Managed Healthcare

Healthcare Sector

Investment Thesis

We recommend an **overweight** rating for the Managed Healthcare industry over the next year. As healthcare is naturally a defensive sector, it would be beneficial to the portfolio if we overweight the sector when we forecast a potential economic slowdown in the next 6-12 months. The insured population has been increasing steadily as more people are getting hired as well as more people getting eligibility in the government-sponsored plans.

**Drivers of Thesis**

- The national health expenditure (NHE) has been increasing at a CAGR of 3.6% for the past decade and CMS projects NHE to grow at a CAGR of 6.3% for the next 6 years. NHE is expected to reach nearly 20% of the U.S. GDP in 2028.
- Medical cost inflation has been increasing at a greater rate than the general goods and services and the annual NHE would not get affected by the economic environment.
- Among the healthcare sub-industries, managed healthcare has the highest profit share and has the steadiest stream of revenue as compared to biotechnology and pharmaceuticals.

**Risks to Thesis**

- The healthcare industry has more regulations and compliances that companies have to follow; thus, limiting their profit margin.
- The U.S. government is currently in a budget deficit and might want to deduct spending on the national healthcare expenditure and eventually affecting the plan’s eligibility.
- Slowing merger and acquisition activities due to the economic environment and the deals are being reviewed by the Department of Justice more often as it is concerned about anti-trust law.

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**Key Industry Statistics**

<table>
<thead>
<tr>
<th>Market Cap: (in $ billion)</th>
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<tbody>
<tr>
<td>UNH</td>
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<td>ELV</td>
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<td>CVS</td>
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<th>NTM P/E</th>
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<td>UNH</td>
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<th>Operational Margin</th>
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<th>EV/EBITDA</th>
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**12 Month Performance**

**Company Description**

Managed Health Plans, also referred to as prepaid health plans, work through a network of providers with the intent to reduce the cost of healthcare and provide insurance plans to individuals. Companies often supply the whole vertical chain of services to their clients including prescribed drugs and technology platforms. Other than the commercial side of the insurance plans, Medicare and Medicaid are also provided.
Unlike other sub-industries within the healthcare industry like Biotechnology and Pharmaceuticals, the Managed Healthcare sub-industry captures more than 23.4% of the profit share of the entire Healthcare industry with a relatively low EBITDA margin\[12\]. This is due to the United States of America’s unique healthcare structure that strongly encourages the population to purchase insurance plans to protect them from high healthcare costs.

As of 2022, it is estimated that 300.8 million people in the U.S. has some form of health insurance plan and the uninsured population dropped to 26.4 million people, which is about 8% of the population, making the uninsured rate recover back to the pre-pandemic level.\[1\]

While the industry has a low threat of new entrants, the industry is competitive among its big players; 6 companies contributed 97% of the market capitalization in the managed healthcare sub-industry \[1\]. With that, UNH has thrice the industry average market capitalization, making them the sole market leader in the managed healthcare space.

Overall, the managed healthcare industry has constantly outperformed the S&P500 index. As of February 2023, healthcare stocks contribute 14.66% to the S&P500 index, having the second most weightage after the Informational Technology sector \[2\].

In the past twelve months, three out of five managed healthcare stocks outperformed the index. CVS and CNC stocks underperformed the S&P500 quite a bit since they both face similar headwinds of losing the Centers for Medicare and Medicaid Services (CMS) star rating and not
being eligible for the bonus payment for future payment years.

One of the investment drivers for the Healthcare industry is that people would always require healthcare products and services, regardless of the economic environment; therefore, during a period where we would expect a bearish market in the short term, overweighting the defensive industries would be beneficial and potentially diversify some risks away.

As mentioned above, more than 20% of the profit share in the Healthcare industry comes from Managed Healthcare; thus, if we estimated the unemployment rate to maintain at a low rate in the future and with more people get enrolled in the plans, the managed healthcare sub-industry would continue to experience its slow but steady growth.

