Biotech funds: Only for those immune to fear

John Waggoner
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1

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As everyone knows from disinfectant commercials, germs lurking on the kitchen counter can give you infections so virulent that you'll be sent home from the hospital in a soup tureen. Fortunately, there are also cures for those diseases, although the side effects may include drowsiness, catatonia, dyspepsia, Cotard's Syndrome and uncontrollable shrieking.

Our constant fear of diseases—stoked by ads for drugs to combat illness—may be one reason behind the boom in biotechnology stocks. More likely, however, is our fondness for a good story and a red-hot stock. Biotech has been so hot the past two years that the sector is starting to raise red flags. And, while it may have longer to run, it's an area that the weak of heart and the short of cash should avoid.

Despite a recent backup—more on that in a moment— biotech funds are standouts in an otherwise mediocre quarter for mutual fund investors. The average health and biotech fund has gained 5.4% this year vs. 0.2% for the average stock fund. The difference is more striking if you look at the funds' three-year records: They're up 100% vs. 46% for the average stock fund.

Those big gains have raised the question of whether biotech is in a bubble, which is in itself a loaded question. By definition, bubbles are extraordinarily difficult to detect before they pop. And high returns are not, by themselves, the only hallmark of a bubble. CBS is up 1,902% since the stock market bottom in 2009, but no one is claiming that media stocks are in a bubble.

What makes bubbles so hard to spot? For one thing, there's always a plausible story behind them. In the 1830s, canal stocks boomed because it is indeed much easier to push something over water than over rutted dirt roads. And in the 1990s, people invested in the dot-com bubble because they believed that the Internet would be an enormous gateway for commerce—which, in fact, it has evolved to be.

With biotechnology, the plausible story is that medicine is making some spectacular breakthroughs, and doing so after a fairly long dry spell. The most notable is Gilead Sciences' hepatitis C drug Sovaldi, which actually cures the disease rather than controls it. The disease makes life a misery for 150 million to 200 million people around the world and ultimately kills many of them.

"Biotechnology is a real, great American story," says Rajiv Kaul, portfolio manager of Fidelity's Select Biotechnology Portfolio (FBIOX). "It's very difficult to make medicine. It takes hard work and the failure rates are high. But it's a really exciting time."

Furthermore, the industry's rise has come after a fairly long dry spell, when relatively few blockbuster drugs hit the market, says Evan McCulloch, portfolio manager of Franklin Biotechnology Discovery Fund.

"Big pharma and biotech together had a significant period of underperformance," McCulloch says. During that period, biotech became extremely cheap relative to earnings.

Another problem in the middle part of the last decade: The Food and Drug Administration became more conservative after the failure of Vioxx, an anti-inflammatory drug sold by Merck, was shown to increase the risk of stroke and heart failure in patients.

Currently, however, the FDA has been more accommodative toward getting new drugs on the market, says Kaul. "The FDA is doing the right things, and government has done good things in terms of working with industry to get innovative therapies to be priorities," he says.

The question then is whether investors are getting too giddy about the prospects for biotech stocks. **Gilead** (GILD), for example, sells for about 12.4 times its estimated 12 months' earnings, which is fairly reasonable. On the other end of the spectrum is **Intercept Pharmaceuticals** (ICPT), up 748% the past 12 months with no earnings.

But the market for small-company biotech stocks has always been giddy. One way to look at frothiness is the number of initial public offerings in the biotech industry—25 in the industry this year alone vs. 45 last year. In a biotech bubble, you start seeing IPOs of companies composed of two guys, a microscope, and a dream.

"It's not that bad yet," McCulloch says. "Companies raise money when they can, not necessarily when they need it." And right now is an excellent time for most companies to raise IPO money.

Biotech not oversold, went through correction: Pro

Max Herrmann, partner and healthcare research analyst at Oriel Securities, said biotech stocks have gone through a correction after a "phenomenal" rally.

Nevertheless, biotech is a sector that has had a good run, which means that investors are likely to become skittish quickly. In the past few weeks, biotech stocks have sold off, in part because of Rep. Henry Waxman's recent letter to Gilead questioning the company's $84,000 price tag for Sovaldi.

"It was a shot across the bow," says McCulloch. "And what it means is that there could be some revision to drug pricing in the long term."

Any laws restricting drug pricing are highly unlikely in the Republican-held House, however, and Gilead's champions note that the drug's price tag is far less than for a liver transplant or for the years of care needed by hepatitis C sufferers. But the letter may make companies wary of their pricing—not necessarily a bad thing.

"Companies want their prices as high as they can make them without landing on front page of newspaper," McCulloch says.

Right now, it's hard to recommend biotech investing for anyone but those who don't mind risk. While the best years of biotech may be before us—and they probably are—you don't want to pay too much for the future. For the brave, the top-performing health and biotech companies are in the chart.

Otherwise, consider a general diversified fund. Health care is about 13% of the Standard and Poor's 500 stock index. You don't want your portfolio to come down with unwanted side effects, such as itching, sneezing or hives.