Invest with Yen

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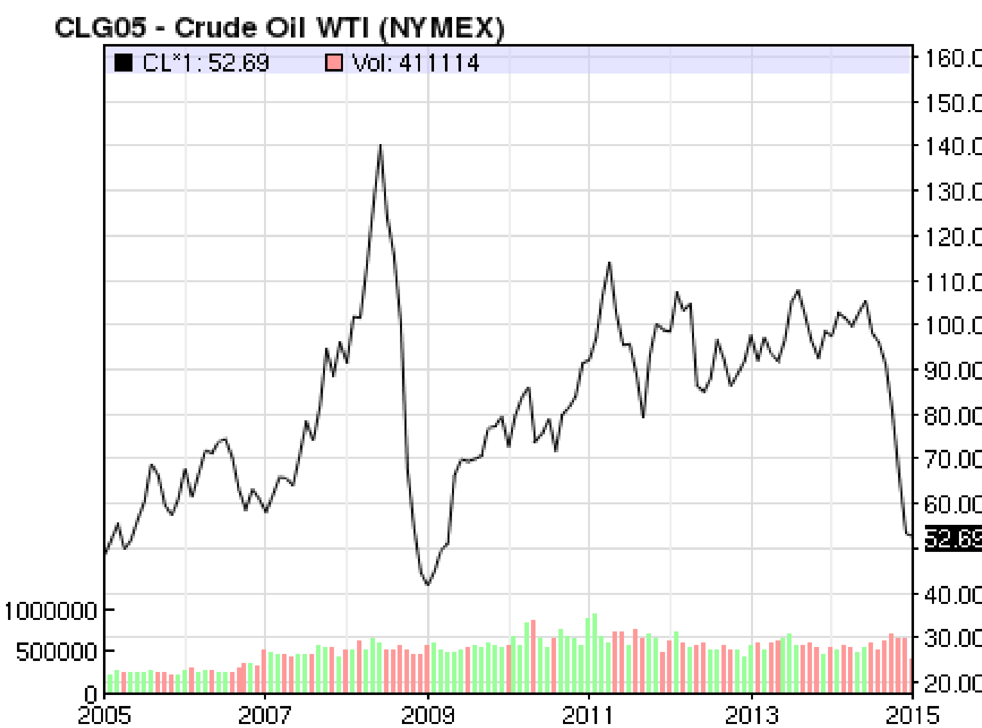
Review of 2014

Overall the market performed very well in 2014. The Dow gained 8% and NASDAQ gained 13%. After the devastating loss of the third quarter, our composite portfolio gained some of the value back but still lost 4% for the year, losing to both indexes. Our poor performance can be directly contributed to the losses of several of our top holdings: IMGN (-58%), CYTR (-56%), DVAX (-14%), ATRS (-43%), and SGEN (-20%). We were saved by the excellent performance of INFN (+51%), PACB (+50%), and INCY (44%). On first glance, one might believe that the gain and loss would cancel each other out; but alas, each 50% drop requires 100% gain to cancel. Our top ten holdings at the end of the quarter are INFN (www.infinera.com), PONDX, CYTR (www.cytrx.com), IMGN (www.immunogen.com),SGEN (www.seattlegenetics.com), DVAX (www.dynavax.com), PACB (www.pacificbiosciences.com), BMY(www.bms.com), ATRS (www.antarespharma.com), and INCY (www.incyte.com). During the quarter, I sold some INFN, IMGN, ATRS, DVAX, and PACB and bought some CYTR, and SGEN.

Economical Driving Forces of 2015

We are heading into a very interesting economical world in 2015. There are some very powerful driving forces that will dictate where we should deploy our investment resources. They include:

- Prolonged low oil price – Oil prices dropped from above $100/barrel in June 2014 to about $53/barrel at the year's end. We have not seen oil prices this low since 2009 after the big market crash in 2008. See chart below.



There are many reasons low oil prices will persist in 2015, including the high supply brought on by new drilling technology (also known as fracking in the US) and the low demand as a result of slow economic growth throughout Europe, Japan, and China. Since OPEC nations have decided not to cut production, it is not likely we will see oil prices rising any time soon. According to some economists, including Ed Morse of Citigroup, the low oil price so far is equivalent to more than a $60 billion tax cut for US citizens and more than a $1.1 trillion stimulus to the world economy. This is a tremendous economic driver.

