

Healthcare in 2022: Innovation and Opportunity

COVID-19 continues to reshape how we view healthcare and the opportunities it presents in the year ahead.

As we close 2021, the world is in various stages of recovery from the global COVID-19 pandemic. Notably, though the healthcare sector has performed well since the start of the crisis, it has lagged the broader market as consumer-oriented and information-technology sectors benefited more from the reopening of the economy. While COVID-19 disruptions could continue for months, we believe strong fundamentals and robust innovation will fuel growth across healthcare sectors in the year ahead.

Breakthrough innovation in the biopharma industry—particularly in oncology, immunology, and certain rare diseases—is generating a rich opportunity set for specialist investors. Key medical-technology companies are also facilitating significant drug development and are benefiting from the increased spending and proliferation of new drug candidates. Finally, diagnostics companies are helping with widespread COVID-19 testing while also creating more convenient routine medical tests and, increasingly, enabling early cancer screening.

Importantly, the overall delivery of healthcare continues to evolve. The US, for example, is experiencing a decades-long transition toward a fee-for-value payment system from a fee-for-service approach. This shift encourages new business models and supports substantial growth potential for lower-cost care models.

These tailwinds across the various healthcare subsectors, coupled with strong valuation support, leave us with a more positive outlook for the sector than ever before.

Biopharma

Entering 2022, the opportunities for value creation in the biopharma industry are especially strong. A last-minute compromise on drug pricing in President Joe Biden's US \$1.75 trillion social-spending bill in November was an important step toward lowering out-of-pocket drug costs for seniors in the US and addressing high drug prices generally. The threat of reform, in the form of greater industry subsidies and reduced pricing power, has been a risk to biopharma for much of the last decade. Valuations of large-cap biopharma companies in aggregate have been at historic lows in part for this reason. Progress on this issue should now help refocus attention on company pipelines and overall research and development (R&D) productivity.

Among small- to mid-cap biopharma companies, 2021 was a challenging year. A significant pullback started in February, perhaps triggered by some high-profile clinical setbacks, unexpected regulatory decisions, high valuations, and a volatile market backdrop. However, looking to 2022, we remain very encouraged by the state of pipelines across the industry.

Insight from sub-adviser Wellington Management



Charles Seidman, CFA
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In this outlook, Charles shares insights from David Khtikian, Wen Shi, Rebecca Sykes, and Fayyaz Mujtaba.

Key Points

- Breakthrough innovation in the biopharma industry is generating a rich opportunity set for specialist investors.
- Tailwinds across the various healthcare subsectors, coupled with strong valuation support, leave us with a more positive outlook for the sector than ever before.
- Scientific and product innovation, continued economic recovery, and structural changes to US healthcare delivery systems could provide a boost for the sector and benefit investors longterm.

Today, advances in basic science, the advent of new drug-discovery tools, and entirely new treatment modalities are enabling the development of high-impact drugs for critical diseases. For example, antibody-drug conjugate technology allows more potent and less toxic treatment of more types of cancer, as evidenced most recently by a groundbreaking new drug for breast cancer. In addition, the once science-fiction concept of gene editing was recently validated for the first time in humans with the rare disease transthyretin amyloidosis. Lastly, the COVID-19 pandemic has notably rekindled interest in vaccine development, including for common respiratory viruses such as flu and RSV.

Medical Technology

We are just as enthusiastic about the opportunities within medical technology. Many life-science tools and diagnostics companies excelled during the pandemic. Companies involved in the development of diagnostic-testing equipment were in high demand, as were those selling critical-care equipment to help hospitals cope with the surge in COVID-19 patients. Life-science tools companies, in particular, have strong fundamentals as they support both increased biopharma R&D and robust bioprocessing demand that helps bring advanced therapeutics to the market.

Importantly, many of these companies could exit the pandemic stronger than they entered, as a rise in their installed customer base should lead to increased recurring revenue in the years to come. Additionally, the pandemic has spurred governments globally to reassess their emergency preparedness. This should provide new sources of demand for many diagnostics companies, as well as increased government funding for life-science research.

