

BB Biotech

Strong rebound for established specialist

BB Biotech (BION) is a long-established investor in biotech innovation, offering access to a concentrated portfolio of c 30 companies covering a range of therapeutic areas. It seeks to provide long-term capital growth, but also offers a yield of c 5% as a result of a capital distribution policy adopted in 2012. Performance has been strong both over the long term and more recently, with the fund ranking first among peers (in Swiss franc terms) over one and five years, and also outperforming the benchmark NASDAQ Biotechnology Index over one, three, five and 10 years. Although biotech and healthcare stocks may continue to see some near-term share price volatility as the direction of US policy becomes clearer, BION's managers point to lower-than-average biotech valuations as a source of support.

12 months ending	Share price (%)	NAV (%)	NASDAQ Biotechnology (%)	MSCI World Healthcare (%)	FTSE All-Share (%)
31/01/13	34.9	38.2	25.1	22.8	15.7
31/01/14	71.5	82.0	68.5	28.0	13.5
31/01/15	71.8	52.2	33.4	22.6	(0.6)
31/01/16	(6.3)	(14.5)	(7.2)	7.4	0.3
31/01/17	20.6	15.8	0.6	0.1	2.5

Source: Thomson Datastream, Bloomberg. Note: All % on a total return basis in Swiss francs.

Investment strategy: High conviction approach

BION is managed by specialist healthcare investment manager Bellevue Asset Management, whose mainly Europe- and US-based portfolio management team includes qualified medical doctors, bioscientists and economists. The team uses a four-stage investment process, with an emphasis on clinical assessment, to filter the global biotech universe of c 800 companies down to a concentrated and high-conviction portfolio with around half its assets invested in five to eight core holdings. Investments are made across the market cap spectrum to ensure exposure to fast-growing smaller companies that could be the market leaders of tomorrow.

Market outlook: Bright spots amid political risks

Biotech stocks experienced significant volatility during 2016, owing to a combination of political fears, spikes in investor risk aversion and some stock-specific issues. While political risk in the US – which is the largest market for most biotech companies – has not abated, the structural supports for continued growth (including scientific innovation, medical need and a supportive regulatory environment) remain intact, and company valuations do not look stretched.

Valuation: Structural support for narrower discount

At 23 February, BION's shares traded at a 2.7% discount to cum-income NAV. This is narrower than the 4.2% average discount over the last 12 months, and substantially tighter than the longer-term averages, reflecting a significant narrowing from late 2015. Factors supporting the narrower discount include BION's high distribution policy (yield of c 5%) and share buyback programme, as well as consistent performance, a broader shareholder base, high levels of daily trading liquidity and inclusion since December 2014 in the Stoxx Europe 600 Index.

Investment companies

27 February 2017

Price CHF57.55
Market cap CHF3,188.3m
AUM CHF3,276.9m

NAV* CHF59.15

Discount to NAV 2.7%

*Including income. Data as at 23 February 2017.

Yield (historic) 5.0%

Ordinary shares in issue 55.4m

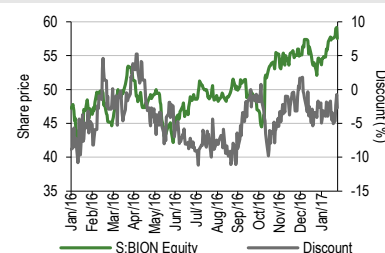
Code BION

Primary exchange Zurich

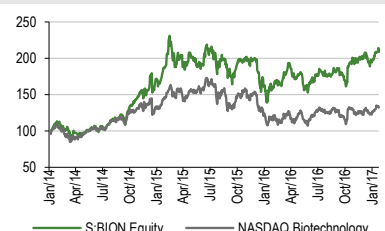
AIC sector N/A

Benchmark NASDAQ Biotechnology

Share price/discount performance



Three-year performance vs index



52-week high/low CHF59.20 CHF42.15

NAV* high/low CHF60.65 CHF43.20

*Including income.