There are many winners and losers with low oil prices. Several examples are provided below:

- ✓ Consumers are the obvious winners, as you may have noticed at the gas pump. High end consumer goods outlets may benefit most as discretionary spending increases.
- ✓ Industries that consume a lot of oil are winners. These include airlines, shipping companies, and airplane manufacturers such as Boeing.
- ✓ Oil producing countries, oil production companies and associated supporting industries are losers.

The market may have already reacted to this shift, meaning the stock prices of the impacted winning and losing companies may have already increased or decreased in response, but there are still many investment opportunities to be had out there. In this newsletter, I suggest one (NBR) that may have been over-corrected/punished by the market.

- Extended low interest rates – The US Federal Reserve has been practicing its low interest rate policy since the Big Recession. Given the weakness of the economy elsewhere in the world, I don't see this policy changing any time soon. The continued low interest rate policy coupled with the stimulus effect of low oil prices should see the US economy continue to grow at a healthy rate in the coming year. If this holds true, I don't foresee a big stock market correction or a real estate market crash in 2015.

- Relatively low US federal government spending on discretionary budget items – We have a split government in the US between the executive branch and Congress for the next two years and the one thing we can count on from a split government is that the discretionary budget will not grow even as the economy (i.e., tax receipt) grows. This is probably also good news for investors.

Noticeable News/Events with Our Top Ten Stocks and Recent Picks in the Past Quarter

INFN: The share price of INFN took off in the 4th quarter and gained about 41%, resulting in a gain of 54% for the year. I have sold some to lock in the gain. I am continuing to implement the plan to sell about a third of our current holdings between $15 and $20 per share to recover all the original investment cost. After that, I believe that INFN should have the technology lead to be continuously successful for the next three to five years if not acquired during that time.

IMGN: On December 19, 2014, IMGN and Roche announced the ultimate surprising disaster phase III trial results on Kadcyla being tested of first line use for HER2-positive breast cancer patients: Instead of showing outright better long-term surviving rates as indicated in the Phase II trials, Kadcyla treatment managed to only produce median progression-free survival (PFS) findings that were not signficantly superior the currently used Herceptin plus chemotherapy treatment that it had hoped to replace. On reflection, why should Kadcyla have better survival rates anyway? The improvement over the current Herceptin and chemotherapy treatment is much lower toxicity and less side-effects, such as hair loss, nausea, psychosis, etc. I suspect it was probably a trial design error from the get-go. The reasoning behind using Kadcyla as a first line drug should have been an emphasis on the improved quality of life and improved compliance for patients, which are much easier targets to reach than increased PFS to get FDA approval. I am guessing that if the issue was faulty design and reasoning for the phase III trial, Roche may not be able to justify a high price for the drug going forward. In any case, IMGN lost more than 50% with the bad news. For the year, it dropped down from our 1st holding to the 4th, and contributed to much of our poor performance for the year.

Many of you asked me what to do with your holdings of IMGN. In my analysis, IMGN and ADCs will have its triumphant days in the future for cancer treatment. This surprise setback will be hard for IMGN to recover from over the next year or two. However, I expect the stock price will bounce back upon good news for IMGN's new ADC drugs that are currently in early clinical trials. If your cash account can use the tax loss, I would swap the high cost shares with new low cost shares. For most others, I believe patience will pay off in the next two to five years.

On hindsight, we could be much better off now if we had sold some of our earlier gains after Kadcyla originally received FDA approval in early 2013. At its highest price in July 2013, IMGN was near $20 per share, more than double of our average cost basis. I am implementing this lesson learned with INFN, the current number one holding in our portfolio.

SGEN: SGEN had a sympathetic drop in price, although not as severe as that of IMGN. For the year, it lost about 18%. There is a huge difference between IMGN and SGEN: its cash reserve. With their respective cash reserves, SGEN has more than 5 years of cash on hand while IMGN has less than 2 years. This makes SGEN a much less risky investment than IMGN, although IMGN is a much cheaper bargain at this time.

