ALTMAN INVESTMENT MANAGEMENT

INDUSTRY RESEARCH INSIGHTS: HEALTHCARE

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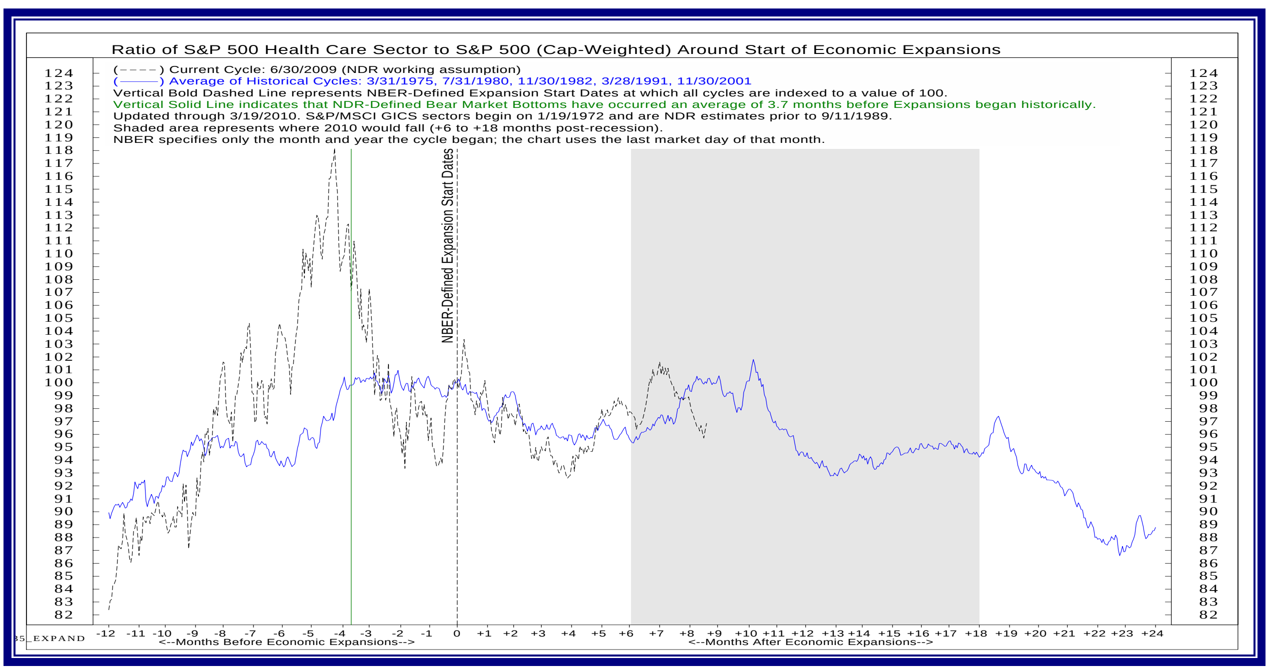
"CLOSE UP" - THE HEALTHCARE REFORM BILL

- ***Earlier this month, the House of Representatives completed a two-step process and successfully passed comprehensive healthcare legislation. Given its significance, we've listed the forthcoming events along with the investment implications of passage.***

- The Healthcare Reform Bill, passed by the Senate and the House, and signed by the President on March 23rd – is now law. Although the House passed the Senate bill, passage was conditioned upon both the House and Senate passing a second bill which "fixes" the Senate legislation, modifying the new law. More specifically, the reconciliation fix expands subsidies, closes the Medicare prescription "doughnut hole", significantly reduces the tax on high value benefit plans while increasing cuts to Medicare Advantage and imposing a new 3.9 percent payroll tax on capital gains income for taxpayers with more than $250,000 of income.

EXHIBIT I

Healthcare Sector Capital Weight at the Start of Economic Expansions



Source: Ned Davis Research

- Now that the President has signed the original Senate legislation, the Senate can begin to consider the "reconciliation fix" bill. We expect this to occur later this month. It is important to note the rules governing reconciliation, which protect the Senate from a 60-vote filibuster, are very strict and generally confined to tax and spending initiatives. As such, we would expect two major issues that will challenge the bill in its current form.

