Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

One Step Forward, Two Steps Back

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In our view, health care is a natural place to look for high quality, defensive companies. In many cases, revenues and barriers to entry are protected by patents, regulation and long-term contracts. However, the longer-term compounding power of individual companies must be considered on a stock-by-stock basis, as fortunes can diverge materially.

AUTHOR

HELENA MILES
Senior Associate

It is not enough to rely on long patent lives, generous pricing and decade-old therapies and frameworks. We look for companies with the ability to innovate, provide new therapies and treatments, and participate in scientific paradigm shifts, all of which may directly impact longer-term earnings power and the ability to sustain high returns on operating capital. One of the most important shifts to consider with respect to our health care companies is the development of "personalised medicine". Personalised medicine is impacting many parts of the health care value chain, and is paving the way for novel therapies and cures for diseases that were once thought to be incurable.

Take for example Usher syndrome, a rare genetic disorder that causes deafness and blindness in young children, for which there is currently no cure. Formulating a cure for diseases such as this will be revolutionary, but the science and technology underpinning it is not new. It lies in the process of "genomic sequencing", which involves comparing the genetic make-up of someone with a particular disease to that of someone without it, allowing researchers to identify the faulty gene that is the cause. In 1990, sequencing the first human genome cost $5.5 billion and took 13 years. Today it takes less than one day and costs approximately $200. Usher syndrome may

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be cured when the faulty gene can be replaced with a working one, preventing the onset of symptoms that lead to deafness and blindness. Genomic sequencing has already been central to the development of treatment for certain diseases. Immunotherapy drugs, for example, directly attack cancer in a new way, by altering the expression of cancer genes. Enter the era of personalised medicine: treating patients based on their own genetic make-up, predicted response and risk of disease.

One step forward: the promise of personalised medicine

The genomic revolution has enabled a shift from a one-size-fits-all approach in health care to a personalised approach. Using the traditional one-size-fits-all approach is like walking into a shoe shop and buying any old pair of shoes without checking the size or trying them on. Personalised medicine is the tailoring of medical treatment to the individual genetic characteristics of each patient and their specific disease. A Swiss multinational pharmaceutical's Zolgensma is perhaps the most stunning example of gene therapy, which is a specific type of personalised medicine. Zolgensma works by replacing a faulty gene with a working gene and is used as a cure for inherited spinal muscular atrophy in young children. While still in their early development and costly to access, gene therapies hold the promise of being able to cure a variety of medical conditions beyond this point.

Another example of personalised medicine is a British-Swedish biopharmaceutical company's Enhertu. This represents a huge step forward in the war against cancer through the development of personalised medicine. Existing chemotherapies poison healthy cells in the body, in the hope of catching the cancerous ones in the process. Enhertu uses complex technology to deliver chemotherapy only to the cancerous cells: this saves the healthy cells and allows physicians to give more of the highly toxic and powerful drug to a localised site. Enhertu holds the promise of treating very specific types of breast cancer, for which there is negligible existing treatment available.

Two steps back: the pitfalls of personalised medicine

The development of personalised medicine is a rocky road. Drug developers have faced the usual threats of trial failures where therapies are not effective or safe enough. Even in cases where these drugs make it through trials and are actually approved by regulators, some may carry unwanted side effects. In the case of some gene therapies, only 25% of potential populations are eligible for treatment due to prohibitive cost and safety issues. On top of this, some physicians demand a better track record of safety for the drug before administering a "one-shot cure" that will affect the patient for life and cannot be reversed.

For conditions like haemophilia, patients may prefer to stay on existing treatments and wait 10 to 20 years to see how the hoped-for cure is working. However, not all patients have this luxury. Children with inherited spinal muscular atrophy have a life expectancy of just two years, meaning Zolgensma is potentially life-saving. For some, the step forward is worth the risk.

The impact of the personalised medicine revolution on investing in the health care sector

What do these promises and risks around personalised medicine mean for stock-picking opportunities in health care? We do not believe in owning individual companies on the basis that they are developing a specific drug. Single drug companies (such as early stage biotechs) are on the front line of progress and drug development, but are also the first to suffer from the setbacks. Single drug investments also carry significant concentration risk and do not necessarily translate into longer-term compounding power, particularly once the drug goes off patent (roughly 10 years after approval).

Fortunately, this revolution is not limited to the drugs themselves. The shift to personalised medicine requires extensive adaptations in the way that health care is provided, paid for and monitored, resulting in second and third derivative health care beneficiaries that offer investment opportunities.

As treatments become more targeted and complex, so too does the way diseases are diagnosed and monitored. How do you know which therapy to give a patient if you are not able to properly classify the specific type of disease? Diagnostics drive 70% of treatment decisions, and if treatments are changing, diagnostics must change with them. Diagnostic testing is crucial for health economics. If physicians are able to correctly identify the relevant marker of disease through testing, health care systems do not waste drugs on patients who would never have responded to the drug in the first place. The likes of a U.S. diversified health care company and a U.S. diversified science and technology company are at the forefront of developing molecular diagnostic tests that are used in assessing a patient's individual suitability for personalised medicines. Diagnostics companies carry the benefit of having exposure to the trend of increasingly complex drug development, without the associated risks of trial failures, patent expiries and pricing pressures.

Health care has made massive strides in the development and delivery of personalised medicine. Revolutionary benefits to patients are also bolstering the compounding potential of these high quality investments.

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