

PART TWO

NOW

Deciphering election results from an investment management perspective.

WHAT?

Victory Capital and its portfolio of independent investment franchises have been closely following the political winds. This is the second in our two-part series aimed at helping investors understand the recent election and its potential impact on the economy, the markets, and specific industry sectors. We hope you find this commentary informative and helpful.

Victory Capital is an integrated multi-boutique asset management firm with approximately \$51.4 billion in assets under management, as of September 30, 2016. Comprised of 11 autonomous investment franchises, each with an independent culture and investment approach, we're focused on empowering specialist managers to meaningfully advance client outcomes.

Higher ground for healthcare?



Dan Lang, MD, is Chief Investment Officer, *RS Investments Value*.

It's not always easy to distill campaign bombast from true policy, but we continue to believe there are ample healthcare opportunities worth investigating for value-oriented investors.

It's official. Donald Trump will soon be sworn in as the 45th President of the United States. This outcome was a shocker for many investors, as was the Republican sweep of both Houses of Congress. Although we are eager to move beyond all the election posturing to distill the best businesses and buying opportunities, we are encouraged by what appears to be a promising backdrop for one of the largest and most important segments of the U.S. economy. This was obvious in the first days after the Trump victory as so many healthcare stocks rallied strongly.

We are now tasked with anticipating President-elect Trump's likely policy positions to determine how they might impact an enormous industry that represents more than 17% of the country's GDP. It's not always easy to distill campaign bombast from true policy, but we continue to believe there are ample healthcare opportunities worth investigating for value-oriented investors.

For starters, the large secular trends of a growing (and aging) population and rising demand for medicine, devices, and all things healthcare remains unchanged. And now a large cloud that has been hanging over healthcare has been removed. The election virtually ensured that there will be no rampant price controls for drugs and even specific services or procedures. This combination excites us as investors.

That said, here are some general thoughts on potential winners and losers in the emerging healthcare environment, with the caveat that each company needs to be evaluated on an individual basis, which we do by disaggregating businesses and understanding their key drivers:

- > Managed care companies have taken large losses related to their participation in state health exchanges, but things may be looking up for these companies. Without a supermajority, we don't expect the Republican-controlled Senate to fully repeal the Affordable Care Act (ACA), but they may be able to change it significantly. This could create some near-term volatility, but closing loopholes and expanding allowable price bands should provide relief. In a revamped environment, insurers may bear watching, particularly since some HMOs may have limited downside from here as a few have fully exited the individual exchange market.
- > Hospital systems may face initial pricing pressures as their customer base could shrink depending on how the ACA is overhauled. However, the most efficient hospital systems might still be positioned to excel and differentiate themselves.
- > Drug pricing has been a flash point throughout the election, but pharmaceuticals appeared to have avoided the more extreme policy

proposals of negotiated drug prices or other pricing controls. However, it's important to remember that President-elect Trump also encouraged greater competition and the import of cheaper foreign drugs. However, the Republican rhetoric aimed at drug makers was far less worrisome on the whole. Drug wholesalers, retail pharmacies, and pharmaceutical benefit managers (PBMs), and generic drug makers may also be positioned to do well.

> Healthcare IT systems continue to show promise for reducing costs and improving risk management. However, some investors have been skeptical that if hospital systems come under pressure, healthcare IT demand will fall. Perhaps initially, but it's important to remember the larger forces at play. If enterprise-wide care coordination can help move care delivery to the lowest-cost, less-acute facilities, there ultimately will be demand for these technology solutions. Plus, innovative compa-

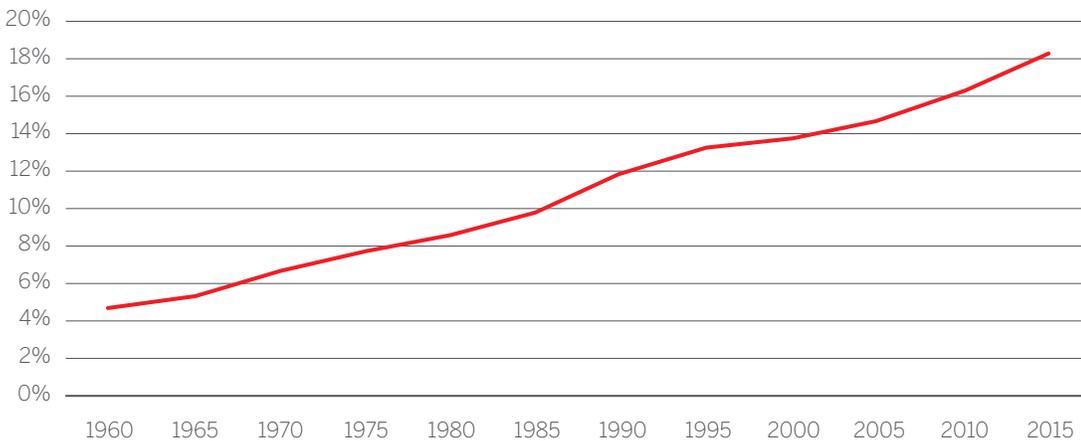
nies providing tele-medicine may still have a major role to play if they can deliver on their potential to lower costs and improve access.