Medical-device companies lagged relative to other parts of medical technology in 2021 but are poised for outsized growth in 2022 and beyond. The pandemic caused a halt in elective procedures, brought on first by hospital cancellations and compounded later by patient skittishness to schedule elective care. However, this drop in demand did little to slow the prevalence of underlying disease across patient populations. We expect to see strong multi-year demand in categories such as aortic-valve replacements, cataract surgeries, colonoscopies, and others that have been deferred since the pandemic.

Notably, lost in the short-term implications of COVID-19 is the fact that innovation pipelines across medical technology firms have never been stronger, with far more attractive medical-device categories poised to accelerate in the 2020s compared to the 2010s. In the coming years, we believe many firms will grow their addressable market through geographic expansion, new technologies, and the use of existing technologies to treat new patient populations.

Healthcare Services

The healthcare services subsector is also exiting the pandemic in a better position than it entered. The early stages of the pandemic were challenging for business models leveraged to underlying volume trends, such as post-acute care, hospitals, dialysis, and others. Conversely, managed-care companies performed well initially, as an overall reduction in healthcare utilization resulted in falling costs and rising profits.

We believe healthcare-service companies are well positioned to help solve one of the greatest societal challenges we face for the future: rising healthcare costs. One of the silver linings of the COVID-19 pandemic is that we feel it has accelerated a structural change in human behavior, as customers are now willing to consume

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healthcare in lower-cost settings and will become less reliant on hospitals. We believe this shift in behavior could benefit companies involved in home health, ambulatory care, IT solutions, and telehealth.

This transition is part of a broader trend that will see healthcare delivery change from fee-for-service models to fee-for-value models. In recent years, we've seen business models emerge in which primary care physicians and other healthcare providers work together to provide care to individuals throughout their healthcare journey—potentially improving outcomes and reducing costs. Importantly, risk has shifted from payers to providers, allocating primary-care physicians a fixed-dollar amount to treat patients, with the goal of incentivizing more prudent, cost-effective care.

Healthcare ESG Considerations in 2022

As we look to the future of healthcare, drug pricing and the affordability and accessibility of healthcare coverage in the US are two potential risks. While these risks can be simply thought of as political risk, we believe a wider environmental, social, and governance (ESG) lens is warranted for a more complete evaluation.

Drug Pricing

We have long believed that some level of drug-price reform will occur in the US, but believe large-scale changes are unlikely. Recent legislative updates have confirmed our view that any measures passed into law may be manageable for the biopharma industry as a whole, and that innovation will still be rewarded. Proposed solutions, which have yet to be signed into law, include capping year-on-year price increases for marketed drugs, modest levels of direct government negotiation for certain drugs, and capping out-of-pocket costs for seniors.

From an ESG perspective, drug pricing is the biggest issue facing the biopharma industry. In our company engagements, we therefore focus our efforts on understanding each firm's pricing strategy. Our research aims to identify companies who grow revenue through the development of innovative drugs that address previously unmet needs and eschew companies reliant on price increases as their primary source of improving returns. While we don't know the exact details of how drug-price reform will be passed into law, we do believe that any sort of resolution may lift the overhang that currently weighs on biopharma valuations, as the market ultimately favors clarity over uncertainty.

Healthcare Reform

We believe wholesale changes to the US healthcare system are unlikely. We don't foresee a future where a version of Medicare for All becomes reality. Rather, we view improvements to the existing infrastructure first introduced by the Affordable Care Act as our base case. In our engagements with healthcare-services companies, we focus on the importance of embracing their social responsibility to address rising costs and improve health outcomes. We believe it's critical to showcase specific metrics aimed at measuring the populations served and types of care consumed, as well as indirect metrics aimed at tracking how people feel about the care they receive.

In addition to the societal benefit of lowering costs, we think emphasizing ESG efforts would go a long way to improve healthcare services' public perception, which could lead to a rerating for the sector.

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Bottom Line

As we enter 2022, we're excited by the opportunity set across the entire healthcare sector. Scientific and product innovation, continued economic recovery, and structural changes to US healthcare delivery systems could provide a boost for the sector. We believe these tailwinds, coupled with more clarity on US healthcare reform, could ultimately benefit long-term investors in the sector.

**For more information about healthcare and investing,
talk to your financial professional.**

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