A Closer Look at Health Care

– Danke Wang, Portfolio Manager

Currently, Health Care is one of the top sectors in the Pacer US Cash Cows 100 ETF (COWZ), occupying ¼ of the fund's holding, the highest weighting since the fund's inception in 2016.

A sector with such a heavy weighting in one of our most popular funds deserves a closer look. Here's what we found:

Key takeaways:

1. Fundamental growth, not multiple expansion, has been the driver of the Health Care sector's investment return.
2. Thanks to investment in intangible assets, the Health Care sector provides strong free cash flow generation and high free cash flow yield, revealing opportunities that investors can take part in.
3. The sector delivers both growth and stability with attractive valuation.

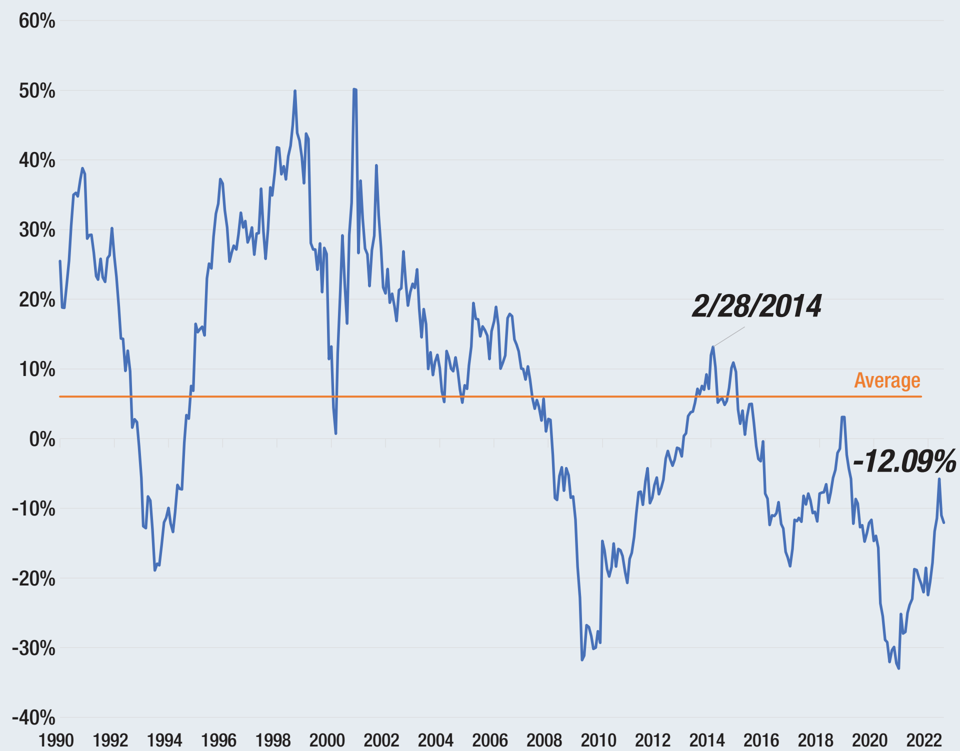
Health Care Out of Favor During the Past Decade?

Since the end of the 2008 financial crisis, there has been a rally of growth stocks led by the Technology sector.

But things have been different among Health Care names. Until the end of 2021, Health Care had seen almost no multiple expansion from 2014 to 2021. Meanwhile, the market's (S&P 500) forward P/E increased by more than 40%, and the valuation for the Technology sector was up almost 90% on a forward earnings basis. Due to this year's sell-off, the market's valuation has come down (as of 8/31/2022), but Health Care still trades at a considerable discount.

Source: Bloomberg

Health Care Forward P/E relative to S&P 500
12/31/1990 - 8/31/2022



PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. YOU CANNOT INVEST IN AN INDEX.

Health Care's major headwind is drug prices, which have been under considerable pressure since the middle of the 2010s. Specifically, there is a high degree of risk regarding legislation passing to curb drug prices. At the same time, Health Care names are facing a "patent cliff," or a loss of market share and revenue as patents expire and generic drug challenges emerge. This pessimistic sentiment has been haunting Health Care companies resulting in low valuation levels.

