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Building a Circle of Competency

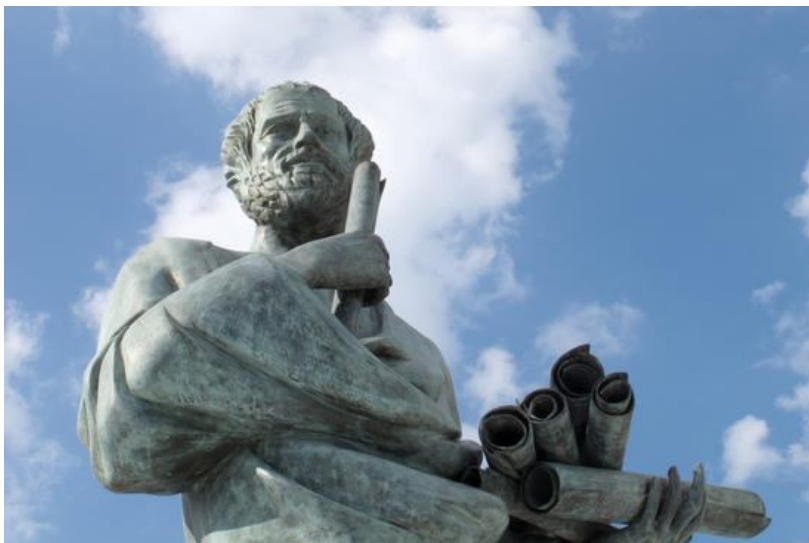
My journey of building a circle of competency in the pharmaceutical business

December 05, 2017 | About: [AGN +0%](#) [AZN +0%](#) [BMY +0%](#) [CELG +0%](#) [MRK +0%](#) [RHHBY +0%](#) [VRTX +0%](#)

In my previous article I shared my favorite quotes from Li Lu on the subject of circle of competency. While those quotes are great, they won't have any practical value unless we can actually put them into practice. Today I'll share my journey of building a circle of competency (could very well be a circle of incompetence) in the pharmaceutical business.

In his 2010 Columbia University Lecture, Li Lu said the following:

"A certain industry might have characteristics that make it different than others. In certain industries you might have better prospects than others. Find the best of the players in the industry and the worst players. And see how they perform over time. And if the worst players perform reasonably well relative to the great players — that tells you something about the characteristics about the industry. That is not always the case but it is often the case. Certain industries are better than others."



It was a very simple and sound idea. The way I compared industries was to order a gigantic Value Line collection, which has the most recent Value Line reports of all the industries and companies they cover. I did that a while ago. It was a very interesting exercise to see how companies in different industries have different economics and the worst companies in some industries have better economics than the best companies in a certain other industry. In the end, the industry that jumped out to me was the pharmaceutical industry – the margins are so high and the cash flows are so good that it almost seemed too good to be true.

- Warning! GuruFocus has detected 2 Warning Signs with AGN. Click here to check it out.

Even though I was attracted to the economics of the pharmaceutical business, I had serious concerns about the understandability of the

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Symbol	Company	Current Price	Change (%)
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LUV	Southwest Airlines Co	\$ 54.76	-1.06 (-1.90%)
UNP	Union Pacific Corp	\$ 137.86	-1.30 (-0.94%)
DAL	Delta Air Lines Inc	\$ 54.71	-0.50 (-0.91%)
NSC	Norfolk Southern Corp	\$ 138.03	-0.58 (-0.42%)
BRK.B	Berkshire Hathaway Inc	\$ 200.18	0.67 (0.34%)
BRK.A	Berkshire Hathaway Inc	\$ 299,970.00	765.00 (0.26%)
UAL	United Continental Holdings Inc	\$ 70.68	0.10 (0.14%)
CSX	CSX Corp	\$ 61.02	0.01 (0.02%)
Summary			-0.80%

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About two years ago, I decided to take a shot at trying to learn a little bit more about the pharmaceutical business as it became clear to me that the aging of population and the prevalence of unhealthy lifestyles all around the world is too big of a wave to ignore. And one of the best ways to catch this massive wave is through investing in pharmaceutical companies. Further, the economics of the pharmaceutical companies are so attractive.

Through friends and introductions, I consulted a few investors who specialized in the pharma and biotech industry. I asked them whether one needs to have a biology or chemistry degree to understand the business. Encouragingly, they all told me it doesn't require a science background to understand pharmaceutical companies. In fact, one of them had a degree in journalism and another had a degree in accounting.

After speaking to them, I thought maybe it was time for me to commit a few hours a day for a few months to focus on the pharma business and see how much I could learn. I had planned to spend at least six months.

At first, I downloaded the annual reports of the big pharmaceutical companies such as AstraZeneca (NYSE:AZN), Bristol-Myers Squibb (NYSE:BMJ) and Eli Lilly (LLY). I then started off alphabetically with AstraZeneca's 2014 annual report. It was like reading in another language – I had no idea whatsoever what was going on in the business after reading the annual report. I felt extremely frustrated and defeated.

The next step was to figure out a better game plan. Instead of diving into the companies, maybe I should learn some basic knowledge first. So I purchased a few textbooks – molecular biology, genetics and immunology, and downloaded a great 329-page primer by Deutsche Bank called "Pharmaceuticals for Beginners." There's also a book called "The Biotech Primer," which seemed helpful. For the next few weeks, I spent a number of hours a day reading the aforementioned materials. After reading the Deutsche Bank primer and The Biotech Primer twice and grabbing the big ideas from the few textbooks, I picked up the AstraZeneca annual report again. This time I felt much better but still very uncomfortable.

