



## What makes bulls and bears run?

*The Madness of Crowds and Popular Delusions* is a book written almost a hundred years ago about the booms and busts that have affected markets since the beginning of financial history. Given the recent sharp decline in the technology sector of the stock market, I think it is useful to look at the biotech industry, which is a good example of the lessons delivered in this classic book of financial wisdom.

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Real Money

Investor interest in specific stocks or sectors of the market is affected by media coverage. Investment bankers promote the stocks they take public and articles in leading financial publications can pique other investors' interests, leading to a *snowball effect*. This phenomenon is certainly visible in the biotech industry, which has seen a kind of mania build up that drove prices sky-high in 1999. Average prices for this sector as a whole went up approximately 200 percent during the last nine months of 1999.

Let's take a look at the factors influencing the performance of biotechnology stocks and some of the attendant problems that face investors who now desire to participate in this area. For the first few months of 1999, many biotech companies had a difficult time raising money in the markets in order to continue their research. Yet, by early 2000, there was so much demand for these kinds of companies that some biotech stocks soared 300 percent during their first day of trading. Same kind of company, same business facts but a totally different reception from investors in the space of only 12 months.

For the biotechnology industry, a January 1999 *Time* magazine cover article entitled "The New Century: The Biotech Century" started the frenzy. First, Internet discussion boards were set abuzz with talk about small

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biotech firms that supposedly had tantalizing prospects. The price of most biotech stocks had languished since reaching their last highs in 1992. But immediately after the article hit the newsstands, biotech companies who wanted to raise new cash hired sophisticated public relations firms to approach investment banks, stockbrokers, and mutual fund managers.

Once a few funds began buying biotech companies, the rest of them were gripped with panic, asking themselves "Do I own the right names?" Most mutual funds had been holding big positions in traditional blue-chip pharmaceutical companies, not in biotechs. The blue chips, such as Merck, Pfizer, and American Home Products, all have tremendous marketing strength around the world, but they may lack a treasure chest of prospective drugs to sell in the future. As mutual fund managers began to dump drug companies and buy biotech, the markets began to take notice. Large company stocks declined while biotech companies went up.

The amazing run-up in the biotech stocks has boosted the value of their stock to where they are almost equal to companies such as American Home Products and Eli Lilly, even though these giants have vastly greater infrastructures and personnel at their disposal. If the stock market trend continues, we might see the acquisition of a huge drug company by an upstart biotech rather than the opposite.

Once the biggest biotech companies like Amgen picked up momentum, investment bankers started calling up and encouraging their biotech clients who had put off issuing new stock to proceed, so a flood of new offerings hit the stock market in the early part of this year. While the returns of biotech stocks have been great up until the beginning of this March, their risk had also increased. The drugs that these companies are attempting to create are years or even decades from being offered to potential patients. Investors don't seem to mind as large amounts of money are poured into a market based sole-

ly on excitement of the prospect of having a blockbuster scientific advancement.

One danger in biotech investing is that the intellectual property being claimed by company scientists does not necessarily translate into practical patents, which have copyright protection. Any doubts about the long-term sanctity of these commercial rights would send the stocks plummeting. Publicity has been huge regarding the Human Genome Project, a collaborative effort of governments and businesses around the world. This effort to map human chromosomes, which are the basic building blocks of chemistry, has generated a great deal of stock speculation. Each advance in the mapping of human chromosomes does yield the possibility of insight into many human disorders. For example, chromosome #22 has been linked to schizophrenia as well as some forms of cancer. It is important to remember that at this point, these are conceptual links only. Laboratory procedures and the understanding of how to make practical applications of this new knowledge is still far away.

Nonetheless, the investing public and especially those trading for quick profits were so impressed by this "news" that most initial public offerings for biotechs that hit the market in 1999 were an instant success. One company, Human Genome Sciences, received a patent giving it commercial ownership of a gene that the AIDS virus exploits when it infects a cell. It is hard to imagine a corporation having commercial ownership of a gene. This small company is now receiving a lot of attention from the big drug companies. However, many people fear that commercial custody of a gene may impede important research from occurring elsewhere, outside of the "discoverer" of the particular data. There is an important debate going on concerning the validity and value of all such patents.

Much of the biotech industry's stock valuations are based on exclusive rights to this kind of intellectual property, which is subject to political intervention. President Clinton and British Prime Minister Blair made a

joint statement that there are international claims to all basic human and biological research. There will be court battles aplenty in this field. This unease created a 50 percent decline in biotech companies in one month.

Companies that find and map new genes don't necessarily understand the gene's functions in the human body. Other people who are researching the functions in the body don't necessarily have the clout or capability to develop or test treatments that utilize their research. This is similar to the personal computer industry of the early 1980s. Many competing small players making large claims serve to get the general public excited, but there is little certainty about what or who will be the ultimate beneficiaries of these new discoveries. Most of the original computer inventors have long since gone out of business. The legal quagmire that awaits gene researchers may or may not allow large players like Pfizer and Merck to eventually dominate the biotech industry. Only great management will allow a company's culture to change to take advantage of these new opportunities.

In the end, only companies that can deliver true value to the public will reap long-term rewards. We believe that both biotech and the pharmaceutical companies will be under pressure over the course of this election year, as the health care industry always makes for good political discussion. If you are interested in being part of this kind of technology investing, look for a broadly diversified offering such as the stock BBH, which is a basket of 20 biotechnology companies. That way, if one or two or five of the 20 go belly up, which they will, the long term winners will more than make up for the losers. Diversification of this kind should insulate you from the madness that grips all types of technology stocks at times, where the future is bright but unsettled.

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