Despite the uncertainty on drug policy and revenue growth, the Health Care sector has maintained strong fundamentals. During this period of muted multiple expansion, the sector delivered 152% cumulative earnings growth, not far behind the 173% growth from the Technology sector. And Health Care's 146% Free Cash Flow growth is even slightly better than Technology names (144%).

Despite all the pessimism Health Care has faced during this time, the sector has churned out a 140% total return entirely driven by fundamental growth — not multiple expansion.

2/28/2014 - 12/31/2021	S&P 500 Health Care	S&P 500 Index	S&P 500 Info Tech Index
Forward P/E change	**3.36%**	43.72%	89.65%
PE change	**-5.14%**	41.03%	88.15%
Earnings growth	**152.47%**	81.75%	172.90%
FCF growth	**146.69%**	41.80%	143.55%
Price return	**139.48%**	156.32%	413.44%

Source: Bloomberg

Bearish investors' concerns that suppressed the sector's multiple are justified to some extent, but there are a couple of things those investors might have overlooked:

1. Initiating policy changes is neither quick nor easy, especially with the complex political landscape and the strength of biopharma lobbying groups (even the Medicare drug price negotiation provision will not take effect until 2026, so the bill may only have a limited impact on growth).

2. Health Care companies can power future growth through their drug pipeline, innovation, and acquisitions, which may secure promising returns and profitability for investors.

Moving forward, biopharma companies should continue to have healthy business fundamentals, with minimal downside earnings risk compared to the broader market (though it is not guaranteed).

Is there anything else to like about the Health Care sector?

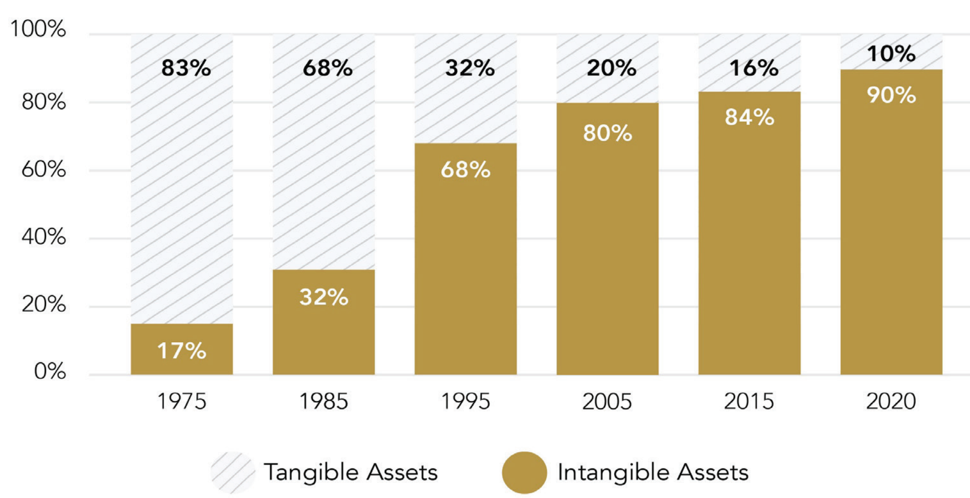
Yes.

Intangible Assets and Free Cash Flow

In the past two decades, more US companies are relying on a capital-light business model, differentiating their services or products by design, innovation, research development and intellectual property.

Source: Ocean Tomo, LLC Intangible Asset Market Value Study, 7/1/2020: https://www.oceantomo.com/intangible-asset-market-value-study/

