
The Healthcare Sector Benefits from Moats and Growth Trends.

The Morningstar US Healthcare Index tracks a diverse, competitively advantaged sector exposed to long-term tailwinds.

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One of the most fundamental means of classifying securities is by economic sector. Investors have long grouped companies by their areas of focus, from technology to utilities, financial services to healthcare. Companies within a sector often respond similarly to catalysts. Commodities prices, consumer trends, and demographics are among the many forces that drive divergence between equity market sectors. Investment portfolios can behave very differently depending on their sector exposures.

According to Morningstar assets flows data, nearly \$2 trillion sits in sector-specific equity strategies as of the fourth quarter of 2023. They are used as both short-term and long-term investments. Amplifying strategic exposure to favored areas, hedging risk, and making tactical bets based on macro or micro factors are among the many use cases for sector strategies.

The Morningstar US Healthcare Index¹ measures the performance of public equities belonging to the 10 industries within the healthcare sector, with constituents weighted by market capitalization.

Key Takeaways:















- ▶ Healthcare is a diverse equity sector, including companies in industries such as pharmaceuticals, biotechnology, devices, insurance, and care delivery.
- ▶ Healthcare is a sector rich in economic moats, or durable competitive advantages as determined by Morningstar Equity Research analysts. Intangible assets and switching costs are the two most common sources of moats within the healthcare sector.
- ▶ Healthcare is exposed to many secular growth drivers, including innovation, rising demand for therapies, and higher spending stemming from demographics.
- ▶ Healthcare also faces risks such as policy and regulation, patent expiration, and product safety. Morningstar Equity Research expects steady growth for the healthcare sector despite some headwinds.
- ▶ Variability in sector performance demonstrates the stakes of sector allocation. Healthcare's defensive attributes supported its 2022 resilience and its sluggish 2023 returns.

¹ For a full discussion of index methodology, see "Construction Rules for the Morningstar Global Sector Indexes."

Constructing the Morningstar US Healthcare Sector Index

Morningstar's Global Equity Classification Structure² divides the equity universe into 11 sectors, starting at the security level. First, each public company is classified into one of 145 industries based on information from regulatory filings and input from Morningstar's team of more than 100 equity analysts. Industries are subsequently mapped into 55 industry groups based on common operational characteristics. Industry groups are then rolled up into 11 equity sectors, which in turn belong to one of three Super Sectors: Cyclical, Defensive, and Sensitive.

Exhibit 1 Morningstar Classifies Equities Into 11 Sectors and 3 Super Sectors

 Cyclical	 Defensive	 Sensitive
 Basic Materials	 Consumer Defensive	 Communication Services
 Consumer Cyclical	 Healthcare	 Energy
 Financial Services	 Utilities	 Industrials
 Real Estate		 Technology

Source: Morningstar.

The Healthcare sector is composed of the following 10 industries:

- ▶ Biotechnology
- ▶ Diagnostics & Research
- ▶ Drug Manufacturers—General
- ▶ Drug Manufacturers—Specialty
- ▶ Health Information Services
- ▶ Medical Care Facilities
- ▶ Medical Devices
- ▶ Medical Distribution
- ▶ Medical Instruments & Supplies
- ▶ Pharmaceutical Retailers

The Morningstar US Healthcare Index includes all healthcare stocks belonging to the above industries from the Morningstar US Market Index, which represents the top 97% of the U.S. market. The index had 172 constituents as of the fourth quarter of 2023.

Maintaining Liquidity in the Healthcare Sector

Several measures are taken to ensure the liquidity and tradability of the Morningstar US Healthcare Index. The Morningstar US Market Index, from which the healthcare index is derived, includes large-, mid-, and small-cap stocks but excludes micro caps, whose market caps are among the smallest 3% of the U.S. equity market—a segment where trading volume is thinnest.

² For a full discussion of sector methodology see "[Morningstar Global Equity Classification Structure](#)."