CYTR: CYTR also had a bad-press day in the 4th quarter: In late November, FDA put a partial hold on recruitment of new patients of the Aldoxorubicin Phase III clinical trial after a patient under "compassionate use" died. This particular patient was at an advanced stage of cancer and was not qualified (read: too sick?) for the clinical trial. The FDA is now requiring a revision to the patient screening protocols before the partial hold is lifted in early 2015, potentially delaying the trial. CYTR's stock price dropped about 20% during the two week news cycle. This action certainly fits the adage that no good deed goes unpunished.

DVAX: The price of DVAX bounced between about $13 and $20 in 2014. This is actually not a surprise since we don't anticipate DVAX to complete its large safety Phase III trial of Hepatitis B vaccine Heplisav until mid-2015. Additionally, in late December 2014, DVAX announced that it had received a $40 million loan (convertible to stocks within a year) from a venture capital firm to fund the clinical trial of its cancer immunotherapy using its toll-like receptor (TLR) technology. TLR is the same technology used in Heplisav which boosts the efficacy of the current Hepatitis B vaccine from about 70% to over 90%. The hope is that TLR technology could boost the efficacy of current antibody based cancer treatment such as Ipilimumab (See IWY Newsletter of April 2012). Our one-trick pony is getting versatile; and the market has rewarded it by more than 20% price increase in the last two weeks.

PACB: The price of PACB continued it three year uptrend in 2014. Depending on its potential success in developing the clinical DNA sequencing kits in its collaboration with Roche, share price of PACB could either go side-ways or explode up in 2015.

ATRS: The price of ATRS bottomed out in mid-September 2014. For the year, its stock price dropped a total of 42%, becoming one of the few biotech companies that have lost value after an FDA drug approval. I sold some ATRS holdings during the 4th quarter for tax loss purposes. However, I still like the company and I believe that it will have a good year in 2015.

INCY: I love to have picks that end up working wonderfully and INCY is one great example. I just did not buy enough of it. Since my recommendation at $50.08 on October 19, 2014, INCY has gained 46% to close at $73.11 for the year. As I compare IMGN against INCY, the most striking difference is the top management: INCY obviously has a much better CEO than IMGN. I wish that I had pick up on that assessment and passed on the knowledge to you much earlier.

Stock Picks

Our stock picks this quarter are Nabors Industries Ltd. (www.nabors.com, NBR on NYSE), Stratasys Ltd. (www.stratasys.com, SSYS on NASDAQ), and Groupon, Inc. (www.groupon.com, GRPN on NASDAQ). I have been watching NBR for almost a decade and the other two for more than a year. All three have seen their stock prices decline in the past quarter. This may provide good entry point for each of them.

"Oh, how the mighty has fallen with low oil prices!" This was my reaction in late November 2014 when almost all the stocks related to the oil industry were on a free fall. NBR was among the ones hardest hit by the combination of low crude prices, low demand for oil and high supply because of its expertise in land-based and off-shore drilling. On June 29, 2014, NBR's stock price was at $30; and by December 8, 2014, its share price had dropped to $10 per share. As usual, the market tends to over-correct. In addition, the down market will also create an environment to weed out the weaker players and allow the stronger ones to survive. I believe that NBR will come out of this stress test well in a year or so. Why? Oil drilling, in its current applications such as off-shore, deep sea, and horizontal fracking, is a very capital intensive and skill labor dependent business. These capital investments cannot be easily mastered by a startup competitor. This is part of the reason why, at this time, only the US has developed a significant oil production with land-based fracking, and not other countries in the world (We should not pretend that only the US is endowed with oil shale formations that can be hydraulically fractured). NBR is one of the best in this industry.

Let's look at some of the fundamental numbers of NBR:

- Annual revenue is $6.6 Billion
- Annual profit is $1.75 Billion
- Current capitalization is $3.6 Billion
- Current debt is $4.3 Billion
- Current cash on hand is about $460 Million
- Current P/E is about 10

Based on the above, the current market capitalization is only above half of its annual revenue, or twice of its annual profit. In other words, the market doesn't believe it will make any money in 2015. The debt is relatively high; but is consistent with a previously very profitable and booming business. Put in another perspective: In November 2014, Halliburton acquired Baker Hughes Industries (BHI) at about $78 per share, or 41% market premium to become the largest oil drilling and services company in the world. The purchase price exceeds $75 per share in June 2014, the 52 week high of BHI. NBR looks very cheap to be an acquisition candidate by comparison.