- First, the opposition will seek to throw out the entire reconciliation bill for violating the 1974 Budget Act which prohibits Social Security from being affected in a reconciliation bill. If this effort is successful, the reconciliation fix would not be considered and the original Senate bill becomes the law. It is unknown at this time how this challenge will fare.

- Second, the opposition is expected to raise objections to any provision that does not directly affect revenues and spending. The importance of the line item challenges should not be underestimated. Should one change be made to the reconciliation bill in the Senate, the legislation will need to go back to the House of Representatives for a vote after the Senate passes the bill. To overcome a procedural challenge, the Senate needs 60 votes and the Republican opposition will ensure that level is not attainable, and the probability of a change is high. We expect House members to take heat in their districts following the passage vote and a re-vote, while expected to pass, is not something that members will desire. We would not expect members to shy away after casting their votes, but the scenario does create some minor risks to full passage.

- Finally, there are some questions about whether the Senate has the stomach to pass the fixes via reconciliation. This became even more complicated with the last minute addition to eliminate the private student lending program FFELP. Reconciliation requires just 51 votes for passage but the number has been dwindling due to the student lending provision and the removal of some state deals. Moreover, the secrecy surrounding the Senate letter promising changes has raised even further questions. For the time being, we expect the Senate to pass the reconciliation bill but the events of the coming week warrant close attention.

- Yet, the biggest hurdle was just cleared with passage of the bill and now that this is clear, the probability of full passage has increased. Here is how we see the investment implications:

Investment Focus:

- ***The Case for Investment Overweight*** - Since the release of the President's budget in February 2009, healthcare stocks have traded with a great degree of legislative uncertainty. Last night's passage should clear nearly all of that uncertainty and serve as a positive catalyst. Healthcare appears to have broken ranks from the other defensive sectors in the market, and in January of this year was the only defensive sector that traded above its 50-day and 200-day moving averages.

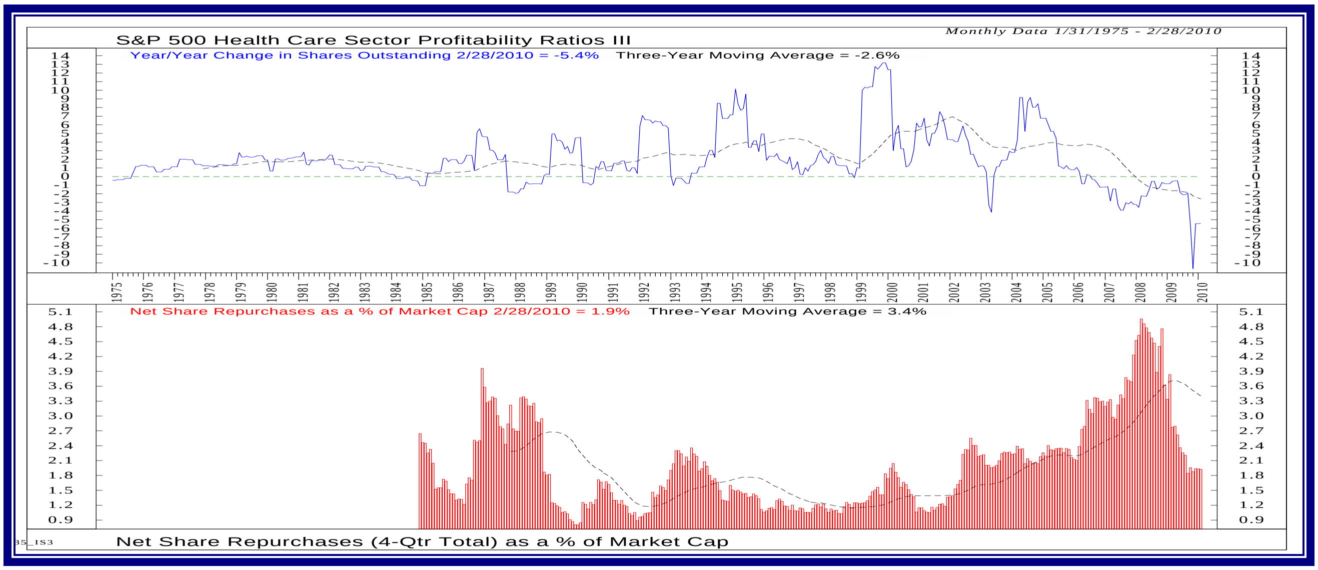
- ***Why the strength in the sector at a time when defensive shares in general have been laggards?*** The stalemate over healthcare reform has certainly played a role, and its imminent resolution is likely the reason for the recent surge in share prices. However, after closer scrutiny, the healthcare industry has the potential to break away from the other defensive groups in the ensuing months. According to Ned Davis Research, the relative strength is broad based and not driven by one particular healthcare industry - giving us greater confidence to increase our participation. Certainly if defensiveness comes back into the market in the latter half of the year, a move to overweight may be warranted. Over the longer-term, and relative to the resolution of the healthcare reform, there could be the start of a new secular bull market in the sector. We will have more on this subject in upcoming publications. Exhibit I shows a window of outperformance of 12 to 18 months after an economic expansion when the healthcare sector improves its relative performance in the markets.