When market cap is calculated, it is adjusted by float. To accurately reflect the composition of the market available to investors, only free-floating shares are considered when determining a company's total outstanding share count. Strategic holdings that are not publicly traded are excluded.

Index eligibility rules also require that securities meet the following criteria at the time of reconstitution (resetting membership) in June and December:

- ▶ Securities with more than 10 nontrading days in the prior quarter are excluded.
- ▶ A security must be among the top 75% of the companies in the investable universe based on its liquidity score, which is the average of its rank on each of the following measures:
 - ▶ average monthly trading volume during the six calendar months immediately prior to reconstitution or, in the case of corporate entities younger than six months, since the security was first issued (partial months are prorated by the number of trading days in the month)
 - ▶ lowest two months' total trading volume during the six calendar months immediately before reconstitution (months need not be sequential)

The Morningstar US Healthcare Index is weighted according to float-adjusted market cap. This ensures that the most-liquid stocks represent the largest weight in the index. Smaller and less-traded securities receive proportionally less weight.

Inside the Healthcare Sector

Morningstar Equity Research³ qualitative coverage of the healthcare sector spans all 10 industries. The 78 stocks rated by Morningstar analysts represent 91% of the \$5.5 trillion in U.S. healthcare sector market cap.

Healthcare is a sector rich in economic moats, or durable competitive advantage as determined by Morningstar analysts. Just as physical moats were dug around medieval castles to keep enemies at bay, economic moats protect returns on capital. Morningstar Economic Moat Ratings are assigned to a company by considering its unique portfolio of products and services and competitive positioning. As of the fourth quarter of 2023, 79% of U.S. healthcare companies covered by Morningstar analysts possessed an economic moat. This compares favorably with most other sectors.

Moats are critical because they can be a strong indicator of future profitability. A company might be benefitting from growth trends, but if it lacks a competitive advantage, it will struggle to profit over the long term.

³ For a full discussion, see "[Morningstar Equity Research Methodology](#)."

Moats in healthcare stem from each of the five sources identified by Morningstar Equity Research (explained below). As displayed in Exhibit 2, intangible assets are the most common moat source for healthcare companies followed by switching costs. Companies can benefit from multiple moat sources.

Exhibit 2 Within Healthcare, Durable Competitive Advantages Are Common

Economic Moat Source	Intangible Assets	Switching Costs	Cost Advantage	Network Effect	Efficient Scale
Percentage of Companies Benefitting	59%	27%	17%	8%	1%
Examples of Companies Benefitting	Regeneron	Intuitive Surgical	Beckton Dickinson	Elevance	Biomarin

Source: Morningstar. Constituent Morningstar US Healthcare Index and Morningstar Equity Research Data as of Sept. 29, 2023.

To expand on the nature of moat sources in healthcare:

Intangible Assets are largely represented by patents covering areas of innovation and proprietary technologies. Patent protection for drugs, devices, and diagnostics enables enduring pricing power.

Switching Costs are expenses or inconveniences customers incur changing from one product or service to another. Heavy regulation of the drug manufacturing process creates highly durable switching costs for end users and long potential revenue streams for life science toolmakers. When medical practitioners develop expertise in using a differentiated set of tools and devices, switching costs grow.

Cost Advantages in the healthcare space can accrue to companies that benefit from economies of scale.

Network Effects occur when the value of a good or service increases as the network expands. Insurance networks, for example, become more valuable as their membership rolls expand.

Efficient Scale applies to firms serving a market of limited size, such as therapeutics targeting rare diseases.

Moats determine the ability of companies to profit from the many secular trends benefitting the healthcare sector. These include:

- ▶ Innovation in several therapeutic areas, including oncology, immunology, and rare diseases
- ▶ Rising demand for many therapies, such as obesity drugs and brain health solutions
- ▶ Healthcare spending increases stemming from demographic trends and rising costs

Like all sectors, healthcare also carries risks. These include:

- ▶ Policy and regulatory threats
- ▶ Patent expiration and lack of R&D productivity
- ▶ Product governance (safety risks) and litigation costs

Affordability concerns and charges of price gouging are a persistent threat to healthcare sector profitability and have brought the sector into the crosshairs of policymakers and regulators. The United States is a unique market when it comes to healthcare affordability: Higher prices in the U.S. mean the market accounts for roughly 40% of sales in the global prescription drug market and half of biopharma profits.

