BB Healthcare

BBH has a differentiated approach to a secular-growth theme…

Update
17 June 2020

Summary

BB Healthcare Trust (BBH) is a differentiated trust within the AIC's specialist Biotechnology & Healthcare sector. The managers invest in companies providing new approaches to what they view as fundamentally broken healthcare systems around the world.

AS we discuss in the **Portfolio section**, the managers employ a highly active approach to stock-picking on a global basis. It's a concentrated portfolio, holding a maximum of 35 stocks which are at times augmented by gearing (to a maximum of 20%). The managers are entirely benchmark-agnostic, therefore the current portfolio has high exposure to the US (94.4%) and no specific bias (in absolute terms) in terms of market capitalisation.

Returns since the December 2016 IPO have been strong, and are ahead of the trust's twin objectives set at the time of launch. BBH has performed significantly ahead of the benchmark, delivering strong absolute returns and outperforming both its UK-listed healthcare peers over three years.

Discount volatility since launch has been muted, thanks to an annual redemption facility which allows investors to exit close to NAV at each year end (30 November). However, as we show in the **Discount section**, over the short term the discount can widen.

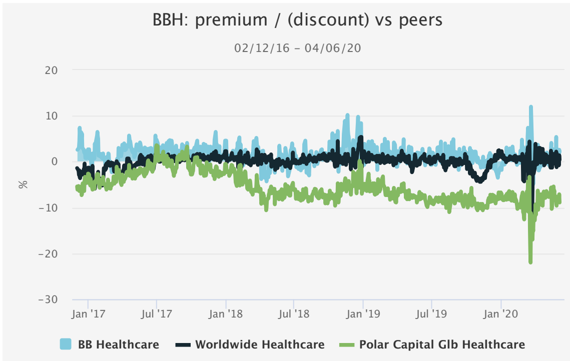
BBH seeks to achieve high total returns over the long term, whilst also paying a dividend to shareholders. The portfolio's organic yield's relatively low, but BBH has so far achieved a consistent dividend through paying it from capital at a rate of 3.5% of the year-end NAV. At the current price this equates to 4.1%. BBH is the only diversified healthcare trust with such a dividend policy, and its yield is thus materially higher than peers'. The board has said it's committed to this high yield for the long term.

Analysts:

William Heathcoat Amory
+44 (0)203 384 8795

Key Information:

Price (p)	157.5
Discount (%)	1.7
OCF (%)	1.16
Yield (%)	3.1
Gearing (%)	5
Ticker	BBH
Market cap (£)	712,530,000



Kepler View

BBH offers a compelling investment proposition, which is expected to benefit from long-term secular tailwinds. Demographics and, more recently, the dire economic constraints governments around the world are likely to find themselves in make this trust a potential candidate for long-term investors seeking to achieve high total returns.

Having launched in late 2016, the trust doesn't have a particularly long track record, although Bellevue Asset Management has more than 25 years' experience of running a concentrated investment-trust strategy with its Swiss-listed BB Biotech vehicle. BBH has come out of the blocks fast, and has put in a strong performance so far. Being a 'newbie' also means that the trust has several shareholder-friendly, and in our view attractive, features: low discount volatility, high dividend security and transparent fees.

Ultimately however, the differentiated and focussed investment thesis as well as the highly active manner in which it is employed should be the main attractions for investors. The NAV has a slightly higher volatility than peers, but as we show in the **Performance section**, the Sharpe ratio shows that the managers are using this extra risk well. On the other hand, discount volatility is likely to be minimised by the annual redemption option.

In conclusion, BBH is not the cheapest in its sector, but in our view is very much worthy of consideration for investors wanting a differentiated high-growth exposure to what we view as a secular-growth story.

BULL
Highly active approach and focussed investment thesis
Good track record so far
Attractive dividend (albeit paid from capital)

BEAR
Limited track record of manager prior to launching trust
Dividend based on NAV, which means it will likely fall if NAV also falls year on year
Gearing and the concentrated portfolio can mean potentially high volatility in NAV

Portfolio

BB Healthcare Trust (BBH) is a relative newcomer to the AIC Biotechnology & Healthcare investment-trust subsector, having launched in December 2016. That said, the trust now has an admirable three-year track record against peers. As the name suggests, BBH aims to invest in the healthcare (rather than biotech) space, but is differentiated from peers in that it is very concentrated, takes a truly multi-cap approach and has a clear investment thesis. In particular, the managers tend to eschew the diversified mega-cap companies that account for the bulk of the weightings in the benchmarks and amongst many of the open- and closed-ended peer-group funds.