COMPONENTS *of* S&P 500 MARKET VALUE



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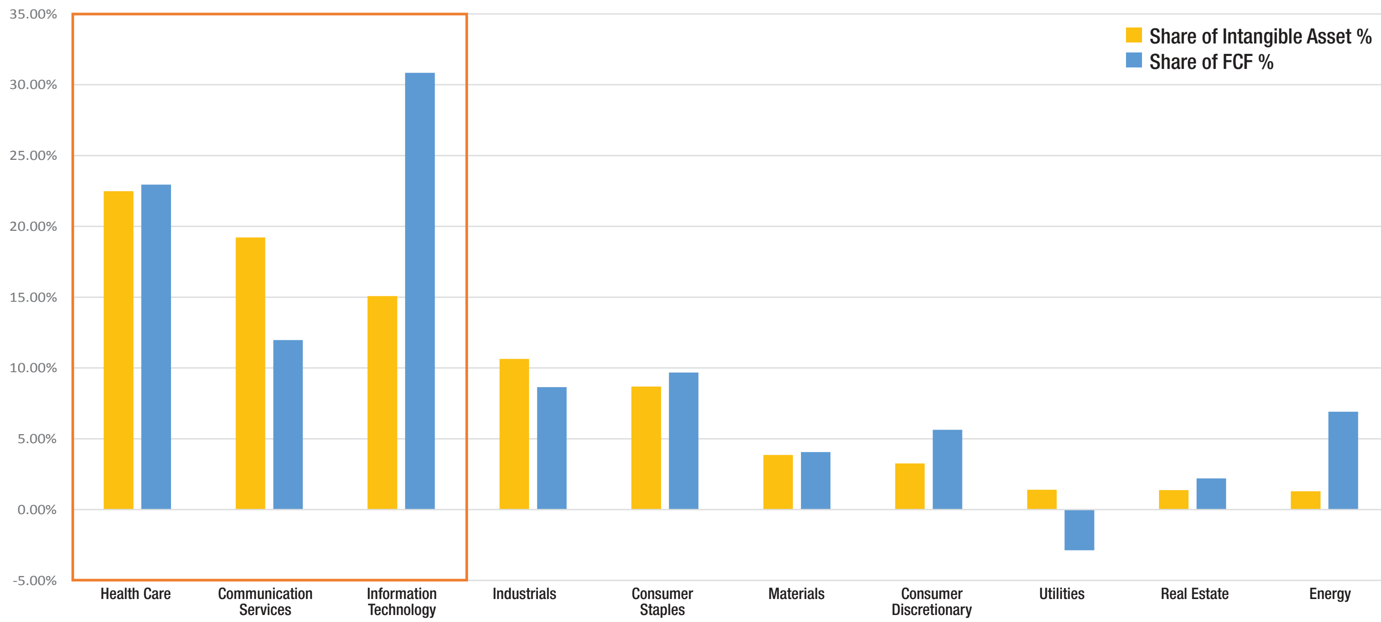
With massive investment in drug development, Health Care's source of cash flow comes from many intangible assets. Among S&P 500 companies, Health Care ranked #2 on the percentage share of aggregate Free Cash Flow (FCF) and #1 on the share of intangible assets[1], comparatively technology ranked #1 and #3, respectively.

[(1)]Intangible assets booked on the balance sheet

S&P 500 (ex Financials) Share of Intangible Asset vs FCF
as of 12/31/2021



Source: Factset

FCF and FCF Yield
The Health Care sector's cash flow generation strength is reflected in the total FCF aggregate dollar amount and in the FCF generated in every dollar of sales (FCF Margin).

Larger companies or sectors tend to have a larger FCF dollar amount. So FCF margin paints a more complete picture regarding the strongest free cash flow generators.

Based on FCF margin, the top two industries within the Health Care sector are Biotechnology and Pharmaceutical, and both sectors are also overweighted in COWZ. Particularly, Biotechnology is producing the highest FCF margin among S&P 500 industries. At the same time, Biotech names trade at an 8.50% Free Cash Flow Yield, implying that the market is skeptical of the industry's elevated level of profitability.

The market seems unconvinced these companies will continue to generate high FCF in the future, despite their strength in research and development and their uncanny ability to cash out intangible assets.

