

The Best & Worst Health Care Sector ETFs

Structural Integrity – and – Investment Merits

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- Our top picks for ETFs for the Health Care sector are: Biotech HOLDRS (BBH) and Pharmaceutical HOLDRS (PPH).
- We rate the investment merit of the top 9 Health Care sector ETFs.
- We benchmark the individual ETFs against the entire Health Care sector and the S&P 500.
- This research enables investors to analyze ETFs and mutual funds as they do stocks.
- We offer custom and enhanced ETFs based on our top-ranked stock rating system.
- Our ETF/fund analysis is based on aggregation of models for companies held by the fund and weighted according to the fund's allocations to those companies, excluding cash.



Figure 1: The Investment Merit of the Top Health Care Sector ETFs

Fund/Benchmark	% of Fund Allocated to Each Rating*						Overall Fund Rating
	Very Attractive	Attractive	Neutral	Dangerous	Very Dangerous		
BBH	76.6%	0.0%	0.0%	16.8%	0.3%	Very Attractive	
PPH	42.5%	1.7%	52.0%	0.0%	0.0%	Very Attractive	
IYH	38.0%	8.2%	45.6%	5.0%	0.2%	Attractive	
Overall Sector	33.1%	11.2%	45.6%	9.5%	0.7%	Attractive	
FXH	23.6%	22.0%	36.1%	11.3%	1.1%	Attractive	
PRN	1.4%	21.1%	40.7%	30.3%	5.2%	Neutral	

* % may not add up to 100% due to the exclusion of cash and holdings not in our coverage universe.

Sources: New Constructs, LLC and company filings

Our Risk/Reward Ratings have a solid track record of outperformance for investors.

[Barron's ranked us #1 for stock-picking.](#)

Custom ETFs: [Contact us](#) for best-of-breed and enhanced ETF products for a particular sector or index.

Methodology

This report offers recommendations on Health Care sector ETFs and benchmarks for (1) investors considering buying Health Care sector ETFs and for (2) comparing individual ETFs to the Health Care sector and the S&P 500. Our analysis is based on aggregating results from our models on each of the companies included in every ETF and the overall sector (415 companies) based on data as of 04/05/11. We aggregate results for the ETFs in the same way the ETFs are designed. Our goal is to empower investors to analyze ETFs in the same way they analyze individual stocks.

To make an informed ETF investment, investors must consider:

- 1) **Structural Integrity:** ability of an investment vehicle to fulfill its stated objective. We use [XTF, an ETF research firm](#), to find the top 12 ETFs with the best structural integrity rating.
- 2) **Investment Merit:** investment quality of the ETF based on its holdings. We apply our stock rating system to each ETF's holdings to determine its investment merit.

Given the [success](#) of our rating system for individual stocks, we believe its application to groups of stocks (i.e. ETFs and funds) helps investors make more informed ETF and mutual fund buying decisions. Barron's featured our unique ETF research in "[The Danger Within](#)".

Recommendations Summary

If you require exposure to the Health Care sector:

We recommend investors buy Biotech HOLDRS (BBH) or Pharmaceutical HOLDRS (PPH). Both BBH and PPH allocate a substantial amount of their value to Very Attractive-rated stocks, earn above average XTF ratings of 6.8 and 8, and earn a Very Attractive Overall Risk/Reward Rating.

If you require exposure to any other sector:

We recommend investors review our 9 other sector ETF reports, beginning with our Consumer Staples sector, which is the only other sector to earn an Attractive Overall Risk/Reward Rating.

If you require exposure to a Health Care ETF or an index ETF:

We recommend investors buy the following Health Care sector ETFs over an S&P 500 ETF: BBH, PPH, XLV, IHF, VHT, FXH, IHI, and IYH. The S&P 500 earns a Neutral Overall Risk/Reward Rating while these 9 Health Care ETFs earn an Attractive-or-better Overall Risk/Reward Rating.