This investment thesis – for which the trust was specifically launched – seeks to invest in companies operationally geared towards providing a new approach to what the managers view as fundamentally broken healthcare systems around the world.

In their view, the sector as a whole is underpinned by long-term demographics and structural changes in society. However, it is lost on no one that healthcare systems as they are currently designed are being stretched. The managers believe that simply pumping more money into the existing system is not going to solve the 'care crisis' over the medium to long term, especially when the demographic evolution of developing countries is continually ratcheting up the pressure.

BBH's managers believe that governments and healthcare providers are increasingly recognising the need to 'bend the trend' and adopt innovative new ways to reduce costs and make healthcare more effective. Increasingly this can be done by technology, and by prevention in a number of different areas. The managers recognise that there is more to healthcare than prescription drugs, which only make up 10% of US annual healthcare spend (Source: US Centers for Medicare and Medicaid Services). Instead the managers aim to invest in companies that provide solutions to the key bottlenecks in the healthcare system, which should improve both the system's quality and its effectiveness for users. The team aim to take a longer-term view than the market, aiming to invest for between three and five years, based on five- to seven-year cash flow and earnings outlook. Given the backward-looking nature of indices, the managers take a purely bottom-up approach to investing and pay no heed to any benchmarks.

We show the current breakdown of exposure to the subsectors within healthcare in the chart below. However, all of the companies identified by the manager are specialist, and likely to be in the vanguard of developments shifting towards a new paradigm in healthcare. A couple of examples which were long-standing top-ten positions for the fund until relatively recently, but which have been scaled back in terms of weighting due to considerations around the ongoing coronavirus epidemic and its impact on healthcare-utilisation patterns, are Intuitive Surgical and Align Technology.

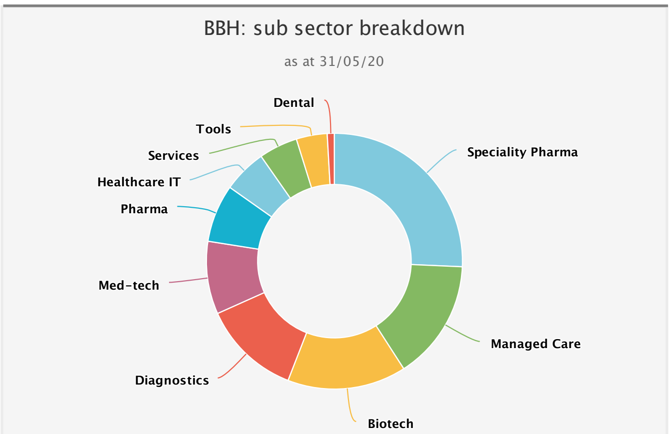
Intuitive Surgical is a world leader in surgical robots. The company's machines enable surgeons to perform keyhole surgery inside people's bodies in ways that have not historically been possible. The results for both patient and healthcare provider are strongly positive. For the patient there is considerably less risk from the procedure, not to mention less scarring. For the provider, significantly less trauma for patients leads to a lower cost in terms of recovery.

Align Technology is behind the Invisalign dental treatment, which in many cases can replace the braces or 'train tracks' often used in teenagers' mouths to straighten teeth. The company is a leader in customised iterative dental treatment and it has seen strong global demand for its product. The Invisalign treatment is simpler and less invasive for patients, but no less effective.

Given their benchmark-agnostic approach, it is perhaps no surprise that the managers do not restrict themselves to only investing in companies in the healthcare sector. They see the entire industry as their universe, including as it does companies within industries such as: pharmaceuticals; biotechnology; medical devices and equipment; healthcare insurers and facility operators; information technology (where the product or service supports, supplies or services the delivery of healthcare); drug retail; consumer healthcare; and distribution.

The recent changes to the portfolio highlight that, whilst BBH has a long-term investment horizon, the managers make full use of their unconstrained approach to alter company and sector weightings over time to try to optimise risk/reward.

