ClearBridge Investments

Differentiated Growth: Biotech Well Positioned to Outperform

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Health care has been one of the most unpopular areas in the market for more than two years - particularly biotechnology stocks. Yet we still regard the sector as a compelling source of sustainable performance in the Large Cap Growth Strategy. We view biotech companies as a potential driver of above-average long-term earnings growth and utilize them as part of our "select" bucket of growth stocks. Companies in the select bucket typically carry higher multiples to reflect their higher growth rates, but for biotechs, multiples have been compressed by increased scrutiny of drug pricing. To better understand the current malaise in the biotechnology industry and what the near-term future holds, it's helpful to review the bull and bear markets the group has experienced over the last six years.

From 2011 through the summer 2015, biotechnology and pharmaceutical stocks significantly outperformed the broader market. This bull market was driven by four trends: the end of the patent cliff of branded drug expirations, increasing optimism about innovative drug therapies and technologies, a more favorable regulatory environment for new drug approvals, and robust prescription-drug pricing power.

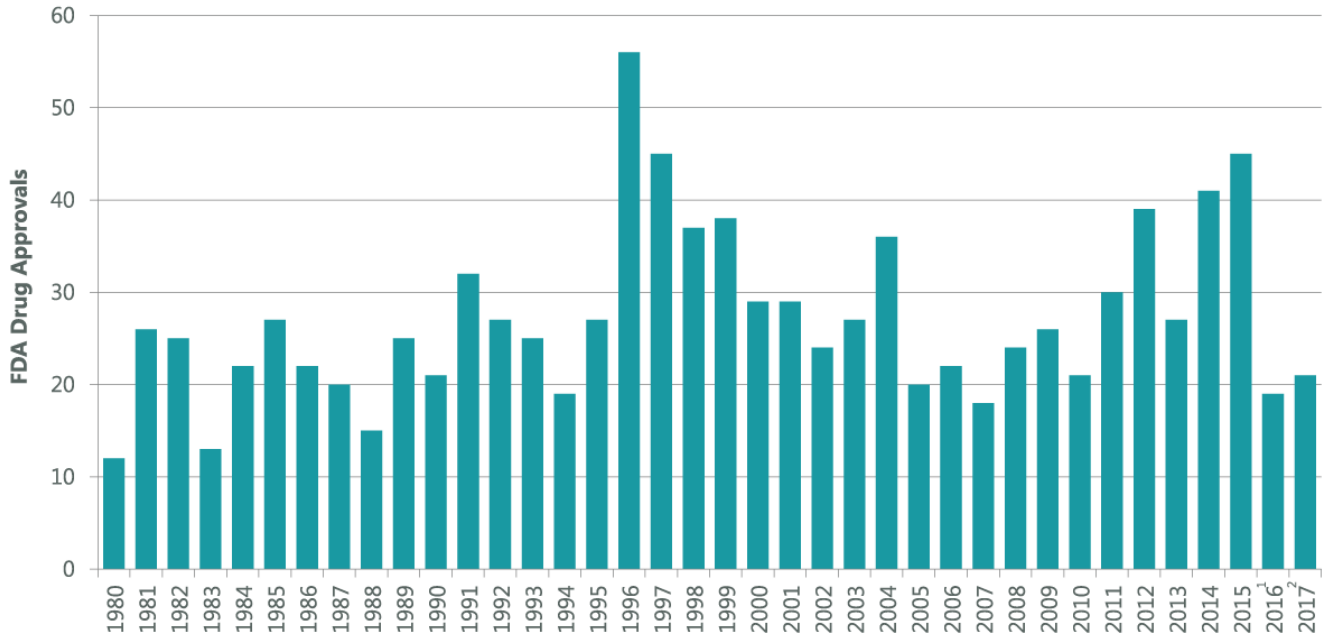
Hillary Clinton's initial tweets on the campaign trail about the high prices of certain branded drugs coincided with the end of the rally. Since then, biopharmaceutical stocks have endured above-average volatility, with negative sentiment overshadowing resilient fundamentals. From July 1, 2015 through May 31, 2017, the NASDAQ Biotechnology Index of large cap biotech stocks lost more than 22% while the S&P 500 Index was up 15.5%.

Despite recent weakness, three of the four trends that powered the biopharmaceutical bull market remain in place today. The patent cliff is still not an issue, with no major patent expirations expected until the middle of the next decade. Regulators remain supportive of new drug treatments (Exhibit 1), and we are optimistic that the regulatory environment will continue to be favorable for innovative new drugs under the Trump administration.

Perhaps most importantly, innovation is alive and well. Based on our fundamental research and active management approach, we continue to invest in biotechnology companies that are developing innovative treatments for rare diseases and inflammatory conditions with high unmet need. Treatments in these areas face less competition and should be less vulnerable to pricing pressure.

Celgene[1], for example, currently generates most of its revenue from Revlimid, a cancer drug with no direct competition. The company is also testing two drugs in phase 3 clinical trials for ulcerative colitis and Crohn's disease, two inflammatory conditions of the bowel with high unmet needs. **Regeneron Pharmaceuticals'** Eylea is a best-in-class product for age-related macular degeneration and related eye diseases. In addition, Regeneron and Sanofi's Dupixent was just approved in the U.S. for severe eczema, another inflammatory condition with a high unmet need. Dupixent's strong launch underscores the size of this market.

Exhibit 1: The Rate of Drug Approvals is Expected to Increase



1. While new drug approvals by the U.S. Food and Drug Administration (FDA) dipped in 2016, we view this as an aberration and a function of timing, with multiple approvals coming at the end of 2015 and start of 2017. 2. 2017 figures are year-to-date through May 31, 2017. Source: FDA.

Biogen is expanding beyond its core multiple sclerosis franchise with the recent approval of Spinraza for the treatment of the ultra-orphan disease spinal muscular atrophy, an often fatal genetic condition with no other approved drugs. Biogen and Eisai's aducanumab is in Phase III trials for Alzheimer's disease. While other Alzheimer's treatments have shown early potential only to fail to live up to hopes, aducanumab is one of the most promising drugs in development for this devastating condition. **Alexion Pharmaceuticals** is a company focused solely on rare diseases. This biotech company has three products on the market that provide a meaningful clinical benefit and are expected to drive sustainable, long-term growth for the company. Importantly, Alexion is developing a new treatment that should help extend its key Soliris franchise into the late 2020s.

Few of these positive catalysts are being recognized by investors as share prices have yet to catch up with business fundamentals. Profitable biotech stocks are trading at their biggest discount to the overall stock market in more than 20 years. We believe current valuations assign little to no value to companies with rich research & development pipelines.

Due to the political spotlight shining on drug makers, our biotech holdings have experienced significant volatility over the last two years. Consistent with our diversified approach to growth investing, we balance the higher risk aspects of biotech with exposure to more stable health care stocks including **UnitedHealth Group**, a leader in managed care, and **Johnson & Johnson**, a diversified health care company with prescription drug, medical device, and consumer businesses.

Although drug pricing remains a headwind for the industry, innovation should continue to be rewarded. Over the long term, we believe the value of quality biotech assets will be realized through a re-rating of share prices or a significant wave of industry consolidation. Johnson & Johnson announced its largest purchase ever in January, a $30 billion acquisition of Swiss biotech firm Actelion and a move that could repeat across the pharmaceutical and biotech industries. In the meantime, we will use short-term periods of volatility to continue to add to our biotech exposure.

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