Health insurer investors strap in for bumpy ride

By Lewis Krauskopf – Analysis

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(Reuters) - If one certainty exists for investors in health insurance stocks, it is to expect a bumpy ride for the next two months.

A U.S. health system overhaul that threatens the industry's future profitability is now in the home stretch after the Senate Finance Committee cleared its bill last week.

News from Capitol Hill is already rattling the stocks, with the headlines primed to hit a fever pitch as Congress moves closer to a decision on the legislation.

"At the very least, these stocks are going to remain highly volatile," said Steve Shubitz, an analyst with Edward Jones.

But for investors who can stomach a rough few months and hold them into next year, scooping up health insurance stocks may be a smart move.

The six largest health insurers are trading at between 6.8 and 8 times next year's earnings estimates -- a paltry premium compared to 14 times for the S&P 500 stocks on average.

"They're priced for maximum pessimism," said Scott Richter, a portfolio manager with Fifth Third Asset Management who said he was considering adding to the managed care position in his large-cap value fund.

"My premise on the whole is that the fundamentals are sound, the near-term headline risk is high and that there's some upside to be seen once we kind of digest this whole thing and the uncertainty removes itself," Richter said.

After rallying this summer on dwindling prospects for a government-run insurance plan in the private market, health insurer shares have fallen back in the past month as the Senate Finance Committee weighed and passed a bill deemed as increasingly negative to the industry.

The S&P Managed Health Care index of large U.S. health insurers has declined some 15 percent since mid-September -- presenting an opportunity in some eyes.

Market strategists at Barclays Capital last week recommended going long on a basket of health insurance stocks, "given the trough valuations seen," after recommending shorting them earlier this summer.

"While the end result of the reform process is likely to have a negative impact on the insurers, the present discount is overpricing the risk," the Barclays analysts said in a report.

Dean Dordevic, a healthcare analyst at investment advisory firm Ferguson Wellman Capital Management, said it recently recommended Humana Inc (HUM.N: Quote, Profile, Research, Stock Buzz) to clients, noting the "compelling" valuations for the industry, but was hesitant to invest more.

"We wanted to at least have some exposure there," Dordevic said.

"Our view is that if nothing happens there's upside clearly, but if something that is relatively negative comes out of Washington, the stocks could have some modest downside or possibly be dead money," he said. "There's sort of a value trap possibility."

One factor keeping investors away is even if they become comfortable with the impact the current legislation may have on the companies, it may not be possible to predict what lawmakers may try to add to the bills in the next couple of months.

"Determining what is actually incorporated in the stock price under these conditions is very difficult," said Les Funtleyder, a healthcare analyst with Miller Tabak.

"The problem is it's very difficult to get comfortable with the downside risks when you don't know what they are."

The focus on Washington has put the approaching third-quarter earnings season in the background -- this for an industry whose shares can see sharp moves on results.

UnitedHealth Group Inc (UNH.N: Quote, Profile, Research, Stock Buzz), the largest health insurer by market value, kicks off the reporting season on Tuesday. WellPoint (WLP.N: Quote, Profile, Research, Stock Buzz), Aetna (AET.N: Quote, Profile, Research, Stock Buzz) and Coventry Health Care (CVH.N: Quote, Profile, Research, Stock Buzz) are due next week.

During third-quarter reports, companies often give some sense of their profit outlooks for the following year, although reform uncertainty may lead them to delay their forecasts.

"While only a few parts of the reform bill are likely to have an impact in 2010, strategic planning concerns could prevent companies from showing their hands until a reform bill has been passed by Congress and signed by the President," Wells Fargo analyst Matt Perry said in a research note, adding he expected "tepid" growth for 2010.

One factor that could grab investors' attention this earnings season is the H1N1 swine flu. A flood of people heading to the doctor in search of vaccines or treatments may drive up medical costs for the insurers.

"If the swine flu turns out to be a lot worse than what people are expecting, that I don't think is really accounted for in the current guidance that these companies have given," Shubitz said.

(Reporting by Lewis Krauskopf, editing by Dave Zimmerman)