For the next few months, I broke down my readings into a few buckets: company annual reports, sell-side research reports, pharma and biotech periodicals and articles, and knowledge-building reports. One helpful tool was Wikipedia's great book-building function. For instance, I built a diabetes knowledge book that had all the Wikipedia articles on the diabetes-related terminologies I need to understand. It was a great reference book. I also purchased a few books on Amazon on the history of some of the best-known companies such as Vertex (NASDAQ:VRTX) and Merck (NYSE:MRK). I learned a great deal about the history of the modern pharmaceutical and biotech industry and how the best companies have evolved over the past century.

After reading thousands of pages, I started to feel that I understood a little bit about the pharmaceutical companies. But more importantly, I became fascinated by the science behind drugs. It was amazing to understand how cells work, how our bodies work, how drugs work and how breakthrough new therapies save lives. Gradually it became a personal passion for me. I was especially impressed by the immune-oncology drugs Keytruda and Opdivo developed by Merck (MKR) and Bristol-Myers Squibb. The idea of utilizing our own immune system to fight cancer cells is breathtaking. It wasn't all about investing any more.

Once I felt like I've known enough to have a basic conversation, I reached out and visited a few pharma and biotech companies. During those meetings, I would ask the management team the Warren Buffett (Trades, Portfolio) question: If you have to put 50% of your net worth into one pharmaceutical company and you can't sell it for the next 10 years, and it can't be your own, which company would it be and why? Roche (RHHBY) and Genentech (part of Roche) came up quite a few times. Therefore, I bought the book, "Genentech: The Beginnings of Biotech." It was a great book.

I also asked management what the characteristics of the best drug companies are and if they had to start over again, which company would they choose to emulate. I got a lot of great answers. At the

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the drug companies – I also need to learn about the payers, the distributors, the PBMs and the pharmacies. Therefore, I repeated the process of reading and meeting management teams. I would again read all the annual reports, transcripts and sell-side reports and once I'm done reading, I would visit one or two companies within each industry and ask questions to management teams. In the end, I learned a lot about the drug value chain.

After two years, I am still not 100% confident that pharmaceuticals and biotech companies are within my circle of competency. The industry is rapidly changing. It's very hard to tell who the winners will be in a certain disease category – two years ago everyone thought Opdivo was ahead of Keytruda by a large margin but now Merck has turned the corner.

Fortunately, it became clear to me that the game is not about picking the winners. As Mindy Perry shrewdly pointed out at this year's GuruFocus conference, the time to buy pharmaceutical companies is when the market doesn't assign any value to the pipelines. True, but it takes an enormous amount of time to make that call. It appears to me that Allergan (NYSE:AGN) and Celgene (NASDAQ:CELG) are great bargains today.

Conclusion

I embarked upon this incredible journey of building a circle of competency around pharmaceutical companies because of Lu's inspirational wisdom, Lu's approach definitely took a long time, but I could vouch for the superiority of the high-way approach – you can gain valuable insight over time and you can recognize market inefficiencies when they appear. There is no substitute – you have to spend years to do the research. The pharmaceutical business may still be too hard for me and it may require a few more years to understand it. But I firmly believe, in the end, it's worth the time and effort.

Lu's exercise has taught me the value of real, deep research. In the end, it seems fitting to quote Lu again, "I'm still learning, and I'm still interested. I'm still young, and still incredibly curious. So, who knows? Hopefully, I will continue to gradually expand my circle of competence."

Disclosure: Long AGN and CELG.

About the author:

Grahamites

A global value investor constantly seeking to acquire worldly wisdom. My investment philosophy has been inspired by Warren Buffett, Charlie Munger, Howard Marks, Chuck Akre, Li Lu, Zhang Lei and Peter Lynch.

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Comments



Thomas Macpherson - 4 months ago

You'll get there my friend. It's a complex business that operates in an even more complex ecosystem. It took me 13 years consulting in the industry to finally invest in a pharmaceutical company. What you have learned to date can only add to your ability as a value investor - whether you end up investing in biopharma or not. Best. - Tom

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Hi Tom, I am really enjoying Seeking Wisdom and trying to put at least some of it to work. Avoiding debt and waiting for the mockingbird to sing are timeless learnings.



Grahamites - 4 months ago

Tom - Good to know I have at least 11 more years to get there haha. Hats off to you for having built probably one of the hardest circle of competency in a complex adaptive system. Thank you for a great presentation on the subject last year. I was just looking at the notes I took from your presentation, they were really helpful even though I didn't understand enough to truly appreciate how great it was.



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Great stuff Grahamites - thanks for shedding some light on your process.



Alex Garcia - 4 months ago [Report SPAM](#)

Awesome stuff Grahamites, thanks for sharing..

-Alex

<https://www.buffettindicator.co>



Leviapham - 4 months ago [Report SPAM](#)

Thank you!

I enjoy your articles very much and appreciate the time and effort you put into each one.



Grahamites - 4 months ago

Science - Thanks for the nice words. We are all in this together:)



Grahamites - 4 months ago

Alex - You are welcome. Thanks for commenting.



Grahamites - 4 months ago

Leviapharm - I appreciate the encouraging comments. And you are very welcome. I've had fun writing each article.

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