Fig.1: Portfolio Breakdown

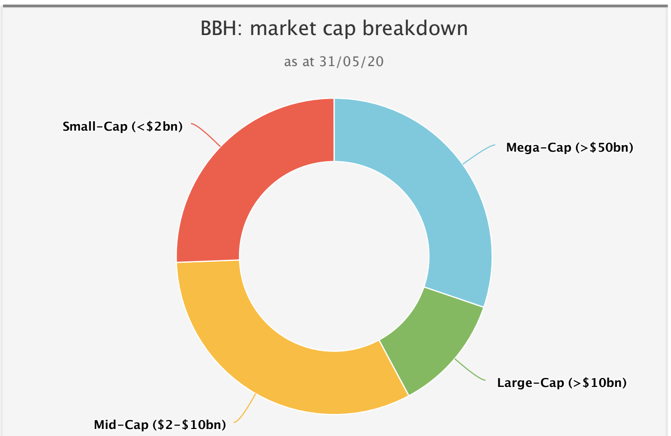


Source: Bellevue Asset Management

The mandate constrains the trust to a maximum of 35 stocks at any one time, and with 29 currently being held, the portfolio might be considered highly concentrated relative to typical equity funds. However, a highly concentrated portfolio is one sign (amongst many) that the manager is highly active, and as such the good relative performance that we discuss in the **Performance section** could be a result of manager skill, rather than beta. Typically, we understand that the US-listed businesses are likely to feature heavily, given the strong medical and technology ecosystem that exists there.

Currently 94.4% of the portfolio is listed in the US, 3.1% in Europe and 2.5% in Asia. With a bottom-up approach, it is perhaps not surprising that the trust has exposure to companies of all sizes, as shown in the chart below. Within this, the managers typically limit themselves to companies which have a market capitalisation of greater than $1bn at the time of investment.

Fig.2: Portfolio Breakdown



Source: Bellevue Asset Management

As we note in the **Gearing section**, BBH is currently cautiously positioned, with net cash of 4.9% as at 31/05/2020. Generally the managers expect to be fully invested at all times, between a range of a maximum of 20% geared and a minimum exposure of 95% invested (i.e. 5% cash), and they aim to run a long-term average gearing in the high single-digit range.

The caution expressed by the current net cash level is also reflected in the holdings, with the managers having pivoted out of more highly valued investments (companies whose exposure to special medical procedures and essential medical services has been pushed much higher by investors thanks to the COVID-19 pandemic), and into more attractively valued (from a risk/reward perspective) companies.

The team have recently ramped up exposure to various companies exposed to US health insurance. Humana is the leader in US health insurance for over-65s. Anthem has a changed management team, and is benefitting from a virtuous circle of cutting costs and gaining market share. Evolent Health provides essential healthcare software for insurance companies. Bristol Myers Squibb is a rare venture into mega-cap pharmaceuticals, mainly on valuation grounds. The managers believe the company is amongst the cheapest of all of its peers, despite what they see as some intriguing pipeline opportunities in oncology and inflammation. Some exposure to larger companies can also be useful from a portfolio-construction perspective, in order to mitigate 'factor' risks – recognising that from a portfolio context it is sometimes unwise to have an entire portfolio exposed to high-growth opportunities.

Top Ten Holdings As At 31/05/2020

COMPANY	%
Esperion	7.7
Bristol Myers Squibb	7.3
Anthem	7.1
CareDx	4.9
Charles River	4.9
Insmed	4.7
Hill-Rom Holdings	4.7
Humana	4.6
GW Pharmaceuticals	4.4
Evolent Health	4.3
TOTAL	**50.3**

