FoHFs eye healthcare alpha

Deluge of healthcare start-ups reflect vast opportunities in sector, according to multiple investors

By Michael Rodwell, 16 November 2020

Fund of hedge fund (FoHF) managers are seeing ample opportunities in the fast-growing healthcare-focused hedge fund space.

Morgan Stanley Investment Management, Gopher Asset Management, and Lighthouse Partners, among many others have all added, or are looking to add, healthcare specialist funds to their portfolios.

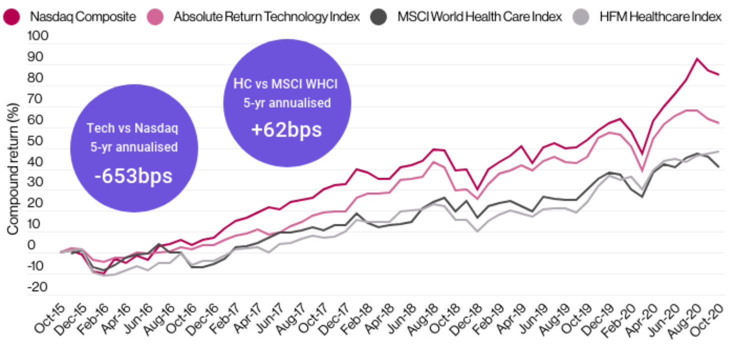
"We do spend a fair amount of time thinking of what sectors offer the most attractive opportunities, both from a quantitative and qualitative perspective. And we would argue the most attractive and idiosyncratic area is the healthcare sector," according to Morgan Stanley's Mark van der Zwan, hedge funds managing director at the $665bn investment behemoth.

A number of FoHFs explained to HFM what is driving the recent boom in healthcare-focused hedge fund launches, how they assess the current crop of specialists, and how best to maintain a balanced portfolio while delivering alpha.

Dawn Yu, portfolio manager at Hong Kong-based investor Persistent Asset Management, believes hedge funds have the edge when extracting returns from the healthcare industry. "It is not a buy and hold sector. It is hard to find any healthcare stocks where you can close your eyes over the past 10 years and compound impressive returns versus technology where there are many."

HFM data confirms this assertion, over the past five years healthcare hedge funds have delivered returns just above the MSCI World Healthcare Index while technology-focused funds have lagged the Nasdaq.

Nasdaq, healthcare, technology: 5-year performance



Source: HFM data

Healthcare investors say the sector is backed by long-term tailwinds that make the industry more attractive than others. They draw attention to the ageing population, innovation in the sector, which has driven a boom in M&A and IPO activity, and increasing government spending.

Earlier this year, New York-based Optima Asset Management authored a whitepaper outlining the short, medium- and long-term tailwinds for healthcare and biotechnology. In the report, the $10bn firm argues that the increased spotlight on the sector, considering the Covid-19 outbreak, "will help chart the path for new, more efficient companies and processes to disrupt and improve current systems."

Within this environment there are growing opportunities for investors to generate alpha, this has led to a spate of start-ups in the sector, HFM has counted 16 healthcare-related launches in the US alone this year.

Bruce Harington, head of long/short strategies at Stenham Asset Management, says there are roughly 120 healthcare specialist hedge funds globally. From this pool, Stenham holds around 8-10 funds in its healthcare-focused commingled FoHF and typically hires one or two managers per year.

"We have very good managers so that sets the bar high in terms of finding new people," Harington says. "But we are always looking… especially with new launches, or funds that have been around for a long time that are reopening, we always try to monitor that."

Optima aim to be long term investors but are also similarly willing to "upgrade" managers, says Yehuda Spindler, managing director, sector head, research. This would be based on a belief that a manager has a more compelling investment pipeline than those already in the portfolio. He notes that there could be other reasons to switch out managers, such as, key person or asset changes that may affect the firm's ability to perform in the future.

Quantitative analysis can only take you so far says Spindler, "the key is to be forward looking not backward looking." From a qualitative perspective, he tries to look for firms that have a marriage between investment acumen and deep sector knowledge. To this end, if a firm is led by someone with an investment background it is important they hire analysts with medical backgrounds and vice versa.

Portfolio construction

There are plenty of things to consider when building a balanced portfolio of healthcare managers. Differing AuM's, net exposure and areas of focus can all be key differentiators.

The FoHFs agreed to some extent it is good to have exposure to a select group of smaller, more nimble funds, with a higher volatility level and greater risk/return profile while also having exposure to low-net or larger firms that target more stable alpha generation.

U.S. Healthcare hedge fund launches 2020

New Firms	Fund manager(s) (former firm)
Albemarle Management	Tyler Saeli (PAR Capital Management)
Alera Partners	Jason Bonadio (FrontPoint)
Audentix Capital	Walid Gardezi (Serrado Capital)
Averill Capital (Suvretta platform)	Kishen Mehta (Citadel)
Black Coffee Capital	Mitch Livstone (Geode Capital Management)
Darwin Global Management	Abhishek Trehan (D.E. Shaw)
Dellora Investments	Kevin Pyun (Consonance Capital)
Dune Lake Capital	Curtis Hogue (Discovery Capital Management)
Eagle Health Investments	Gary Stern (Ziff Capital Partners)
Jaguar Capital	Chris Hammond (Millennium)
Lynx1 Capital Management	Weston Nichols (Perceptive Advisors)
M28 Capital	Marc Elia (Bridger Capital)
Stratome Capital	Richard Klemm (Orbimed Advisors)
TBC	Watt Boone (GMT Capital) & Reed Deupree (Mendon/GMT Capital)
TBC	Jason Hong (Third Point)
Tri Locum Partners	Prashanth Jayaram (Citadel)

Existing Firms	Fund Name
Decheng Capital	Decheng Global Healthcare Fund
Glenview Capital	Glenview Healthcare Partners
Kingdon Capital	Kingdon Healthcare Fund
Orbimed Partners	Orbimed New Horizons Fund

Source: Original reporting

Yu also makes a distinction between managers that invest early and those that invest further down the line.

"Some people are really good at looking at scientifically sound, later stage companies and are looking for the commercial success of drugs… they go after the FDA approval or after drug launches," she says. "We also have people that are really good at taking the preclinical risks [and] are great at picking binary events, but they can have more volatile performance."

Analysts are also keeping an eye on the rise of crossover funds as the healthcare and biotech space is rife with companies on the cusp of going public. Spindler believes that specialist pre-IPO analysts can get a head-start in identifying potential competition and new technologies, "I think having that tool enables many gatekeepers to generate alpha," he says.

China is another area that is gaining a lot of attention. Yu says she has seen a trend of healthcare hedge funds hiring analysts in the region and said firms had begun to list SPACs with the intention of buying Chinese healthcare companies.

It is vastly important that firms understand the market she says, "healthcare here [in China] is not like in the US, where pricing is more mature… In the US, you have got a very active M&A market for biotech… in China, we don't have that market yet."

With so much attention on healthcare, and new firms continuing to emerge, fears of market saturation may be premature. Ten years ago, it was possible to keep track of most of the trends in the industry Harington says, that isn't true today which is an indication of the opportunities that exist.

"If you continue having this number of funds getting launched for the next five years, maybe it becomes crowded, but now, I would say that is not a concern," he said.