

The logo for Naples Global Advisors is set within a dark red rectangular banner. On the left side of the banner is a faint, light-colored grid pattern resembling a globe. The text "NAPLES GLOBAL ADVISORS" is centered in a white rectangular box with a thin gold border. "NAPLES" is in a dark red serif font, while "GLOBAL ADVISORS" is in a gold serif font.

## NAPLES GLOBAL ADVISORS

“To be an investor, you must be a believer in a better tomorrow” ~Benjamin Graham

Successful product launches, technological breakthroughs, and innovative new services are a few of the catalysts that can propel earnings higher for companies. Those wins, which vary in frequency, financial impact, and societal value, are often part of our workday highlights. We are certainly thrilled when we see companies in our clients’ portfolios bear the fruits of their labor and boost the bottom line. However, it is important to recognize that disappointments and stresses are embedded, if not more frequent, part of the business cycle as well. Our optimism is tested on a daily basis as we watch the rigorous trials and errors that accompany business expansion and product development, often resulting in “earnings estimate misses.” As the live implementation versus prior expectation equation plays out in real time, a stock’s price can stray well beyond the likely economic impact of the single event. The resulting price divergence can provide opportunities as well as frustrations. Having patience, experience, and an investment horizon reaching beyond a single quarter, are vital components for managing the inevitable volatility associated with real time business execution.

No market sector is immune to price swings, but the nature and pace of business activity within the *Technology* and *Pharmaceuticals* industries tend to have disproportionate volatility. Discounting the future cash flows of a *Utility* is usually a more predictable exercise than for a *Biotech* firm with only a few drug

offerings or for a start-up *Tech* firm. The Wall Street Journal recently reported that the odds of a drug compound making it all the way from testing to FDA approval are roughly 10,000 to 1. In the land of *Tech* startups, *Facebook* and *Twitter* are the extreme exceptions of successes, with as many as 75% of venture backed companies funded with \$1 million or more, never returning **any** cash to investors, according to Harvard lecturer Shikhar Ghosh. Of the 6,613 U.S. based companies funded by Venture Capital from ’06 to ’11, less than 1% made it to IPO registration. Similarly, commercial success in the world of *Pharma* is also not the norm. To that end, *AstraZeneca* throws a posh annual event, known as the “Science Oscars,” to award its researchers for pursuing promising leads, while *Bristol Myers* provides awards for failed research.

An economic oxymoron is that commercial successes fund the much more frequent failures, yet it is the repeated failures that typically lead to the successes. Engineering, design, testing equipment, marketing studies, and patent contracts, are all examples of hard dollar expenses that tend to precede trials, product launches, and ultimately sales revenues. Great companies build off of their research expenditures because there is simply no guarantee of an immediate payoff. During 2016, Research and Development (R&D) expenditures totaled over \$1.7 billion for *3M*, and \$6.9 billion for *Merck*. Hidden in their R&D expense lines are all manner of ideas, many of which

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will never be directly monetized, all for the chance of uncovering the next **Post It Note**. Those companies fostering creative failures, and with the discipline and vision to see beyond a single quarter's earnings, are setting the foundation for future successes.

Thankfully, a product that recently made it through the entirety of the FDA approval process was from *Medtronic*. The diagnostic medical products firm received approval for an Artificial Pancreas, the first such device in the U.S. The purpose of the product, called the MiniMed 670G, is to monitor patients' blood sugar and automatically supply insulin. In practice, MiniMed takes the human element out of the insulin measuring equation, relying on the machine's sensors to monitor and provide the appropriate amount of insulin, versus the need for self-induced and often cumbersome testing. While not a cure, those dealing with Type 1 diabetes now have a bit more hope, a bit more free time, and less distraction in their lives from a growing global disease.

More dramatic is the story of a 32-year old Wyoming man, who received life changing surgery in 2016 in the form of a full face transplant. Andrew Sandness suffered extensive facial injuries from a gunshot wound at the age of 21. Dr. Samir Mardini of the Mayo clinic led the team that required a total of 50 hours of continued surgical efforts, as well as months of preparatory training, to restore Sandness' nose, upper and lower jaw, palate, teeth, cheeks, facial muscles, salivary glands, and facial skin (ear to ear).

Note & Sources

Rockoff, Jonathan D., "Celebrating Failure in a Tough Drug Industry," 3.3.17, [The Wall Street Journal](#)

Cortez, Michelle, "Artificial Pancreas Approved," 9.28.16, Bloomberg News

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Surgical planning software, 3-D imaging, and anti-rejection drugs, served an integral part of the process, with those technologies or supporting technologies represented in our portfolios. So while President Trump's tweets and the initial public offering of SNAP (*Snapchat*) made headlines in early 2017, there is a young man in Wyoming whose life has been positively altered in a way that can't be measured by a company's quarterly earnings, or by the years of trials, errors, and development expenses leading up to that ultimate success.

We remain exceedingly practical as it relates to a bottom line requirement for consistent and growing profits, and the acknowledgement of shareholder's rights via dividend distributions. Still, we feel it is important to be reminded of the broader picture of the investment process, and to consider a future that will be positively impacted by the capital investments of our clients. That future could involve new carbon friendly power sources, creative engineering to build the fastest diving roller coaster in the world (available at our holding of Cedar Point Park in Ohio), linear processors that help autos avoid accidents, or, indeed, life altering medicines and devices. We agree with Ben Graham, the father of modern value investing, that it takes optimism to be a successful investor. From our perspective, there is ample cause for economic optimism in the coming quarters and beyond. Yes Ben, we pay attention to valuation, but we also pay attention to innovations that can drive future earnings and cash flows.