



The Rainier philosophy is simple. We invest in quality growth companies at prices that make sense. We believe that rewarding stock performance comes from companies with superior growth, attractive relative valuations, competitive strength, and financial integrity. Our decisions are based on fundamental analysis, which emphasizes bottom-up stock selection by sector specialists. We invest in all major market sectors because we believe that investment opportunities are found in industries that are frequently overlooked.

Sector Insights

Focus: Health Care

Health Care sector specialists: Mark W. Broughton, Mark H. Dawson, Michael D. Emery, Stacie L. Cowell

Q: How does Rainier use its sector experts to manage a diversified portfolio?

A: Sector teams consist of two to four people, with each person acting as both analyst and portfolio manager. These are sub-groups within the greater nine person equity team, in which each portfolio manager serves on multiple teams. We maintain a research focus in every area of the market, with a view that growth opportunities exist in all sectors and that market leadership shifts over time. Our sector teams seek to capitalize on that phenomenon. Different nuances exist for companies in different sectors related to the keys to growth, sources of profitability, and appropriate valuation metrics. Our sector teams specialize in understanding the most important factors that will influence price movements of stocks in their areas.

Q: What are the major industries within this sector?

A: One of the largest and most well-known industries within the health care sector is pharmaceuticals. This industry includes the companies that focus on the research to develop new name brand drugs and obtain patents, as well as companies that specialize in generic drug offerings. The branded pharmaceuticals industry long been dominated by larger firms; however, concentration has increased recently due to a number of large acquisitions. Generic drug companies are generally smaller in size and target opportunities in a highly competitive marketplace once branded drug patents expire. These firms maintain large legal staffs and typically challenge the patents of the branded drugs, hoping to shorten patent lives and obtain a period of exclusivity. Another segment of the industry, specialty pharmaceuticals, consists of companies that produce drugs that are more targeted toward a specific therapeutic area, such as oncology.

Biotechnology is another key industry in the sector, and is generally differentiated by capitalization, with large cap companies mostly profitable and smaller cap companies unprofitable. Large-cap

biotech companies are positioned more like branded pharmaceutical companies in that they market established drugs with long patent lives, maintain large research and development budgets and have a history of being profitable. Smaller-cap biotech companies are engaged in the early development stage of drugs and most often have not been profitable. The stocks of these early stage firms are often quite volatile as their success is typically centered on clinical outcomes, making them subject to “binary events” with an extremely high risk and reward. As a result, when we invest in this arena we seek to identify companies that are on the verge of becoming profitable or those that have established products in addition to a clinical opportunity.

The medical technology industry includes companies that produce devices which target specific therapeutic categories such as cardiovascular and orthopedic. This area of health care has proven to be more economically sensitive in the past few years as limited innovation and higher-deductible insurance plans have resulted in greater pricing pressure and lower utilization. Within the diagnostics industry, there are a few major large laboratory firms that dominate but exhibit limited growth, while several smaller companies operating in niche areas have proven successful. Facilities and services companies are another important part of the industry, and include a wide variety of sub-groups such as hospitals, home care providers, nursing homes, insurance providers, distribution networks, pharmacy benefit managers, and health care IT. While many of these areas have been negatively affected by health care reform and the slowing economy, certain niche segments continue to be ripe for investment ideas.

Q: What is Rainier’s approach to buying stocks in the health care sector?

Our focus within the health care sector is on identifying companies that we believe are likely to grow earnings faster than their competitors, yet are priced at reasonable valuations. Health care is

an interesting sector in that there is a fair amount of differentiation within the sector, so it is rare that companies within the sector move entirely in tandem with one another. Successful investments can typically be found within the sector even during times that the group is out of favor. Over the years, the sector has seen its stature as a leading growth area diminish and we have altered our approach here somewhat. Today we are much more attuned to the economic sensitivity of the group and the effects of reform on the broader landscape. Despite the pricing and regulatory pressures facing these companies, certain stocks do have growth potential due to product differentiation.

Q: How has the sector been affected by the recent recession?

While health care has historically been viewed as a defensive sector, this view was challenged in recent years as the sector proved to be economically sensitive during the 2008-2009 recession resulting in lower utilization in all areas of the sector. This problem was exacerbated by the secular change that has been underway in benefit plan design changes. For a number of years, the cost of health care has been shifting from the employer to the employee as a result of trends such as higher deductibles and co-pays. This has altered patient behavior much more than many expected.

Q: What has been the effect of health care reform legislation and what has been the effect of recent government budget issues on the health care sector?

A: A major goal of the Affordable Care Act is to control the cost of health care for the consumer. The legislation attempts to accomplish this through changes in insurance policies that both limit costs and increase coverage. While these policies are designed to be good for the consumer, the policies have negatively impacted health care stocks. The legislation has hurt industry pricing power and has decreased industry profit margins. Many health care companies today are growing more slowly and are less profitable than before health care reform. As a result, equities in the health care sector have seen multiples compress.

The Federal Government is a major financier of health care services. The Congressional Budget Office estimates total spending on health care to be more than 16% of gross domestic product, of which public spending accounts for more than 50%. As the government becomes increasingly conscious of the long-term debt and current budget deficits, health care spending will come under increased scrutiny. Payment rates set by Medicare and Medicaid will be reviewed and rationalized. The net result will likely be lower payment rates to companies providing health care services and products, as well as a slower adoption of new health care technologies.

Not all industries within the health care sector will be impacted equally by the reform legislation. Some areas, such as cardiology and orthopedics, have already begun to see lower procedure growth rates and price erosion. Other areas, like life science tools and diagnostics, are anticipating reduced demand but have not seen significant fundamental erosion. These are areas that have been de-emphasized in our portfolios. Conversely, health care industries that provide cost savings – such as generics and pharmacy benefit managers – should be benefactors of health care reform and budget rationalization. These have been areas of focus in portfolio strategies.

Q: What major themes do you see in this sector going forward?

A: As previously mentioned, a major issue facing this sector involves the consequences of government involvement, ranging from new regulations to budgetary constraints. Another theme that is occurring within the industry is the increased consumption of generic drugs. There are a number of branded drugs with patents expiring in 2012 and 2013 that will increase the market share of generic pharmaceuticals. In addition, the certification of bio-similar products (generic versions of biotech compounds) by the FDA will create a new opportunity set for generic distributors and producers. These trends may slow the growth of revenues for a number of large-cap pharmaceutical companies, while potentially benefiting generic drug producers as well as those companies involved in the distribution of generics.

Q: What areas within the sector do you currently view favorably?

A: Within our portfolios, we have emphasized distributors and pharmacy benefit managers that appear poised to benefit from the coming generic wave, select service companies that have benefited from lower utilization rates, and specialty pharmaceuticals. Many of these specialty pharmaceutical companies have targeted products or services that allow them to differentiate themselves from others in the industry. Some may provide products that are more cosmetic in nature and thus related to consumer discretionary spending, while others produce orphan status drugs. Orphan status refers to diseases that affect small populations, and often include children. To encourage companies to pursue research in this area, drugs that target these populations are usually given more patent protections from the government. Any government funding they receive is also less likely to be cut, given the small percentage of the budget it represents and the political cost of targeting these more vulnerable groups. This exclusivity can lead to pricing power for these specialty pharmaceutical companies, a rarity in recent years among health care companies given the intense pressure on profits from the government.

Next edition: Consumer Staples

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