

H&Q HEALTHCARE INVESTORS  
Form N-CSR  
December 05, 2013

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

**FORM N-CSR**

**CERTIFIED SHAREHOLDER REPORT OF REGISTERED  
MANAGEMENT INVESTMENT COMPANIES**

Investment Company Act file number 811-04889

H&Q Healthcare Investors  
(Exact name of registrant as specified in charter)

2 Liberty Square, 9th Floor, Boston, MA  
(Address of principal executive offices)

02109  
(Zip code)

2 Liberty Square, 9th Floor, Boston, MA 02109  
(Name and address of agent for service)

Registrant's telephone number, including area code: 617-772-8500

Date of fiscal year end: September 30

Date of reporting period: October 1, 2012 to September 30, 2013

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**ITEM 1. REPORTS TO STOCKHOLDERS.**

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**H&Q HEALTHCARE INVESTORS**

*Annual Report*

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To our Shareholders:

On September 30, 2013, the net asset value (NAV) per share of the Fund was \$24.90. During the twelve month period ended September 30, 2013, total return at NAV of the Fund was 40.18%, with distributions reinvested. During the most recent six month period ended September 30, 2013, total return at NAV of the Fund was 23.77%, with distributions reinvested. The total investment return at market with distributions reinvested was 41.12% during the twelve month period ended September 30, 2013 and 24.57% during the six month period ended September 30, 2013. The NASDAQ Biotech Index (NBI) return exceeded both the Fund's market and NAV returns for both periods. However, the Fund's NAV and market performance were greater than the broad S&P 500 Index in both periods. Comparisons to the relevant indices are listed below.

<b>Investment Returns</b>	<b>Six Months Ended 9/30/13</b>	<b>Year Ended 9/30/13</b>
Investment Return at Market	24.57%	41.12%
Net Asset Value	23.77%	40.18%
NASDAQ Biotech Index	31.32%	47.77%
S&P 500 Index	8.31%	31.32%

#### **Portfolio Highlights**

Things have not changed substantively from what we communicated in our most recent semiannual letter. For both the six and twelve month periods ending September 30, 2013, the broad S&P 500 market has performed well. In the same periods, both the NBI and your Fund have performed even more impressively. In the semiannual letter, we noted that the NBI had approximately tripled in value since early 2009 and doubled since mid 2011. We also noted that this performance trend had brought the biotechnology sector to all time highs. We further note that the NBI has advanced by an additional 31% in the six month period ending September 30, 2013, since our semiannual letter, bringing the Index's overall advance for the fiscal year to over 47%.

As we have detailed in previous shareholder letters, HQH invests broadly in healthcare companies. In particular the Fund invests a significant

percentage of its assets in the biotechnology sector, as well as certain pre-public venture companies. However, the Fund also invests a not insignificant percentage of its assets in larger, more mature companies including traditional pharmaceutical companies, payers, hospitals and healthcare IT companies. In the twelve month period ending September 30, 2013, HQH benefitted from being overweight in Warner Chilcot plc as well as smaller NBI components, such as Neurocrine Biosciences, Inc. In addition the Fund benefitted from owning a numbers of companies (such as Puma Biotechnology, Inc., Keryx Biopharmaceuticals, Inc., and Covance, Inc.) that are not NBI index members. On the other hand, the Fund was disadvantaged by its cash position which averaged approximately 5% through the fiscal year. Ownership of several companies not members of the NBI Index (such as Merck & Co., Hologic, Inc., Teva Pharmaceutical Industries Ltd., A.P. Pharma, Inc., Allergan, Inc. and Edwards Life Sciences Corporation) also limited Fund performance, as did non- or under ownership of NBI components that outperformed the index (such as Alnylam Pharmaceuticals, Inc., Celldex Therapeutics, Inc., Aegerion Pharmaceuticals, Inc., Isis Pharmaceuticals, Inc., BioMarin Pharmaceutical Inc. and NPS Pharmaceuticals, Inc.) and overweight positions in companies that underperformed the NBI index (such as Amarin Corporation plc).

