Sam's Club

BY CHARLES BUTLER

PHOTOGRAPHS BY RANDY HARRIS

Sam Isaly's formula is simple: Just win. And for most of the past 10 years, that's exactly what his health care fund has been doing, returning about 20 percent a year and beating virtually all comers. But this year the sector and his numbers are in a tailspin. Will his best-laid plans come undone?

Joseph Mollica was in a bind, and Sam Isaly knew it.

Last summer Mollica's company, Princeton, N.J.–based Pharmacopeia, had announced plans to buy Eos Biotechnology, a small drug-discovery firm near San Francisco. Though Eos had revenue of just $4 million and was unprofitable, Mollica argued that the purchase was an important long-term move. The problem was, he needed to ensure that investors would support his plan at a shareholder meeting scheduled for January.

Could he count on support from Isaly, manager of the $2 billion Eaton Vance Worldwide Health Sciences fund and Pharmacopeia's top shareholder at the time?

In a word: no.

As he sat across from Mollica in the fund company's conference room one afternoon last November, Isaly let loose. He told Mollica that Pharmacopeia would be taking a big step backward and that the smaller Eos would siphon earnings from his only recently profitable company. Furthermore, he argued, Pharmacopeia's stock would be diluted and its price weighed down by the acquisition's costs. (Already, it had shrunk, from $17, when the deal was announced, to $13.) "Joe, if you don't turn this down, if you don't withdraw this deal, we're gonna fight you," Isaly remembers saying. "We're serious."

"Sam, *we're* serious," Mollica shot back. "You've got to do what you've got to do, but this is going forward."

"All right, then," said Isaly, a former high school wrestler. "We're going to the mat."

The fight was on. As the founding partner of OrbiMed Advisors, a $4 billion New York asset management firm that runs the Eaton Vance fund and six other private equity and hedge funds all dedicated to health care, Isaly, 57, had spent his entire 34-year career poking around drug companies. This, though, would be his first proxy fight ever.

Why now? Was it frustration with a once-roaring biotech market that had begun to show signs of imploding? Was it the unending pressure to keep his own numbers up? Isaly says no. "[This deal] was just so awful—so outside the bounds. And we were in a position of strength because we had a lot of stock."

One obstacle: His 2.4 million shares, out of a possible 24 million, would hardly be enough to kill the deal at the shareholders meeting. So Isaly started making calls to a dozen or so large shareholders, including Robert Hall at Brown Capital Management, Arnie Snider at Deerfield Partners, and his own archrival, Ed Owens, manager of the Vanguard Healthcare fund. Isaly also paid proxy solicitor Georgeson Shareholder $100,000 to pepper Pharmacopeia's leading shareholders with press releases detailing Isaly's objections to the deal.

By the first week of January, he had locked in a 35 percent bloc of votes, including Owens's, even though a number of large shareholders had already committed to Pharmacopeia. The night before the vote, Isaly knew he held a slim lead, 9 million votes to Pharmacopeia's 7 million. Then, around 9 p.m., he got a call from Pharmacopeia. The vote was off—the merger canceled. "They knew they weren't going to get enough votes," Isaly says. (Pharmacopeia did not return repeated phone calls for comment.)

The next morning, instead of traveling to Princeton for the shareholders meeting, he and his 25 employees toasted their success with champagne. For Isaly—who's been in a wheelchair ever since high school—the victory meant more than simply keeping a money-losing company out of his fund. Sitting behind his oval desk, a Bloomberg terminal glowing behind him, he now says, "People are aware that they should solicit our thinking." Then he pauses a moment. "Or not cross us."

There's no getting around it: Sam Isaly can come across as a cocky SOB. "I have a personality that is a little nasty," he admits. But then, he has the numbers to back it up. Since taking over the Worldwide Health Sciences fund in 1989, he's tranformed it from a sleepy $2.5 million portfolio into the fourth-largest health care fund. Long term, the fund has easily beaten the S&P 500 and nearly everyone else in the sector. The sole exception: Vanguard's Owens.