Gearing

Gross* 6.8%

Net* 6.8%

*As at 31 December 2016.

Analysts

Sarah Godfrey +44 (0)20 3681 2519

Mel Jenner +44 (0)20 3077 5720

investmenttrusts@edisongroup.com

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Exhibit 1: Investment company at a glance
Investment objective and fund background

BB Biotech (BION) is a Switzerland-domiciled investment company, targeting long-term capital growth from biotechnology companies that are developing and marketing innovative drugs. At least 90% (currently 100%) of the portfolio is invested in listed companies, primarily large and mid-cap names that are already profitable. It is benchmarked against the NASDAQ Biotechnology Index, but is managed bottom-up with a concentrated 20-35 stock portfolio.

Recent developments

- 17 February 2017: Results for the 12 months ended 31 December. Share price total return of +0.3% in CHF, +1.9% in € and -1.4% in US\$. NAV total returns -19.1% in CHF, -17.6% in € and -20.6% in US\$, versus -21.3% (in US dollars) for the benchmark NASDAQ Biotech Index.
- 20 January 2017: Dividend of CHF2.75 per share (5% of the average share price in December 2016) to be approved at the general assembly on 16 March 2017.

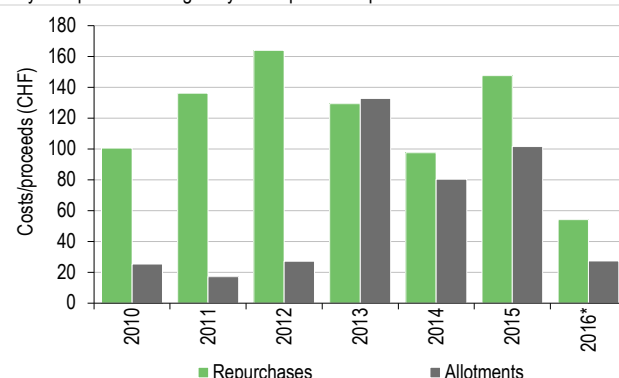
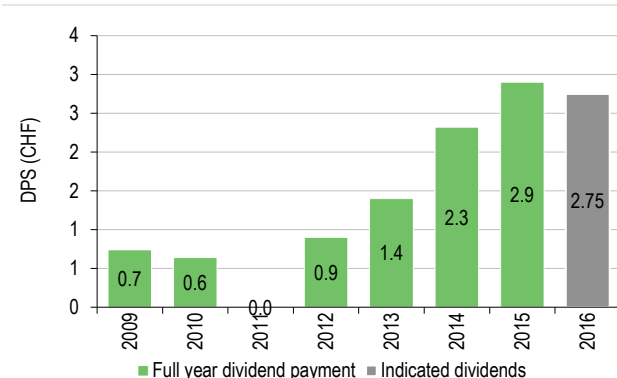
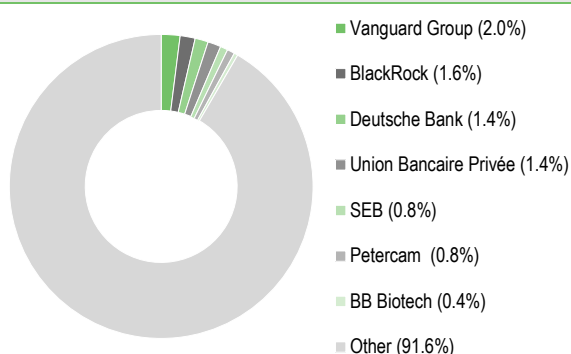
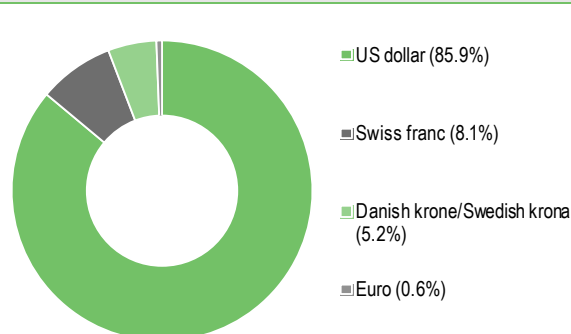
Forthcoming		Capital structure		Fund details	
AGM	March 2017	Ongoing charges	1.28% (31 December)	Group	Bellevue Asset Management
Quarterly results	April 2017	Net gearing	6.8% (31 December)	Manager	Team-managed
Year end	31 December	Annual mgmt fee	1.1% on market cap	Address	Seestrasse 16, 8700 Kusnacht, Switzerland
Dividend paid	March (part capital return)	Performance fee	None	Phone	+41 (0)44 267 6700
Launch date	November 1993	Trust life	Indefinite	Website	www.bbbiotech.com
Continuation vote	None	Loan facilities	See page 7		