Source: Bellevue Asset Management

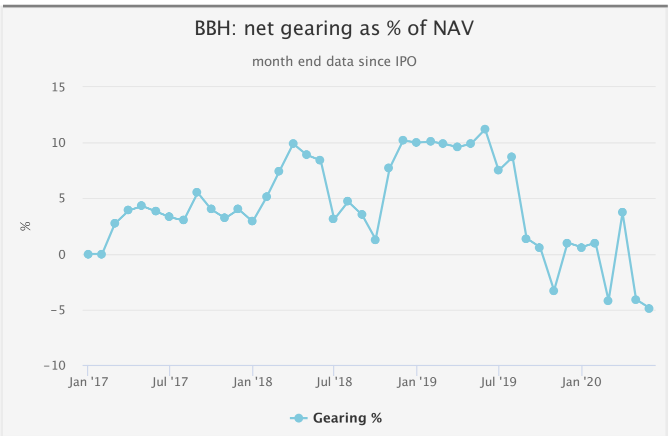
In terms of outlook, the managers remain sanguine. In the immediate term, they observe that markets are being driven by a macro narrative, about which they have little informational edge. They believe that a continued cautious approach seems warranted, but observe that the long-term structural opportunity for capital returns in healthcare is undiminished, which is not something that one can say for large swathes of the wider economy at this stage.

Gearing

BBH is expected to be fully invested at all times within the range of a maximum of 20% gearing and 5% net cash. Over time, as the graph below illustrates, the trust has typically been modestly geared. The maximum level of gearing so far deployed has been 12%.

The managers see gearing as an opportunity to improve returns over time, and choose to deploy leverage based on bottom-up opportunities, as well as on top-down views. Reflecting their current caution on the market's rapid 'post-COVID' rebound, the managers have net cash of c. 4.9% (as at 31 May 2020).

Fig.3: Gearing



Source: Morningstar

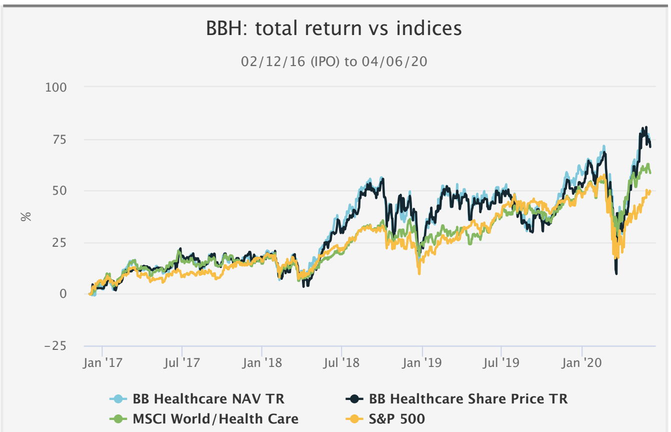
Returns

BBH was first floated on the London Stock Exchange on 2 December 2016. The trust's aim is to provide capital growth and income over the long term. More specifically, its return objectives are:

- To beat the total return of the MSCI World Health Care Index (in sterling) on a rolling three-year period
- To seek to generate a double-digit total shareholder return per annum over a rolling three-year period

So far, there has been only one rolling three-year period since BBH's launch three and a half years ago. However, what is clear from the graph below, which shows NAV and share-price total returns since IPO, is that performance has been ahead of the healthcare index over this time. The only exceptions to this have been a few short periods such as May 2018, and in the depths of the most recent equity-market sell-off. Given a large chunk of the portfolio is listed in the US, we also compare the trust with the S&P 500, and find that both the healthcare sector and the trust have been strong performers relative to this broad US equity index.

Fig.4: Total Returns Since IPO



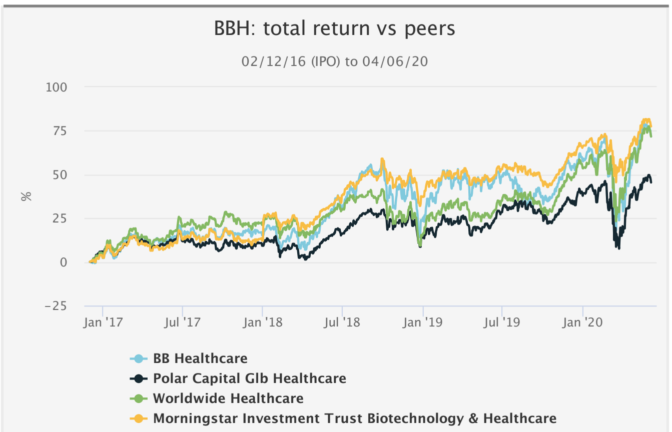
Source: Morningstar

The trust also has an objective of achieving a double-digit total return per annum over a rolling three-year period. We calculate that as at 04/06/2020, the trust has generated a total return of 16.7% per annum on an NAV basis, and 16.5% per annum on a share-price basis – which is well ahead of the 10% target. Clearly, if the market hadn't recovered over the last few months, BBH would not be ahead of its target. However, our analysis shows that only a short period of between 12 March and 23 March, BBH has returned less than 10% per annum on a rolling three-year basis. With what in our view is quite an impressive target over the long term, we think it is notable that BBH has performed ahead of the target so far, and it is also notable how far ahead of the target it currently is.