Spotlight on Healthcare Fundamentals:

- Profitability appears to be stabilizing.

EXHIBIT II

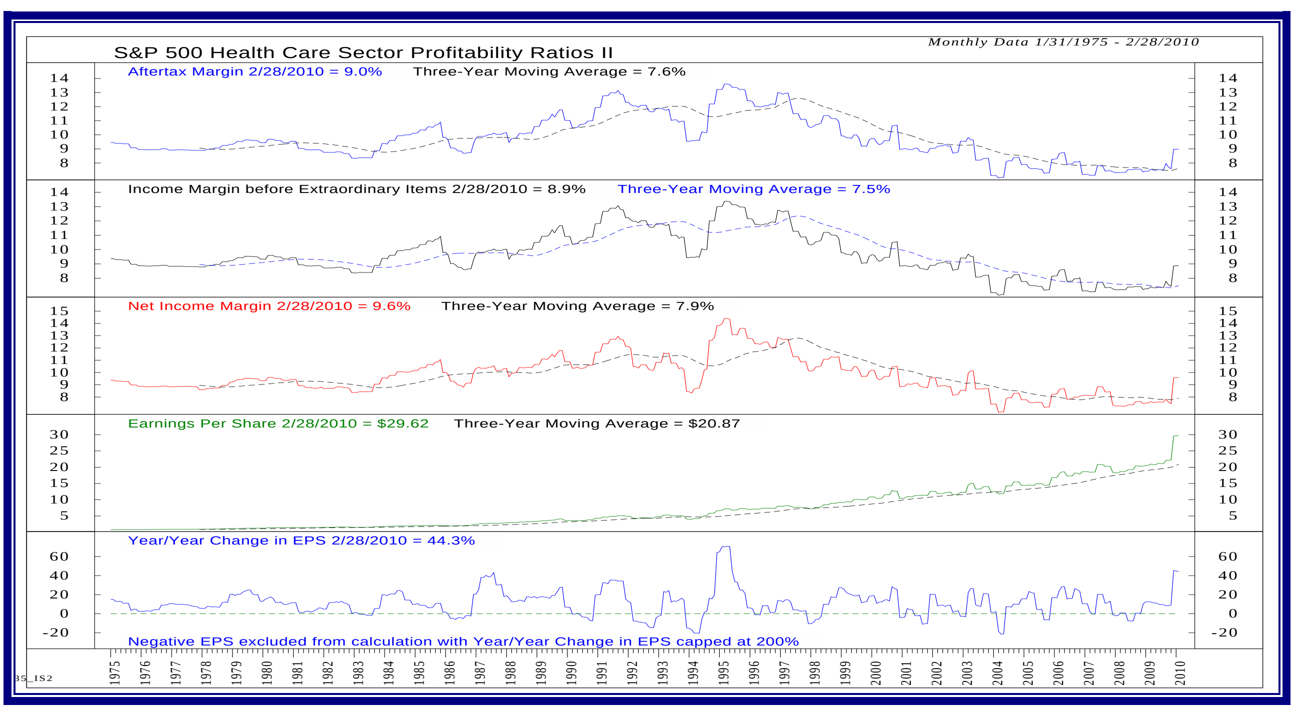
Healthcare Aggregate Profitability Analysis