We also want to note that the pre-public venture assets in the Fund's portfolio are generally decreased as a percentage of net assets relative to prior years. This is due to the rapid increase in the value of the public securities in our portfolio rather than to a lack of commitment to the restricted assets. We remain very committed to growing the Fund's venture/restricted portfolio and see it as an important, differentiating feature of the Fund.

### **Investment Highlights**

Given the recent advance in both the NBI and the Fund's NAV and market price, we are satisfied with the multi-year performance of the Fund. However, we think it is important to examine whether we can reasonably continue to expect additional solid performance after such an extended period of sector outperformance. The bottom line is that the last several years have represented one of the best performance periods the biotechnology sector has seen. And while we haven't ever and don't now anticipate the kind of dramatic sector performance we have seen since 2009, we do think there are a number of reasons to be generally optimistic about healthcare overall and biotechnology in particular. And while there can certainly be periods of underperformance, relative to many other sectors, I would not bet against healthcare in the intermediate and

potentially the longer term. It is important to point out that healthcare in general, and particularly biotechnology, is fraught with binary event risk and with susceptibility to sentiment change. From those points of view one must always keep the downside risk in mind. However, from what we see at the moment, there are a number of encouraging factors that make us lean toward being optimistic. Those factors include 1) favorable demographics, 2) an impressive industry pipeline, 3) impressive sell side growth estimates, 4) an apparently more accommodative (but still vigilant) regulatory environment, 5) positive sentiment among both investors and acquirers and 6) not unreasonable growth adjusted valuations.

We have discussed population demographics in several prior shareholder letters. We note again that the U.S. and global populations are aging. In 2010, approximately 13% of the U.S. population was 65 years of age or older. Over time this group will increase in size relative to other age groups. It is estimated that by 2050, the population 65 years of age or older will comprise approximately 20% of the U.S. population. As is commonly known, healthcare spending increases significantly with age. In fact, in the U.S., approximately 37% of all healthcare related spending is attributable to individuals 65 years of age or older. This is the highest level of spending of any age group and suggests that demand for drugs and other healthcare related products will increase for the foreseeable future.

We reported in our semiannual letter that, in our view, the biotechnology industry has reached a new level of maturity. Just a decade ago, relatively few companies in the NBI had attained significant product revenue and only a small percentage were profitable. Now, of the 118 companies in the NBI, 95% have some revenue and 80% have revenue of more than \$10M. This maturation has led to what appears to be a promising future for the biotechnology sector. By one sell-side bank estimate, the commercial potential for recently approved drugs, many biotechnology-related, is approximately \$40B; moreover, the same analysis suggests that there is the potential for approximately an additional \$40B in sales among products in Phase 3 clinical trials. This is very encouraging and is, to us, evidence of the maturation of the industry.

We consider many factors in analyzing a company or sector. However, sales and earnings growth are parameters we commonly consider most important in analyzing the potential of the healthcare sector. Our logic is simple and uncontroversial. All else being equal, sales growth generally leads to increased earnings and earnings drive stock price appreciation. Currently, long term sales growth estimates for the biotechnology sector are in the range of 13-15% while long term growth rates for most other sectors of the broad market are below 10%. In addition, earnings growth estimates for the biotechnology sector exceed 20% while for most other

sectors of the market are more in the range of 5-15%. I note that all else is not always equal (e.g., binary event risk and other factors can have a significant effect on valuation) but, on balance, projected growth rates suggest to us that the biotechnology sector should remain an attractive area for investment.

For some years, I have noted that regulatory affairs present a significant risk to healthcare and biotechnology related investment. This remains the case. After all, it is the (important) job of the FDA and other regulatory agencies to make sure that only safe and effective drug and device products are approved for marketing. Thorough examination of drug approval submissions is complicated and takes a long time. However, it appears to us that, without losing any focus on public safety, the FDA has recently become more accommodative. In the last year or two, the FDA has approved more drugs than it had in previous years. Part of this increase may be tied to the general maturation of the biotechnology industry (i.e., sponsoring companies may be submitting higher quality submissions) or to a larger number of higher quality products, but it appears to us that communications between sponsors and the FDA are improving as well. Hopefully, high quality submissions and improved communication will result in continued high rates of drug approvals.

