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Why high-risk, high-reward biotech sector may be poised for a bull run

JOEL SCHLESINGER

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A "buy when there's blood in the streets" moment may be at hand for beaten-up biotechnology stocks, potentially poised for an upswing after several months of falling prices, according to experts who follow the sector closely.

"Biotech is a great place to be with a high potential for profitability because it's coming off a period of extreme capitulation," says Bob Thompson, senior portfolio manager, private client group, with Thompson Investment Partners at Raymond James Ltd. in Vancouver.

"Even the sector's biggest bulls puked out the last stocks this past spring, saying, 'We're done.'"

Biotech – encompassing companies large and small developing biologically-based, breakthrough therapeutics – had been on a bull run until February 2021, says Mr. Thompson, who has long followed the sector.

The pandemic initially drove investor interest in biotech, which proved its value in developing mRNA vaccines from Moderna Inc. MRNA-Q -6.41% decrease and Pfizer Inc. PFE-N -3.22% decrease and BioNTech SE BNTX-Q -4.93% decrease, while fuelled by historically low interest rates, he adds.

Yet, the luster began to wear off at the start of 2021 and a slump turned into a deep bear market as interest rates rose in recent months, drying up capital, especially for companies developing yet-to-be proven medicines, says Eden Rahim, portfolio manager of Next Edge Capital Corp.'s Biotech and Life Science Opportunities Fund.

“The irony is the bloodbath really masks incredible breakthroughs, which the entire planet saw first-hand,” he says.

Of course, the sector plunging amid risk-off conditions comes as no surprise for those following it.

For decades, biotech has been a boom/bust segment offering soaring returns during bull markets while destroying capital in bear markets, and this most recent bear market is no exception.

The S&P Biotechnology Select Index fell more than 60 per cent from peak to trough between early February 2021 and May this year. It has since rebounded almost 40 per cent, with potentially more room to grow if market history repeats itself, Mr. Rahim adds.

“Biotech has had a few bear markets, all followed very strong, multi-year bull markets,” he says.

The historical perspective

Data going back to 1962 reveal “very strong odds of forward outperformance” after a steep bear market, says Denise Chisholm, director of quantitative market research at Fidelity Investments in Boston.

For example, the Nasdaq Biotechnology Index surged more than 1,000 per cent from 1994 to 2000 and almost 600 per cent from 2009 to 2015 following bear markets.

Ms. Chisholm thinks the sector could again be entering another growth phase, given biotech stock valuations, collectively, have been much more compressed than their earnings.

“Like the energy sector coming out of the pandemic being a good opportunity … biotech is in much the same position,” she says, warning any upswing will likely involve high volatility.

A challenge for advisors is they generally don’t have the expertise in the sector.

“It’s not like covering a homogenous industry like banks where you look at balance sheets and compare them,” Mr. Rahim says.

“Each company has unique science with research papers to read through. … So, it’s an intense amount of work, whether it’s the smallest company or the largest.”

Broadly speaking, small-cap companies have been hit hardest, down about 90 per cent in some instances, because they rely the most on investor capital to fund research and trials into unproven medicines, he explains.

With respect to the largest biotech players, Mr. Rahim says they're "winners of the last cycle," so while undervalued, they're "justifiably so" because they must "replenish their pipeline" with new therapeutics.

The situation is likely to lead to a "mergers and acquisitions boom" with many large biotech and big pharmaceutical firms facing "a patent cliff" this decade and, in turn, looking to acquire mid-sized companies with successful, new therapeutics already generating revenue, Mr. Rahim says.

Where the opportunities lie

Acquisitions aside, mid-sized companies offer the most upside with revenue-generating drugs, positioning them to be the next big biotech firms, he adds. Among those with potential are Incyte Corp. INCY-Q -3.36% decrease, which has novel treatments for bone marrow cancer and alopecia areata (patchy baldness).

"It has very defensive attributes – highly profitable even in this environment," Mr. Rahim says.

Other companies may not produce therapeutics but manufacture technologies facilitating drug developments. These include Schrodinger Inc. SDGR-Q -2.12% decrease, which has developed technology to screen "potential drug candidates based on multiple attributes to de-risk drugs being brought to trials," he says.

Most are U.S.-based as Canada's sector is characterized by small-cap companies. Even so, some are notable, including Microbix Biosystems Inc. MBX-T -1.85% decrease, which creates antigens for laboratory tests among other products, he says.

Yet, it's not only mid-caps appearing poised for growth. The entire sector – non-revenue generating small caps included – may see an upswing as headwinds like rising interest rates are likely to be less impactful so long as rates do not rise as quickly as they recently have, Ms. Chisholm says.

The entire sector "looks interesting right now," she says, cautioning that this assessment is based on historical data from similar periods over six decades.

"So, if you had to pick … why not buy a big basket and incorporate it all?" she adds.

Indeed, biotech-focused exchange-traded funds are one way to gain exposure at a low cost, Mr. Thompson says.

Yet, allocating capital to actively managed funds for this sector is his preference for clients.

"A spray and pray approach… buying everything, hoping it all goes up may not produce the result you're looking for," he adds.

"You really need a sector expert who can sort through all the companies and build a portfolio that holds a few that turn out to be winners, driving the high returns."

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