Dividend policy and history (financial years)

A new distribution policy was put in place from the year ended 31 December 2012, whereby BION makes a cash distribution equivalent to approximately 5% of its share price at the year end.

Share buyback policy and history (financial years)

BION has authority, renewed annually, to repurchase up to 10% of its issued share capital. As part of the distribution policy announced in 2012, BION has also committed to returning 5% of its share price at the year end via the share buyback process during the year. *Up to 30 September 2016


Shareholder base (as at 31 December 2016)

Analysis of portfolio by currency (as at 31 December 2016)

Top 10 holdings (as at 31 December 2016)

Company	Country	Main clinical focus	Portfolio weight %	
			31 December 2016	31 December 2015
Celgene	US	Oncology	12.7	10.5
Incyte	US	Oncology	12.4	9.9
Ionis Pharmaceuticals	US	Genetic diseases	10.5	9.8
Actelion	Switzerland	Cardiovascular diseases	8.1	7.5
Gilead	US	Infectious diseases	6.3	6.8
Radius Health	US	Women's health	5.3	6.4
Alexion Pharmaceuticals	US	Orphan diseases	4.8	4.8
Tesaro	US	Oncology	4.2	1.6
Neurocrine Biosciences	US	Women's health	3.9	4.3
Agios Pharmaceuticals	US	Oncology	3.7	3.4
Top 10 (% of portfolio)			71.9	67.6

Source: BB Biotech, Edison Investment Research, Morningstar, Bloomberg.

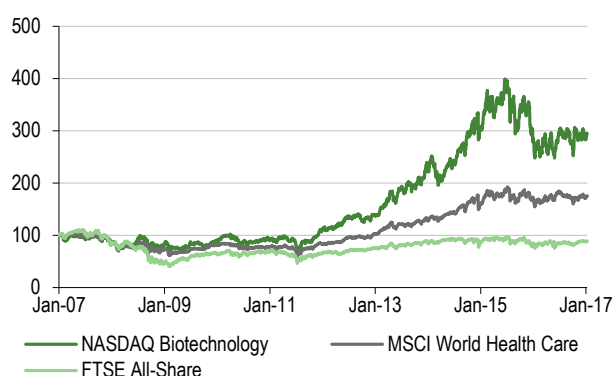
Market outlook: Value remains amid uncertainty

Last year was a volatile one for biotech stocks, with markets struggling to recover losses from a sharp sell-off in January 2016. As well as a rise in risk aversion, which saw generalist investors pull out of the biotech market, stocks suffered from volatility as a result of the US presidential election race, with repeated attacks from both main candidates on perceived overpricing by pharmaceutical companies. However, as shown in Exhibit 2 (left-hand chart), performance of the NASDAQ Biotech Index (shown in Swiss franc terms) has stabilised more recently, and longer-term outperformance of both the broader healthcare market and the UK equity market has been substantial.

