

Perspective: Forward March Higher, and a Biotech Bubble?

Apr 07, 2014

Dear Scott,

The Forward March Higher - What the Charts Say Now:

The S&P500 stock index rose by 0.9% in March. It's not much, but we all like up-side numbers. Although 0.9% is smaller than the average daily variation of the S&P500, it more likely indicates continued strength than weakness.

While market experts (often right about 50% of the time) worry about the disappointing improvements in the jobless numbers and lukewarm earnings reports, they generally expect the market to have a somewhat positive year with some bumps along the way. At least, those are the market experts I choose to believe. And, there is nothing in either of the S&P500 charts to the right that should give a SectorSurfer cause for concern — because the trend is our friend.

However, not all market sectors are the same, and notably the biotech sector funds and stocks have given some cause for concern, as illustrated in the third chart on the right.

Did a Biotech Bubble Just Pop?

The 6-month plots of IBB (biotech ETF) and BIB (ultra 2x biotech ETF) give one cause for pause. Many other biotech ETFs and biotech stocks also have quite similar charts. I received a few concerned emails about Strategies that held a biotech stock or fund, some of which traded out of the position at the end of the month, and some which did not. Of course, the worst thing is to have a fund that lures you in on strong performance one month and then pulls the rug out from under your feet the next.

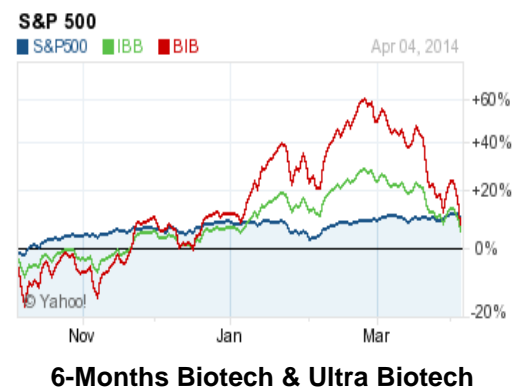
I reviewed a number of Strategies holding biotech and found that most actually had been neutral to profitable over the holding period in spite of the significant downturn last month because almost all Strategies had owned biotech for two or more months. At two months it was a wash, and at three or more months there was respectable return. However, if you bought into the Strategy just last month, then you would certainly be feeling some pain.

A longer-term 3-year view of biotech (shown in the fourth chart at right) reveals that this sector has been outperforming the market for quite some time, with many pundits strongly suggesting that biotech is now in bubble territory. Here are two interesting articles — both by The Motley Fool — that argue the opposite viewpoint:

[Is the Biotech Bubble About to Burst?](#) (see also attached)

[1 Big Reason to Doubt the Biotech Bubble Chorus.](#) (see also attached)

I agree — it's not a bubble yet.



What if You're Late and Still Hold Biotech?

That would be me. I was on a sailboat in the Bahamas last week (see last photo) and the subscribed MIFI internet through the Bahamian Tel. Co. was totally non-functional for 5 days and worse than dial up on a stormy night for the remainder.

So, having now returned to Seattle, and writing this monthly newsletter a bit late, I have still to make my own month-end trades, which include the biotech funds FBIOX and BIB. Unfortunately, Friday was a further 4.2% down day for FBIOX and an even more painful 8.03% down day for BIB. So, do I sell on Monday in hopes of avoiding further devastation and lock in the loss, or do I wait with hope that a bounce will occur? I've personally decided to wait for the latter before getting back in synch with the Strategy for these reasons:

- 1) I believe the Motley Fool arguments are correct, it's not a bubble.
- 2) The 3-year chart doesn't imply that this is an abnormal pull-back.
- 3) Analysis shows [ignoring sharp dips can avoid whipsaw losses](#).
- 4) Jim Cramer says "[panic selling has never been the right strategy](#)."

The wisdom and luck of these reasons will soon be tested ... I hope your trades were timely and comparatively stress free.

Surf Well and Prosper,



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3-Years Biotech



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Is the Biotech Bubble About to Burst?