Below is a table that summarizes the top six players within the managed healthcare sub-industry. At first sight, UNH is the largest company in the space and has the best financial performance among its peers. CVS generated the second most revenue in 2022 but that is mainly driven by its pharmacy benefit management services as only 28% of CVS’ revenue was generated with insurance plans.

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Ticker</th>
<th>Market cap</th>
<th>2022 Revenue</th>
<th>Net Income</th>
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</thead>
<tbody>
<tr>
<td>UnitedHealth Group Inc</td>
<td>UNH</td>
<td>444.0</td>
<td>324.16</td>
<td>20.64</td>
</tr>
<tr>
<td>CVS Health Corp</td>
<td>CVS</td>
<td>112.0</td>
<td>322.47</td>
<td>4.17</td>
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<tr>
<td>Elevance Health</td>
<td>ELV</td>
<td>114.3</td>
<td>156.60</td>
<td>6.02</td>
</tr>
<tr>
<td>Centene Corp</td>
<td>CNC</td>
<td>40.2</td>
<td>144.55</td>
<td>1.20</td>
</tr>
<tr>
<td>Humana Inc</td>
<td>HUM</td>
<td>61.6</td>
<td>83.06</td>
<td>2.93</td>
</tr>
<tr>
<td>Cigna</td>
<td>CI</td>
<td>88.2</td>
<td>180.52</td>
<td>6.75</td>
</tr>
</tbody>
</table>

Types of Managed Health Plans

As the percentage of the uninsured population decreases over years, the private and public coverage trend changes over time as well. While most companies have more commercial businesses, Humana and Centene focus their business on Medicare and Medicaid.

Private and Commercial Insurance

In 2021, private health insurance is still insuring 66% of the insured population; private and commercial insurance are often employer-based healthcare plans and represent the majority of managed healthcare companies’ total insured membership. The trend could see a significant shift when more of the population reaches 65 years old and will be eligible for Medicare.

Government Sponsored Insurance

Government-sponsored insurance or public insurance is often more affordable than private insurance as it has lower administrative costs. However, it could be less flexible, and the network providers could be limited.

Medicare
Medicare is federal health insurance for anyone age 65 and above, and some people who are under 65 with certain disabilities. Ever since Medicare began its service in 1965, it has been steadily serving more individuals who are eligible for the program. As of 2021, up to $839 billion was spent on Medicare for the members [7]. While it is a government-sponsored program, they were largely offered by public companies like UNH and CVS [1]. In 2021, 18.4% of Americans were covered under Medicare healthcare plans and we expect to see an upward trend moving forward [1].

The population of disabled individuals enrolling in Medicare has been staying quite constant at 8.5 million people annually, but the population of elderly has been growing at a 3% annual rate [4]. Historically, Medicare enrollment has been growing at 2.85% annually and it is expected to stay if not increase in the future. By the end of 2030, when the youngest Baby Boomer turns 65, it is estimated that Medicare enrollment would increase by 50%, making 80 million people eligible for the service [8]. This would give the healthcare plan providers plenty of room for growth for the government-sponsored health-care plans.

Medicaid

Medicaid is a joint federal and state program that provides medical assistance to people with low income. Some individuals could be eligible for both benefits, so both plans would work together and provide them with health coverage. As of 2021, there are approximately 11 million people who are eligible under both plans [9]. Every state has its own income requirement to be eligible for Medicaid but overall, one would be eligible to sign up for the healthcare plan if you are under the federal poverty level [9]. Starting in 2023, the government changed the level from 100% to 138% of the federal poverty level, estimating to have additional 16.7 million people eligible for the plan [9]. While the chart below shows the historical and projected Medicaid enrollment, the original projection shows that there will be about 78.5 million individuals enrolled in the plan, the actual enrollment in 2021 was up to 84.4 million [8][9]. Since the beginning of 2020, there was an increase in Medicaid enrollment by more than 32% and this trend can be explained that...
individuals lost their job during the pandemic; hence were eligible to sign up for Medicaid [8].

