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Investing in biotechnology - a lucrative approach

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Investing in the field of biotechnology is an interesting prospect due to massive advances in medical research and development. The industry continues to profit from acquisitions, in addition to its high capacity for innovation. Investment promises attractive potential returns. However, certain peculiarities should be considered when investing: Gambling on individual stocks is usually not worthwhile for private investors. By contrast, (passive) index investments pose the risk of missing out on developments that are relevant for investment success. The stock-picking environment supports actively managed sector funds.

Emerging biotechnology companies have become the backbone of innovation for the large pharmaceutical groups. 70% of all medicinal products in clinical development today already stem from biotech companies. There have been incredible advances in medical research and development in the past few years. These advances were sparked by the decoding of the human genome at the turn of the century. We currently have a better understanding of disease aetiology and are therefore capable of developing more specific and effective medications. It has proven lucrative to invest in biotechnology shares in recent years: an annual gain of 18% was reported over 10 years measured against the performance of the NASDAQ biotechnology index. By contrast, the MSCI World stock market index put on just 10% per year.

Capacity for innovation attracts pharmaceutical companies

Genetic and cellular therapies are particularly promising. Currently incurable, life-limiting genetic conditions can be treated with new cell and gene-based methods, and the drugs even hold out the promise of a cure – often requiring just a single treatment. These are illnesses which can be clearly attributed to mutations of a specific gene. A few months ago, Roche dared to venture into this novel treatment area when it announced the takeover of Spark Therapeutics, and it is by no means the only large pharmaceutical company that is doing so. Novartis, Pfizer, Johnson & Johnson and Biogen are also convinced the area offers potential. There are also numerous smaller companies such as Biomarin, Ultragenyx, UniQure and MeiraGTx – which still operate independently – that have promising medicinal product candidates in the development pipeline.

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There is also the untapped potential of newer approaches in the field of molecular-targeted oncology, as well as relating to diseases of the central nervous system, cardiovascular ailments and autoimmune disorders. Molecular-targeted cancer treatments, for example, currently dominate the medicinal product development pipeline in many companies. Cancer is increasingly understood as a genetic disorder that is primarily defined by genetic modifications and tumour cells and not by the site at which the cancer originates in the body. A large number of the molecular-targeted products are focused on these genetic modifications. In the ideal scenario, they will be able to "switch off" the cancer cells while protecting healthy tissue. This is also of increasing interest to the pharmaceutical industry, hence why Loxo Oncology was taken over by Eli Lilly for 8 billion US dollars in February 2019, and why Pfizer acquired Array Biopharma for 11 billion US dollars in July. The premiums on the share prices most recently paid out before the acquisition were extremely attractive for investors, at 68% for Loxo and 62% for Array.

Betting on individual stocks is not advised

Investing in individual stocks is fundamentally associated with high levels of risk, depending on the stage of development of the company or its product(s) under development. Failures in clinical development are an inherent part of the process. The risks related to marketing authorisation and commercialisation also need to be considered in addition to the clinical risks. The regulatory authorities, such as the representative US authority, the FDA, prefer innovative medicinal products that alleviate disease, or even cure them in a best case scenario. Accelerated development and marketing authorisation procedures are available for particularly innovative medicinal products targeting severe disorders. Another risk that is gaining in importance is the risk of health insurance reimbursement. At present, medicinal products must usually demonstrate an unambiguous competitive advantage, either in the form of a treatment for a disorder that is currently either untreatable or inadequately treated, or in the form of improved efficacy and safety compared to an existing form of treatment. If this is not the case, it is difficult to obtain reimbursement from health insurance, and market success is uncertain. The example of genetic and cellular therapies emphasises the uncertainty “right up until the end". Due to the absence of an industrial manufacturing process and the market potential for these treatments, which is currently relatively predictable, the treatment costs are high. Overall, it is not advisable for private investors to place their bets on individual stocks and small companies with medicinal products still in the development phase. This type of investment requires an enormous amount of specific sector knowledge to ensure adequate consideration of the risks.

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Diversified does not necessarily mean diversified

Index investments would be more suitable from the perspective of diversification. However, this also necessitates certain compromises. Since the middle of 2015, shares from large biotechnology companies have developed less impressively than those of small and moderately sized capitalised companies. The large biotech companies are currently in a similar situation to that of the pharmaceutical industry approximately 10 to 15 years ago. Turnover and profits are not growing as fast now as they once used to. The companies have also had to deal with a number of large clinical setbacks. Involvement in a significant NASDAQ Biotechnology Index that invests heavily in large biotech companies like Gilead, Celgene, Amgen and Biogen poses the risk of overlooking the development – and in particular the promising return potential – of innovative, small and medium-sized companies. These companies have shareholder values of between 2 and 10 billion. The current environment is fundamentally different from the dominant environment between 2011 and 2015. Based on our predictions, this development favours specialised investors who are able to identify the most promising companies early on using a stockpicking approach.