The AIC's Biotechnology & Healthcare investment-trust subsector consists of eight trusts, three of which are BBH and its two direct competitors. The others – such as International Biotechnology, BB Biotech (another Bellevue-managed vehicle) and Syncona – offer rather different (and by some definitions, more focussed) exposures. BB Biotech and Syncona are both well north of £1bn and hence skew the weighted average index.

So whilst the index has done marginally better than all of the healthcare trusts, it is not necessarily a fair comparison, especially on a risk/reward basis. In the graph below, which compares BBH to its two closest peers, we can see that BBH has been ahead of Worldwide Healthcare (WWH) for much of its life, with the race only becoming more evenly balanced in the past few months. Both trusts have done significantly better than Polar Capital Global Healthcare (PCGH). We observe that BBH has a more concentrated portfolio than these other two trusts, which may be the reason that it has higher NAV volatility (23.8% vs WWH's 17.3% and PCGH's 19.2% over three years, according to Morningstar).

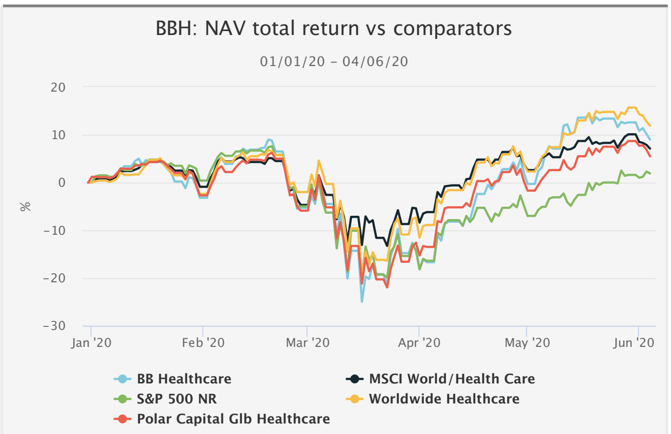
Fig.5: Peer-Group Nav Total Returns



Source: Morningstar

In the absence of a very long track record to analyse, the most recent few months may be of interest to investors. The higher volatility over the last three years relative to that of peers (and the benchmark) shows up in the calendar-year returns to date. It is observable that BBH was ahead of the competition by the time markets peaked, before falling by more than peers did, and then recovering all the lost ground and more. In our view, this is something to be aware of, but is likely to be a result of the combination of having a very active manager which is benchmark-agnostic as well as a concentrated portfolio. Over the long run, such a portfolio might be expected to have a higher volatility, but also (assuming the manager is able to add value) to create outperformance of the benchmark. According to Morningstar, BBH's Sharpe ratio over three years is 0.59, marginally behind WWH's 0.61, but ahead of PCGH's 0.42. This shows that the managers are using this extra volatility to good effect in terms of risk-adjusted returns.

Fig.6: YTD NAV Total Returns



Source: Morningstar

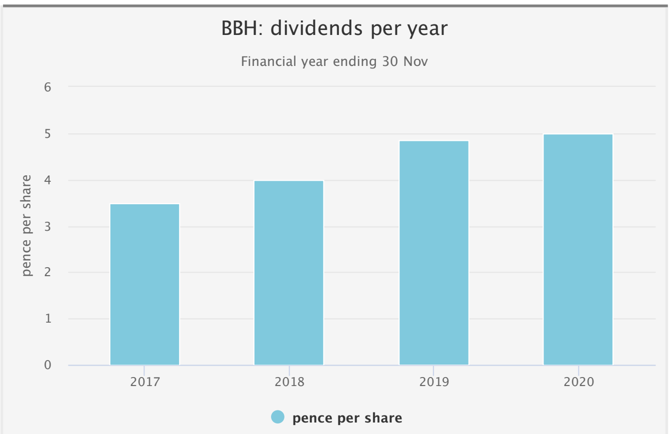
Dividend

BBH has a total-return objective, with a proportion of returns provided to shareholders in the form of a dividend. We understand that the running yield of the portfolio is relatively low (c. 0.5–0.6%) in view of the growth characteristics of a majority of the underlyingly companies. The costs of running the trust mean that effectively none of the income is therefore available for distribution as a dividend. However, BBH targets a dividend payout equal to 3.5% of the prior financial-year-end NAV. This dividend is funded from capital reserves, created by cancelling the share-premium account and creating special distributable reserves out of which dividends can be paid.