By [Keith Speights](#) | [More Articles](#) | [Save For Later](#)

August 27, 2013 | [Comments \(4\)](#)

"Bubble" can be a provocative word in investing circles. Think of all that comes to mind when you hear it -- perhaps other words like over-hyped, overvalued, risky, etc. To quote from our own [Motley Fool investing wiki](#), a bubble "occurs when people are happily paying more for stocks in a certain sector than they are worth given the fundamentals of the businesses." That happy buying keeps on going and going until it stops. Then the bubble bursts.



Many investors are definitely paying increasingly more for biotech stocks. I suspect that they're happily doing so. Major exchange-traded funds, or ETFs, that track biotech stocks are up over 30% so far this year -- easily beating the broader indexes, which have done quite well themselves. But is biotech actually in a bubble right now? If so, is that bubble about to burst? It depends.

Yes and no

Not all of these biotech run-ups have necessarily valued stocks more than the business fundamentals warrant. For example, shares of **Celgene** (NASDAQ: [CELG](#)) have soared by more than 70% in 2013. But if you look at the company's likelihood of continuing to grow earnings with sustained strength from Revlimid and great potential for other drugs like Abraxane and Pomalyst, Celgene's price doesn't seem too high even after an enormous run.

On the other hand, it isn't too difficult to find examples of biotech stocks that seem to have flown well past what their current fundamentals justify. There are some small companies with little to no revenue and no product likely to hit the market in the next couple of years that have skyrocketed to premium valuations.

For example, shares of **Cytokinetics** (NASDAQ: [CYTK](#)) have jumped more than 180% year-to-date. The small biotech currently claims a market cap of around \$325 million. That's nearly 60 times the \$5.7 million in revenue that Cytokinetics has made over the last 12 months -- and it's not likely to see significantly more revenue in the immediate future.

The biotech has no products in phase 3 development yet, although it is in collaboration with **Amgen** (NASDAQ: [AMGN](#)) on a heart muscle drug that is in two different phase 2b studies and has another neuromuscular drug in phase 2b. Amgen holds a \$10 million stake in the company as part of the licensing deal.

There also are biotechs that have had a great ride in 2013 but could see more challenging days ahead. **Astex Pharmaceuticals** (NASDAQ: [ASTX](#)) stock has more than doubled so far this year. It has a market cap of around \$550 million on nearly \$80 million in sales over the last 12 months. However, Astex expects that sales for its lead product, Dacogen, will drop next year in the U.S. with the entrance of generic competition.

Stocks like Cytokinetics and Astex would likely fall heavily if the presumed biotech bubble burst. Of course, when bubbles burst they tend to take most of the stocks in the sector down.

The bubble that wasn't

Back to the original headline question, though: Is the biotech bubble about to burst? My view is that it won't -- because it's not really a bubble after all.

I looked at the top 10 holdings of the **iShares Nasdaq Biotechnology ETF**. These 10 stocks comprise more than 55% of the total assets held by the ETF. If we were seeing a bubble in biotech stocks, how many of these would you think would be at historically high price-to-earnings multiples? Maybe eight or nine of them? At least half?

The actual answer is that only two of the top 10 biotech stocks in the ETF are at their five-year highs for valuation -- **Biogen Idec** and **Gilead Sciences** (NASDAQ: [GILD](#)) . I would argue that, like Celgene, neither of these stocks are too highly priced considering their earnings potential. Gilead, especially, looks strong in my view with its solid HIV franchise and big opportunities ahead stemming from its frontrunner status in commercializing an all-oral hepatitis C virus drug.

Sure, some biotech stocks are overvalued. I don't think the sector as a whole is, though. Biotech could become "bubblicious" at some point. For now, though, I suspect we'll see more stocks continue to pop than have their bubbles burst.



1 Big Reason to Doubt the Biotech Bubble Chorus

By [Keith Speights](#) | [More Articles](#) | [Save For Later](#)
March 26, 2014 | [Comments \(1\)](#)

Raise your hand if you've heard the words "biotech" and "bubble" used in the same sentence recently. Observers from virtually every corner have joined the chorus singing the blues about the biotech sector. Some might even be humming a funeral dirge.

After all, biotech stocks have taken a beating over the last week. Shares of **Biogen Idec** (NASDAQ: [BIIB](#)) dropped 10%. **Alexion Pharmaceuticals**' (NASDAQ: [ALXN](#)) shares plunged 16%. Others didn't suffer as badly, but few have seen any significant gains over the past several days.

