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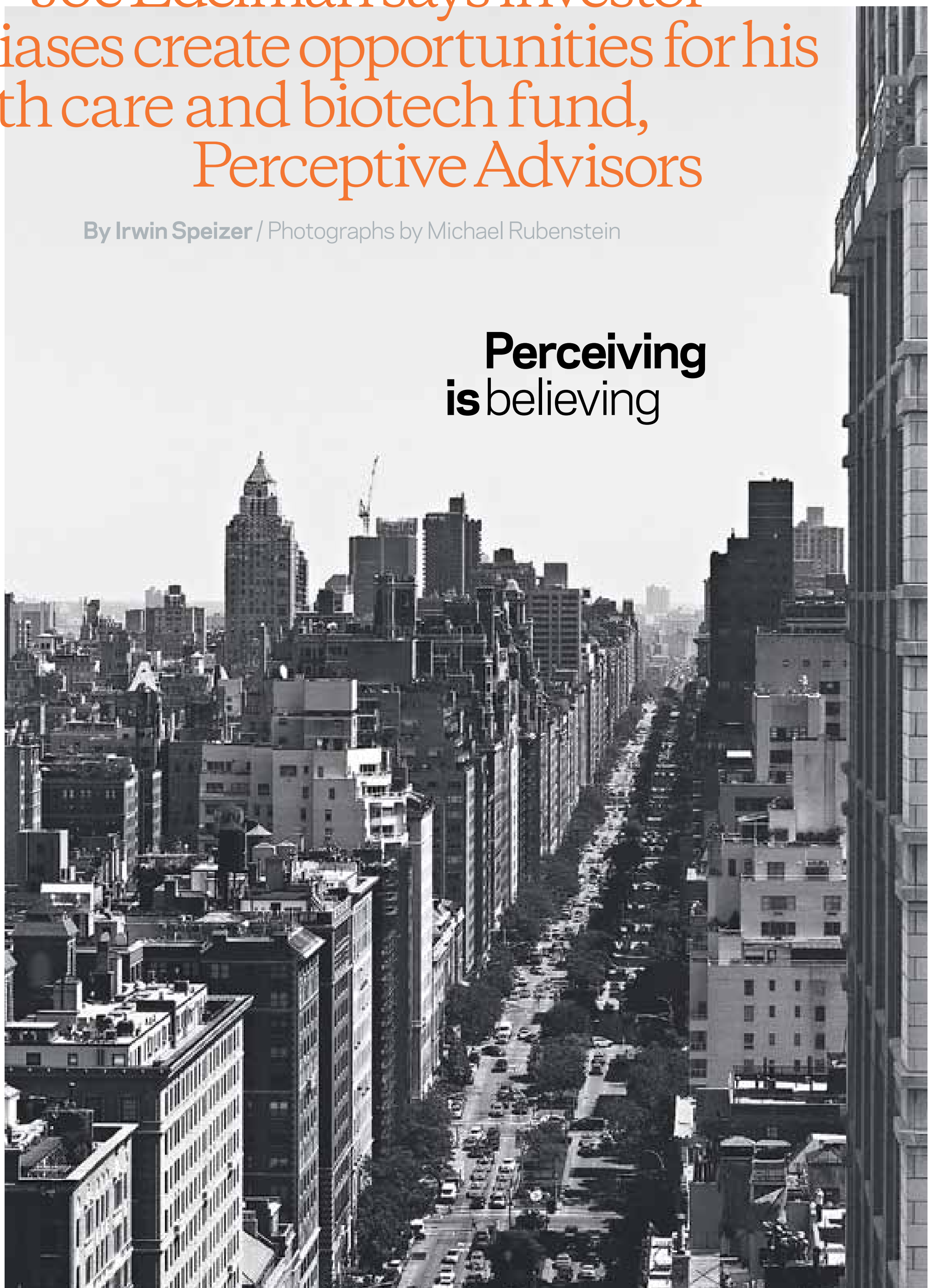