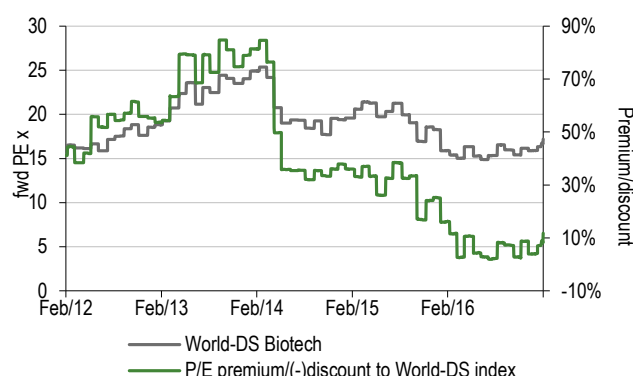
The factors underpinning innovation and growth in biotechnology remain: advances in scientific understanding, an ageing population in the developed world needing more medical treatment, and a growing middle class in the developing world leading both to more Western-style diseases and greater demand for healthcare services. In spite of this, as shown in the right-hand chart, forward P/E ratios for biotech companies have declined substantially compared with global equities as a whole in the past three years, suggesting value still exists in the market for investors with the skill to select the stocks with high likelihood of clinical success.

Exhibit 2: Market performance and valuation

Index performance (total return, Swiss franc terms) over 10 years



12m forward P/E of World-DS Biotech Index compared with World-DS Index



Source: Thomson Datastream, Edison Investment Research

Fund profile: Concentrated biotech specialist

BB Biotech (BION) was launched in 1993 to invest in companies in the innovative area of biotechnology. Based in Switzerland, with a primary listing on the SIX exchange and secondary, euro-denominated listings in Germany and Italy, BION holds a concentrated portfolio of 20-35 stocks, with a bias towards fast-growing smaller and mid-cap names. Five to eight (currently six) core holdings account for as much as half the portfolio. While the fund does invest in some promising earlier-stage biotech companies, holdings are primarily in companies that already have products on the market. Up to 10% of assets may be invested in unquoted companies, although the fund currently has no exposure to these. BION uses the NASDAQ Biotechnology Index as a performance measure, although owing to the fund's short stock list and non-US listed exposure (currently c 15%), the portfolio will tend to differ markedly from the benchmark. The fund is a constituent of the Stoxx Europe 600 Index, which may be a factor in its high level of trading liquidity.

BION is managed by a team at healthcare investment specialist Bellevue Asset Management, led by Dr Daniel Koller, and is overseen by an executive board of healthcare industry experts. Based mainly in Zurich and New York, the management team includes physicians and scientists with a variety of specialisms. Bellevue has managed the fund since its inception.

The fund manager: Bellevue Asset Management

The managers' view: Support from innovation and valuation

BION's managers are positive on the outlook for biotechnology stocks for four principal reasons: the continued pace of innovation, a favourable regulatory environment, overstatement of political risk, and the historically attractive level of valuations compared with the broader stock market.

The team sees multi-billion dollar sales potential for new treatments in areas such as immuno-oncology, liver disease, central nervous system disorders, and orphan diseases such as spinal muscular atrophy (SMA), where BION has exposure both through Ionis Pharmaceuticals, whose Spinraza treatment (partnered with Biogen) has just been approved in the US, and early-stage rival AveXis. Koller points out that gene therapy advances in this area mean that newborns diagnosed with the most serious form of the disorder now have a greater chance to grow up.

The manager argues that breakthrough treatments will continue to enjoy pricing power, as will alternatives to existing therapies where they offer superior efficacy and safety. While US president Donald Trump echoed rival candidates' rhetoric on the need to rein in some high drug prices, he has also signalled the possibility of tax cuts for US drug companies and an even more accommodative regulatory regime.

Koller points to Spinraza as an example of how quickly the FDA can act. The treatment was still in Phase III in the second half of 2016 when the trial was halted early on ethical grounds because of strong evidence of efficacy. Stopping the trial allowed participants who had been receiving a placebo to benefit from the new treatment. Ionis and Biogen filed for approval with the FDA in September 2016 and Spinraza was given the go-ahead in December, with EU approval expected during 2017.