Sector sentiment is difficult to measure. When a sector performs well it is generally thought to be in favor. On this basis, there is little doubt that healthcare/biotechnology has been "in favor" during the twelve months ending September 30, 2013. However, such past sentiment is less important to us than our judgment about current sentiment. Our view is that when sentiment in our sector is high, incrementally more generalist investors will buy stocks in our sector and that such buying will increase valuations. We are unaware of objective measures of sentiment so we use indirect measurements to assess investor favorability. These indirect measurements include, among other things, fund flows, trading volume, ownership and participation in financings within our sector. In general, these parameters are encouraging to us as is the recent spate of successful biotechnology related IPOs.

In our most recent semiannual letter we noted that the NBI had reached an all time high. We also noted that Price/Earnings (P/E) ratio of the larger capitalization biotech companies had increased to about 20-25, approximately double the lows of recent years. Finally, we noted that even with the increases, valuations generally remained at a significant discount to the P/E multiples achieved in the early/mid 2000s.

Since the time of the semiannual letter, this trend has continued. In general, P/E levels for the larger capitalization companies in the index have increased, as have growth adjusted valuations (i.e., P/E divided by

growth or PEG values). This makes us a bit more cautious about the future. Specifically, on an absolute basis, we feel that some biotechnology companies have probably reached a fair value. Independent of macroeconomic factors, we would not rule out (and we might even anticipate) a pullback of the biotechnology group in the short term. On the other hand, relative to most other market sectors or to the broad market itself, we are much more sanguine about the healthcare/biotechnology sector. We think that this sector has a real future. Many new and differentiated products are being developed and will be marketed to a population that is growing in size and for which we anticipate attractive reimbursement. In the intermediate term and longer, this seems to us like a sector that should do relatively well.

Since our semi-annual letter, there have been a number of important M&A, commercial launch and clinical data events in our sector. Regarding M&A's, we note Amgen, Inc.'s acquisition of Onyx Pharmaceuticals, Inc., Cubist Pharmaceuticals, Inc.'s purchase of Trius Therapeutics, Inc. and Optimer Pharmaceuticals, Allergan's merger with Mapp Pharmaceuticals, Inc., Acatis, Inc.'s purchase of Warner Chilcott and Perrigo Company's announcement of its intention to purchase Elan Corporation plc. Drug launches for Tecfidera (Biogen Idec Inc.), Gattex (NPS), Juxtapid (Aegerion) and PROCYSBI (Raptor Pharmaceuticals Corp.) have generally exceeded our initial expectations. There also has been strong and relatively late stage clinical data events in pancreatic cancer (Celgene Corporation and Incyte Corporation), multiple myeloma (Celgene), DME (Regeneron Pharmaceuticals, Inc.), major depression (Alkermes Pharmaceuticals, Inc.), oncology immunotherapy (Bristol-Meyers Squibb and Merck) and cystic fibrosis (Vertex Pharmaceuticals, Inc.). This is in contrast to some notable clinical trial / regulatory negatives such as the failure of Drisapersen in Duchenne's muscular dystrophy (Prosensa Holding N.V.) and the FDA's rejection of Tivozanib in renal cell carcinoma (AVEO). Note that Amgen, Onyx, Allergan, Actavis, Warner Chilcott, Perrigo, Elan, Biogen Idec, Celgene, Incyte, Regeneron, Alkermes, Merck and Vertex are or have all been Fund investments.