Sources: Medpac.gov

Children’s Health Insurance Program (CHIP)

CHIP provides healthcare coverage to eligible children who are under 19 years old through Medicaid and/or CHIP. In 2021, there are 7 million children enrolled in CHIP and children represent 46.5% of the total Medicaid and CHIP program enrollment [9].

The US federal and state budgets are currently facing a deficit, especially when they spent 10% of 2021’s federal budget to fund Medicare, Medicaid, the Affordable Care Act, and CHIP [8]. As a result of this large spending, the federal and state governments have been looking for ways to reduce their spending on Medicaid like cutting payments to health providers [12]. The state governments see a cumulative budget shortage of $555 billion as of 2022 [5]. With these budget shortages, some states have decided they would modify some healthcare plan benefits to save costs. For example, Nevada is cutting 6% payment rates for hospitals, physicians, providers, and nursing homes while Washington canceled dental coverage from Medicaid [5]. If federal and state governments continue to reduce payments to the providers, we could see a decrease in Medicaid enrollment in the upcoming years.

MARKETS AND COMPETITIONS

The Managed Healthcare industry is highly competitive among its big players, with the top 5 companies capturing 48.6% of the market share in health insurance plans [12].

Major Players:

1. UnitedHealth Group
2. Elevance Health / Anthem
3. Centene Corporation
4. Humana, Inc
5. CVS Health Corporation
6. Cigna Corporation

Based on the number of membership enrollments within the top 6 companies in 2022, UNH and ELV made up more than half of the market share and follow by the remaining four companies having almost the same market share. It would be tough for the other companies trying to capture more market shares in the industry as they each have established programs and customer bases; therefore, UNH and ELV are likely to remain the two main healthcare plan providers in the U.S.

Sources: Companies 10-K

The table below shows some industry-wide operating margins. By looking at the NTM P/E ratio, medical cost ratio, and operational margin, we could arrive at a conclusion that UNH is the market leader of the managed healthcare industry with the other competitors trying to gain more market shares by differentiation.

Sources: FactSet

Generally, companies like CNC and HUM that focus on government-sponsored plans would have a higher revenue per member since it is receiving a standard payout and bonus payment from the government, so it has a relatively more stable cash flow as compared to the companies that have more commercial business.
UnitedHealth Group, Inc (UNH)

UNH provides healthcare coverage and data consultancy services and has the highest market share among health insurance companies. In 2022, there are a total of 50.63 million people enrolled in their healthcare plans, giving them 12% of the managed healthcare market share[^1]. In 2022, they see revenue of $324.2 billion[^33]. Most UNH operations are still performed under UnitedHealthcare, and it is also subjected to extensive government regulation since UNH is the largest managed healthcare company in the US[^33]. It offers different kinds of services based on its consumer profile. Currently, UNH operates in 4 different segments:

a. United Healthcare: benefits provider for more than 50 billion members under the plan. Offered plans including Employer & Individual, Medicare & Retirement, and Community & State
b. Optum Health: provides patient-centered care, through clinical sites in-home or virtual services to more than 102 million customers.
c. Optum Insights: connects healthcare systems with analytical platforms to enhance performances.

Optum Rx: operates as a PBM and has more than 67,000 retail pharmacies in its network.

Elevance Health/Anthem (ELV)

ELV changed its name from Anthem to Elevance Health in June 2022 and it is under independent licensee of the Blue Cross and Blue Shield Association and is the second largest healthcare provider after UNH with a total membership of 45.37 billion people[^20]. While UNH is currently the market leader in the managed healthcare industry with the most members, ELV would be able to acquire some independently operate BCBS into the publicly traded company[^13]. In 2022, ELV has a revenue of $155.7 billion[^30].

ELV has relatively fewer members in the government plans as compared to UNH, making most of their memberships come from their commercial business. Below are the 4 segments of their business profile:

2022 ELV Revenue Decomposition

- Commercial & Specialty: benefits providers for 31 billion members. Insurance plans are separated
into Individual, Group Risk-Based, Fee-Based, and BlueCard memberships.


c. CarelonRx: responsible for ELV’s Pharmacy Benefit Management administrative function, and they entered into a 5-year agreement with Caremark PCS Health, a subsidiary of CVS[^20].

d. Other: offers Carelon Services which focuses on integrated care delivery, behavioral health, and health and wellness programs.