After several years of very strong performance, the sell-off in biotech stocks during 2016 has seen P/E valuations fall back to levels last seen at the market trough in 2011, which Koller describes as "a complete misjudgment of the market opportunities". Large-cap biotech stocks are trading at a valuation discount to both large-cap pharmaceutical stocks and the broader S&P 500 Index, with valuations of small- and mid-cap biotech stocks at even more depressed levels.

The BION team views biotech fundamentals as attractive, and Koller says the main driver of the slump in valuations is 'risk-off' sentiment, leading to outflows of funds from more generalist investors and short-selling by institutions. He adds that the market for biotech stocks needs an inflection point, which could come in the shape of increasing policy visibility from the new US administration; in the meantime, uncertainty could provide an attractive entry point for investors.

Asset allocation

Investment process: Rigorous clinical and financial assessment

BION's management team is made up of sector experts with a variety of specialisms, allowing them to assess developing biotech themes and innovations. The managers follow a continuous process of industry analysis, interviewing physicians and specialists, attending industry conferences, monitoring medical journals and meeting company managements. Beginning with a global universe of c 800 companies, the team focuses on indications or diseases where scientific or technological advances coincide with strong market potential. This filters the opportunity set to 300-400 companies, to which qualitative and quantitative tests are applied in order to arrive at a 'long list' of c 150 potential investments.

The team builds in-depth financial models for each candidate stock, as well as assessing factors such as innovation, ownership of intellectual property, quality of management, and

pharmacoeconomics. While screening criteria are weighted towards clinical considerations such as efficacy of new treatments, economic factors are also important, with the fund having a bias towards companies that are already generating above-average sales and profits growth.

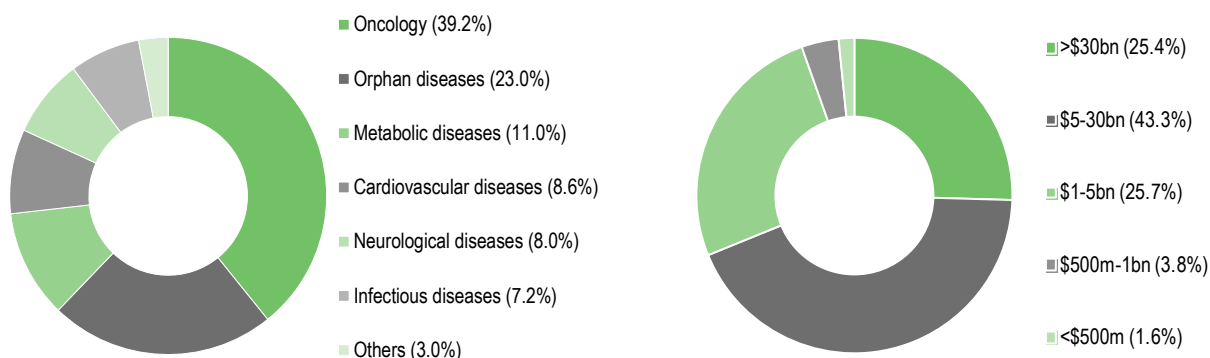
Bellevue's analysts draw up investment proposals based on the outputs of this process, which include clinical data, financial models, recommendations on position size and purchase price, and an estimate of potential upside and downside. The proposals are discussed by the team and presented to the executive board at monthly meetings. The board has final sign-off on new investments, complete exits and major changes in weightings, although the Bellevue team has autonomy in day-to-day portfolio management.

The end portfolio has 20-35 stocks (usually c 30-35), with five to eight core holdings accounting for around half of total assets. The stock list includes companies from across the size spectrum and around the world, although the portfolio reflects the dominance of the US as a home for biotech companies. Once in the portfolio, stocks are monitored from both a scientific and a financial perspective, and debated at regular board and strategy meetings.

Current portfolio positioning

At 31 December 2016, BION had 33 holdings, towards the top of its 20-35 stock range but still significantly more concentrated than most peers. The length of the stock list is indicative of an increase in exposure to smaller and mid-cap stocks that the managers expect to move up the size curve and become the major biotech players of the future. The six core holdings (Celgene, Incyte, Ionis Pharmaceuticals, Actelion, Gilead and Radius Health) made up 55.3% of the portfolio, compared with 50.9% at 31 December 2015. The biggest changes in exposure by clinical focus during the year were a 3.4pp increase in oncology and a 4.2pp reduction in infectious diseases.