### **Investment Changes**

During the twelve month period ended September 30, 2013, within the public portfolio, the Fund established positions in several companies including Actavis, BioMarin, Onyx, Forest Laboratories, Inc., Infinity Pharmaceuticals, Inc., Sagent Pharmaceuticals, Inc., and Avanir Pharmaceuticals, Inc. During the same twelve month period, the Fund exited its position in several companies including VIVUS, Inc., Cerner Corporation, Netkar Therapeutics, Watson Pharmaceuticals, Inc., Thermo Fisher Scientific, Inc., Jazz Pharmaceuticals plc, Covance and NPS. The Fund wrote off Medwave, Inc.

During the same twelve month period, within the venture portfolio, the Fund established positions in two new companies AlterG, Inc. and Inshtra Medical, Inc. In addition, the Fund made follow-on investments in Neurovance, Inc., Palyon Medical Corporation and Euthymics Biosciences, Inc., CardioKinetix, Inc., Labcyte, Inc. and Veniti, Inc.,

As always, if you have questions, please feel free to call us at (617) 772-8500.

Daniel R. Omstead  
President

**H&Q HEALTHCARE INVESTORS**

**LARGEST HOLDINGS BY ISSUER**

**(Excludes Short-Term Investments)**

*As of September 30, 2013*

<b>Issuer - Sector</b>	<b>% of Net Assets</b>
<b>Gilead Sciences, Inc.</b> <i>Biotechnologies/Biopharmaceuticals</i>	9.5%
<b>Regeneron Pharmaceuticals, Inc.</b> <i>Biotechnologies/Biopharmaceuticals</i>	8.1%
<b>Celgene Corporation</b> <i>Biotechnologies/Biopharmaceuticals</i>	7.9%
<b>Amgen, Inc.</b> <i>Biotechnologies/Biopharmaceuticals</i>	4.7%
<b>Biogen Idec, Inc.</b> <i>Biotechnologies/Biopharmaceuticals</i>	4.6%
<b>Alexion Pharmaceuticals, Inc.</b> <i>Biotechnologies/Biopharmaceuticals</i>	4.4%
<b>Vertex Pharmaceuticals, Inc.</b> <i>Biotechnologies/Biopharmaceuticals</i>	3.8%
<b>Puma Biotechnology, Inc.</b> <i>Biotechnologies/Biopharmaceuticals</i>	2.5%
<b>Perrigo Company</b> <i>Generic Pharmaceuticals</i>	2.4%
<b>Aetna, Inc.</b> <i>Healthcare Services</i>	2.3%