For more than 10 years, Isaly and Owens have battled for the top-performing spot among the 75 or so actively managed U.S. health care funds. Reserved and press shy, Owens has run the $16.5 billion no-load Vanguard fund for 18 years by favoring big pharmaceutical companies, HMOs and medical-device makers. Isaly, on the other hand, is blunt with his comments and a bit brazen with his portfolio. While his fund includes such blue chips as Novartis and Pfizer, Isaly has nearly 40 percent of his holdings in risky biotech companies.

Despite their divergent styles, Owens and Isaly have both produced grand-slam results. Through mid-June, Owens had the edge in the 10-year ranking—a 19.9 percent average annualized return, versus Isaly's 17.7 percent. But Isaly, who charges a 5.75 percent load, concedes nothing. "If you add back our expenses," he insists, "we are clearly ahead of Ed." In fact, his three-year annualized return of 24.8 percent easily whips both Owens's 15.9 percent rise and the S&P's 5.2 percent drop.

Such returns have helped Isaly ("EYES-lee") keep a pledge he made in 1996, when Boston-based Eaton Vance began to market and distribute his fund. He told fund company officials he planned to be a 20/20 guy—that is, produce an average 20 percent return for 20 years. And until this June, he had been living up to it, fueled by years like 2000, when he put up Barry Bonds–like numbers. As several of the no-name biotech and international stocks he had been collecting since the late 1990s took off, Isaly's fund roared upward 81 percent. Geltex, which makes a phosphorus binder for dialysis patients, soared in price, as did PathoGenesis, maker of a cystic fibrosis treatment. "Everything worked," Isaly says, smiling. "It was a very rare event."

The past 18 months have proved just how rare. Large pharmaceutical stocks have been clobbered by modest earnings, a rush of patent expirations and, in the case of Bristol-Myers Squibb, questionable management maneuvers. Biotech stocks have fared even worse. This was supposed to be a breakout year for players such as ImClone, Sepracor and Dendreon. Instead, a slew of failed clinical trials, FDA rejections and charges of insider trading have set back stock prices and investor confidence in the sector. Isaly, too, has been burned by the backdraft. Through mid-June his fund was down 20 percent year-to-date.

That's closer to Mr. Magoo than to 20/20.

"We need performance. We've got to have performance," he mutters, reviewing his holdings: Eli Lilly, down 17 percent for the year; Schering-Plough, down 22 percent; Abgenix, a developer of monoclonal antibody therapies, down 60 percent. *Sixty percent*. What's it still doing in his portfolio? "Dreams. It's a technology for the future," Isaly says. "It's hard to make human antibodies, but these guys can make them."

For somebody who wants to put numbers on the board that will "never be touched"—"Babe Ruth hit 714 home runs; that wasn't enough"—now is no time to lose confidence. "I don't want to be Pollyannish and say, 'Gee, all's well,' but I do have some history to draw on when things are this bad," Isaly says one early June evening, the markets closed for the night. "We have been down 20 percent before, and for whatever reason, it marks the bottom. It has never been 30." He scratches the side of his head with his palm. "Minus 20 is not routine, but it is not horrible. Somewhere between 20 and 50 is where my pain

Isaly with his secretary, Nancy Servodio: "I have a personality that is a little nasty."

threshold is intolerable, and it is probably the midpoint, at 35."

There's another problem. Bad numbers could hurt his master plan. He pulls out a sheet of paper. It lists the top 10 health care funds by asset level, headed by Owens's Vanguard fund, with Putnam Health Sciences in second place and Fidelity Select Health Care in third. "I think we can be third by the end of the year," he predicts. "Do we aspire to be bigger than Vanguard? No," he says, explaining that at that size it's hard to be a nimble investor. "Putnam would be the right size."

To get there, he drives his staff—hard. At the end of each week, Isaly, with the help of four college interns, puts together a 50-page document. It features the key financials of the 40 or so companies the fund invests in as well as the 550 other drug and biotech companies his firm tracks. These numbers get torn apart on Sunday nights, when Isaly makes his three partners, nine analysts and an intern show up for a three-hour meeting.