If you are looking for exposure to the best stocks in the market:

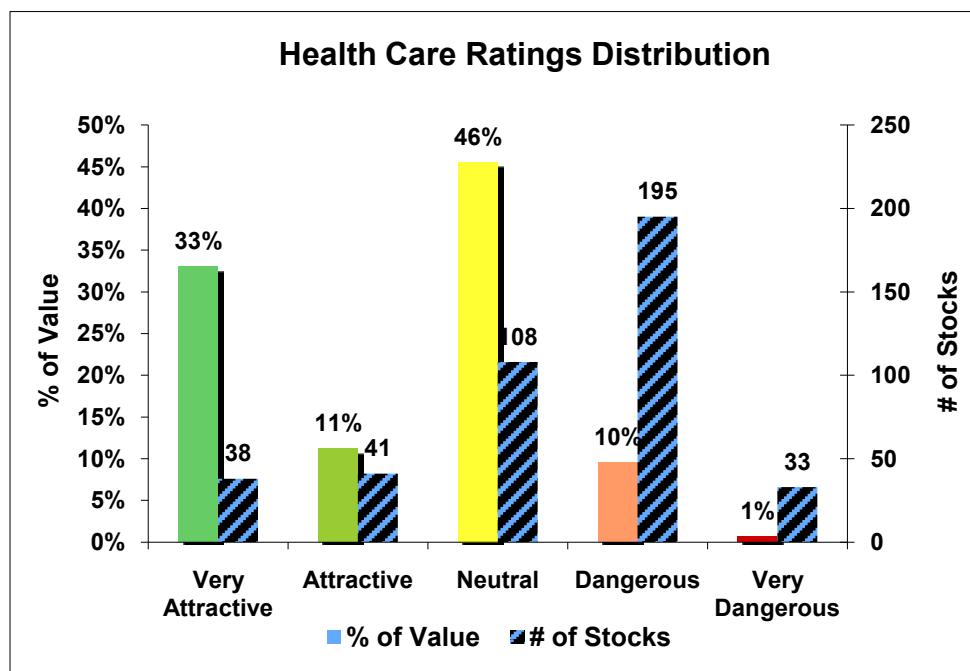
We recommend you buy our [Most Attractive Stocks](#).

Recommendations Detail

Click [here](#) for more info on risk/reward rating system and our approach to equity research.

If you want to be in a sector ETF, the Health Care and Consumer Staples sectors are the best places to shop due to their Attractive Overall Risk/Reward Ratings. Figure 2 shows how the Health Care sector's stocks and the market value attributed to them stack up under the microscope of our risk/reward rating system.

Figure 2: Health Care Sector – Capital Allocation & Holdings by Risk/Reward Rating



Sources: New Constructs, LLC and company filings

The Health Care sector has only 11% of its value invested in dangerous-or-worse-rated stocks and 44% of its value invested in attractive-or-better-rated stocks. The Health Care sector's heavy allocation to attractive-or-better-rated stocks and its low weighting of dangerous-or-worse-rated stocks create large opportunities for attractive-or-better-rated ETFs.

The key takeaway is that the Health Care sector offers both good and poor investment opportunities. The value of each ETF is derived from its constituents, so ETFs like BBH and PPH that overweight attractive-or-better-rated stocks are great investment opportunities while ETFs that overweight neutral-or-worse-rated stocks should be avoided.

When analyzing the Health Care sector ETFs, we started by identifying those ETFs with acceptable structural integrity as measured by XTF. We chose the 9 ETFs whose XTF rating was above the sector average XTF rating. For details on the XTF structural integrity ratings as well as the holdings and weightings for each ETF, see [XTF.com](#).

Figure 3: Health Care ETFs With Acceptable Structural Integrity

TICKER	ETF Description	# of Cap-Weighted Holdings *	XTF RATING
IHF	iShares Dow Jones US Healthcare Providers	49	9.1
XLV	Select Sector SPDR-Health Care	53	8.5
VHT	Vanguard Healthcare Index Fund	292	8.4
PPH	Pharmaceutical HOLDRS	14	8
FXH	First Trust Health Care AlphaDEX Fund	73	7.8
IHI	iShares Dow Jones US Medical Devices	41	7.7
IYH	iShares Dow Jones US Healthcare	123	7.5
BBH	Biotech HOLDRS	12	6.8
PRN	PowerShares Dynamic Industrials Sector	60	6.8

* # of Cap-Weighted Holdings excludes cash

Sources: New Constructs, LLC; XTF and company filings

[Contact us](#) for details on our ratings for any stocks in any equity ETF.

Figure 3 clearly shows that not all Health Care ETFs are made the same. Different ETFs have meaningfully different numbers of holdings and, therefore, different allocations to holdings. Given the differences in holdings and allocations, these ETFs will likely perform quite differently.

After determining the structural integrity, we analyzed the investment merit of each ETF based on how it allocated value to each stock it held. Figure 4 shows how the 9 Health Care sector ETFs stack up against each other and the overall sector based on their Overall Risk/Reward Ratings and the allocation of their holdings by rating.