Exhibit 3: Portfolio distribution by clinical focus (left) and market capitalisation (right)



Source: BB Biotech, Edison Investment Research. Note: At 31 December 2016.

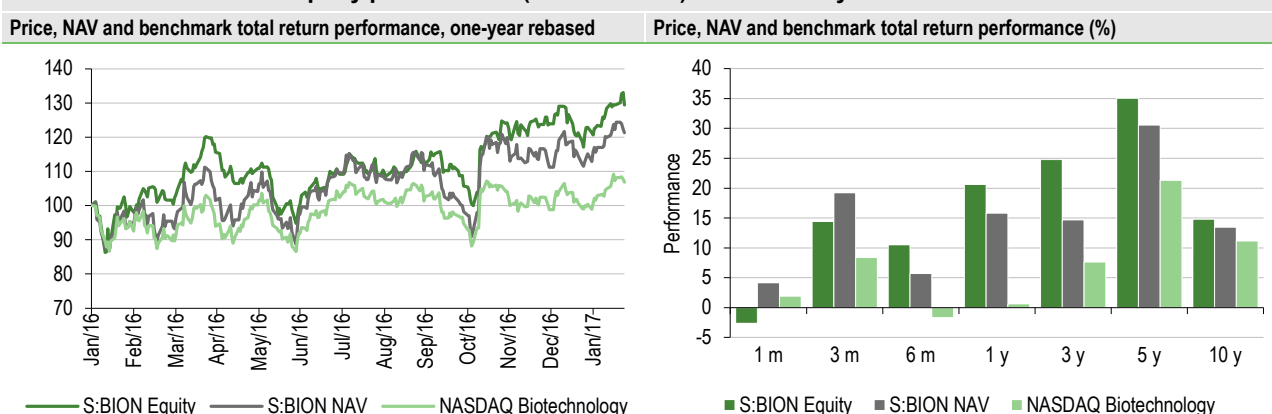
Purchases in the second half of 2016 include antibody technology company MacroGenics, central nervous system specialist Intra-Cellular Therapeutics, AveXis, a gene therapy player developing a treatment for spinal muscular atrophy, and oncology stock Myovant Sciences, bought at IPO in November. Three of these four have market capitalisations below \$1bn, while the largest, AveXis, is c \$1.6bn, illustrating the move into promising smaller companies.

Sales include Clovis Oncology and Infinity Pharmaceuticals, on the back of sub-optimal clinical data, as well as a reduction in the large holding in Swiss cardiovascular specialist Actelion following bid rumours. Actelion has now agreed a takeover by Johnson & Johnson; the former's drug discovery and early-stage pipeline operations will be spun out into a new Swiss-listed entity. M&A activity also saw long-standing holding Medivation (acquired by Pfizer) and new purchase Tobira Therapeutics (bought by Allergan) exit the portfolio in the second half of 2016.

Performance: Strong record of outperformance

BION's NAV performance suffered in 2016 along with the wider biotech market, experiencing a sharp sell-off in January, although it rebounded strongly in early November following the US presidential election, opening up a large margin over the benchmark NASDAQ Biotechnology Index (Exhibit 4, left-hand chart). Longer-term total return performance also remains strong in absolute terms and versus the index (Exhibit 4, right-hand chart and Exhibit 6). BION has strongly outperformed the more generalist MSCI World Health Care Index and (of relevance for UK-based investors) the FTSE All-Share Index over the short, medium and longer term (Exhibit 5).

Exhibit 4: Investment company performance (in CHF terms) to 31 January 2017



Source: Thomson Datastream, Bloomberg, Edison Investment Research. Note: Three, five and 10-year performance annualised.