ELV is a steady insurance company that has a balanced enrollment in both government and private plans. While they are reported to be the second largest benefits provider in the U.S., it is worth noticing that ELV only consists of 14 out of the 34 independently operated BCBS companies. That being said, it is believed that ELV, or BCBS has a larger presence in the insurance industry than reported as a public company.

ELV has the second-highest peer-compared MBR, which resulted from additional quality improvement realignment costs in 2022. MBR is not as concerning as ELV maintained its 4-star CMS rating with the quality of care provided in 2023.

**Centene Corporation (CNC)**

CNC offers healthcare plans but their business model focuses on underinsured and uninsured individuals. Therefore, we can observe that 76% of their membership enrollment belongs to Medicare or Medicaid, a percentage that is more than twice higher than the industry average[^18]. Most of CNC’s revenues come from state governments, so they receive a fixed premium per member per month, making its revenue stream steadier than its competitors. In 2022, they have a revenue of $144.5 billion[^18].

CNC only has two operating segments:

1. Managed care: operates benefits provider for over 27 billion members. Other than Medicare and Medicaid, the company also offers Commercial plans for small employer groups.

2. Group and Specialty Services: generate revenue under contracts with state and federal programs as well as other organizations.

**Humana, Inc (HUM)**

Unlike other companies like UNH and ELV who provide other types of health services, 89.2% of HUM’s revenue comes from their insurance premium[^19]. A significant amount of HUM’s revenue comes from Medicare as they offer services like health assessments and clinical guidance programs to ensure the plans would be more cost-effective for the elderly. HUM entered into a contract with the Centers for Medicare and Medicaid Services (CMS) to provide the insurance plans in exchange to a fixed payment per member per month[^19]. In 2021, they found a revenue of $83 billion[^19].
a. Insurance: operates as a benefits provider for 22 billion members in the retail, group, and specialty. They also account for their PBM business in this segment.

b. CenterWell: represents their healthcare services offerings like pharmacy dispensing, provider services and home services.

**CVS Health Corporation (CVS)**

CVS engages more in pharmacy, retail and long-term care services where they involve more in the sale of prescription drugs and various health products and merchandise \(^2\). While the Health Care Benefits segment is not the segment that bought the most revenue to CVS, they still capture at least 5% of the market share in the health insurance industry \(^12\). Especially after CVS acquired Aetna in 2018, they have been getting more market share as an insurance plan provider. In 2021, CVS generated a revenue of $292 billion \(^17\). CVS has the following segments:

1. Healthcare Benefits
2. Pharmacy
3. Retail / Long-term care
4. Corporate / Other

UNH and ELV continue to be the two leaders in the managed healthcare industry by having the most membership enrollments. Overall, UNH, ELV, and CVS serve more commercial consumers while CNC and HUM focus more of their business on government-sponsored plans \(^1\).

In conclusion, among the 6 major players in the managed healthcare sub-industry, UNH is the company that Henry Fund will recommend investing in if we are only allowed to pick one stock in the space. This is mainly due to its diverse business line and merger activities that made UNH to be able to provide a wider range of services while maintaining its quality of services and cost structure. UNH is by far the best-positioned managed healthcare company and followed by ELV. ELV is in a unique position since the Blue Cross and Blue Shield Association has a larger national network than UNH but most states chose to hold their private licenses, making ELV not reach its full potential as compared to the network they have.

**Medical Cost Ratio**

One important metric in the managed healthcare industry is the medical cost ratio, which is calculated by dividing the total medical expense paid by an insurer by the total insurance premium they collected \(^12\). While a lower ratio indicates that the insurer has higher profit, the Affordable
Care Act requires companies to spend at least 80% of the premium money to improve the quality of the individual and small group markets and 85% on large group markets [8]. If the company failed to meet the limit, the provider would need to provide a rebate to its customers. At the same time, the company would have to manage their cost if the MCR went above 85%, and shareholders would be unhappy about the company’s cost management.