With so many proclaiming that biotech stocks are in a bubble and that bubble is popping before our eyes, why not join the refrain? There's at least one significant reason for doubt that a biotech bubble is in progress. That reason can be summed up in one word: growth.



Expensive bargains?

It's easy to look at the **iShares Nasdaq Biotechnology** ETF's (NASDAQ: [IBB](#)) price-to-earnings multiple of 29 compared to the S&P 500's P/E of 16 and think that biotech is expensive. If the rearview mirror was the only thing that mattered to the market, that verdict would probably be correct. But the market is much more focused on what's ahead than what's in the past.

Future prospects for at least two of the biggest stocks in the iShares biotech ETF appear to justify their lofty valuations and leave plenty of room to run even more. **Gilead Sciences** (NASDAQ: [GILD](#)) and **Celgene** (NASDAQ: [CELG](#)) together make up almost one-seventh of the fund's total assets. And both look like relative bargains in terms of growth potential despite racking up huge gains over the last year.

Sovaldi has been the big story for Gilead. The hepatitis C drug stands to be one of the most successful drugs on the market. Many eagerly await Gilead's next act, a combination of Sovaldi and another of its products, GS-5816, which will be basically the holy grail of hepatitis C -- one oral pill that effectively cures the viral disease.

Largely because of the promise of the Sovaldi franchise, Gilead's P/E-to-growth, or PEG, ratio comes in at a stunningly low 0.52. Legendary investor Peter Lynch's rule of thumb was that a fairly valued company would have a PEG of 1. Using Lynch's premise, and assuming a bundle of other things go right, Gilead could roughly double its share price from current levels to be fairly valued.

Celgene, meanwhile, continues to add to its arsenal. Just a few days ago, the biotech gained U.S. approval for Otezla in treating psoriatic arthritis. Celgene already claims megablockbuster Revlimid and near-blockbuster drugs with Abraxane and Vidaza, along with up-and-comer Pomalyst.

Sustained strength from Revlimid combined with solid performance from Celgene's other drugs led the company to project earnings-per-share growth of 19% this year. The biotech's PEG ratio of 0.81 indicates that the stock still may have potential to move higher.

Bubbling?

The biotech bubble chorus would sing that PEG numbers can be horribly wrong since they're based on estimates. And their song would ring true. Growth projections can sometimes be way too optimistic.

Some might point to risks for Gilead, in particular, after several congressmen requested the company explain why Sovaldi costs so much. Some payers are pushing back against the drug's price tag of \$84,000 per 12-week treatment course. Concerns have risen that a significant backlash could mean Gilead's profits will climb more slowly than initially thought.

It's also important to note that not all biotech stocks appear to be as attractively valued when growth prospects are factored in. Biogen, for example, boasts a terrific drug powering its growth with Tecfidera. However, the company's PEG currently stands at nearly 1.7 -- well above Peter Lynch's fair value benchmark.

Alexion, likewise, continues to experience strong increased sales from Soliris, which treats the rare diseases paroxysmal nocturnal hemoglobinuria and atypical hemolytic uremic syndrome. That growth seems to be perhaps largely baked into the stock, though. Alexion has a PEG ratio of 1.18.

Singing a different tune

My view is that the real answer to whether we're seeing a biotech bubble is more nuanced. I suspect some stocks in the sector that have enjoyed a great ride for a long time could continue to be knocked off their perches. On the other hand, several biotech stocks still look like solid picks for the foreseeable future.

I would definitely include both Celgene and Gilead Sciences in the latter group. I'm looking forward to Gilead's response to the congressional inquiry, which will no doubt point out that patients who take Sovaldi are much less likely to require a liver transplant, which costs in the neighborhood of \$600,000.

As a whole, the biotech sector still looks attractive factoring in growth potential. Geoff Meacham at JP Morgan notes that the PEG ratio for biotech is around 0.7 -- around half the value of the S&P 500.

Let the biotech bubble chorus keep singing -- and making stocks like Celgene, Gilead, and others which may have great days ahead of them more inexpensive to buy. That should be music to Foolish investors' ears.