Figure 4: Investment Merit Based on Holdings and Allocations

Fund/Benchmark	% of Fund Allocated to Each Rating					Overall Fund Rating
	Very Attractive	Attractive	Neutral	Dangerous	Very Dangerous	
BBH	76.6%	0.0%	0.0%	16.8%	0.3%	Very Attractive
PPH	42.5%	1.7%	52.0%	0.0%	0.0%	Very Attractive
XLV	42.0%	7.2%	48.1%	3.7%	0.0%	Attractive
IHF	32.3%	18.1%	41.0%	4.8%	0.6%	Attractive
IYH	38.0%	8.2%	45.6%	5.0%	0.2%	Attractive
IHI	23.4%	27.7%	29.3%	12.4%	1.1%	Attractive
Overall Sector	33.1%	11.2%	45.6%	9.5%	0.7%	Attractive
VHT	34.7%	9.2%	44.9%	9.4%	0.5%	Attractive
FXH	23.6%	22.0%	36.1%	11.3%	1.1%	Attractive
S&P 500	21.5%	19.9%	34.2%	16.6%	7.9%	Neutral
PRN	1.4%	21.1%	40.7%	30.3%	5.2%	Neutral

* % may not add up to 100% due to the exclusion of cash and holdings not in our coverage universe

Sources: New Constructs, LLC; XTF and company filings

Attractive ETFs:

BBH, PPH, XLV, IHF, VHT, FXH, IHI, and IYH – these 8 ETFs earn an Attractive-or-better Overall Risk/Reward rating and therefore, are the only Health Care ETFs we recommend. Our top picks from this group are BBH and PPH.

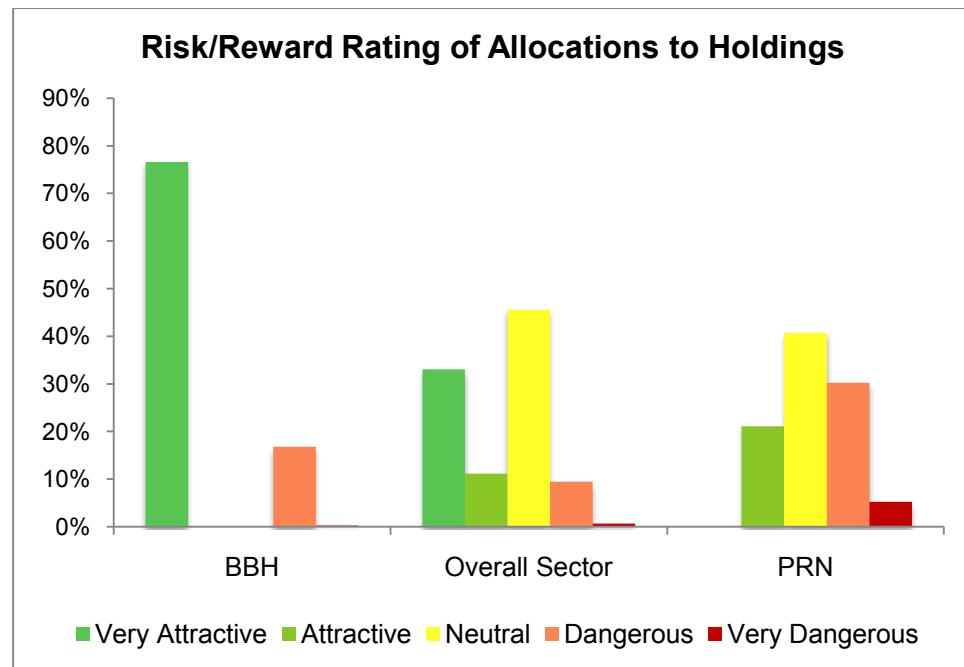
Neutral ETFs:

PRN allocates its value in a way that earns it a Neutral Overall Risk/Reward rating. We recommend investors buy the very attractive and attractive stocks in this sector before buying any of the Health Care ETFs except those we recommend. Figure 5 contrasts the differences in investment merit between PRN, BBH and the overall sector.

Dangerous ETFs:

This report does not include any Dangerous-or-worse-rated ETFs.

Figure 5: Attractive and Neutral Health Care Sector ETFs



Sources: New Constructs, LLC; XTF and company filings

Benchmark Comparisons

Sector Benchmark

BBH outperforms the overall Health Care sector in quality of earnings ratings. BBH earns a Very Attractive Economic vs. Reported Earnings rating because its Economic Earnings are positive and rising while the sector's Economic Earnings are positive and decreasing. BBH also outperforms with an ROIC of 20.4%, earning it a Very Attractive rating, compared to the sector's ROIC of 11.7%.