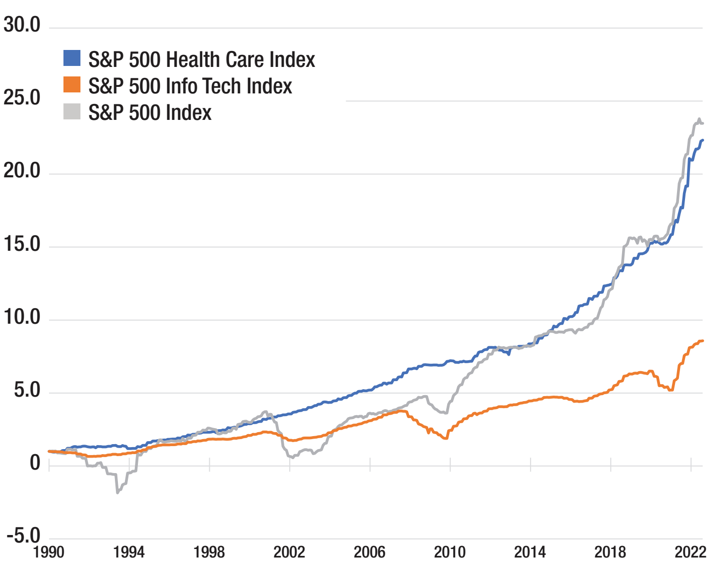
Top 10 Industries in S&P 500 ranked by FCF margin as of 8/31/2022	Free Cash Flow Yield (%)	Free Cash Flow Margin (%)
Biotechnology	***8.50***	***37.59***
Tobacco	7.04	37.56
Software	3.30	28.96
Interactive Media & Services	5.62	24.89
Pharmaceuticals	***5.69***	***23.53***
Technology Hardware Storage & Peripherals	4.28	22.62
Communications Equipment	5.71	22.30
IT Services	3.79	20.58
Semiconductors & Semiconductor Equipment	3.57	18.08
Road & Rail	3.29	17.84

Source: FactSet

Growth

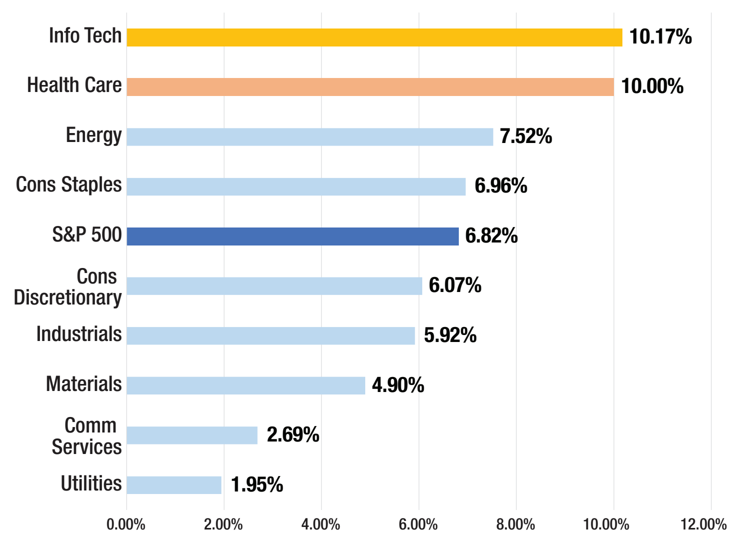
As previously mentioned, Health Care has delivered growth comparable to Technology in the past decade. And over the long run, it has been one of the fastest growing sectors in the market.

Earnings Growth
12/31/1990 - 8/31/2022



Source: Bloomberg

Annulized EPS Growth
12/31/1990 - 8/31/2022



Source: Bloomberg

But valuation-wise, the Health Care sector only trades at 15.3X on a forward earnings basis. Meanwhile, the Tech sector's forward P/E is 22. Health Care's valuation discount compared to the Technology sector is within the lowest quintile in history.

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Stability

Large cap Health Care names are well-positioned in periods with high recession risk.