Why can't the meeting wait till Monday? "It's quiet time," says Isaly. "No phones, no reporters calling." It's when Isaly and his men trade numbers on the 30 or so companies each is responsible for, share news on product developments, discuss changes in the weighting of the fund and pinpoint opportunities to short stocks for their hedge funds. "The biggest problem with the Sunday meetings is the wives," says Eric Bittelman, CFO of OrbiMed, where all the major principals are male. "They haven't gotten used to them."

Over the Memorial Day weekend, Isaly proposed moving the meeting to Monday, so as not to break up the holiday. (Isaly himself is married with three children.) One staffer e-mailed back saying he planned to be at the Jersey Shore with his family for the start of summer. Isaly's one-line reply: "How about meeting on Sunday then?" The meeting took place on Monday.

Says Sven Borho, one of OrbiMed's partners: "Sam can be a real ballbuster." Just ask Nancy Servodio, Isaly's secretary of 13 years. During her first week on the job, after spending an hour typing dictation from her new boss, Servodio accidentally unplugged the computer, losing all of the work. Isaly elbowed her in the head and yelled, "Get out! Get out!"

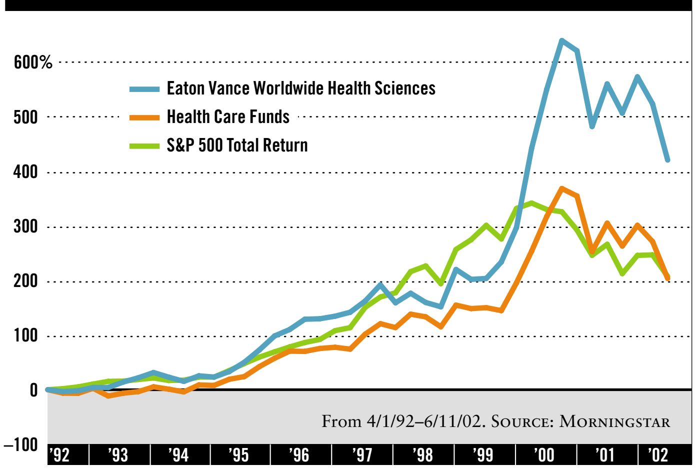
His staff is not alone in finding Isaly demanding. "He can be terrifying," says Paul Herrling, head of research at Novartis. "You have to be very careful what you say. He remembers [everything] years later."

Sally Curley, vice president of investor relations at Genzyme, a Cambridge, Mass., biotech firm, puts it this way: "You'd better come prepared when you go see Sam Isaly." Two years ago, after Genzyme had announced its acquisition of Geltex, she visited him to discuss the deal. The meeting was anything but congratulatory. Isaly, whose fund owned a major stake in Geltex, kept insisting that the company was worth more than Genzyme's bid and that Genzyme stood to profit considerably more from Renagel, Geltex's key kidney dialysis product, than the company was forecasting. "How can you propose this is possibly fair?" Isaly kept asking Curley and other Genzyme officials. "Hey, that is my product—that belongs to me. Why are you stealing from us?"

Curley was taken aback: Isaly owned not only Geltex but

Blinding Them With Science

Isaly's Eaton Vance fund has been one of the best for more than a decade.



From 4/1/92–6/11/02. Source: Morningstar

"Babe Ruth hit 714 home runs. That wasn't enough." Isaly wants his fund to put up numbers that will "never be touched."

Genzyme, too. Today she says, "It was a great deal for both parties, but trying to convince him of that was a challenge."

Isaly, who finally relented, remains unconvinced. "We thought we were getting mistreated," he explains. "And in fact we were. If you were only an owner of Geltex, you got hosed."

To Isaly, that's the way business works. If you let your guard down for one moment, someone may take advantage of you. That's why he wants to work harder than everybody else: to protect himself. Sure, he'll rush out of the office on Friday afternoons to get to his country house in Pennsylvania to "see the trees." Yes, he'll invite his staff and their families out for a backyard party each summer and put them up at a local hotel. ("It still feels like a mom-and-pop place around here," says Nancy Servodio. "We don't take the money and hold our noses up in the air.") And naturally, he tries to get home at a decent hour to see his three-year-old son, David. Yet he motors through the office telling his staff, "Don't stop working." When he investigates a company's cash flow, he calls the mission a "death watch." "I bear grudges," he'll tell you. He has a specially equipped Chrysler Town and Country with the license plate "TON CUL." "That's French," he says, "for YOUR ASS."

