

## Second quarter sees stocks trade on own merits

Biotech stocks rallied in this year's second quarter, rising 17 percent from their lows in April but then slacking off to close up only 8 percent by the quarter's end. Much of the rally came from the second-tier and third-tier stocks, which also contributed to the pullback. The focus in the quarter was on Immune Response (IR, San Diego, CA) and clinical-trial data of its therapeutic vaccine at the IX International AIDS Conference. Although the trial produced statistically significant results on its primary endpoints with no significant toxicity, and despite the fact that researchers at the conference indicated that currently available therapies like AZT appear less effective than they were previously believed to be, AIDS researchers not involved with the IR vaccine chose to remain skeptical about its utility. As a result, IR's stock, which had more than doubled from its low of \$10 in April in advance of the meeting, gave up all of its gains. In sympathy, a few of the third-tier stocks retreated, pulling down the group a little. It is worth noting that there was not a big group sell off and that the following stocks were up substantially for the quarter: Chiron (Emeryville, CA), Emisphere Technologies (Hawthorne, NY), Genetic Therapy (Gaithersburg, MD), Gensia Pharmaceuticals (San Diego, CA), and MedImmune (Gaithersburg, MD).

This disparity among biotech stocks—with some reaching new highs and some new lows—may represent a departure point for biotech investors. We may now be in a period where each stock trades on its own story and merits. The entire group traded up in 1991, with virtually all biotech stocks reaching new highs in early 1992. The entire group traded down later in 1992, with virtually all biotech stocks reaching previous lows in October 1992 and again in April 1993. Now, however, there is a clear split among the stocks. Most are still down, but many have performed quite well.

The difference in performance relates reasonably well to fundamentals. Among first-tier stocks, those that are up for the quarter are those

that are expected to launch significant new products next year resulting in earnings acceleration: Chiron, MedImmune, and Genentech (S. San Francisco, CA). On the other hand, those that remain flat or down are those with earnings deceleration or uncertainty: Amgen (Thousand Oaks, CA), Biogen (Cambridge, MA), Genzyme (Cambridge, MA), and Immunex (Seattle, WA). Genetics Institute (Cambridge, MA) has begun to creep up as new products enter clinical trials and investors speculate on an American Home Products (New York) buyout. The group performance is consistent with the usual investment thinking, which associates value with earnings expectations.

The second-tier and third-tier stocks are trading up when there is a consensus about the expected outcome of trials and the value of the products. Thus stocks such as Genetic Therapy, Alpha-Beta Technology (Worcester, MA), CellPro (Bothell, WA), and Protein Design Labs (Mountain View, CA) are trading at relative or absolute highs. On the other hand, when there is controversy or confusion, the stocks have traded down, including IR, Alteon (Northvale, NJ), Autoimmune (Lexington, MA), and Cambridge Neuroscience (Cambridge, MA). Many of the second-tier and third-tier stocks remain unchanged. Investors have extended their focus on product news to phase II/III trials, and since most of the second-tier and third-tier companies are only in the earlier stages of human testing, significant product news for most of them is not likely until next year. One word of caution: the valuations of the stocks that are up can easily be illusory. Companies such as Centocor (Malvern, PA), Synergen (Boulder, CO), and U.S. Bioscience (W. Conshohocken, PA) attained lofty valuations before producing product results that were not as good as expected.

There are two investment strategies in this market. Among big caps, it is best to be in front of the ones with accelerating earnings going into 1994. Of those we cover, that would be Chiron, based on the

launch of Betaseron for multiple sclerosis, and Genentech, based on the launch of Pulmozyme for cystic fibrosis. But look for a good price. Investors are likely to get a good price with Chiron if Organon (W. Orange, NJ) enters the U.S. hepatitis-C-testing market with a competing product by the end of this year. Among the other big-cap biotechs, investors can consider establishing positions in stocks such as Amgen and Immunex, based on attractive valuations at current prices. Recognize, however, that the stocks may not move up for several more quarters, so the risk is a lost-opportunity cost of investing elsewhere. We advise investors to be selective in small caps and not hold positions in stocks that have appreciated too much. In some cases, the data from human trials are better than expected, but usually not. Because individual stocks appear to be moving based on their individual stories for the first time, it really does make sense to hold a portfolio of these. A few stocks up 30 percent to 50 percent make up for several that are down 25 percent. We would consider establishing small positions in several companies whose stocks have not yet moved, including Alteon, Autoimmune, Advanced Tissue Sciences (San Diego, CA), Cocensys (Menlo Park, CA), Cor Therapeutics (S. San Francisco, CA), and Glycomed (Alameda, CA).

We continue to expect no government policies with serious adverse consequences for the biotech industry. Specifically, we do not expect the government to set prices for new biotech drugs. Biotech will be affected by the increasing power of managed care, but probably less than will the drug industry. Most biotech companies are working on novel therapies for diseases that are currently untreatable. The majority of biotech products to be launched will be novel products without competition. As they will be the only game in town as they are likely to replace costly medical services, we expect that even managed-care providers will be willing to pay a reasonably high price. ///

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