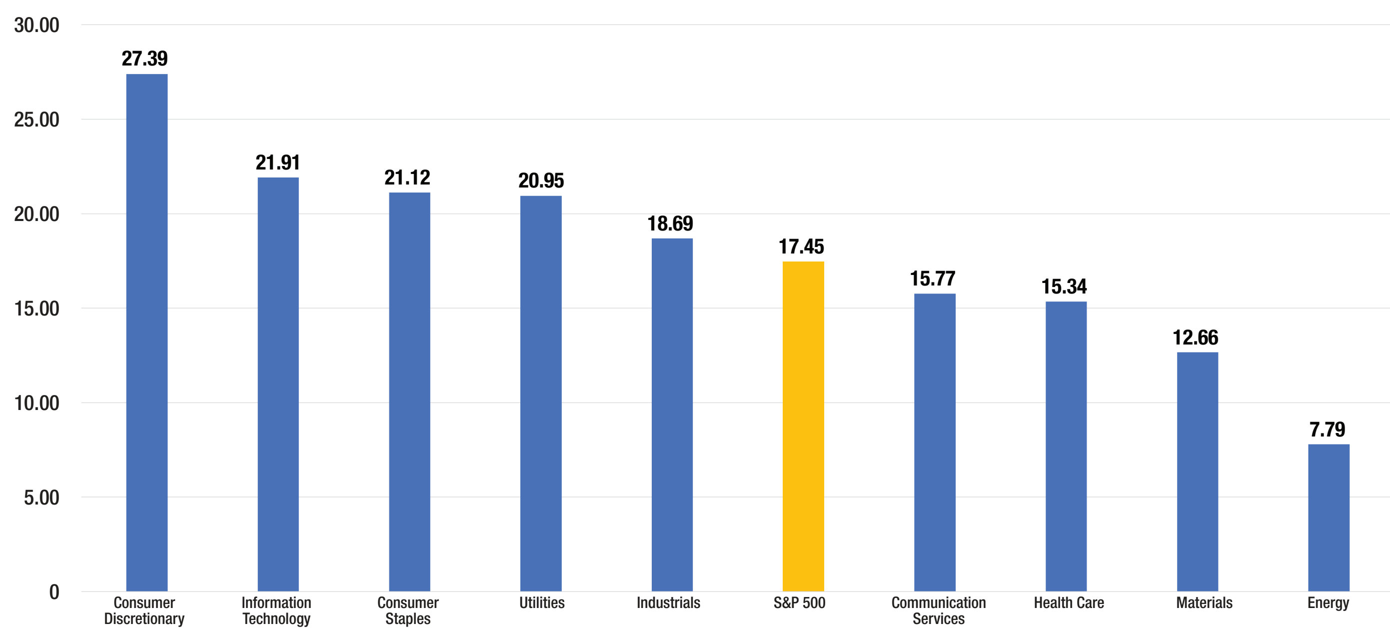
Health Care is traditionally seen as a defensive sector along with Consumer Staples. Historically, the Health Care sector has demonstrated low earnings volatility over the long run and has had the lowest percentage of negative earnings growth periods since 1990.

12/31/90 - 8/31/22	Health Care	Cons Staples	Industrials	Info Tech	S&P 500	Cons Disc	Utilities	Energy	Materials	Comm Services
Volatility of YoY Earnings Growth	8.52%	7.14%	23.34%	568.75%	18.12%	77.78%	12.92%	636.93%	54.14%	25.77%
% of Negative Earnings Growth Period	6.84%	12.63%	21.05%	23.16%	24.74%	25.00%	33.68%	39.47%	43.68%	44.74%

Source: Bloomberg

Investors chase after defensive sectors such as Consumer Staples when facing recession risk and market volatility, pushing their valuation up. For context, the forward P/E of the Consumer Staples sector has averaged around 20 during the past two years, and now the sector is among the most expensive in the S&P 500. Meanwhile, as noted throughout this piece in other scenarios, Health Care (despite its defensive nature) traded at a discount.

Forward P/E
as of 8/31/2022



Source: Bloomberg

The Pacer US Cash Cows 100 ETF (COWZ) invests in the top 100 highest Free Cash Flow Yielding companies within Russell 1000. The portfolio's overweighting in the Health Care sector reflects where free cash flow is generated in the market and where such profitability is undervalued. With downward pressure on equity valuations, Health Care is better positioned than most other sectors.

PACER US CASH COWS 100 ETF
COWZ

Pacer US Cash Cows 100 ETF

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The Pacer US Cash Cows 100 Index was released on 12/8/16.
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Enterprise Value (EV): A company's market capitalization adjusted to eliminate any capital structure bias (i.e. by adding debt and subtracting cash or cash equivalents)
Free Cash Flow Yield (FCF/EV): Measures a company's total free cash flow relative to its enterprise value. This is an internal statistic and does not constitute investor yield.
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