Nasdaq dilutes its biotech index

The Nasdaq Stock Market (New York), the world's largest electronic stock market, added 55 securities to its biotechnology index on November 24, bringing to 129 the total number of companies listed on the index. At least ten of the new companies, however, are not strictly biotech—some develop generic pharmaceuticals and others manufacture medical devices, for example. Although the shift may simply reflect the dynamic nature of biotechnology and its definition from an investor standpoint, the biotech index will now display the sector's successes and failures even less accurately than it used to.

The US government developed Nasdaq's previous classification system in 1972 and required companies to assign themselves to a particular sector. Nasdaq's biotech index has now been reclassified according to FTSE Group's (London) definitions of its biotechnology and pharmaceutical subsectors. John Jacobs, Nasdaq's executive vice president of worldwide marketing and financial products, says the intention was not to make the biotechnology index broader, but to establish an objective benchmarking classification system "so that everyone can readily understand what companies are included in the index." Jacobs points out that the Nasdaq's index has not been a "pure" biotech index for a long time and the stock market has simply continued this natural migration.

Initially, biotechnology was primarily considered to be biology, with companies like Genentech (S. San Francisco, CA, USA) studying genes and coming up with biological targets. Then chemistry companies moved into the space, with firms like Sepracor (Marlborough, MA, USA) focusing on compounds that interact with the biotech companies' biological targets. The industry has since seen the emergence of other groups, including device companies, instrument firms and those that develop hardware.

Sam Williams, research analyst at Lehman Brothers (London), says the definition of biotech "is open to interpretation." Investors, however, treat them all the same if they follow the binary nature of high investment risk but potentially high monetary returns based on a small number of compounds and licensing deals with large pharmaceutical companies. Evaluating these companies requires an understanding of what they do rather than what is in their income statements.

Meanwhile, the several traditional biotech companies that have grown into large entities, such as Amgen (Thousand Oaks, CA, USA) and Biogen Idec (Cambridge, MA, USA), are now trading on a multiple of earnings—which is a typical characteristic of large pharmaceutical companies rather than biotech companies in the investment sense—and should probably not be included on the index, either.

Thus, the difficulty with maintaining the definition of 'true' biotech for an index is that you end up with companies that "trade based on a relatively small number of products or events and so they're quite volatile," says David Southwell, CFO of Sepracor. "What Nasdaq is probably trying to do is give investors the opportunity to diversify between a whole group of different but relatively volatile companies."

Nevertheless, the rationale for including on the index companies whose business is to develop generic pharmaceuticals remains a mystery. Although they might conduct some manufacturing research and abbreviated clinical trials, the companies are largely legal machines that prove bioequivalence of generic formulations without needing to recoup the costs of original research and full development.

Southwell suggests the inclusion of generic firms might stabilize some of the volatility of the index: if the securities of the patent holders go down because their patents expire, then the share price of the generic company that picks up that drug will presumably increase. But because companies that clearly are not biotechs would drive such stability, the index will not accurately reflect the financial state of the biotech sector.

However, some analysts downplay the negative effects that Nasdaq's changes might have on the perceived status of the biotech sector. Eric Schmidt, managing director at SG Cowen (New York), says no index is perfect and Nasdaq's biotech index is still more than 90% biotech despite the additions. "It's still going to be what an index is supposed to be, which is a relatively good indicator of the overall sector performance," says Schmidt. "Indices don't drive biotech fundamentals, it's the other way around."

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