Source: Ned Davis Research

EXHIBIT III

Healthcare Aggregate Profitability Analysis

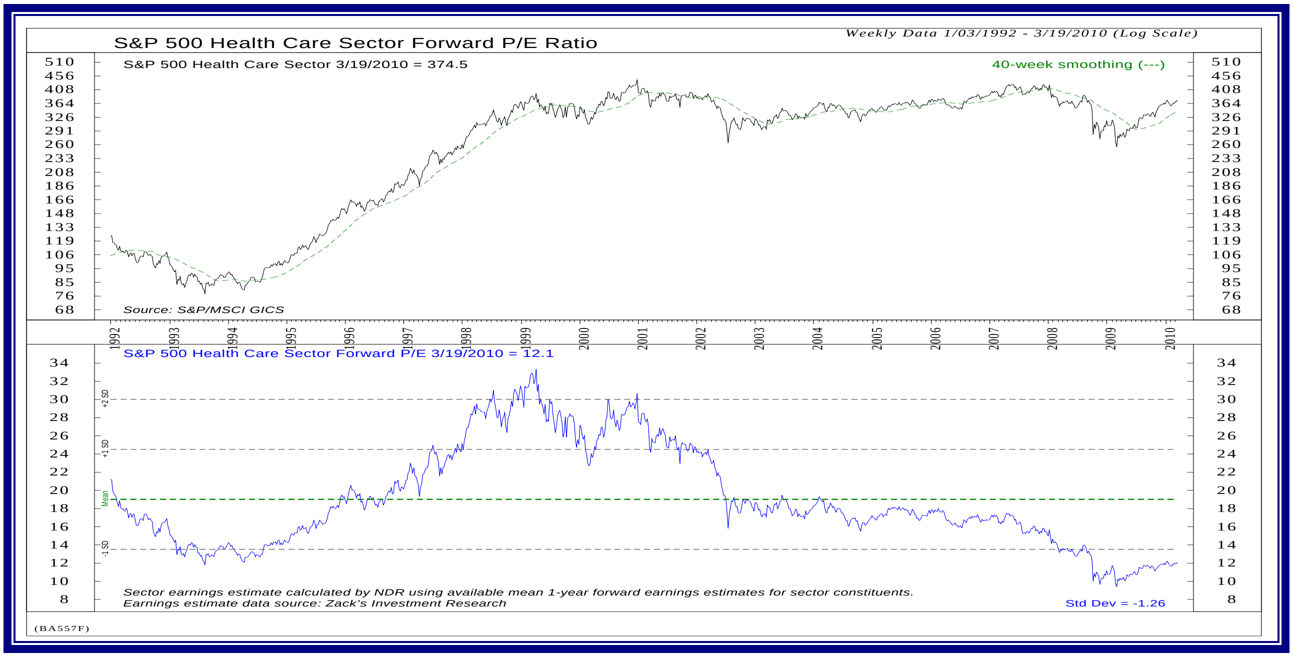


Source: Ned Davis Research

❖ Sector P.E ratios undervalued on an absolute and relative basis.