**M&A Activities**

*UnitedHealth acquiring Change Healthcare, Inc*

In October 2022, UnitedHealth Group completed the acquisition of Change Healthcare for $13 billion deal. The deal was first announced in January 2021 but was pushed back since the Department of Justice attempted to block the deal and mentioned that it could potentially violate the anti-trust law as UNH would now gain access to sensitive data and technology from the acquisition [15]. Optum commented “increasing efficiency and reducing friction will benefit the entire health system and result in lower costs and a better experience.” [15]

*Centene acquiring Magellan Health*

In January 2022, Centene completed the deal with Magellan Health Inc for $2.5 billion in cash [1]. The strategic acquisition would put Magellan Health under the Healthcare Enterprise segment, adding at least 5.5 million members to CNC’s government program and 16 million pharmacy members [15].

**Analysis of M&A Transaction**

Since the managed healthcare industry has 5 main competitors with a large market cap, M&A activities play an important role in the industry. Some managed care companies are trying to turn the operation into vertical integration to have a greater scale and larger influence on the market. The industry would see an increase in vertical integration because if a company has its own PBMs, like UNH and HUM and CNC, it will be able to reduce some medical costs and then lower its medical cost ratio.

**ECONOMIC OUTLOOK**

**GDP Forecast**

Due to the reduction in consumer spending and business investment, the US economy saw a slowdown of 1.4% in the first quarter of 2022 [14]. While inflation and supply chain disruption continue to be an issue, the US economy had a negative growth rate in two consecutive quarters in Q2 2022 with -0.9% which brought the US into a technical recession by definition [14]. This did not last for long as the economy bounced back 3.2% in the third quarter and the advanced GDP reading for Q4 2022 is 2.9%, signaling that the economy has been performing steadily well despite the recession fears and concerns [14].
The Henry Fund analysts projected a short-term real GDP growth of -0.3% in the following year as we estimated that there is a 54.6% chance that the US economy would fall into recession sometime in the next 6-12 months. While it is only an economic indicator, this projection is parallel with the 47.3%, the highest level in 40 years, probability of US recession predicted by Treasury Spread in the next twelve months that was released by the New York Fed in December 2022 [11].

Historically, GDP growth and managed care market have a positive relationship, as more percentage of GDP has been spent on US national health expenditure every year. By 2028, economists expect 19.7% of the US GDP, or approximately $6.2 trillion will be spent on national health expenditure; an amount that is higher than any country in the world [1].

While the U.S. GDP is expected to decrease, it is unlikely that the NHE would decrease along with the GDP since the services would still be demanded, and when there is a political environment that the government has to take care of. Therefore, the Henry Fund expects the NHE to take up a higher percentage of the U.S. GDP when we see an economic slowdown in the future.

**National Healthcare Expenditure**

In 2022, $4.3 trillion was spent on national health expenditure, and up to 66% ($2.84 trillion) was spent on Medicare, Medicaid, or Private Health Insurance [4]. The national healthcare expenditure has grown at a CAGR of 3.6% in the past decade and is expected to grow at a CAGR of 6.3% in the next five years. If the NHE grew as forecasted, it will be growing at a much higher rate than the projected U.S. GDP and increase the government deficit even further.

In 2021, the U.S. has the highest health expenditure as a percentage of GDP in the world and the rate is significantly higher than its comparable countries’ rate. However, with the high medical cost, the U.S. did not show to provide a better quality of healthcare as the U.S. has one of the lowest life expectancies of 77 years old as compared to other developed countries as of 2020. (HST) Moreover, the U.S. also has the lowest healthcare quality and access index rating among the QS countries.
Inflation and Interest Rate Expectations

2022 has been a historically abnormal year for Consumer Price Index (CPI) as the YOY inflation rate once went as high as 9.1%, the highest rate in 40 years \(^1\). That makes the inflation data to be one of the economic data that the FED as well as the whole market is paying close attention to. According to monetary policy, the FED mentioned that they would use the Federal Reserve Fund Rate to tame inflation down to the usual 2%. While the aggressive interest rate hike managed to bring inflation down to 6.42% in January 2023, the Henry Fund in-house projection shows that the inflation rate is very likely to be sticky around the 5-6% level before going back to the low and constant inflation rate.

