

Quadrant's regular newsletter that highlights topics we believe will affect markets or are important in understanding them.

"It is not greed that drives the world, but envy." - Warren Buffet

Quadrant Asset Management

Suite 720, One Lombard Pl

Winnipeg, MB

Ph: (204) 944-8124

email:

inquiries@quadasset.com

web:

www.quadasset.com

The Valeant story and Portfolio Construction

In early 2014, Michael Pearson the CEO of Laval, Quebec based Valeant Pharmaceuticals announced it was his company's intention to become one of the 5 biggest pharmaceutical companies on the planet by market capitalization (stock price multiplied by number of shares outstanding) within 3 years¹. To reach this goal Valeant would need to reach a market capitalization of approximately 150 billion by the end of 2016.

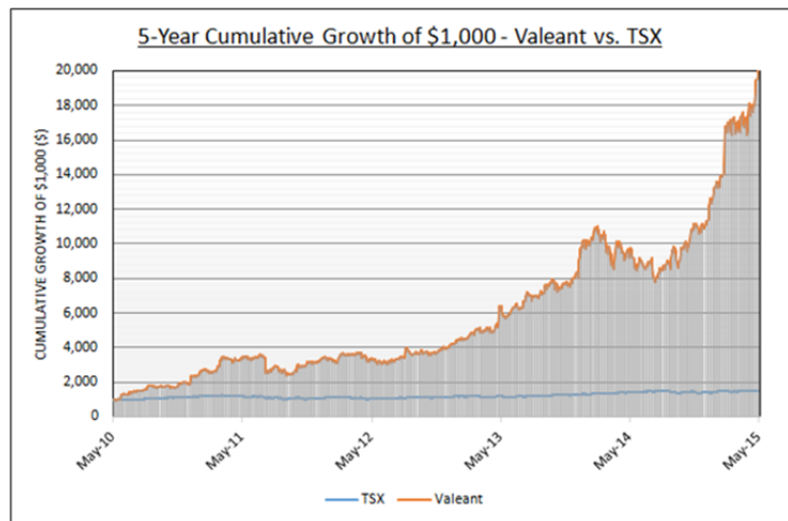
Over the past few years Valeant has rapidly expanded through a flurry of ever larger M&A transactions (at least 17 since 2013, worth at least \$20 billion). Through a series of such deals Valeant has seen its market cap expand almost 40 times in a little over 5 years. From a market cap of only 2.5 billion in May 2010 to a market cap of close to 100 billion as of the writing of this Update in June 2015. Valeant has grown to be the third largest stock (by market cap) in the S&P/TSX Index (it briefly surpassed TD to become the second largest, but has since slipped back to third place).

The S&P/TSX index is weighted by market capitalization, which means that the larger the company the more weight it is given in the index. For the previous year, the rise of Valeant has provided approximately half the return of the TSX index. On a 5 year basis Valeant by itself has provided almost 20% of the index's return. The current outsized influence of Valeant is more stark in light of the fact that on a 1 year basis (again, as of May 31, 2015) the market cap weighted index is up by almost 6%, while over the same time period, a portfolio which gives each company in the index an equal weighting would have actually declined more than 7%.

Valeant currently maintains a trailing price to earnings ratio of approximately 80, meaning that the current price represents 80 times last year earnings. On a forward estimated 12 month basis the price to earnings ratio of Valeant is closer to 19. Valeant has seen earnings per share grow at over 25% for the previous year and earnings per share is expected to grow over 15% per year, over the next business cycle (3-5 years). Valeant's return on equity is 17.5% and the company does not currently pay dividends so its sustainable growth rate is also 17.5%.

Valeant is not a pharmaceutical company in the traditional sense. Valeant does not develop drugs internally and then market them, instead Valeant outsources its Research and Development (R&D). The company purchases other pharmaceutical firms with products either at or just about to reach market. In order to finance its purchases of new companies, Valeant taps the credit markets instead of issuing new shares. Earlier this year in March of 2015, in order to finance its purchase of Salix Pharmaceuticals, Valeant raised approximately \$10 billion from a bond issuance. With Valeant rated the equivalent of BB- by S&P, this meant that the bond issuance was the largest junk bond issuance in about a year. In order to justify the high valuations which investors have placed on the company, there is the implicit expectation that Valeant is choosing the correct companies/products to purchase.