BBH also outperforms the sector in valuation ratings. BBH has a Price-to-EBV of .6, earning it a Very Attractive rating, and a GAP of 4 years compared to the overall sector's Price-to-EBV of 1.0 and a GAP of 11 years.

Figure 6: BBH – Risk/Reward Rating

Overall Risk/Reward Score	Quality of Earnings		Valuation		
	Economic vs Reported Earnings	Return on Invested Capital (ROIC)	FCF Yield	Price-to-EBV Ratio	Growth Appreciation Period (yrs)
Very Dangerous	Misleading Trend	Bottom Quintile	<-5%	>3.5 or -1<0	more than 50
Dangerous	False Positive	4th Quintile	-5%<-1%	2.4<3.5 or <-1	20<50
Neutral	Neutral EE	3rd Quintile	-1%<3%	1.6<2.4	10<20
Attractive	Positive EE	2nd Quintile	3%<10%	1.1<1.6	3<10
Very Attractive	Rising EE	Top Quintile	>10%	0<1.1	Less than 3
Market-Weighted Avg		\$1.97 / \$2.73	20.4%	7.0%	0.6
					4

Sources: New Constructs, LLC and company filings

Figure 7: Health Care Sector – Risk/Reward Rating

Overall Risk/Reward Score	Quality of Earnings		Valuation		
	Economic vs Reported Earnings	Return on Invested Capital (ROIC)	FCF Yield	Price-to-EBV Ratio	Growth Appreciation Period (yrs)
Very Dangerous	Misleading Trend	Bottom Quintile	<-5%	>3.5 or -1<0	more than 50
Dangerous	False Positive	4th Quintile	-5%<-1%	2.4<3.5 or <-1	20<50
Neutral	Neutral EE	3rd Quintile	-1%<3%	1.6<2.4	10<20
Attractive	Positive EE	2nd Quintile	3%<10%	1.1<1.6	3<10
Very Attractive	Rising EE	Top Quintile	>10%	0<1.1	Less than 3
Market-Weighted Avg		\$1.50 / \$2.70	11.7%	3.9%	1.0
					11
Median		\$-0.11 / \$0.18	4.8%	-0.4%	3.1
					97

Sources: New Constructs, LLC and company filings

BBH more effectively allocates capital to attractive-or-better-rated stocks than the overall Health Care sector. Per [Figure 4](#) above, BBH allocates 76.6% of its value to Very Attractive-rated stocks while the sector only allocates 33.08%. However, BBH allocates 17.13% of its value toward dangerous-or-worse-rated stocks compared to the sector's dangerous-or-worse weightings of 10.18%.

Market Benchmark

BBH outperforms the S&P 500 in quality of earnings ratings. BBH earns a Very Attractive Economic vs. Reported Earnings rating because its Economic Earnings are positive and rising while the S&P 500's Economic Earnings are positive and decreasing. Although both BBH and the S&P 500 earn a Very Attractive ROIC rating, BBH's ROIC of 20.4% edges out the S&P 500's ROIC of 18.2%.

BBH also outperforms the S&P 500 in valuation ratings. BBH has a Price-to-EBV of .6, earning it a Very Attractive rating, and a GAP of 4 years compared to the S&P's Price-to-EBV of 1.5 and a GAP of 26 years.

Figure 8: BBH – Risk/Reward Rating

Overall Risk/Reward Score	Quality of Earnings		Valuation		
	Economic vs Reported Earnings	Return on Invested Capital (ROIC)	FCF Yield	Price-to-EBV Ratio	Growth Appreciation Period (yrs)
Very Dangerous	Misleading Trend	Bottom Quintile	<-5%	>3.5 or -1<0	more than 50
Dangerous	False Positive	4th Quintile	-5%<-1%	2.4<3.5 or <-1	20<50
Neutral	Neutral EE	3rd Quintile	-1%<3%	1.6<2.4	10<20
Attractive	Positive EE	2nd Quintile	3%<10%	1.1<1.6	3<10
Very Attractive	Rising EE	Top Quintile	>10%	0<1.1	Less than 3
Market-Weighted Avg		\$1.97 / \$2.73	20.4%	7.0%	0.6
					4