Exhibit 5: Share price and NAV total return performance (in CHF terms), relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to NASDAQ Biotechnology	(4.4)	5.6	12.4	19.9	55.9	71.2	38.0
NAV relative to NASDAQ Biotechnology	2.2	10.0	7.5	15.1	21.0	44.4	22.7
Price relative to MSCI World Health Care	(1.9)	10.3	16.7	20.5	47.5	117.1	131.5
NAV relative to MSCI World Health Care	5.0	14.9	11.7	15.7	14.4	83.1	105.8
Price relative to FTSE All-Share	(1.2)	8.1	6.5	17.6	90.0	234.7	355.1
NAV relative to FTSE All-Share	5.7	12.6	1.9	12.9	47.4	182.3	304.5

Source: Thomson Datastream, Bloomberg, Edison Investment Research. Note: Data to end-January 2017. Geometric calculation.

Contributors to outperformance include strong returns from Actelion, Incyte (+20.9% in January 2017 in US dollar terms, after announcing new pivotal studies), Tesaro, Radius Health and Ionis Pharmaceuticals. Actelion is not widely held by biotech investors as it is Swiss-based and thus outside the NASDAQ benchmark; its shares have risen in value by over 90% since early November when rumours began to surface of a planned takeover by Johnson & Johnson, which was agreed in late January 2017. Takeovers of Medivation and Tobira also added to performance in 2016.

Exhibit 6: NAV total return performance relative to benchmark (in CHF) over five years

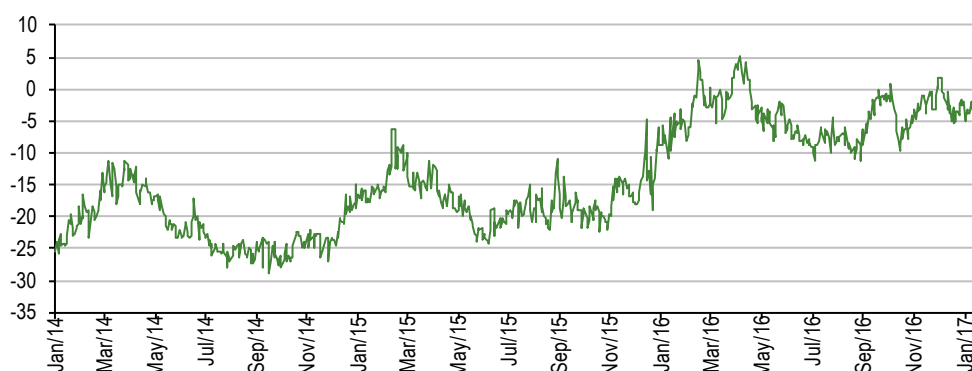


Source: Thomson Datastream, Bloomberg, Edison Investment Research

Discount: A range of factors sees discount narrow

During 2016, BION's discount to NAV – which had averaged c 20% over the previous three to five years – narrowed substantially. At 23 February 2017, the discount stood at 2.7%, narrower than the one-, three- and five-year averages of 4.2%, 14.1% and 17.4% respectively. In a volatile market, BION has ranged from an 11.2% discount to a 5.3% premium over the past 12 months. Factors supporting the narrowing of the discount may include the fund's commitment to returning capital to shareholders via buybacks and capital distributions, its strong performance record, widening shareholder base (including an increasing number of UK investors), high levels of daily trading liquidity and inclusion in the Stoxx Europe 600 Index since December 2014. In March 2016, BION shareholders approved a new repurchase authority for up to 5.54m shares. As of 31 December 2016, no shares had yet been bought back under this facility.

Exhibit 7: Share price premium/discount to NAV (including income) over three years (%)



Source: Thomson Datastream, Edison Investment Research

Capital structure and fees

BION is a closed-ended investment company listed on the Swiss SIX exchange, with secondary, euro-denominated listings in Germany and Italy. Following a five-for-one stock split in March 2016, there are 55.4m ordinary shares in issue. The fund may use gearing via a short-term bank loan with an interest rate of 0.4% pa. At 31 December 2016, CHF204m was drawn (31 December 2015: CHF160m), representing 6.8% net gearing based on net assets at that date. Bellevue Asset Management receives an all-in annual management fee of 1.1% of average market capitalisation, with no performance fee payable. The stated total expense ratio at 31 December 2016 was 1.28%, up from 1.13% at 31 December 2015.