We are glad that our Managers have avoided Valeant, even as that decision has hurt performance for the past years (to put it in perspective see the graph that shows that \$1,000 invested in Valeant shares 5 years ago would trade for close to \$20,000 today). Trading with 20:20 hindsight would make a world of difference. While we'd all love to have benefited from the price appreciation of this stock, the problem for investors is that we invest without the benefit of hindsight. In fact we invest in an environment of considerable uncertainty. We are very mindful of hindsight bias as the inclination to see events that have already occurred as being more predictable than they were before they took place.



Source: Bloomberg

Hindsight bias may cause memory distortion, where the recollection and reconstruction of content can lead to false theoretical outcomes. A basic example of the hindsight bias is when, after viewing the outcome of a potentially unforeseeable event, a person feels he or she "knew it all along".

Valeant has doubled its shares outstanding in the five past years. Warren Buffet wrote on his last letter to shareholders "At both BPL² and Berkshire, we have never invested in companies that are hell-bent on issuing shares. That behavior is one of the surest indicators of a promotion-minded management, weak accounting, a stock that is overpriced and – all too often – outright dishonesty."³

Valeant may achieve its goal of becoming one of the largest companies in the world. We don't know. What we do know is that no matter the sector or index or how well it has done, it doesn't sound like a good idea to put too much hope on stories like this when constructing a long-term portfolio. We at Quadrant don't wish to date ourselves but we have seen similar stories in Canada before. Between 2003 and 2008 Research in Motion and Potash Corporation of Saskatchewan combined accounted for almost

20% of the return of the TSX and, at their peak, made for 10% of the index. But even these market leaders pale in comparison to Nortel which, at its peak, comprised over a third of the entire index.

In an effort to reduce management fees many investors have been moving from active management to more passive strategies which primarily track indices. The Valeant story also helps highlight some of the hidden dangers of this approach, particularly if done blindly.

The indices in Canada have historically been narrowly concentrated, particularly at the sector level. This can leave investors exposed to sudden change in fortunes. The most popular ETF in Canada is XIU (the iShares S&P/TSX 60 Index ETF) which tracks the 60 largest companies on the TSX. For investors in this ETF the rise of Valeant has been a boon. The more heavily concentrated TSX 60 index is up by almost 8% on 1 year basis. As Valeant continues its rise however, it attains an ever greater weight in the index. Were Valeant to actually achieve its goal of becoming a 150 billion market cap company, it would be by itself almost 10% of the weight of this index/ETF. If this occurs the index would have almost 75% of its weight in Financials, Resources and Valeant. By contrast in the S&P 500, the largest individual holding of Apple has a weight of only 4% and no sector has a total weighting above 20%.

Historically the Health Care sector in the TSX index has been tiny (0.5% weight as of May 31, 2010), however the rise of Valeant has meant that this sector now makes almost 6% of the index weight.

While Valeant is not the only company in the sector (there are actually 6 in total) it makes over 80% of the space.

We are not anti-indexers. Quadrant believes that managing an investment portfolio does not rest either in adopting an active or passive approach but rather a hybrid of the two depending on the asset class. Ultimately these asset classes should be structured to create a dynamic asset mix that is “right” for a particular client and situation.

Just remember to beware the Index.

¹ “Valeant seeks to become top 5 pharmaceutical company: CEO”, Reuters, Jan 7th, 2014 - <http://ca.reuters.com/article/businessNews/idCABREA060I120140107>

² BPL was Buffett Partnership Ltd. was the investing entity that Mr. Buffet managed before becoming CEO of Berkshire Hathaway Inc.

³ Berkshire Hathaway Inc. – 2014 Annual Report <http://www.berkshirehathaway.com/2014ar/linksannual14.html>

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