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# EXPERIMENTING WITH DRUGS

I have written on a number of occasions about my admiration for Warren Buffett. When faced with a new investment idea I will often end up asking myself "What would Warren do in this situation". Sometimes I have come to the conclusion that he would answer by saying that he would dismiss the idea. One particular example of this has been in relation to my investments in technology companies. Warren regularly says that he never invests in technology because he doesn't understand it. When I thought about investing in ASM Pacific and Linear Technology I had to recognise that I did not fully understand the underlying technology. I have written about these two companies in other opinion pieces (No 15 and 16) and I go into a lot of detail as to why I have been prepared to break one of Warrens main rules.
Maybe the magnificent returns on ASM Pacific have been down to good luck because at the end of the day I do not know whether they will continue to dominate the wire bonder market. Maybe Linear Technology will never generate the type of returns I need to justify the risk but at the end of the day I have tried to develop my own way to invest and given my time as a technology specialist there are one or two companies where I have placed my trust in the management of the company.
ASM Pacific has just reported their 2007 results and I am happy to read about their record sales and profits. In 1996 I put my trust in Patrick Lam and he did not let me down. I hope his successor will continue that success.
In 2006 I put my trust in Paul Coughlan of Linear Technology. I believe that he will not let me down. In other words I may not understand technology but I hope there are certain people that are trustworthy. If you read about Warren Buffett you will see how much emphasis he puts on the people who run a business.

When I started out on my own in 2005 I decided to look closely at the drug sector because it has some of the industry characteristics I think are important:

- Patent protection creates barriers to entry (Warren calls it a moat!)
- Aging populations mean demand should increase
- Wealthy populations will pay anything for innovative drugs
- Margins tend to be good
- Free cash flow can be strong

Given the above characteristics of drug companies I was always inclined to think that drug companies had a significant role to play in any portfolio once they could be bought at a reasonable price.
What generally prevented me from getting too excited about drug companies was:

- Lack of new blockbuster drugs
- Generic threats
- Valuations were never particularly cheap
- Governments were always interfering in pricing

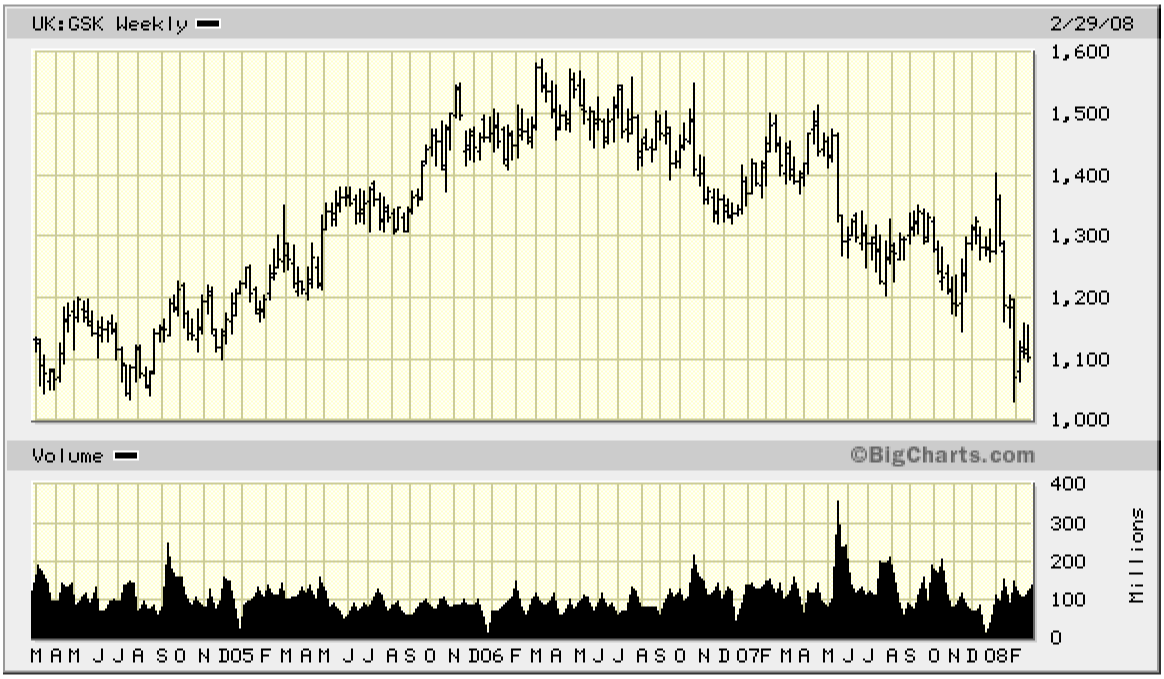
In 2005 I spent a good bit of time listening to JP Garnier the CEO of Glaxo and reading about their existing drugs and pipeline of new drugs. I knew that a number of their drugs were due to come off patent in the coming years but I also knew that they had one of the best pipelines of new drugs in the industry. In particular their cervical cancer vaccine, Cervarix, sounded like a potential blockbuster.

On a valuation of about 14x 2006 earnings and with a dividend yield of over 3% I felt that the downside should be relatively limited. I felt that there was a certain degree of confidence in the way JP Garnier spoke about the future.

Before I bought any shares I asked my usual question, would Warren buy it? Even though he owned shares in Johnson and Johnson, a company that had a major drug unit, he did not own any companies where the majority of their revenues came from drugs. As far as I can remember I think he is on the record as saying that he did not understand drug companies well enough to invest in them.

Once again I went against what I felt Warren might do. I put my faith in JP Garnier. (This was a change for me as I had not met JP Garnier in person whereas I had met Patrick Lam and Paul Coughlan)

I bought some shares for myself in 2005 and more in 2006. As you can see from the chart below it has not yet been a successful investment.




In 2006 I felt reasonably confident that it was only a matter of time before Glaxo broke out on the upside.

I was surprised to see that Warren had bought some Sanofi Aventis, the French drug company. This confused me because I have never heard him explain what had happened to change his mind. The very fact that he then owned a drug company gave me some comfort.

Moving forward into 2007 a couple of events made me think that maybe Warren was right in the first place, maybe we should not buy drug companies. I began to wonder if

Warren would have to add drugs to airlines as a sector he invested in but got wrong. (Warren is the first person to admit that he has made mistakes).

The first event that concerned me happened last May. There was academic analysis of clinical trials (known as meta analysis) that suggested Glaxo's second biggest drug, Avandia for diabetes, increased the risk of heart attack. Sales of Avandia fell rapidly.

The second event has been the delay to the launch of Cervarix in the United States. Analysts seem to be unsure as to the reason for the delay.

I am obviously not the only investor that was beginning to despair. How else would you end up with Glaxo now being on a valuation of 11x 2007 earnings with a dividend yield of 5.5%? Expectations and confidence had fallen away, Glaxo was (and still is) unloved.

In January it was announced that Warren had just bought some Glaxo shares. My initial reaction was one of surprise but then it dawned on me that Warren loves when something has become really unloved because then the price tends to be cheap. The only thing I remain confused about is why he now feels he understands the industry when in the past he said he didn't. I was hoping that he would talk about it in his annual newsletter that was published on February 29th but there was no mention of it so I remain in the dark. All I know is that we are now in it together. Both of us are now experimenting with drugs.................