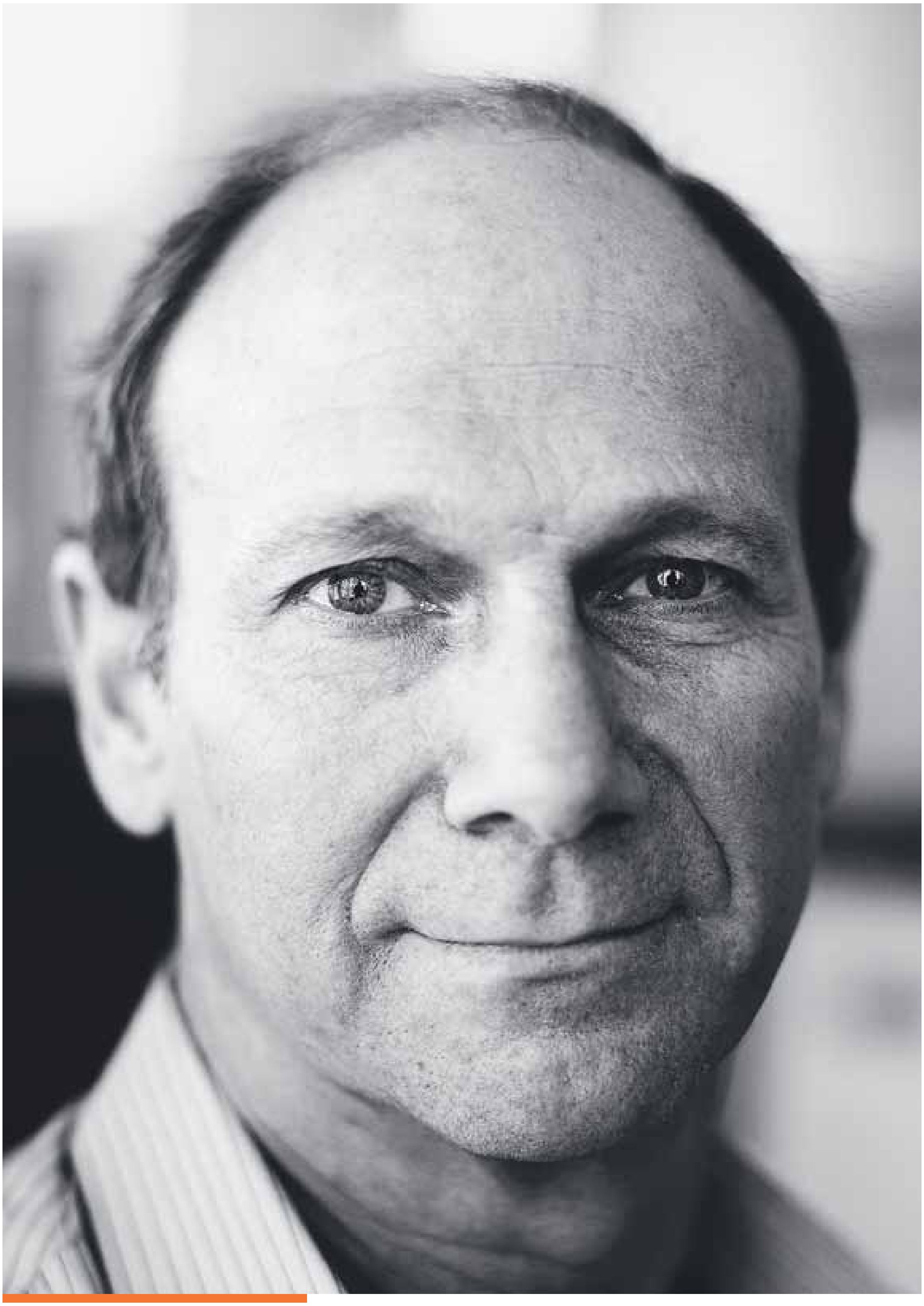
Absolute Return + Alpha

