BioTech - Scott OReilly and Rajiv Kaul

O'REILLY: Hi, I'm Scott O'Reilly, vice president of investment product at Fidelity Investments. I'm here with portfolio manager Rajiv Kaul, and we're here today to talk about biotech. Rajiv, the biotech industry is very known for exciting innovation in therapeutics, but it's also got individual stock risk as well as volatility at the industry level. What's your investment approach to the industry?

KAUL: Thanks, Scott. This is a great time to be investing in biotech. The big long-term trend in the industry is that we're in a golden age of innovation and medicine. We have made great progress in curing cancer. We're at the early stages of addressing some of the biggest medical problems that our society is going to face for the next 20, 30 years -- Alzheimer's disease, age-related disease, Parkinson's diseases, obesity, heart disease, which is still the number one killer in the United States. So being able to pick the stocks based on strong fundamentals, which essentially means drugs that have a high probability of success, is a real key factor for success for biotech investing. And that involves understanding the science and being able to read the data in order to make that judgment on the probability of success. The other important factor in biotech investing is valuation. You have to understand that this industry is full of fundamental risk. It's obviously very difficult to predict which drugs are going to work, since the drugs that enter the clinic typically have a high rate of failure. Only one out of every10 drugs that go into the clinic actually succeed. So being able to not overpay for companies, being able to buy companies at a good valuation is a really important factor. And finally, having the expertise and the networks that we have at Fidelity to be able to talk to the leaders in every medical area around the world, to understand the reimbursement systems, to understand which drugs really save patients' lives and add value at the right price. Making those complex investment decisions, it really helps us stand apart from everyone else, and is a big reason why I think we've been very successful in this field over the last decade.

O'REILLY: Given the risk that can exist both at the stock level as well as at the industry level, how do you think about building a portfolio?

KAUL: There's a few things to keep in mind. First, you don't want any one company to define the whole fund, because of what I just talked about, the inherent fundamental risk -- unforeseen risk, often, when drugs are developed. Often, not only is it hard to predict which drugs are going to be successful, often drugs that are approved by the FDA, that have been tested extensively when given to a wide population of people, can come up with unforeseen risks. So being able to manage risk is a really important factor in portfolio construction. And after owning a diversity of names, and having a barbell approach is what's really helped the fund manage through periods of volatility in the past. The industry is divided into these sort of two halves. On one hand, you have the successful biotech companies that generate a lot of cash, that have great businesses, global franchises, that are much more stable growth companies. On the other hand, you have the emerging new companies that are the most promising science, where you're going to get the biggest percentage returns over the next few years. But they also tend to be the riskiest companies, with high failure rates. So constructing a portfolio that balances in a sort of barbell approach -- you know, strong cash flows and steady growth with a mixture of many companies that have a high probability of success, but inherently more volatile and more risky, is a good way to be able to manage risk and portfolio construction in this industry.

O'REILLY: How important is the pipeline for companies that you're investing in?

KAUL: I'm very excited about the pipeline in biotech today. There's over 7,000 to 8,000 diseases that the NIH says we understand the molecular basis of what's driving these diseases. But we have only treatments for 300 of those. So I'm very hopeful that that number could double from here in the next five to ten years. And there's a lot of good reasons to believe that the science is at a point -- genetics, the progress that we made there, the cost of genomic analysis has come down substantially in the last 15 years. It cost $1 billion to sequence a genome not too long ago, now we can do it for several hundred dollars. That just allows the promise of personalized medicine to expand to every individual. I'm very optimistic that in diseases like cancer, it's still a huge problem, obviously, in the United States today. There's 14 million Americans living with cancer today. There's 1.6 million new Americans diagnosed with cancer every year, and we need to cure the disease. And when I look at the pipelines of these companies that we own in the funds, I'm really excited about the promise to continue to make a major dent in cancer. So I'm very optimistic Scott. The other important factor to think about today is what's occurring in the markets. There's a lot of skepticism in the biotech industry, at least in the last few months. And I understand that. I think part of that is you have to put this in perspective. In the last ten years, in the last five years, this industry has had enormous returns in the funds. And that's because of the great fundamental breakthroughs we've seen in biotechnology over these last few years. In the last six months, there's been a lot of political rhetoric around the high cost of drugs, and there have been companies that have taken old, generic drugs and raised prices, cut R&D. The market's not differentiating those companies right now. They're sort of lumping it in together. That's where I see a great opportunity. No matter what the political outcome is in the United States is in the next election cycle, there's always going to be a need for lifesaving drugs that can save dollars for the healthcare system.

Scott. O'REILLY: Some of the early-stage companies require funding from the capital markets. What's the environment for funding today?

KAUL: What's important to understand is the last five years have been a great period for funding today. So the last three months have been tougher, which is fine, because there were a lot of companies -- you know, the biotech industry goes through these periods of exuberance and then fear. You know, there's a sort of bubble-bust mentality. So you really want to make sure that the best quality companies are the best funded companies. The other important factor to understand is that the larger companies have never been stronger in terms of their free cash flow generation. So typically, what happens in periods of selloff like this is that it's a great opportunity for the larger companies to buy some of the smaller innovative companies, because the ones -- smaller innovative companies tend to have the highest cost of capital, and they get hit most when there's, sort of, this broad-based, undifferentiated fear on the street. And a big, fundamental criteria for our investment has always been, you know, we'll not invest in a company if they're not fully funded for three to five years. So take advantage of it. And then with the most innovative smaller companies, I think it's a great opportunity in that set of companies too, as long as you pick the right stocks. I mean, biotech's always been a stock picker's group

O'REILLY: Thank you for taking the time today, Rajiv.

KAUL: Thanks a lot, Scott. It's a pleasure to be here
