
HOW DO YOU ‘PRICE’ INNOVATION?

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Equity investment strategies that focused on specific ‘themes’ or ‘megatrends’ have been largely out of favour in the early weeks of 2022. The commonly held belief at the macroeconomic level is that relatively high inflation readings seen in many markets is leading central banks to shift course and considering varying ways to take liquidity out of the global system. Since that liquidity was a driver of strong equity market performance in recent years, many companies are seeing their valuations dropping, leading to significantly negative performance over short periods.

During the 2020 portion of the pandemic, many companies with innovative ideas were given funding in the private markets and high valuations in the public markets. Equity investors appeared focused on the stories and the possible transformative potential more than they focused on current cash flows, earnings or dividends. In early 2022, there has been a shift, and equity investors are now more interested in cash flows, earnings and dividends and less geared towards exciting stories of massive future potential.

So, what is the ‘right’ approach?

Innovation–If it was ‘Certain’ or ‘Predictable,’ it wouldn’t be Exciting

Venture capital investors reference the ‘power law,’ an approach to concentrated investing in private companies with big potential. It is understood that of a subset of investments, many will fail completely, seeing their values stagnate and possibly go to zero. A small number will have remarkable, world-changing results. The success of the ‘world-changers’ makes up for the fact that the others failed, hence giving venture capital investing the possibility of being a highly lucrative space.

Vibrant capital markets give entrepreneurs a seemingly ever-increasing set of options to achieve their financing. Venture capital is fine within the private markets sector, but now companies have differentiated options–the Special Purpose Acquisition Vehicle (SPAC), direct-listing, initial public offering (IPO)–to get into the public markets. If entrepreneurs are able to go public sooner in their life-cycles, then investors might get a risk profile that is more similar at the company level to what is seen on the venture capital side.

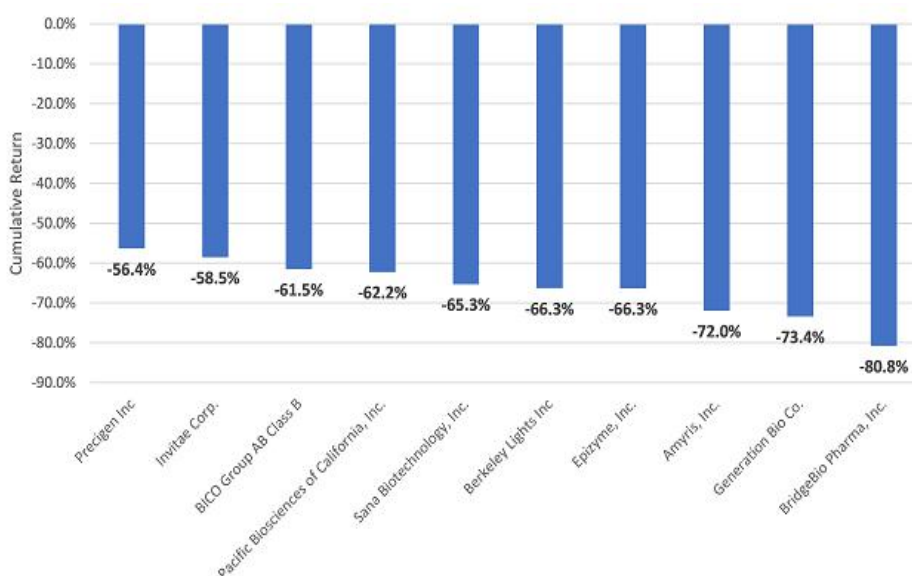
There are now public companies in the human health space, for instance, where if they can develop and scale certain therapies or techniques in their respective markets, they could change many aspects of how healthcare is done. However, the risk is high in that if they are unable to develop and scale these ideas, then the consequence would be the businesses cease to exist. Share prices can move massively on certain announcements–like clinical trials–lending a degree of idiosyncratic risk investors wouldn’t typically see in broader equity strategies or more established companies.

BioRevolution: The Market in Early 2022 has been ‘Re-Pricing’ Innovation

For those who have been following the biotechnology space in recent years, the ride in terms of share price returns has been, well, WILD. The period from 2019 - 2020 saw unbelievable returns in many cases, with little attention paid to such concerns as ‘revenues’ or ‘positive earnings.’ 2021 was a bit more volatile, and then the start of 2022 has been very challenging. True, those investors who might have initiated their positioning prior to 2019 may still be above water, but others who were swept up in the excitement and returns of 2019-2020 might be significantly negative.