EXHIBIT IV

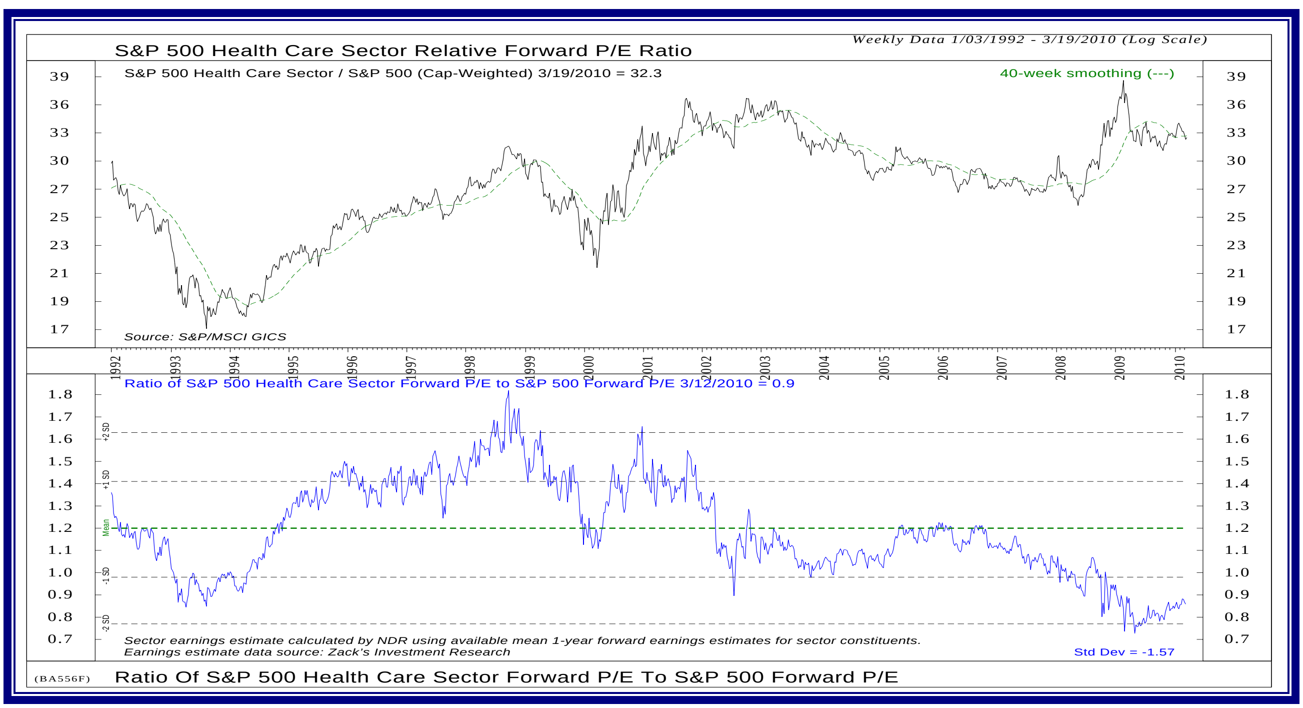
Healthcare Sector Forward P/E Ratios



Source: Ned Davis Research

EXHIBIT V

Healthcare Sector Relative Forward P/E Ratios



Source: Ned Davis Research

PERSPECTIVE ON HEALTHCARE REFORM: PHARMACEUTICALS

- **An increase in the number of insured as a result of healthcare reform will ultimately lead to higher sales for pharmaceutical companies.** On the other hand, the impending costs to pharmaceutical companies associated with this reform have been weighing on shares, and is evident in the Profitability Studied Exhibits II-III. U.S. pharmaceutical companies will now be required to pay a fee on branded sales to government programs such as Medicare. These fees will total $2.3 billion annually. Additionally, U.S. pharmaceutical companies will be expected to help close the Medicare Part D Coverage Gap, or doughnut hole (the difference between the initial coverage limit and the catastrophic coverage threshold). We believe the additional costs to pharmaceutical companies are already reflected in current valuations and justify our overweight in this industry. See Exhibits IV -V.