**SECTOR DIVERSIFICATION (% of Net Assets)**

*As of September 30, 2013*



**H&Q HEALTHCARE INVESTORS****SCHEDULE OF INVESTMENTS**

SEPTEMBER 30, 2013

<b>CONVERTIBLE AND NON-CONVERTIBLE SECURITIES AND WARRANTS - 5.8% of Net Assets</b>		
<b>SHARES</b>	<b>Convertible Preferred and Warrants (Restricted) <sup>(a)</sup> <sup>(b)</sup> - 5.7%</b>	<b>VALUE</b>
	<i>Biotechnologies/Biopharmaceuticals - 1.3%</i>	
7,399,474	Celladon Corporation Series A-1	\$ 6,467,140
3,696,765	EBI Life Sciences, Inc. Series A <sup>(c)</sup>	18,854
4,118,954	Euthymics Biosciences, Inc. Series A <sup>(c)</sup>	1,582,914
358,852	MacroGenics, Inc. Series D	234,007
3,696,765	Neurovance, Inc. Series A <sup>(c)</sup>	287,608
9,955,096	Neurovance, Inc. Series A-1 <sup>(c)</sup>	774,507
		9,365,030
	<i>Healthcare Services - 0.9%</i>	
5,384,615	PHT Corporation Series D <sup>(c)</sup>	4,200,000
1,204,495	PHT Corporation Series E <sup>(c)</sup>	1,866,606
149,183	PHT Corporation Series F <sup>(c)</sup>	395,529
		6,462,135
	<i>Medical Devices and Diagnostics - 3.5%</i>	
3,364,723	AlterG, Inc. Series C	1,379,536
114,158	CardioKinetix, Inc. Series C <sup>(c)</sup>	1,606,089
205,167	CardioKinetix, Inc. Series D <sup>(c)</sup>	781,071
632,211	CardioKinetix, Inc. Series E <sup>(c)</sup>	1,799,905
N/A	CardioKinetix, Inc. warrants (expiration 12/11/19) <sup>(c)</sup> <sup>(d)</sup>	0
N/A	CardioKinetix, Inc. warrants (expiration 6/03/20) <sup>(c)</sup> <sup>(d)</sup>	0
3,109,861	Dynex Technologies, Inc. Series A <sup>(c)</sup>	923,629
142,210	Dynex Technologies, Inc. warrants (expiration 4/01/19) <sup>(c)</sup>	0
11,335	Dynex Technologies, Inc. warrants (expiration 5/06/19) <sup>(c)</sup>	0
4,499,218	IlluminOss Medical, Inc. Series C-1 <sup>(c)</sup>	1,725,000
8,150,248	Insightra Medical, Inc Series C <sup>(c)</sup>	3,450,000
3,669,024	Labcyte, Inc. Series C	2,615,647
160,767	Labcyte, Inc. Series D	133,372
3,109,861	Magellan Diagnostics, Inc. Series A <sup>(c)</sup>	2,131,188
142,210	Magellan Diagnostics, Inc. warrants (expiration 4/01/19) <sup>(c)</sup>	0
11,335	Magellan Diagnostics, Inc. warrants (expiration 5/06/19) <sup>(c)</sup>	0
18,530,887	Palyon Medical Corporation Series A <sup>(c)</sup>	18,531

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27,100,879	Palyon Medical Corporation Series B <sup>(c)</sup>	1,880,801
N/A	Palyon Medical Corporation warrants (expiration 4/26/19) <sup>(c)</sup> <sup>(d)</sup>	0

The accompanying notes are an integral part of these financial statements.

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**H&Q HEALTHCARE INVESTORS****SCHEDULE OF INVESTMENTS**

SEPTEMBER 30, 2013

(continued)

<b>Convertible Preferred and Warrants (Restricted) <sup>(a)</sup> <sup>(b)</sup> - continued</b>		<b>VALUE</b>
<b>SHARES</b>		
65,217	TherOx, Inc. Series H	\$ 652
149,469	TherOx, Inc. Series I	1,495
4,720,000	Tibion Corporation Series B	387,040
N/A	Tibion Corporation warrants (expiration 07/12/17) <sup>(d)</sup>	0
N/A	Tibion Corporation warrants (expiration 10/30/17) <sup>(d)</sup>	0
N/A	Tibion Corporation warrants (expiration 11/28/17) <sup>(d)</sup>	0
3,750,143	Veniti, Inc. Series A <sup>(c)</sup>	3,432,506
1,881,048	Veniti, Inc. Series B <sup>(c)</sup>	1,721,723
		23,988,185
	<b>TOTAL CONVERTIBLE PREFERRED AND WARRANTS</b>	39,815,350
<b>PRINCIPAL AMOUNT</b>	<b>Non-Convertible Notes (Restricted) <sup>(a)</sup> <sup>(b)</sup> - 0.1%</b>	
	<i>Medical Devices and Diagnostics - 0.1%</i>	
\$ 40,596	Tibion Corporation Non-Cvt. Promissory Note, 0.00% due 12/31/18	40,596
342,899	Tibion Corporation Non-Cvt. Promissory Note, 0.00% due 12/31/18	342,899
	<b>TOTAL NON-CONVERTIBLE NOTES</b>	383,495
	<b>TOTAL CONVERTIBLE AND NON-CONVERTIBLE SECURITIES AND WARRANTS</b> (Cost \$46,209,433)	40,198,845
	<b>COMMON STOCKS AND WARRANTS - 90.4%</b> <i>Biotechnologies/Biopharmaceuticals - 59.6%</i>	
<b>SHARES</b>		