As mentioned above with the inflation expectations, the terminal FED Fund rate that the market predicted and is currently being priced in is 5.1%, signaling at least one more 25bps hike, from the next FED meetings. According to the CME Group’s FED Watch Tool, 70% of the analysts believe that there will be a second 25bps hike in May, making the FED Fund rate to be 500-525bps \(^6\). However, observing how the FED pays high attention to the Consumer Price Index and unemployment claim data, their decision would change according to the short-term market outlook.

Unemployment Rate

Unlike most of the economic data mentioned above, the unemployment rate remained at a steadily low rate for the past months. While the economy is starting to see hiring freezes or layoffs from bigger companies, especially in technology companies, the job market is still looking solid as the unemployment rate as of January 2023 is 3.4%, the lowest rate in the past five decades \(^16\). The Henry Fund analysts do not pose as many fears of job cuts as we believe that these companies had hired more employees in the past 2 years than the current layoffs. However, we are also paying close attention to the unemployment rate as it could be used as one of the indicators for a recession warning.

In the Managed Healthcare industry, the unemployment rate is an important driver since 50.1% of the population’s health insurance plans were offered by their employers \(^1\). Moreover, employer-sponsored health insurance plans could cover employees’ families, making the average annual premiums for employer-provided family health insurance plans in 2021 to be $21,381 \(^1\). Therefore, if the economy sees an increase in the unemployment rate, the total insured population is expected to be affected as well.

CONCLUSION

As discussed in the industry overview, the Managed Healthcare sub-industry has been over-performing the S&P500 index for the past years. While the past three years have shown an interesting climate in the equity market due to the pandemic, we do believe that investing heavily in the defensive industries would be important to diversify some portfolio risks. However, we only think we should overweight the sector in the short term (6-12 months) when we are predicting a potential recession hitting the US economy and the weight should reverse to
its usual weight when the economy stabilizes. The National Healthcare Expenditure has been and will continue to be a large percentage of the US GDP, making the healthcare industry to be profitable in a business point of view. As the labor market is expanding and the unemployment rate of 3.4%, we can expect more employees will be covered with private insurance plans; at the same time, with more Americans growing older to age 65, Medicare coverage is expected to increase in the next decade as well, giving the industry some room of expansion. Overall, we have a positive outlook and expect slow but constant growth for the managed healthcare sub-industry and recommend an overweight rating for the next year.

Currently, the top managed healthcare company that the Henry Fund would recommend buying is UNH as it has the best financial performance, the most stable revenue stream as well as the most insured populations under its plans. Other than selling traditional insurance plans, UNH also provides technology services through its Optum brand. Therefore, making them the best-positioned managed healthcare company. However, if we are looking for a company that has managed healthcare presence and is also involved in other healthcare businesses, CVS is a good investment too. CVS has a significant managed healthcare business while being the largest pharmacy benefit manager and retail pharmacy in the U.S., making CVS to provide a different business exposure than other managed healthcare companies.

At the same time, CNC is the worst-positioned company as it does not have the market capitalization advantage as compared to other peers. Since CNC focused its business on the government-sponsored program, the latest announcement of losing the CMS 4-star rating would make CNC not eligible for the bonus payment starting from fiscal year 2024 and it would affect the revenue negatively. Furthermore, almost 60% of CNC revenue was generated from Medicaid in 2022, and if the U.S. government decided to reduce spending on Medicaid payments as mentioned in the report, CNC would see a reduction in membership enrollment and revenue in the upcoming years.
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