> Life sciences tools are yet another exciting area with many innovations in genomics, diagnostics, gene sequencing, and other areas. Pharmaceutical companies are major users of life sciences tools, and now they may have more funds available to invest. Ultimately, anything that empowers consumers to understand their health profile is likely to see continued long-term demand.

It's easy to generalize, but that can be dangerous. Healthcare is really a catch-all term for a very diverse group of businesses, and it would be naive to think that all healthcare businesses will face tailwinds (or headwinds) under the new administration. Each business opportunity needs to be individually evaluated, and we continue to see healthcare as a rich and fertile area for investment.

A HEALTHY PERCENT OF GDP (from 1960–2015)

The percent of GDP allocated to healthcare.



Source: CMS.gov

Ratcheting up risk management



U-Wen Kok is Chief Investment Officer, *RS Investments Developed Markets*.

Global markets are grappling with an array of questions surrounding the potential impact of a Donald Trump presidency.

As global stock pickers covering an array of sectors, the RS Developed Markets Team uses a very wide lens in analyzing both U.S.-based and foreign multinationals. Given the ongoing quantitative easing in Japan and Europe, not to mention the continuing ramifications of the Brexit vote, one might assume that the U.S. elections were of secondary importance. But that's not the case. The entire world closely follows our political theater.

Clearly the election outcome was not handicapped accurately by pollsters or investors. That was reflected by the significant volatility and wide swings seen in the hours and days following the election. In short, global markets are grappling with an array of questions surrounding the potential impact of a Donald Trump presidency. For example, global markets want to know:

- > Will the new president move aggressively to abolish NAFTA and build a wall (physical and trade-wise) between our country and our southern neighbor?
- > Will the United States cease to fund and participate in NATO, and will that, in turn, undermine the U.S. dollar's default position as the world's reserve currency?
- > Will America cancel its participation in the Paris climate agreement?
- > Is the Affordable Care Act dead?

- > Will President-elect Trump propose tariffs and start a trade war with China?
- > Is Russia our new ally, and will capital flows create new opportunities related to Russia's current sphere of influence?

The truth is we don't know all of these answers just yet. What we do know is that during the course of his campaign, President-elect Trump's statements were often contradictory and strayed from traditional Republican discourse, so it's difficult to predict with any certainty what his policies will be.

While the markets typically dislike uncertainty, we are reminded that episodes of volatility and short-term disconnects from fundamentals are ingredients that astute active managers can exploit. So while we fully expect increased global market volatility to be the norm for the foreseeable future, we also believe our investment strategy and risk management protocols lend themselves to this environment.

Going forward, we believe that it will be important for investors to be nimble, diversified and acutely focused on overall portfolio risk based on a variety of factor exposures, such as geography, currency and sector. This is how we have been operating our portfolio of global equities.

As an example, in the run-up to the election with the prospect of a Clinton presidency, we made subtle adjustments by trimming those healthcare stocks most at risk from potential drug pricing pressure while still maintaining some exposure to this sector. That flexibility and continued exposures may be beneficial now that President-elect Trump appears to have given healthcare stocks a reprieve. Still, we remember that some of the positions President-elect Trump touted on the campaign trail—such as allowing for greater drug imports and encouraging health insurance competition across all state lines—could be headwinds for certain healthcare sub-sectors. Thus, our overall optimism on global healthcare remains tempered.

President-elect Trump is also viewed as a protectionist, and the market consensus has taken a dim view of global trade prospects. The key risks, of course, are new tariffs toward major trading partners, such as China. Nevertheless, we believe it's prudent to maintain some exposure to Asian export-oriented companies.

In general, these times of heightened uncertainty require keen risk management efforts. This can be achieved by careful fundamental analysis and by diversifying across sectors, countries, regions, and currency exposures.

All eyes on financials

The seemingly never-ending and volatile campaign season is over, and investors can move forward, albeit with some uncertainty about what's ahead. The base case for most investors had been a Clinton presidency and a split Congress, with the Republican Party retaining their majority in the House of Representatives. However, much to the pollsters' surprise, we landed with a full Republican sweep of the White House and Congress.