The graph below shows that the dividend has been steadily increasing every year, and it is worth noting that it is paid in two equal instalments. The board calculates a dividend target for each following year based on 3.5% of the year-end NAV (at 30 November), and this figure is published shortly after the year end. This gives shareholders a good amount of visibility, and being paid from capital, gives them reassurance at times like this when sources of dividend income are looking shaky elsewhere. That said, because the dividend is calculated as a proportion of the year-end NAV, it is possible that the dividend could fall if the NAV has also fallen. Whether the board chooses to override this and provide a progressive dividend in such an eventuality is so far unproven, although we are told that it has been discussed by the board, and the merits of maintaining a progressive policy by paying at least a flat dividend year on year are well understood.

The board is currently targeting 5p per share for the current financial year, which at the current share price would yield 3.6%. The first instalment of 2.5p will be paid in August 2020. There is also the option to elect from a scrip dividend, for those who would prefer it.

Fig.7: Historical Dividends



Source: BB Healthcare Trust, 2020: target

Management

Paul Major and Brett Darke co-manage BB Healthcare Trust. Paul has been a healthcare investment specialist for nearly 20 years. For the majority of his career, he has worked as a sell-side research analyst. Initially at UBS, he then worked at Redburn for 13 years. He joined Bellevue in May 2016 in his first buy-side role in order to launch BB Healthcare. In September 2017 Paul was joined by Brett Darke, who similarly has a medical and healthcare background, having previously spent 11 years on the buy side at TT International. The two have known each other professionally for a number of years and they both work from London. BBH is the only fund they run and is their sole focus.

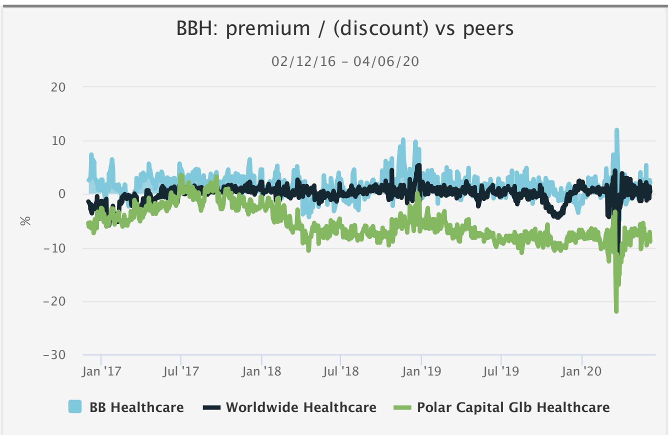
Bellevue Asset Management is a Swiss asset-management company listed on the Swiss stock exchange, which has grown from being a specialist healthcare-investment boutique to providing many other strategies for clients around the world. In total, Bellevue now manages $10bn, of which c. 70% is in the healthcare sector and related sectors. The firm has another investment trust – the Swiss-listed fund BB Biotech (BION). Paul and Brett can draw upon the experience and resources of a wider team of 18 healthcare investment professionals, managing 17 different healthcare-focussed strategies.

Discount

BBH aims to minimise discount risk for shareholders and ensure that over anything other than the short term the trust does not trade on a material discount to NAV. In order to manage the discount, the trust has an annual redemption facility for 100% of shares in issue at year end. The redemption point is the last business day of November each year.

By the last redemption point of 30 November 2019, the board received redemption requests for 402,260 shares (representing 0.09% of the shares in issue at that time). At that time (and as in prior years), all of these shares were matched with buyers and so there was no change to BBH's share capital. In our view, this is a strong discount-control mechanism, which is reflected in the graph below. At the same time, the discount can blow out over the very short term with this sort of discount-control mechanism. This was witnessed during the very volatile markets during March this year, despite the trust continuing to make daily NAV announcements. According to Morningstar, the discount widened to c. 10% between 17 and 19 March 2020, before narrowing back to a premium on 23 March. BBH has been issuing shares since then on a regular basis at a small premium to NAV, and the shares currently trade on a premium of 2%.

