

R I V E R P O I N T R E P O R T

April 5, 2010

MARKET UPDATE

This past month may go down in the books as one of the least-exciting terrific months in market history. Without a specific “big bang” moment, the S&P 500 returned well over 5% in March. The combination of an uptick in corporate merger activity, benign macroeconomic data, the containment of European debt problems as well as continued low bond yields have drawn equity investors back into the game. The rise was consistent and remarkably unspectacular – the broad S&P 500 index only posted six negative days in the month (totaling less than 2.0% in losses) and only two days of gains greater than 1%. This slow and steady march upward has been occurring on trading volumes roughly 20% below last year’s levels, suggesting that investors who missed last year’s rally are slowly beginning to dip their toes back into the water. If this market continues to gain steadily on gradually increasing volumes, we could be setting up for the second leg of a new bull market.

HEALTH CARE LEGISLATION PRETTY MUCH A DONE DEAL

President Obama was elected to office largely due to voters who demanded “change” in the health care and financial industries. Ever since his campaign began to gain steam, it has been clear that health care reform has been high on the President’s agenda; we’ve been following developments in this area since the campaign and the primary unknown was the scope of the final product. With the passage of the House Reconciliation Bill (H.R. 4872), investors finally have a good idea of what this change will actually look like. Below is a non-partisan examination of the potential impacts of the bill for stocks and investors.

Private health care insurance companies will definitely benefit from the legislation, as an estimated 30 million new customers will enter the market. While the bill proposes caps on premium increases and some controls on gross margins, the increased volume should lead to greater profitability. These companies are experts in assessing claims data, so spreading out existing risks over a larger pool of customers should lead to increased earnings over time.

The biggest upside for the insurance companies, however, comes not from 30 million new customers but the lack of a government-run health insurer. It would have been difficult for private companies to match prices with a government-run entity. A government-run insurance giant would have been able to fund its operations by tapping into the relatively cheap U.S. Treasury market, while privately-run insurers would have to pay higher costs in the private capital market. Due to low-cost funding, a government-run insurer would be able to remain profitable at lower price levels than private insurers. Eventually, private insurers could be priced out of the business. Private insurance companies and their investors are more than happy to take slightly less profitable business than compete head-to-head on a price basis with a government entity.

Insuring individuals with pre-existing conditions won’t be very profitable for the insurers (if it was, they would have been covering these folks all along), but it has been estimated that this subset of the total number of uninsured Americans is between 8 and 10 million. This low-margin new business won’t hurt insurers too much since these policies will be spread out over an even

larger pool. We have avoided shares of the health insurers because of the uncertainty regarding the “government insurer” option, as well as pricing issues and management blunders that have plagued these companies in recent years. Instead, we have focused on more traditional property and casualty insurance companies whose stocks trade below their book values, which we feel present better return opportunities.

Thirty million more insured individuals will also lead to an increase in the number of drug prescriptions. According to some estimates, the newly insured could add 154 million new prescriptions per year. That amounts to a 4% increase in the existing market for drug makers. While not a game-changer, this growth amounts to a nice increase for a fairly mature end market. Pharmacy Benefit Managers (PBMs) and drug wholesalers will also benefit from the rise in total prescriptions as volume increases benefit their bottom lines. PBMs and wholesalers also stand to benefit – at least marginally – from the closure of the “donut hole” in Medicare Part D. This coverage gap for Medicare participants (currently, drug costs between \$2,830 and \$6,440 are not reimbursed by Medicare) will lead to more prescriptions being filled. We continue to like the PBM industry, believing that larger competitors can enjoy benefits from scale. An aging population will also help these companies, such as CVS Caremark, as more Americans need more prescription drugs in order to maintain their quality of life.

Another “winner” in this whole equation seems to be the for-profit hospitals, which now can feel better about getting paid for patient treatments. Studies have estimated that physicians and hospitals collect, on average, between 60 and 70 cents for every dollar that they are owed. Clearly, more insured individuals will increase the certainty of payment. Historically, we have avoided the for-profit hospital industry due to perceived flaws in the business model and potential litigation risk arising from improper employee behavior.

One item in the bill that won’t make investors happy is the 3.8% tax on net investment income for households that make over \$250,000. This tax, which begins in 2013, is designed to help fund Medicare. Increasing taxes on investment activity is clearly a negative for investors. Beginning in 2011, long-term capital gains taxes will be 20%, and dividends will be taxed as ordinary income (top bracket: 39.6%); the Medicare tax will tack on an additional 3.8% and add to the increasing tax burden on investing activities.

This Medicare tax only affects taxable investments, so income from municipal bonds will remain tax exempt and therefore will not be subject to the new 3.8% tax. Therefore, stocks could be negatively impacted. Throughout history, investors have shown a reluctance to let Uncle Sam get his hands on their investment income. While the magnitude of the tax may not seem tremendously large, it could nonetheless lead investors to change how they view dividend-paying stocks, or could lead to the increased usage of tax-free investment vehicles. High-income earners will also be hit with an additional 0.9% Medicare tax on their paycheck. While the health care bill’s impact on specific industries may be material, on the whole the most significant part of the bill for our clients may end up being the Medicare tax on unearned investment income.

At RiverPoint, we view the passage of the House’s reconciliation bill as clearing away the cloud of uncertainty that was hanging over the health care sector. Investors dislike uncertainty and now we can assess the impacts of this bill going forward. Overall, this bill has no immediate impact on our investment approach. We continue to look for attractive opportunities in the equity market as we gain more conviction that the economic difficulties of the past couple of years are behind us. As always, feel free to contact a RiverPoint professional if you have any questions.

<u>Market Summary</u>	<u>3/31/10</u>	<u>2010 Price Change</u>
Dow Jones Industrial Average	10,857	4.1%
Nasdaq Composite	2,398	5.7%
Standard & Poor's 500 Index	1,169	4.9%

For information about RiverPoint Capital Management or to view our report archive visit us at <http://www.riverpointcm.com/>.