Those who know him well say Isaly has been this way his whole life. "He is just naturally competitive," says Bucky Clarkson, who played with Isaly when they were preschoolers in Grove City, Pa. "That's the way he came into this world."

He comes from a family with a history of success. Isaly's grandfather, William, launched the Isaly Dairy Co. in the early 1900s, which grew to include more than 400 ice cream parlors around Ohio and western Pennsylvania. Isaly's father, Samuel, who died when his son was two, created the Klondike bar.

In his senior year of high school, Isaly was a top wrestler and captain of the football team, juggling acceptances from Yale and Princeton. But nothing could have prepared him for what happened that winter. As he was practicing for an upcoming wrestling match, a teammate put him in an awkward hold. Suddenly, he was sprawled out on a mat, barely breathing—his life changed in an instant.

Isaly's neck was broken and his spine severely injured between the fifth and sixth vertebrae. He nearly died while being rushed to a Cleveland hospital. Eventually, doctors got him breathing again, but he lost virtually all voluntary movement below the waist. He'd spend a good part of the next year just learning to use his arms and hands to limited ability.

Clarkson figures that the accident just added to Isaly's drive, giving him something else to prove. But Isaly, who calls himself a "partial quad," insists that his disability doesn't motivate him. He's not out to prove to anyone who underestimated him how wrong they were. No, he won't be a cliché—the high school honors student struck down by a freakish accident who overcomes tragedy to beat the S&P. "I don't ever want to be seen that way," he says, "except when I need a parking space." He laughs.

In fact, press him about the injury and he'll usually say, "Won't go there. Ancient history. Next question."

But on a warm spring New York night, sipping beers at an outdoor cafe on Second Avenue, he confides that things have worked out differently than he had once planned. "I saw myself going off to college and playing football. Oh, you can't tell, but I'm 6-foot-2, 200 pounds. And that would have been all muscle back then. That's at least a good starting place to play college football. And I'm fast—or at least I was."

When you look at Isaly, you see a man who can raise his right arm only inches. A man whose right hand's fingertips dangle limply as he shakes your hand. Later he'll fidget to get a metal writing instrument squeezed between his thumb and index finger. There's a black marker attached to it, which he manages to push in order to take notes that only a few people, like Servodio, can decipher. Servodio feeds him sticks of Wrigley's gum and packs his papers into a bag for his commute downtown, aboard a bus where the driver has to strap him in.

To this day he keeps the letter from Yale, mailed in the summer of 1963—after the school had learned of his accident—that informed him that his acceptance was being withdrawn. It wouldn't be the last time he'd feel the sting of discrimination. After Isaly graduated from Princeton and the London School of Economics, a vice president at a big firm shooed him away. "He said I couldn't do the job because of the wheelchair, the travel and stuff," says Isaly. He also suspects that the executive regarded him as "visual pollution." Thirty-five years later he remembers the guy's name as easily if it were printed on his own driver's license: "Bruce Coe, Kidder Peabody. Said I couldn't do the job. God rest his soul, because he's surely dead." (Coe is actually alive and well and living near Princeton. He has no recollection of the interview. "I never would have said those things," he adds.)

Isaly's first job, after returning from London in 1968, was at Chase Manhattan, where he worked under Lee Kitchen, the bank's longtime pharmaceutical analyst. "Lee taught me the importance of technological advancement and how to look forward," Isaly says. "Every drug that will be introduced in the next 10 years has already been synthesized, already been discovered. But it takes that long to get it to market."

Long before it does, Isaly wants to pounce on it. Half his biotech holdings are in companies that currently have no profit, and 40 percent of his portfolio is in foreign companies, ranging from Japan's Chugai to Israel's Given Imaging. International stocks hold up his fund when U.S. markets are down, and small biotechs—when they finally mature—can accelerate returns well beyond a sector's average. The trick: finding them, or, as Isaly puts it, "anticipating the anticipators."