Joe Edelman says investor biases create opportunities for his health care and biotech fund, Perceptive Advisors

By Irwin Speizer / Photographs by Michael Rubenstein

Perceiving is believing





Joe Edelman: *If you don't know who the sucker is, it is probably you*

In his first job as a junior biotech analyst in a small New York brokerage house, Joe Edelman spotted a company he was convinced would self-destruct. Cambridge BioScience of Worcester, Mass., had developed a five-minute AIDS test in the late 1980s that wowed other analysts, who projected strong sales for the product. Buy this stock, they recommended.

Edelman disagreed. He detected flaws in the company's clinical trials serious enough to raise questions about how accurately the product could predict the presence of the AIDS virus. Doctors would be reluctant to use it, and sales would not materialize, he decided. And since the company had pinned its future on the AIDS test, the stock was a dog that should be sold immediately, he concluded.

"People were up in arms," Edelman says. "They didn't know who I was. I hadn't visited the company. I had never spoken with anyone at the company." Unfortunately for everyone else, Edelman was right. Sales limped along in 1989 just as Edelman predicted. The stock price crashed. Other analysts raced to adjust their projections but could never seem to catch up to the stock slide or to Edelman. Cambridge finally landed in bankruptcy.

Cambridge may have been a flop, but Edelman's analysis of it made him an instant success in the biotech investment field. Edelman went on to found his own hedge fund company specializing in long/short biotech investment, which he named Perceptive Advisors.

Combining his knowledge of science and medicine with what he learned about investor behavior in the Cambridge example provided the basis for the strategy that Edelman continues to run at Perceptive today.

"Cambridge was the genesis of everything for me," Edelman says. "It led to my theory that initial investor bias leads to repeat surprises. There is a tendency for negative earnings surprises to follow negative surprises, and for positive surprises to follow positive." Perceptive's mantra is to gain a competitive advantage by knowing when the market's perception of a certain company has diverged from reality. "The world is a set of probabilities," he says. "You give yourself emotional comfort with conviction, but conviction may not be an accurate reflection of probability."

His Cambridge analysis also provided Edelman with a bit of cautionary wisdom that helps guide him today: "If you don't know who the sucker is," he says, "it is probably you."

Edelman has turned out some eye-popping gains over the years at Perceptive. In its first full year of operation in 2000, the flagship Perceptive Life Sciences Fund gained a net 154.89%. Returns have leveled off considerably since the heady days of the tech boom.

But under Edelman's guidance, the Perceptive Life Sciences Fund has regularly bested market indices, recording compound annualized returns from inception in July 1999 to the end of April 2011 of 30.9% with a Sharpe ratio of 0.84 (based on the firm's own calculation, which assumes a risk-free rate of 5%). Over the same period, the Nasdaq biotech index produced a compound annualized gain of 6.9%, while the Nasdaq returned 0.6%. Perceptive Life Sciences gained 6.31% for the year to date through May.

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Through it all, Edelman has never wavered from his original goal, which was to run a hedge fund that specialized in biotech stocks. Perceptive focuses its investments on the top 20 to 30 biotech firms along with about 500 other biotechs that are smaller and get less attention, and are often more volatile. Edelman likes investing in drug development companies, but he also follows medical device companies and health services firms.

At 56, Edelman manages $440 million in assets from his small office on the 25th floor of a Park Avenue building in Midtown Manhattan, overseeing a small staff of 11 built around biotech wonks like himself. He has no desire to try to grow into a multibillion-dollar firm with a collection of different funds; he is content to spend his days reading dense technical reports of drug clinical trials and placing long and short bets on biotech companies.

While Edelman is far from perfect in his stock picks and market predictions (Perceptive took big hits in 2008 and in the tech bust of 2002), his winning percentage—and how he produces it—has attracted a loyal following of investors. Those who know and invest with him say they appreciate Edelman's critical view of the industry he covers and his unflinching willingness to short biotechs.