Fig.8: Discount



Source: Morningstar

Charges

BBH pays a flat management fee of 0.95% per annum on the market capitalisation of the trust. This aligns the managers with shareholders, and helps incentivise them to prevent the shares trading on a discount for any period of time. It also deals neatly with the question of gearing, with the managers not incentivised through the fee to employ gearing (which might be the case if fees were based on gross assets). It is worth noting that the trust's board is also remunerated in shares, and these are locked up for a minimum period of three years after issuance.

There is no performance fee payable. BBH is a relatively large trust, with net assets of c. £700m at 04/06/2020. As such the OCF of 1.19% compares favourably with the simple average of the peer group of 1.33%. That said, Worldwide Healthcare (with net assets of c. £2bn) has an OCF of 0.9% (albeit with a performance-fee element as well). If BBH continues to grow, we believe the best way for it to remain competitive would be if the board were to secure a tiered management-fee structure, a feature which has become much more prevalent in the investment-trust universe in the past few years. The KID RIY is 1.35%.

ESG

Bellevue Asset Management is a signatory to the UN Principles for Responsible Investment (UNPRI). The company has a centralised ESG team who work with managers on each strategy to integrate ESG analysis into all aspects of the investment-management process. As such, Paul and Brett take ESG factors into account when making investment decisions. This is especially relevant given their preference to invest on a long-term (three- to five-year) time horizon, where ESG risks can weigh on the long-term sustainability of a company.

Given the emphasis on healthcare, we think BBH could be positioned in portfolios geared towards the social aspect of ESG. The underlying thesis of the trust is well aligned to this – the managers aim to invest in companies providing new approaches to what they view as fundamentally broken healthcare systems around the world. However, the team do not have a negative screen for investments, and so very strict ESG mandates may not be able to include BBH in portfolios. That said, we think many of the companies the trust invests in are helping to bring more affordable healthcare to more people, and it could therefore suit other investors who have a less strict definition of ESG.

Disclaimer

This report has been issued by Kepler Partners LLP. **The analyst who has prepared this report is aware that Kepler Partners LLP has a relationship with the company covered in this report and/or a conflict of interest which may impair the objectivity of the research.**

Past performance is not a reliable indicator of future results. The value of investments can fall as well as rise and you may get back less than you invested when you decide to sell your investments. It is strongly recommended that if you are a private investor independent financial advice should be taken before making any investment or financial decision.

Kepler Partners is not authorised to make recommendations to retail clients. This report has been issued by Kepler Partners LLP, is based on factual information only, is solely for information purposes only and any views contained in it must not be construed as investment or tax advice or a recommendation to buy, sell or take any action in relation to any investment.

The information provided on this website is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject Kepler Partners LLP to any registration requirement within such jurisdiction or country. In particular, this website is exclusively for non-US Persons. Persons who access this information are required to inform themselves and to comply with any such restrictions.

The information contained in this website is not intended to constitute, and should not be construed as, investment advice. No representation or warranty, express or implied, is given by any person as to the accuracy or completeness of the information and no responsibility or liability is accepted for the accuracy or sufficiency of any of the information, for any errors, omissions or misstatements, negligent or otherwise. Any views and opinions, whilst given in good faith, are subject to change without notice.

This is not an official confirmation of terms and is not a recommendation, offer or solicitation to buy or sell or take any action in relation to any investment mentioned herein. Any prices or quotations contained herein are indicative only.

Kepler Partners LLP (including its partners, employees and representatives) or a connected person may have positions in or options on the securities detailed in this report, and may buy, sell or offer to purchase or sell such securities from time to time, but will at all times be subject to restrictions imposed by the firm's internal rules. A copy of the firm's Conflict of Interest policy is available on request.

PLEASE SEE ALSO OUR TERMS AND CONDITIONS

Kepler Partners LLP is authorised and regulated by the Financial Conduct Authority (FRN 480590), registered in England and Wales at 9/10 Savile Row, London W1S 3PF with registered number OC334771.