CREDO WEALTH

Off balance

Cigna is an American managed health care company. It offers medical, dental, disability, life and accident insurance. Express Scripts is a pharmacy benefits management (PBM) organisation. PBMs maintain lists of approved medicines, using their bulk to negotiate discounts with drug manufacturers. They also process and pay claims for reimbursement. In March 2018, it was announced that Cigna would buy Express Scripts. The deal was approved in August, by the shareholders of both companies.

As active, equity managers, there are various points of uncertainty which we can take advantage of. The key isn't to predict the future. The key is developing a process that gets a good sense of the risks involved. We look for asymmetric positions, acknowledging that we won't be correct every time. What we want is to limit the downside risk when we are wrong, and position ourselves to benefit handsomely when we are right. A portfolio of businesses then becomes a risk management exercise, where over the long term the process is more important than any individual outcome.

The Cigna-Express Scripts deal provided two such opportunities. We bought Express Scripts in May just after the bid. The market initially expressed a view that there was a very low probability that the deal would go through. This was clearly the consensus because there was a large gap (~25%) between the Express Scripts share price, and the price shareholders would receive if the deal was successful. Our sense was that Cigna shareholders hated the deal, preferring to own a pureplay insurer, without any PBM exposure. PBM's are opaque and operate between the health insurers and the drug companies to negotiate better discounts on drug pricing, keeping some of the benefit for themselves.

We were more positive on the likelihood that the deal would go through, and the benefits to Cigna of combining the two companies. Management's guidance, and our research, makes a compelling case for cost synergies and cross-selling opportunities. Cigna was trading at a discount to its peers, while historically its premium rating had reflected a track record of superior profitability and growth. Despite the market negativity around the deal, the highest valued company in the sector is United Health, which also combines insurance and PBM in the way the new Cigna will.

By August, the gap had narrowed as shareholders had voted to approve the deal, and only regulatory hurdles remained. As a result, the balance of risks changed. The spread had narrowed such that we were no longer being compensated for the risk of the deal collapsing, so we sold the Express Scripts shares. However, we still believed the broader prospects for the merged Cigna-Express Scripts were underappreciated, and so in early September after the US Department of Justice approved the merger, we bought Cigna shares.

As fundamentally-based, long-term investors, we don't initiate our positions as situational plays. We weren't betting on an outcome. The underlying business is something we believe is adding value. The more short-term perspective of the market of course allows us to benefit in timing as to when we establish and exit our positions. When the risks are off balance, we use that excessive optimism and pessimism as a buffer.

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Important notice