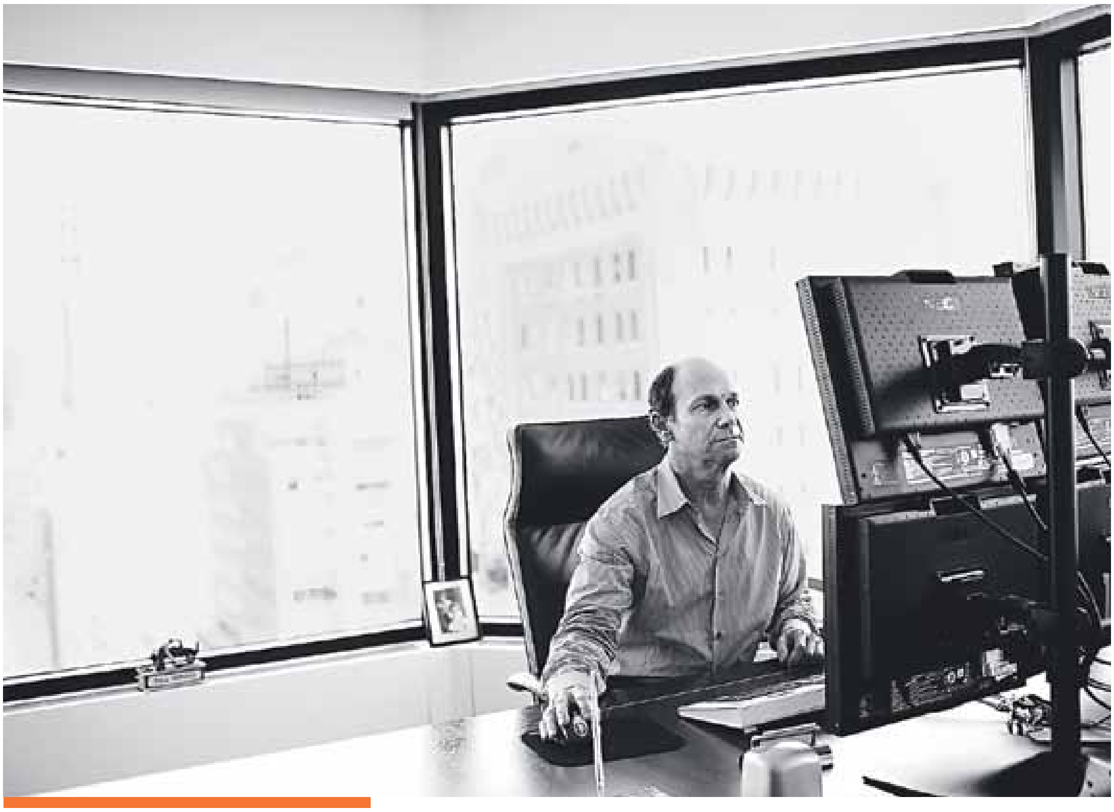
"Usually, sector managers just tend to be biased in favor of the industry," says Lewis Turner Jr., a private investor in the Perceptive fund. "Joe is not. He is kind of a skeptic. He plays around with and utilizes options, both puts and calls, to a greater extent around his positions than other managers I have seen. He generates more of his profits from shorts than most of the long/short equity managers."

Leslie Lake, who has invested with Perceptive as a managing director at Invus Financial Advisors and has known Edelman since his early days as a stock analyst, says Edelman's critical view of biotech companies and executives has helped keep him out of trouble. "He is incredibly suspect of management," Lake says. "I think he is right. You can get sucked into the story about new drugs or products."

Edelman notes that while investors may remember him for contrary shorts like the call he made on Cambridge, he actually makes most of his money on long plays and maintains a long bias in his fund—it is now about 40% net long.

What has helped him survive and thrive in a volatile field littered with hedge funds that have shut down over the years is that he directs his skepticism not just at other investors and company executives but at his own ability to correctly predict the future of stock prices.

The biotech field is full of well-intentioned dreamers with miracle cures



Joe Edelman: *You have to be willing to buy something back higher than what you sold it at yesterday*

and analysts and investors who are often susceptible to the hype. Edelman has spent his career trying to ignore that hype.

"I am trying to look with new eyes every day," Edelman says. "If you are really unbiased, you have to be willing to buy something back higher than what you sold it at yesterday. I am also willing to sell something much lower than I bought it for if I believe there is too much bias on the part of bulls."

Edelman and his team get their investment ideas from numerous sources—company news, conferences, sell-side research—then conduct intensive research and analysis to come up with their own interpretation of a stock's prospects. Edelman generally invests in long positions with the aim of holding onto them for a while, but he likes to stay flexible in the event new information comes to light that changes his investment thesis.

"It's not a very formal place—I want to react very quickly," he says. "We track hundreds of companies and also want to track news on a real-time basis."

Edelman says big wins on shorts like Cambridge are tougher to find today as investors have become more savvy about biotechs. He still makes plenty of short bets, but these days he rarely commits as much to them as he once did. Those shorts are frequently based on an analysis of clinical tests on a new drug or device that has been highly touted, often as a breakthrough.

That is how Perceptive came to short a Fremont, Calif., company called Genitope, which had developed a treatment for a form of non-Hodgkin's lymphoma. The company had reached an important point in the clinical trial process that appeared to show promise and was attracting strong interest from investors.

But Perceptive's analysis of the data indicated that the hoped-for rate of patient improvement was unlikely to be achieved at a fairly advanced stage of testing. The likelihood of ultimate success for the product in the time left in trials looked doubtful, Perceptive decided.

Edelman shorted the stock at about $4 in 2007. By early 2008, Genitope had failed to win FDA approval for its cancer treatment and was tottering on the edge of bankruptcy. The stock price fell, as Edelman had predicted.