EATON VANCE WORLDWIDE HEALTH SCIENCES FUND (ETHSX)

NAV	$8.21
Front-End Load	5.75%
Expense Ratio	1.69%

TOP 10 HOLDINGS	% OF TOTAL
Novartis	5.7
Altana	5.1
Amgen (with Immunex)	4.9
Takeda	4.6
Pfizer	4.4
Fujisawa	4.4
Genentech	4.3
Schering-Plough	4.0
Serono	3.8
Lilly	3.7

Data as of 6/7/02. Source: OrbiMed Advisors

His investing style is hardly revolutionary. He favors companies with strong financials (15 to 20 percent earnings potential), good management and superior technology (drugmakers developing treatments for chronic illnesses, such as HIV or arthritis, that will have repeated use). To spot these companies, Isaly depends on analysts who are part number crunchers and part cell dividers. Take Sven Borho, who joined Isaly in 1991 right out of business school. His only tie with drug research was a paper he'd done in grad school on Merck. Back then, Borho says, "it was mostly MBAs who became pharma analysts." These days, "Sam and I joke that we wouldn't get a job at OrbiMed."

That's because Isaly has staffed up with a half-dozen analysts who came on board only after spending time in laboratories. Carl Gordon, who has a Ph.D. from MIT, was doing research in yeast secretion at Rockefeller University when Isaly hired him. Another MIT Ph.D., Richard Klemm, who has been tagged "Dr. Doom" for his tracking of companies that should be shorted in the firm's hedge funds, joined OrbiMed two years ago shortly after finishing his studies in molecular biology.

Isaly says the combination of eclectic experience and manpower separates his funds from others. "[Other funds] don't follow all 600 pharmaceutical and biotech companies. They only follow the top 100. They don't turn as many stones as us."

Finding stocks is what Isaly enjoys doing most. He has few hobbies. For a couple of years, he spent his off hours tracing his family genealogy, dating back to when the first Isalys left Switzerland for Ohio. Usually, though, he prefers to be on the phone at 6:30 in the morning checking in with a trader in Tokyo to see how his Japanese stocks fared overnight. (He'll check in with them again at 11 p.m., when Tokyo opens.) He spends a good portion of his weekend reading medical journals or prepping for his Sunday-night meeting. He teaches his interns—who act as his hands—to read 10-K reports. Even so, he says, "I wish I had more time for pure, unadulterated, in-the-dirt research."

Then he tells you that his fund record could be better—even better than his 18 percent per-year average—and that his disability affects his performance. That's surprising. You'd expect him to say that his mind, his math skills, his 18-hour workdays are a match for anyone with two good legs. Instead, he says, "I get tired. My energy level shouldn't be different walking or sitting down, but sitting down consumes a lot of me. My energy gets allocated between getting through the day and getting things done. I could have worked harder because I would have had more energy."

Has he given up hope of ever walking again? "I don't want to be negative, but I have a lot to do," he says. "And frankly, I don't think I can influence whether or not I'll ever walk. So I'm better off doing things that I can influence."

Like getting his fund back on track.

Of course, that means Isaly needs to find the next Geltex, or something quite like it. And guess what? He thinks he's spotted it. Last fall Merck announced plans to go to Phase III clinical testing sometime in 2002 on a new diabetes drug candidate, tagged KRP-297. When Isaly and two of his junior researchers, Fred Guintu and Bernard Liu, went to the pharmaceutical giant's December analyst meeting to scrounge for more information on the proposed drug, they came back with little. But then Isaly instructed Guintu to put together a list of drugs that had gone to Phase III testing at Merck between 1990 and 2001. Turns out nine of the 10 ended up getting FDA approval.

With that piece of evidence, Isaly was eager to take a position—but not in Merck. Rather, in May he began acquiring shares of Kyorin Pharmaceutical, a Japanese pharma that had licensed KRP-297 to Merck. Isaly projects that, with Merck's backing, the drug will sell more than $4 billion annually, four times as much as similar drugs now. "And the minute Merck announces it will go to Phase III testing, we'll double our position. We'll wait five years, and the price will be up five to 10 times."

He pauses. Then, with the cockiness that CEOs and his coworkers know so well, he adds, "Guaranteed." And he smiles. SM