The recent drop in oil price finally brought the share price of NBR down to our desirable range. I have bought some shares between $10 and $12. With the potentially continued drop of oil price, we may have another chance to buy NBR at lower than $10 per share. NBR closed at $12.99 on December 31, 2014. I have assigned NBR a value rating of 2 (out of 5 with 1 being of the best value) and a risk rating of 3 (out of 5 with 1 being the least risky).

Stratasys (SSYS) is our second stock pick. Angie collaborated with me in the development of this stock pick.

By now, you've probably heard about the amazing things can be accomplished with the power 3D printing: from detailed art to household items like clocks to space food to cars to medical models to camera lenses to chemical compounds to the much more controversial guns undetectable by metal detectors. In recent years, the average cost of 3D printers have dropped from over $25,000 in 2011 to under $15,000 in 2014 and further projected price declines through 2017. More consumers and households as well as companies have access to this revolutionary technology than ever before with only growth projected within the industry in the future.

Founded in 1989 in Eden Prairie, Minnesota by Scott and Lisa Crump, Stratasys (SSYS) is now one of the largest providers of 3D printers in the world with dual headquarters in Minneapolis, Minnesota and Rehovot, Israel. In the early years, Scott Crump invented Stratasys's patented fused deposition modeling (FDM) technology that builds finished products layer-by-layer by heating and squeezing out thermoplastic filament along a set pathway, following instructions from 3D computer aided design (CAD) files.

In 2013, Stratsys acquired MakerBot Industries (http://www.makerbot.com/), one of the leading names in prosumer desktop 3Dprinting. By the time of acquisition, MakerBot had sold more than 22,000 3D printers since its inception in 2009 and by January 2014, post-acquisition, they had doubled their historical total unit sales to 44,000.

Stratasys holds nearly 500 granted or pending patents worldwide, making it a relevant and heavy contender in the growing 3D printing industry. I feel that SSYS is strongly poised to continue its growth and dominance in 2015.

SSYS closed at $83.11 on December 31, 2014. I have assigned SSYS a value rating of 3 (out of 5 with 1 being of the best value) and a risk rating of 3 (out of 5 with 1 being the least risky).

Our third pick is Groupon, Inc. (GRPN).

Groupon, Inc. operates online local commerce marketplaces that connect merchants to consumers by offering goods and services at a discount worldwide. In other words, GRPN wants to be the super online coupon issuer for all kinds of groups of market sectors in the US.

In the past ten years or so, we have seen a flurry of online companies that made huge fortunes matching technologies with the marketing needs at the right time under the right circumstance: Google matches its backward priority search technology with the need of online users of getting the most useful information; Facebook matches its database technology with the need of exhibitionists' nature of human kind; Amazon.com expands from books to online shipping of all goods; and Alibaba exploits the lack of marketing infrastructure with the proliferation of online access in China to build the largest online shopping network in the world. Groupon is a languishing online company that may be finally getting its time: The time is right because finally through low oil prices, many people are looking for a way to "treat" themselves with their extra disposable income. Of course, there are plenty of choices for people to spend their extra cash. The time has finally come where both the old coupon clippers of this country have grown up to be literate with the powerful internet tools and the new technology-centric generation is taking advantage of the digital coupon age. The question is whether GRPN can catch this ideal opportunity or not.

Let's review GRPN's fundamentals:

- Annual revenue is $3 Billion
- Annual loss is $160 Million
- Current capitalization is $5.4 Billion
- Current debt is $0
- Current cash on hand is about $855 Million
- Current P/E is negative but forward P/E is estimated to be about 50

This set, when compared with that of NBR is a very interesting one: Our current market obviously values the software side much more than the hardware side. Then again, the consumer dominated market will make the revenue (top line) and potential profit (bottom line) much larger for the likes of GRPN than NBR.

GRPN closed at $8.26 on December 31, 2014. I have assigned GRPN a value rating of 2 (out of 5 with 1 being of the best value) and a risk rating of 4 (out of 5 with 1 being the least risky).

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