Sources: New Constructs, LLC and company filings

Figure 9: S&P 500 – Risk/Reward Rating

Overall Risk/Reward Score	Quality of Earnings		Valuation		
	Economic vs Reported EPS	Return on Invested Capital (ROIC)	FCF Yield	Price-to-EBV Ratio	Growth Appreciation Period (yrs)
Very Dangerous	Misleading Trend	Bottom Quintile	<-5%	>3.5 or -1<0	more than 50
Dangerous	False Positive	4th Quintile	-5%<-1%	2.4<3.5 or <-1	20<50
Neutral	Neutral EE	3rd Quintile	-1%<3%	1.6<2.4	10<20
Attractive	Positive EE	2nd Quintile	3%<10%	1.1<1.6	3<10
Very Attractive	Rising EE	Top Quintile	>10%	0<1.1	Less than 3
Market-Weighted Avg		\$0.73 / \$4.08	18.2%	2.5%	1.5
Median		\$0.23 / \$2.21	7.8%	3.2%	1.5
					26
					12

Sources: New Constructs, LLC and company filings

BBH allocates capital more effectively than the S&P 500. Per [Figure 4](#) above, BBH allocates 76.6% of its value to Very Attractive-rated stocks while the S&P 500 only allocates 21.47%. BBH also only allocates 17.13% of its value toward dangerous-or-worse-rated stocks compared to the S&P 500's dangerous-or-worse weightings of 24.51%.

Appendix: Risk/Reward Rating System

Our Risk/Reward Rating System assigns a rating to every stock we cover according to what we believe are the 5 most important criteria for assessing the risk versus reward of stocks. See table that follows for details.

Overall Risk/Reward Ranking	The Overall Risk/Reward Ranking provides a final rating based on the equal-weighted average rating of each criterion.
Very Dangerous	FCF Yield is not included in the average.
Dangerous	FCF Yield is not included in the average.
Neutral	All criteria are equal-weighted in the average calculation.
Attractive	All criteria are equal-weighted in the average calculation.
Very Attractive	All criteria are equal-weighted in the average calculation.

Economic vs Reported Earnings	Rates stocks based on how their Economic Earnings compare to their Reported Earnings. Values based on Latest Fiscal Year.
Very Dangerous	Negative and declining Economic Earnings despite positive and rising Reported Earnings
Dangerous	Same as above except Reported Earnings are not rising or Reported Earnings are not positive
Neutral	Negative Economic and Reported Earnings
Attractive	Economic Earnings are positive
Very Attractive	Economic Earnings are positive and rising

Return on Invested Capital (ROIC)	Rates stocks based on their ROIC. Values based on Latest Fiscal Year.
Bottom Quintile	Very Dangerous = the bottom 20% of Russell 1000 companies
4th Quintile	Dangerous = the bottom 40% of Russell 1000 companies
3rd Quintile	Neutral = the middle 20% of Russell 1000 companies
2nd Quintile	Attractive = the top 40% of Russell 1000 companies
Top Quintile	Very Attractive = the top 20% of Russell 1000 companies

FCF Yield	Rates stocks based on their Free Cash Flow Yield. Values based on Latest Closing Stock price and Latest Fiscal Year.
<-5%	Very Dangerous = less than or equal to -5%
-5%<-1%	Dangerous = more than -5% but less than or equal to -1%
-1%<3%	Neutral = more than -1% but less than or equal to +3%
3%<10%	Attractive = more than +3% but less than or equal to +10%
>10%	Very Attractive = more than +10%

Price-to-EBV Ratio	Rates stocks based on their Price-to-Economic Book Value Ratio. Values based on Latest Closing Stock price and Latest Fiscal Year.
>3.5 or -1>0	Very Dangerous = greater than or equal to 3.5 or less than 0 but greater than -1
2.4>3.5 or <-1	Dangerous = greater than or equal to 2.4 but less than 3.5 and less than or equal to -1
1.6>2.4	Neutral = greater than or equal to 1.6 but less than 2.4
1.1>1.6	Attractive = greater than or equal to 1.1 but less than 1.6
0>1.1	Very Attractive = greater than or equal to 0 but less than 1.1

Growth Appreciation Period (yrs)	Rates stocks based on their Market-Implied Growth Appreciation Period. Values based on Latest Closing Stock price and Default Forecast Scenario.
>50	Very Dangerous = greater than or equal to 50 years
20>50	Dangerous = at least 20 years but less than 50
10>20	Neutral = at least 10 years but less than 20
3>10	Attractive = at least 3 years but less than 10
0>3	Very Attractive = at least 0 years but less than 3

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1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

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