Contrary views have also helped Edelman's long picks. For example, in early 2010, Perceptive bet on Salix Pharmaceuticals, based on a new drug called Xifaxan for the treatment of irritable bowel syndrome. The drug was still in development, but Perceptive decided it would win FDA approval and go on to generate strong sales. Perceptive built its position to 2.6% of its assets in advance of an expected favorable FDA ruling on the drug in early 2010. But on February 19, the FDA's neurology division released an interim review voicing some concerns about the drug, and the stock fell 9%.

Perceptive reevaluated its position and research on the company and decided that the drug was in fact sound; the interim ruling was only a minor setback and not an indication that the drug was flawed. The market, Perceptive decided, was overreacting to an interim report by one FDA panel that was not indicative of how the full FDA would finally rule. So while others sold, Perceptive kept buying, raising its position to 3.6% of assets.

On February 23, another FDA panel voted decidedly in favor of approval. In

March the drug won final FDA approval, prompting a surge in the stock price. Perceptive gained 44% on its investment.

Lake says Edelman's intimate knowledge of the medical field helps inform picks like Salix. But she notes that unlike many fund managers in the field, Edelman gained that expertise without the benefit of an advanced medical degree.

"He is in a space that is heavily dominated by people who are doctors or medical professionals," she says. "Ironically, he is not, yet he has one of the longest track records. If I were an investor looking for a manager in this space, I would ask myself, why has he survived as long as he has when he doesn't have a medical background?"

The answer may be a combination of Edelman's contrarian competitive streak and a drive to succeed in a medical-related field as a way of proving his mettle in relation to his father, who was something of an academic star in the bioscience research field. Edelman's father, Isidore, who died in 2004, was a pioneer in researching the key role played by electrolytes in maintaining health. In his later years he became the chairman of biochemistry and molecular biophysics at Columbia University, and he also founded and ran the Genome Center there.

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Isidore Edelman began his career in medical research at Harvard Medical School and then became a professor of biochemistry at the University of California, San Francisco. Joe Edelman grew up the third of four children in the comfort of the Presidio Heights section of San Francisco, where his father's success cast a long shadow over the Edelman offspring. One brother is now a biochemist, and a sister is a psychologist. "He was a pretty high-level scientist," Edelman says of his father. "I got a lot of my scientific critical thinking from him, as well as some skepticism." Edelman was a good student in math and science in high school and thought of following the family career line. He graduated magna cum laude with a bachelor's degree in psychology from the University of California at San Diego in 1980, and enrolled in its graduate program in psychopharmacology, aiming for a career in neuroscience and psychology. He lasted only a few weeks.

"It really came to me fairly suddenly that I don't want to do this," Edelman says. "First of all, I concluded that I didn't want to be in the exact same field as my father. Those were pretty big shoes to fill. The other part of it was that I concluded that doing scientific research requires a great deal of patience. I don't necessarily have the patience to test ideas. It can take years, and you can fail after years of trying."

There was also the question of money. Science could be a satisfying career, Edelman decided, but probably would not be as financially rewarding as, say, something in business or finance. Edelman recalls that when he was growing up, he always admired an uncle who was a lawyer and who seemed to be financially quite well-off.

Edelman had a vague idea that he might find the finance and investment field interesting and lucrative. He had worked at Bank of America one summer doing credit card reconciling and had enjoyed the simple accounting tasks he was given. After his father moved to a high-level post at Columbia University, Edelman decided in a bit of youthful optimism to relocate to New York, move in with his father until he got settled, and try to edge his way onto Wall Street.

He was a good enough talker to get himself hired doing basic accounting work, including a job as assistant comptroller of the Actors Equity Union. Supporting himself with accounting jobs, Edelman enrolled in the Stern School of Business at New York University and earned his MBA in 1988. By then he was already past 30 years old, but he had finally settled on a career goal: working in the securities business with a focus on life sciences, which would combine his early education with his new business degree.

"The whole thing seemed perfectly suited," Edelman says. "You could do analysis that combined business and science. If you were successful, you could make a lot of money. The only issue was that I did not have an advanced degree in science. It was going to be a challenge." Edelman's graduate project at Stern was to analyze and project revenues for the Abbott Laboratories diagnostics business. Once the report was complete, Edelman sent it out along with his résumé to every sell-side analyst he could find, hoping that would be enough to get him an interview. He got nothing but rejections until he finally landed one nibble, from a small specialty brokerage called Labe, Simpson, which paid him to write a report on the entire diagnostics business.

