

March 2010

Dear Valued Investor:

On Tuesday March 23, President Barack Obama signed into law a major change to the U.S. health-care policy that will impact every American and affect one-sixth of the economy. The social benefits of these policies we will leave to others to debate, our focus is what this means for the markets.

Within the Health Care sector the impact is mixed. There are three categories of companies affected by the legislation with the Health Care sector. In general:

- The Managed Health Care Industry is negatively impacted by extensive new regulation limiting profitability.
- The Pharmaceuticals, Biotechnology, Health Care Equipment, and Health Care Facilities industries benefit from broader health care coverage leading to greater volumes, but these positives are offset somewhat by Medicare reimbursement cuts and higher industry excise taxes.
- The Health Care Services and Health Care Distributors industries benefit from broader health care coverage leading to greater volumes with no direct cuts to pay for them.

Much of the impact has already been priced in to the stocks in the sector. In the near-term, Health Care sector investors are likely to be relieved that the period of uncertainty is now over.

A potentially negative longer-term outcome for the broader market stems from the tax and deficit impacts of the legislation. The legislation imposes a new 3.8% tax on investment income. This lowers the after-tax return on investments. It also adds a 0.9% tax on wages for those earning more than \$250,000, set to take effect in 2013. The macroeconomic impact that may be most significant is the potential to increase the deficit despite the tax hikes.

Two important facts are necessary to understand the concern evident in the markets over the deficit impact of the legislation:

- The average cost of a family health insurance policy offered by employers was \$13,375 in 2009, according to the Kaiser Family Foundation and the Health Research & Educational Trust. On average, employees pay about 20% of premiums with the employer making up the rest (an average of \$10,700 per employee).
- The legislation establishes new insurance exchanges for the purchase of health insurance by those who do not have insurance offered through their employer. Under the exchange, the cost of a policy would be subsidized by the taxpayers for individuals and families with incomes up to 400% of the poverty level. This means that a family of four with the national average income of about \$70,000 (at 317% of the poverty level of about \$22,000) would have their spending capped at 9.5% of income which would be about \$6,650. The other half of the cost of the insurance would be picked up by taxpayers.

The Congressional Budget Office, the agency that tabulated the budget impact of the legislation, estimates that about 25 million people would take advantage of the exchange to obtain subsidized health insurance by 2019. However, if employers that currently offer health insurance drop their coverage in order to save \$8,700 per employee (\$10,700 less the \$2,000 penalty for employers with more than 50 employees that do not provide coverage) and shift that cost to the taxpayer, the number of people getting subsidized health insurance could surge well beyond the budgeted 25 million. After all, there are 127 million people with incomes between 150% and 400% of the federal poverty level. If a large percentage of these 127 million people were shifted to the exchange, with a typical annual subsidy around \$5,000-\$6,000, the annual cost of the legislation would soar

and significantly worsen the budget deficit. While all of the potential effects of the health care legislation are unknown, market participants may focus on the risks.

While the passing of the uncertainty surrounding the health care legislation may be welcomed by many investors, it could contribute to higher interest rates as fears of the rising deficit combine with rebounding economic activity and excess money provided by the Federal Reserve. We expect Treasury yields to rise this year so we would caution against government bonds.

As always, we encourage you to contact your financial professional if you have any questions.

Best regards,



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Health Care Sector: Companies are in two main industry groups—Health Care equipment and supplies or companies that provide health care-related services, including distributors of health care products, providers of basic health care services, and owners and operators of health care facilities and organizations. Companies primarily involved in the research, development, production, and marketing of pharmaceuticals and biotechnology products.

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