rising level of prescription drug prices and threat of price controls will be part of the debate. During the 1992 election season, recent revenue growth from pharma companies had been primarily driven by price increases rather than innovation – and then Governor Clinton made it a signature campaign issue to target pharma pricing. This contributed to major pharma stocks losing 25% during the two-year period between January 1992 through December 1993, while the broader market increased by more than 10%. We believe that 2019-2020 could be at risk to parallel the 1992-1993 period. While pharma spending is only 10% of total healthcare, it is a visible and easy target for those running for office.

From an investment standpoint, we recommend holding a diversified group of healthcare companies across the various sub-sectors of the industry. Holding only pharmaceutical companies increases the potential volatility in your portfolio, as drug prices are at risk of declining with each round of price level bashing. First Bankers Trust can help you build a portfolio of high-quality healthcare companies offering a variety of products and services – including consumables, medical devices, pharmaceutical research, managed care, and more. The healthcare segment of our economy will remain an integral source of quality dividend growth. A diversified group of providers will help you sleep at night as well.