Working at a desk inside a closet at the firm, Edelman produced a report good enough to land him a real job and a desk in a real office. Edelman churned out a series of reports there as an analyst until he got his big break with the Cambridge BioScience analysis.

The Cambridge report got him noticed at Prudential Securities, which hired him as a senior analyst in 1990. From there, Edelman landed a job in 1994 as a senior analyst for Paramount Capital Asset Management on its Aries Fund, a biotech hedge fund.

Edelman left Paramount and began working in February 1999 for First New York Securities, a proprietary trading firm that staked him with $6 million to run a managed account. Working inside the First New York offices, Edelman ran the biotech portfolio and quickly realized he had a following among investors.

In July 1999 he launched his Perceptive Life Sciences Fund with $3 million. Biotech was in the midst of a boom at the time, and Edelman rode the wave, with long bets boosting his returns. From July to the end of December 1999, the fund returned a net 128.57%, followed by his record 154.89% return in 2000. He added another 38.69% gain in 2001.

When the tech bubble burst, biotech stock prices collapsed. Perceptive recorded its first losing year in 2002, down 10.33%. It could have been a great deal worse, with the Nasdaq biotech index down 45% for the year. Short plays helped the firm keep losses manageable.

But the slide prompted Edelman to rethink his strategy. He had started out in an overheated market and made his outsize returns by placing outsize bets, taking positions that represented as much as 15% of his assets. After 2002 he switched to a more conservative approach, reducing the size of his largest positions and hedging his bets with options. These days his largest holding can represent 8% to 10% of the fund's total assets, while his top five positions never amount to more than a total of 15% to 25% of assets. As of March 31 his five largest long plays amounted to about 19% of assets, while his five top shorts represented about 18%. The fund holds 15 to 20 core positions, which the firm defines as a position that accounts for more than 2% of the fund's assets.

Commenting on what happened after the tech crash, Edelman says, "People had been chasing stocks knowing they were paying too much but thinking they could get out in time. After the crash, I figured people would be more reluctant to chase stocks if they felt they were too expensive. I decided I should become much more hedged. My goal was not to try to keep hitting it out of the park. The market would be much more difficult."

Even with his new approach, Edelman still found plenty of highly profitable plays, and just a few months into 2003, he had gotten back above his high-water mark. He ended 2003 gaining a net 53.08%. The Perceptive Life Sciences Fund's assets, which peaked at $215 million in May 2002, retreated briefly but started rising again in 2003. Edelman began 2004 with $318 million. As the assets kept piling up, he decided he was growing too quickly for the niche strategy he pursued. He closed the fund to new investors in early 2004 when assets hit $400 million to make sure he had adequate systems and controls to handle the increased capital, then reopened in 2005.

The fund began 2008 at its peak of $584 million, then shed more than half its assets in the market collapse as a result of redemptions and trading losses. The fund fell 23.98% in 2008, recording some of its worst months since its founding. Edelman did not restrict redemptions, so the money kept flowing out, with the fund hitting bottom in April 2009 at $228.7 million.

By then the market was picking up, and Edelman was back up to speed on his stock picks. Perceptive recorded a net gain of 24.14% in 2009. It added another 16.29% in 2010, compared with a 7.36% gain in the AR hedge fund technology index and a 15.06% increase in the Nasdaq biotech index.

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Edelman's most loyal investors stuck with him through the down period, and new investors began arriving as his performance numbers turned positive again. Perceptive ended 2010 managing some $380 million.

With assets north of $400 million as of the end of May, Edelman is back in his comfort zone. He says his strategy and operation can effectively manage $500 million and could conceivably expand to as much as $800 million.

He doesn't want to hit the billion-dollar mark, however, in part because he thinks it would be harder to maintain his desired portfolio mix of larger, less volatile stocks and smaller companies that can juice up the fund's returns.

"Over half the book is in large companies," he says. "But if you want to have these smaller companies have an impact on your portfolio, that changes the picture. Over a billion, most of your return gets focused on the bigger stocks."

In his spare time, Edelman sings and plays rhythm guitar in a rock cover band. But as for his day job, he says he says he has no desire to be anything but the manager of a niche biotech fund.

"I don't try to go too far afield from what I understand," he says. "I believe in sector investing. I am not investing in banks. I am investing in health care."

To illustrate his point, Edelman trots out a reference to one of Clint Eastwood's Dirty Harry flicks, in which the grizzled detective growls out one of his signature lines: "A man's got to know his limitations."

Edelman knows his and is perfectly happy to stay within them. AR