Diversifying in biotech

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Investors seeking diversification often turn to mutual funds (unit trusts in the United Kingdom and elsewhere). These typically pool investor cash to purchase shares in 50, 100 or even more companies, spreading a fund shareholder's risks broadly. This lowers potential returns, but also reduces the chance that one stock's bad performance can ruin your whole day (or more).

Biotech investors can use this tool to spread their risks, too. But because Wall Street's aggressive marketing of mutual fund products often obscures their true costs, you must tread carefully to avoid paying for products you don't need.

Fees, fees and more fees

Though funds differ from country to country, examples of US fund fees should alert you to the fee types you would find anywhere. Today, most investors wisely eschew mutual funds that charge front-end commissions, or 'loads,' at purchase, but there are more traps. Funds may levy back-end loads, or contingent deferred sales charges, that you pay when you redeem your fund shares. Also, funds can recoup from investors so-called 12b-1 fees for advertising and public relation expenses.

Investors should watch a fund's annual total expense ratio, which is the fee paid to the investment advisor/manager plus administrative costs, such as record keeping, mailing and customer service. According to several sources, the industry's average combined total expense ratio and 12b-1 fee has been 1.5% and rising. Not worth a fuss? Measure that against the Standard & Poor 500's (S&P 500) long-term average annual performance of 8%–11%, and the seemingly small 1.5% lops off 14%–19% from your returns every year.

Funds must disclose both their performance and their fees, which you can also find through online sources, such as Yahoo Finance! and Morningstar. For biotech funds, total expense ratios range from Fidelity Select Biotechnology's low 1.24% to Franklin Biotechnology Discovery A's 1.57%, to which Franklin then adds a 0.35% 12b-1 fee and 5.75% maximum front-end load. Performance rarely merits that high a ticket price.

Fee-based mediocrity

In the past ten years, the number of mutual funds exploded into the thousands while their fees rose. Not so their performance. You might think that having professional investment advisors determining which stocks to buy and sell would improve results, but Ibbotson Associates (Chicago, IL, USA) and others produce data asserting that 75% and up of managed mutual funds fail to outperform the broad stock market averages over a period of five years or more—and that percentage grows the longer the time period. Investors rightly ask, why pay out any significant percentage of returns for underperformance?

The index solution

John Bogle and his company, Vanguard (Malvern, PA, USA), came up with an answer: unmanaged funds that passively mimic stock market averages as represented by familiar indexes, such as the S&P 500. Because there is no analysis involved—fund managers simply buy the index's stocks and sell what the index drops—the fees are as low as 0.20%. This is the original 'no brainer.'

Before you rush willy-nilly to index investing, be cautious. It isn't all cheap. Other companies refuse to cede the turf to Vanguard, but their index funds often charge much higher fees. At least one I know levies an annual management fee over 2% just to mimic the index. It's a rip-off.

Biotech indexing

Biotech investors have one major index investing option. Though there are two commonly used indexes of US biotech stock market performance—the American Stock Exchange (AMEX) Biotechnology Index and the Nasdaq Biotechnology Index—there is only an index fund to track the latter.

The Nasdaq Biotechnology Index is weighted by market capitalization. That is, a company whose shares times stock price exceeds another is given proportionally greater weight. It offers broad diversification with two provisos: first, Amgen (Thousand Oaks, CA; Nasdaq: AMGN) makes up almost a fifth of the index by weight; second, only Nasdaq-traded companies are included. This excludes Genentech (S. San Francisco, CA; NYSE: DNA), which would be represented at a level approaching Amgen.

Investors can buy the Nasdaq Biotechnology Index through a type of mutual fund called the exchange-traded fund, or ETF. An ETF is a fund that you can buy or sell just like a stock. The iShares Nasdaq Biotechnology Index Fund mimics the index passively and trades on the AMEX with the symbol IBB. It sports a paltry 0.5% total expense ratio and no junk fees.

Other diversification options include closed-end funds, such as Hambrecht and Quist (H&Q) Life Sciences Investors (NYSE: HQL), Biotech HOLDRS (AMEX: BBH), health care funds including biotech, and more, but the basic rule doesn't change: investors are best served either by carefully choosing stocks of individual companies they know and understand, or by using a low-expense index fund that tracks the market index they want.

Though they call index investing passive, it's anything but to make a smart choice in the face of the financial world's relentless media marketing firepower. Paying less and sleeping well offer substantial rewards.

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