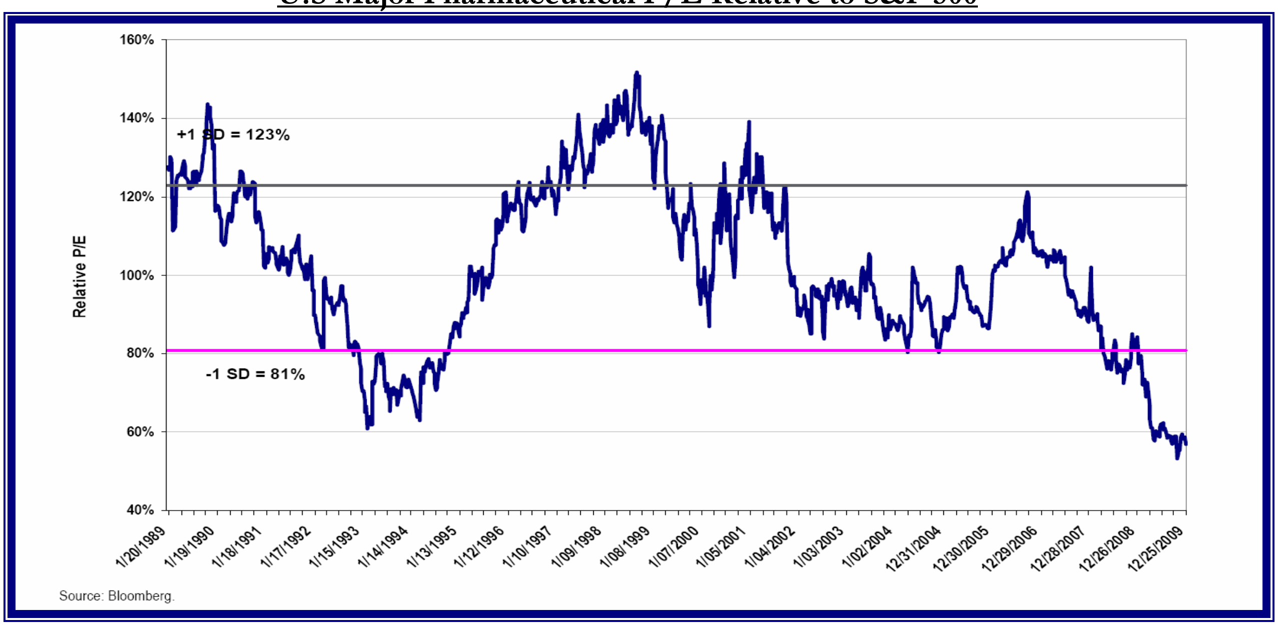
- **Another large issue in healthcare reform is the length of time a biotech drug is protected from generic competition.** As part of the current legislation, it is proposed that the timing be significantly shortened as a way to help pay for healthcare reform and to help consumers gain quicker access to cheaper drugs. Earlier this year, the election of Republican Scott Brown to fill the Senate seat in Massachusetts was thought to give Republicans an additional seat (41 total) in the Senate and forced the Democratic majority to come up with a new version of the healthcare reform bill addressing some key revenue and cost issues.

- **Pharmaceuticals:** After putting $90bn up for reform to avoid price controls, the industry appeared nervous over the past several weeks due to the independent commission which can recommend cuts to the industry and a potential cost driver by expanding the $340bn program. These issues were not fully resolved. So the pharmaceutical industry faces additional costs (above their $90bn contribution) but also receives higher volume from the closing of the doughnut hole.

- **Pharmaceutical Valuations** - Multiples for the U.S. major pharmaceutical companies have contracted on both an absolute and relative basis, as compared to the S&P 500. This group is trading at a relative multiple near 60% of the S&P 500 which is well below the last historical trough which occurred in 1992/1993.

