With roughly two-and-a-half months completed in 2013, the Medical Services Industry has fallen precipitously in the *Value Line* rankings. After rising near the top of the list following the announcement of the Affordable Care Act, the sector's prospects have cooled some for the coming year. This period should be one of great transition for many of the entities on the following pages, but those that play their hand correctly will be set up for ample long-term growth.

The investment community is aware of the ramifications of President Obama's forthcoming legislation, and has shown a willingness to deal with flat/lesser earnings from many companies in 2013. In particular, health maintenance organizations (HMOs) may have the toughest time adjusting to the spending floors that are set to be rolled out in the near future. In that same vein, the Centers for Medicare and Medicaid Services (CMS) has already begun to send out negative vibes on the reimbursement front. It appears the first government service due for the chopping block will be Medicare Advantage payouts.

Despite the coming headwinds, subscribers may notice significantly higher quotations from many of the forthcoming stocks. Some have reached these levels on their own company-specific merits, while others have simply piggybacked the overall sector's incline.

Hospitals Lead The Charge

Hospital operators have seen their shares pushed well higher in the past three months. Some of this rise is associated with the fact that volumes and surgeries are inching up, stemming from a strong flu season. However, much of these gains are investors looking to get on board for the long haul, as 2014 should bring with it a sizable decrease in bad-debt expense. For years, hospital chains have been undermined by the cost of caring for the uninsured, but next year when the Affordable Care Act goes into law the number of Americans with health insurance should balloon.

Those in the hospital business are wisely getting their bed counts up as the boom in insured persons is set to begin. We expect many operators to continue this trend as 2013 progresses. Deals in areas with elderly populations, namely Florida, are obviously the most sought after. *Health Management Associates* is set to partake in this phenomenon, and its preexisting base in states where many Americans retire has sparked a rally in its shares.

Labs Face Some Concerns

While the eyes of the investment world are on the potential for 2014, the clinical laboratory duopoly of *Quest Diagnostics* and *Laboratory Corporation of America* is ailing a bit. Trips to the doctors' office are being eschewed, and anything not of an immediate nature is being put off until the reform kicks in. Because of this occurrence, volumes at the labs are down.

Another factor hurting the subsector is the run-off of some testing to hospitals. Cost-cutting moves by many providers have pushed a portion of the testing market to physician chains that are aligned with the larger hospital groups, or keeping the patient "in-house". *Quest* has tackled this concern head on by signing agreements with

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operators of this nature, but the deals are often of the revenue-sharing variety, and up to this point their impacts have been muted.

In fact, things in this space might be even worse if not for the fact that *LabCorp* has private-equity buyout whispers circling around it, and *Quest* has raised its dividend significantly to further its appeal versus its most immediate competitor.

HMOs Deal With Headwinds

This industry's significance in the U.S. economy was demonstrated by *UnitedHealth Group*'s addition to the Dow Jones Industrial Average. But this same tie has had much to do with the recent struggles of the HMOs. Poor employment figures have led to tough enrollment comparisons. This development has come at a most opportune time for health maintenance groups as they try to trim their budgets to get in line with the changes that will be enacted by reform. The most notable of these are the spending floors associated with each individual account. Undoubtedly, medical cost ratios will be in the spotlight throughout much of this year.

More recently, the CMS announced that rates on Medicare Advantage (MA) would be coming down considerably in the near future. The HMOs, particularly *Humana*, which has a substantial MA portfolio, had expected such a maneuver, but likely not to this degree. A negotiation period is now in effect, and the general belief is that the CMS will work with the companies to perhaps find some middle ground.

Conclusion

The near term will probably not be pretty in the Medical Service Industry. Adjustments and alterations to business models will be rampant. With that, timely selections are not prevalent throughout the sector. Niche players are the best bet for momentum investors. Conversely, for the stretch to 2016-2018 there is a bevy of companies that should be able to cash in once the winds of change have died down.

As is always the case, we recommend that subscribers peruse each of the following pages before committing funds.

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