The BioRevolution is one of WisdomTree’s megatrend investment strategies, and its most recent semi-annual rebalancing occurred in early November 2021. Unfortunately, this also coincided with the near-term equity market peak and the start of a more generalised equity market sell off particularly in the more growth-oriented market segments. Figure 1 indicates the ten worst performers on a share price basis from within the WisdomTree BioRevolution Environmental, Social and Governance (ESG) Screened Index.

Figure 1: Cumulative Returns (7 November 2021 to 7 February 2022)



Source: Bloomberg as of 7th February, 2022.

Historical performance is not an indication of future performance and any investments may go down in value

Goldilocks: Likely an impossibility in the BioRevolution

The Goldilocks fable is well-known for the principle of getting something ‘just-right’ rather than too much or too little. Scientific innovation takes a certain amount of time, and it is difficult for non-experts to interpret the mile markers along the way. Therefore, the stocks are susceptible to over-reactions. The 2019-2020 period was likely an over-reaction to the positive side, in that many of the companies had great ideas and excitement, but had not scaled their products fully into their markets. Similarly, the early 2022 period is likely an over-reaction in the other direction, since the actual prospects for scientific innovation to dramatically change in short periods, based on things like US Federal Reserve (Fed) communications, are also not highly likely.

We therefore find it important to indicate what these companies in Figure 1 (that have faced these difficult returns) are doing¹:

- **Precigen, Inc:** Precigen has, as of writing this, seven innovative therapies at various phases of the clinical trial process.
- **Invitae Corp:** Presently, the company's mission is to share genetics on a global scale to diagnose more patients correctly, earlier and bring therapies to market faster. The future could see the provision of information services that inform genetic healthcare throughout life.
- **The Big Convergence Company (BICO) Group:** BICO indicates industry-leading expertise in 'Bio Convergence' by combining the power of biology, engineering and computer science. Robotics, artificial intelligence (AI), advanced genomics and bioprinting would be intersecting to create these potential outcomes.
- **Pacific Biosciences of California, Inc:** Pacific Biosciences is creating some of the world's most advanced sequencing technologies. The company has leading long-read and highly accurate short-read technology for sequencing the genome.
- **Sana Biotechnology:** Sana Biotechnology utilises engineered cells as medicines. If we assume that many diseases are caused by damage to or dysfunction of cells, Sana's ambition is to repair or replace any cell in the body.
- **Berkeley Lights:** Berkeley notes their function as 'bringing DNA sequences' to life. The company is active across such verticals as Cell Therapy, Synthetic Biology, Gene Therapy and Agriculture Biology.
- **Epizyme:** Epizyme focuses on the global oncology opportunity.
- **Amyris:** Amyris uses biology, the most precise and efficient chemistry on earth, to manufacture the molecules needed in the everyday lives of humans.
- **Generation Bio:** Generation Bio operates across multiple modalities, including closed-ended DNA, internal large scale manufacturing capacity and cell-targeted Lipid nanoparticle (LNP) delivery.
- **BridgeBio Pharma:** BridgeBio is seeking to discover, create, test and deliver transformative medicines to treat patients who suffer from genetic diseases and cancers with clear genetic drivers. The company has actually achieved 25 Food & Drug Association (FDA) approvals for drugs targeting rare genetic diseases or genetically defined cancers in 2020 and 2021.

Conclusion: What is the 'Right Price'?

The volatility in the market is telling us that this is not an easy question for companies operating within WisdomTree's BioRevolution megatrend. It is difficult to justify a high valuation on a firm that may not yet have proved its capability to scale its business model, but that also doesn't preclude investors from getting carried away with excitement at different points in time. We believe in the potential benefit of a long time horizon to at least give companies a chance to execute, recognising that some will likely not make it and others may be massively successful. Trying to figure out which ones end up in each category is part of the fun of assembling the puzzle that leads to the potential for strong returns.

Sources

¹ Sources: The bullet points specifying details behind each company are sourced from the respective company investor presentations and websites, using what was current as of 7 February 2022.

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