Active and prudent portfolio management

This environment supports actively managed sector funds; Chart 1 shows their share price development. This also includes the HBM Global Biotechnology Fund (A Cap USD, ISIN: LU1540961759, Bloomberg: HBMGACU LX Equity). The fund was launched by the Swiss specialists HBM Partners almost 8 years ago. This investment vehicle relies on the principle of "innovation". Almost 50% of the fund is invested in small and medium sized companies. The fund is more active in biotech companies outside the US than its competitors, with approximately 20% allocated in Europe and Asia. Companies only become candidates for a portfolio once as many product candidates have been validated as possible, or once they have proven efficacy in clinical trials and it is foreseeable that they do not have excessive side effects. Risks from individual events, such as the announcement of clinical trials, are minimised or diversified to the greatest possible extent. High portfolio weightings of individual stocks ("concentrations") are avoided, with the exception of positions in established companies. The result is a moderate risk of deviation from the benchmark NASDAQ Biotechnology Index, measured by the tracking error of just over 4%. The fund does not tend to lose more than the benchmark in the negative scenario, but surpasses the benchmark in a positive environment due to its active management, measured by the "active share" component, and the risk-

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conscious investment and portfolio management strategy. Since its inception in January 2012, the fund has outperformed the benchmark by more than 40% (after charges).

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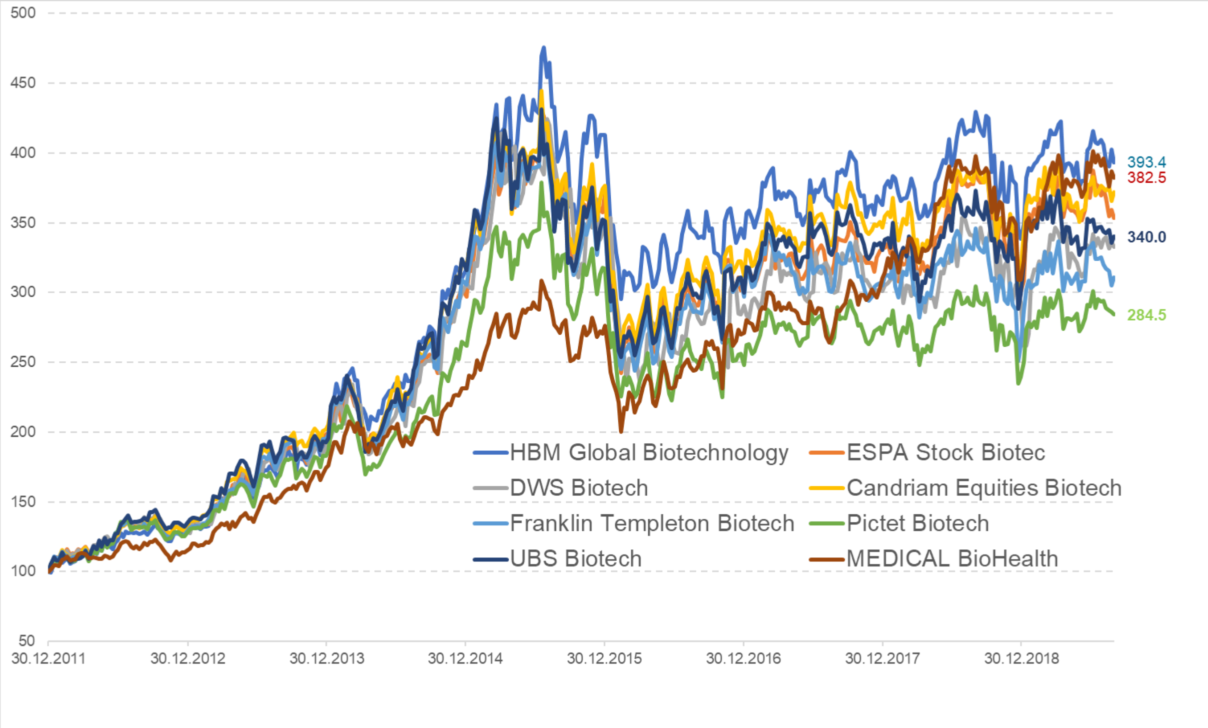
Chart 1: Performance of biotechnology funds since the launch of the HBM Global Biotechnology Fund on 1 January 2012 *(all values in EUR, indexed to 100, mutual funds only)*



Source: Bloomberg

Table 2: Return/risk comparison of mutual funds since 1 January 2012 (all values in EUR)

	HBM Global Biotechnology	ESPA Stock Biotec	DWS Biotech	Candriam Equities Biotech	Franklin Templeton Biotech	Pictet Biotech	UBS Biotech	MEDICAL BioHealth
Seit 1.1.2012 (kumulativ)	293.4%	253.7%	232.6%	272.0%	211.0%	184.5%	240.0%	282.5%
Rendite pro Jahr	19.8%	17.9%	17.0%	18.7%	16.0%	14.6%	17.3%	19.1%
Volatilität annualisiert	24.2%	25.9%	26.8%	25.1%	25.8%	24.9%	26.5%	20.1%
Rendite / Risiko Verhältnis	0.82	0.69	0.63	0.75	0.62	0.59	0.65	0.95

Source: Bloomberg, calculations by HBM Partners

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