One area that we are watching is the financial sector. The rhetoric around financial services is always sharp

leading up to an election. But given the election outcome, we remain cautiously optimistic on the financial sector as a whole. Still, it will be critical for investors to anticipate the changes and position properly. Here are a few items to consider:

- > The Dodd-Frank Wall Street Reform and Consumer Protection Act is probably here to stay, although we anticipate some possible reforms. Big banks should continue to be able to manage their expenses well enough to offset the costs of all the significant new regulations that followed the financial crisis of 2008.



Erick Maronak is Chief Investment Officer, *NewBridge Asset Management*.

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It's unlikely that the big banks will be forced to break up further, and it is unlikely that the more draconian oversight and rules regarding consumer lending, mortgage origination and servicing, and pricing on credit will become a reality. This is also good news in general, which we believe would be positive for banks, exchanges, credit card issuers and processors.

- > We expect the current Department of Labor rules impacting investment firms to be watered down. However, this might not provide much relief to the financial services companies that have already begun the process for adopting the new rules, which they believed were inevitable. Similarly, we are closely watching the mutual fund industry to see what, if any, additional headwinds it faces in terms of new SEC reforms. And we continue to believe that some of the leading ETF companies with scale and robust infrastructures may continue to benefit from the ongoing shift from mutual funds to ETFs.
- > The tax rules for carried interest, which is income flowing to the

general partner of a private investment fund, is often a flashpoint during elections. The tax preference given to carried interest is viewed as unfair, and it is likely that the new administration may try to change this loophole. If successful, valuations of publicly traded private equity firms and alternative asset managers could be under pressure.

- > Finally, real estate as an asset class could benefit from additional favorable tax changes that the new administration is likely to propose.

For the most part, however, it seems that the financial sector has avoided the proverbial tail events—such as immediate pressure to break up the biggest banks and a much more powerful Consumer Financial Protection Bureau, which a recent U.S. appeals court ruled is unconstitutional because power is too concentrated in the Bureau's sole director. Overall, we believe that the financial sector will benefit from less regulation and lower taxes. The challenge, as ever, is positioning properly on a company-specific basis.

Post-election healthcare check up

While we have new, and unexpected, leadership in the White House, what hasn't changed is the fact the United States still spends more money on healthcare as a percent of GDP than any other country in the developed world.

Healthcare accounts for an estimated one-sixth of our economy and was one of the focal points for the U.S. presidential candidates throughout this election year. During his campaign, President-elect Donald Trump railed on rising insurance premiums

and made a complete repeal and replacement of Obamacare a central part of his agenda, but he gave very few policy details beyond that. While it is plausible that Mr. Trump will be able to put forth this major policy initiative now that he will be working with a Republican-controlled Congress, there are certain aspects of the Affordable Care Act (ACA) that could make a complete repeal more difficult than previously thought. The guarantee of coverage for pre-existing conditions and allowance for young adults to remain on their parents' policy until age 26 are just two parts of the ACA that remain popular with much of the population. Both of these aspects would likely need to be part of whatever plan replaces Obamacare. An expected late push by the current administration to boost enrollment over the next 10 weeks could also make a complete repeal more difficult and costly.

Unlike his opponent, Donald Trump's healthcare agenda has been less focused on drug pricing, and thus his victory has boosted investor sentiment for many of the most innovative pharmaceutical companies. Although Mr. Trump was also critical of prescription drug prices during the campaign, his rhetoric has been far less hostile to drug makers than his opponent. Rather, President-elect Trump has been advocating for increased supply and competition through cheaper imported pharmaceuticals, as opposed to new legislation that directly targets pricing. Still, the near-term investment landscape may be volatile, particularly for manufacturers of generic drugs,

following the Department of Justice's announced investigation of 12 generic drug manufacturers for price collusion.

The ACA's most obvious impact to date has been on healthcare accessibility and an increase in the number of people insured. This has benefitted care providers, particularly hospital and acute care service operators. However, these businesses might be negatively impacted if new legislation hampers future demand and decreases the number of Americans with access to healthcare. This risk bears close watching.

It's important to remember, however, that some larger trends within the industry are bigger than politics and are likely to continue regardless of which party is in control of the White House. More competition from biosimilar drugs is coming, and generic drugs already account for a significant share of the prescription volume in the U.S.

We believe that some new policies could be especially constructive for healthcare. In fact, any legislation that focuses on innovation and mandates that drug companies invest heavily in research could be powerful tailwinds. Such legislation would promote new drug development and favor innovative companies that exhibit strong long-term growth potential. We continue to believe healthcare will yield many exciting investment opportunities in the future.



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Investing involves risk. Principal loss is possible.

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