Analysis: Health insurer stock run may just be starting

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By Lewis Krauskopf

NEW YORK (Reuters) - The fast start for U.S. health insurer shares this year may turn into a long climb.

Shunned like pariahs during the economic crisis and healthcare reform debate, the stocks have caught fire, with the Morgan Stanley Healthcare Payor index of large and small insurers up more than 16 percent so far in 2011 compared with a 5 percent rise for the broader S&P 500 index.

Many investors have already accounted for the potential near-term costs of a U.S. health overhaul law passed last year and its impact on the industry's bottom line. Some of that impact may even be delayed by efforts to undermine the law from a new Republican leadership in the House of Representatives and by legal challenges in court.

Companies like Aetna Inc and UnitedHealth Group Inc posted strong financial results in 2010 and provided reassuring forecasts for 2011, when rules from the new law begin that require certain levels of spending on medical costs.

They could also benefit if Americans remain cautious about their own healthcare spending and an anticipated rise in medical procedures fails to materialize.

Portfolio managers who shied away from the stocks during the health reform debate are now seeing deep value.

U.S. and foreign mutual funds added more than $4 billion of health insurance stocks to their portfolios on a net basis at the end of the year, according to recent data compiled by Thomson Reuters.

Even with their recent run, the stocks still trade at about a 20 percent discount to the broader market.

"Fundamentally I think they're going to have a very good 2011 earnings season. I think they're under-owned, and I think the political environment is probably more favorable for them now than it has been for a while," said David Heupel, portfolio manager with Thrivent Investment Management, which holds shares of Aetna.

Aetna, which recently issued a far stronger-than-expected forecast and substantially raised its dividend, has seen its shares climb 23 percent this year. UnitedHealth and WellPoint Inc, the two biggest insurers, are up 18 percent and 15 percent, respectively.

Shares of Cigna Corp, Humana Inc and Coventry Health Care Inc have also outpaced the broader market in 2011.

Heupel sees the potential for the stocks in general to rise another 15 percent to 20 percent this year, in part driven by broader generalist investors becoming more interested in the group.

"A lot of folks, as they're scouring their universes, are looking at these things and they're saying: 'Now that all this healthcare reform carnage is over, or at least is better understood, we can now begin to gauge how profitable these companies will be,'" said Scott Richter, who oversees the Fifth Third Disciplined Large Cap Value Fund.

"I really do feel the fundamental picture is as strong as it's been in several years and that's going to propel investors, especially value investors, toward these stocks."

BOOST AT THE DOCTOR'S OFFICE?

Health insurers were the main political target as President Obama's Democratic party rallied support last year to pass the overhaul law. But the Democrats suffered significant losses in the November elections, suggesting to investors that the industry would face a friendlier climate in Washington.

Another crucial factor is Americans' use of medical services. Last year, health insurers saw evidence of people avoiding procedures and doctors visits to save money -- dropping the medical-cost bills for the companies and boosting their profits.

This year, the companies have priced in a rebound in medical utilization into their premium rates, so if Americans continue to save money by avoiding health costs it could push the companies' profits higher.

"All the companies are factoring in a pick up," said Maria Mendelsberg, a principal with Cambiar Investors. "If that doesn't happen then there will be upside to earnings for sure."

Skittish investors may want to sell the stocks to lock in gains now.

Even bulls concede that the group could see patches of volatility, especially as important regulatory decisions near, such as next week's expected announcement by the U.S. government about proposed Medicare payment rates for 2012.

And the new regulatory climate leaves some fund managers more wary.

Michael Gregory, portfolio manager of the Highland Long/Short Healthcare Fund, said the combination of tougher regulation of premium increases and new rules that mandate how much the companies spend on medical costs present a serious threat to the industry.

Weaker yields from investment income also stand to pressure the companies, Gregory said.

"The valuations within managed care are still fairly reasonable relative to historical trends, but I think from this point onward it's unlikely that managed care stocks are going to outperform the S&P 500," Gregory said. "I'm not convinced these names are going to see continued multiple expansion."

Other fund managers are more optimistic. Steve Demas, portfolio manager with The Archer Funds in Indianapolis, bought WellPoint shares in the past six months and has been adding to the position.

"We came in because they looked incredibly cheap," Demas said. "We still see them as cheap."

(Editing by Steve Orlofsky)