Dividend policy and record

Most biotech companies, because of their need to invest heavily in research and development, do not pay a dividend. However, in recognition of investors' appetite for income, and as part of its discount management policy, BION seeks to return 5% of its market capitalisation (based on the volume-weighted average share price in December) to investors each year by way of a capital distribution. For FY16, a distribution of CHF2.75 per share has been declared. This compares with an equivalent figure of CHF2.90 for FY15 (the actual distribution was CHF14.50, but a five-for-one share split took place in March 2016). Because the distribution is set at a fixed percentage of the share price, it may fall as well as rise from one year to the next. Based on the 23 February share price of CHF57.55 and the FY16 dividend, BION has a prospective yield of 4.8% (5.0% based on the FY15 dividend).

Peer group comparison

For comparison purposes, Exhibit 8 below includes the four members of the AIC's specialist Biotech & Healthcare sector, as well as Switzerland-listed public/private equity fund HBM Healthcare Investments. Three of the funds have a specific biotech focus while the other three invest more generally across healthcare. Within the group (all data in Swiss francs), BION is the largest fund. It ranks first for NAV total returns over one and five years and second over three years. In terms of risk-adjusted performance as measured by the Sharpe ratio, BION is in line with or above the average over one and three years. The discount to NAV is below average. Ongoing charges are average, although it is important to note that BION is the only fund not to levy a performance fee, so the actual fees paid by investors in other funds may be higher. Owing to its high distribution policy, BION has the second-highest yield in the group.

Exhibit 8: Biotech and healthcare peer group (in CHF terms) as at 23 February 2017

% unless stated	Market cap £m	NAV TR 1 Year	NAV TR 3 Year	NAV TR 5 Year	Ongoing charge	Perf. fee	Discount (ex-par)	Net gearing	Dividend yield (%)	Sharpe 1y (NAV)	Sharpe 3y (NAV)
BB Biotech AG	3,188.3	29.0	48.7	291.1	1.1	No	(3.5)	101	5.0	0.9	0.5
Biotech Growth Trust	518.0	12.8	20.3	187.6	1.0	Yes	(6.9)	103	0.0	0.4	0.2
HBM Healthcare Investments AG	835.5	18.4	55.5	187.2	1.7	Yes	(28.8)	100	5.2	0.7	0.6
International Biotechnology Trust	282.2	23.0	44.6	175.2	1.4	Yes	(7.4)	100	3.9	0.9	0.5
Polar Capital Glb Healthcare	300.9	10.4	20.2	85.8	1.0	Yes	(4.9)	100	2.2	0.4	0.1
Worldwide Healthcare Trust	1,362.3	17.4	45.4	165.6	0.9	Yes	(0.0)	107	0.7	0.9	0.6
Weighted average		22.7	45.0	227.6	1.1		(6.6)	102	3.8	0.8	0.5
BION rank in peer group	1	1	2	1	3		2	3	2	1	3

Source: Morningstar, Edison Investment Research. Note: TR=total return. Sharpe ratio is a measure of risk-adjusted return. The ratios shown are calculated by Morningstar for the past 12- and 36-month periods by dividing a fund's annualised excess returns over the risk-free rate by its annualised standard deviation. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

The board

BION has three executive board members, all of whom are highly qualified industry experts. The directors sign off on all major investment decisions, although day-to-day portfolio management responsibility resides with Bellevue. The chairman (since 2013), Dr Erich Hunziker, has been on the board since 2011 and is a former CFO of Roche. The longest-serving director, Dr Clive Meanwell, was appointed in 2003 and is also founder and CEO of The Medicines Company. Professor Dr Klaus Strein joined the board in 2013, following senior R&D roles at Roche and Boehringer Mannheim.

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