EXHIBIT VI

U.S Major Pharmaceutical P/E Relative to S&P 500

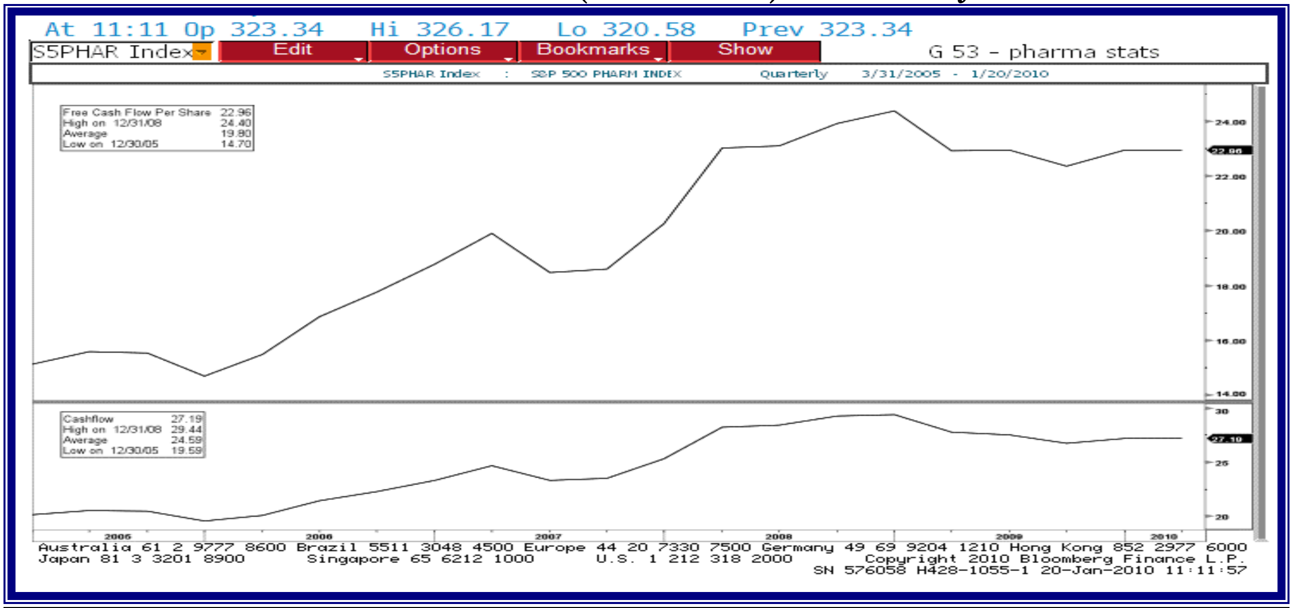


- **Cost cutting has been a major theme in this industry as a means to improve operating margins.** This should continue in the future as biologic vaccines require less sales support and hence will lower SG&A expenses. Additional proactive initiatives are underway across the industry to close manufacturing plants and reduce headcount to significantly lower cost structures.

- **Pharmaceuticals continue to offer yields above the S&P 500 of 3.44 vs. 2.07 respectively.** The pharmaceutical group has displayed strong cash flows on both an operating and free cash flow basis.

EXHIBIT I

S&P 500 Pharmaceutical Index (S5Phar Index) 320.99 as of Jan 20 2010



- **Catalysts**

  - We see upside potential in pharmaceutical valuations as a result of merger synergies and strategic initiatives to navigate through upcoming patent expirations.

  - Merck's 2009 acquisition of Schering Plough and the Pfizer/Wyeth merger are examples of companies gaining diversification, both in product line and geographic mix, to strengthen pipelines. Traditional pharmaceutical businesses have a tendency to be more volatile because of patent expiration schedules and their reliance on fewer blockbuster drugs. Therefore greater exposure to biological products, as is the case with the aforementioned business combinations, should work to lessen the volatility in the industry.

  - Other companies such as Bristol Myers have unlocked shareholder value by spinning off Mead Johnson, their non biopharma assets; perhaps we will see others following this trend.

  - There are a number of late stage data releases, new product launches and other clinical data due out this year that can be potentially opportunistic for the industry.

  - The trend in growth through acquisition is expanding both product line as well as geographic reach. For example, 70% of Schering Plough's revenue was from outside the United States. This will not only increase Merck's global reach, but also its emerging market exposure.

Outlook on Healthcare Industry Groups:

Hospitals: We believe that reform will be positive for hospitals. If reform has a chance of succeeding, hospitals should perform better. They made the deal to reduce their cuts with corresponding increases in health coverage. As such, the reforms should go a long way towards reducing hospitals' bad debt problems.

Managed Care: Managed Care had a great run earlier this year, but we would expect some of the companies to take a hit as new regulations will squeeze profit margins. Smaller players will have trouble surviving under the new rules, and firms tied to the individual market face higher costs. Larger, commercial-based companies appear to be more favored within the managed care space.

Generics: Reform is a positive for generics as greater volume will occur. And the push for lower costs in the future will further help generics.

Medicaid HMOs: Reform will add 15 million new customers and will be seen as a positive.

Biotech: Exclusivity deal became a non-issue for the industry.

Pharmacy Benefit Managers (PBMs): Appear to be neutral on the outcome. Investors are favoring the space in both passage and failure outcomes.