Morningstar Equity Research considers the market's perception of the risks in 2023 overblown, writing:















*"The market appears overly concerned by U.S. drug policy changes in the Inflation Reduction Act, a drag on acquisitions from Federal Trade Commission scrutiny, and patent losses. Covid vaccines and treatments also create tough comparables in 2023 that mask strong underlying industry growth."*⁴

Sector Allocation Matters

As seen in Exhibit 3, the performance of equity sectors can vary dramatically. Short-term sector behavior is driven by a range of variables. In 2022, the U.S. equity market fell sharply in response to inflation and its monetary policy response. Healthcare was down, but not nearly as much technology, communication services, or consumer cyclicals. In 2023, the market has bounced back, but healthcare has lagged.

⁴ Cash, M. 2020. "Corning Updates Third-Quarter Guidance; Raising Fair Value Estimate to \$28." Morningstar.
<https://my.pitchbook.com/?rcpubr=271965>

Exhibit 3 Sector Performance Varies Widely; Healthcare Was Resilient in 2022 but Lagged in 2023

Sectors	2023 (%)	2022 (%)
 Cyclical		
 Basic Materials	3.5	-11.5
 Consumer Cyclical	24.1	-35.5
 Financial Services	1.3	-12.3
 Real Estate	-5.2	-25.6
 Sensitive		
 Communication Services	38.3	-40.9
 Energy	6.5	62.5
 Industrials	6.5	-8.1
 Technology	35.7	-31.6
 Defensive		
 Consumer Defensive	-3.3	-2.60
 Healthcare	-4.3	-5.20
 Utilities	-14.4	1.70

Source: Morningstar Direct. Morningstar U.S. sector index total return, USD terms as of Sept. 29, 2023.

As discussed above, healthcare is considered a "defensive" sector in the Morningstar classification system. Demand for healthcare is relatively inelastic compared with more discretionary areas of consumer spending. Healthcare businesses have historically possessed pricing power, unlike companies in areas like energy and basic materials that operate in a commodity space.

Writes Morningstar Equity Research:

*"...[T]he healthcare sector continues to remain relatively immune to several macro challenges, including rising inflation and rising interest rates along with banking system pressures. The innovation within the sector, along with the defensive nature of healthcare products, should support stable demand through economic cycles. While some healthcare firms may have a lag time before passing along inflation-related price increases, we expect most of the healthcare firms in our coverage (especially those with moats) to maintain strong pricing power due to patents and high switching costs."*⁵

⁵ Utterback, J. 2023. "Innovative Products and Defensive Nature Should Support Solid Results." Morningstar. <https://my.pitchbook.com/?rcpubr=366521>

Long-term Opportunity in Healthcare

Uses of sector strategies vary, from opportunistic to strategic. Some investors prefer to assemble their own market portfolio from sector-specific sleeves so they control exposure levels. Such an approach allows for underweighting and overweighting sectors based on outlook.

Sector allocators rely on a range of signals. A value-driven allocator might favor less-loved areas of the market that possess upside potential and underweight more-popular segments. Some sector rotation strategies are premised on the belief that leadership changes at different stages of the business cycle. Consumer cyclicals, for example, often rally in recoveries. Healthcare is less economically sensitive.

Like all sectors, healthcare goes through cycles. Short-term investor sentiment waxes and wanes, depending on macro conditions, earnings announcements, and innovation. Policy and regulation also matter, whether real or perceived.

Over the longer term, though, the impact of structural growth trends on sectors is deeply important, and healthcare benefits from several. Just as importantly, many companies within the healthcare sector possess economic moats around their businesses. Moats insulate profits from competition and ensure that the benefits of growth flow to the bottom line. ■■

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