The Perils of Not Picking Stocks

An investor who hires a professional investment manager might be surprised at how much work goes into stocks that never wind up in a portfolio. Stock ownership involves owning a fraction of a business, hopefully a good business, hopefully one that generates profits and pushes each investor toward their goals. There are many ways to pick a security; a portfolio manager will screen hundreds of stocks, read broadly about dozens, and carefully consider a handful. Stocks are selected based on profitability, quality of management, valuation, growth expectations, and myriad other characteristics – all with an eye toward buying only the very best. Defining the very best of course can be its own riddle.

There are a great many reasons for a company's stock price to increase in value. Boosting profits tends to be the most easily understood, starting or hiking a dividend can increase the investor base, new product lines, and new technologies all provide the opportunity for a share price to rise. What can be easily forgotten though is that the same sentiments that drive real estate prices or an art auction impact the market. When there are more buyers than sellers, prices go up. And for all the smart money and careful stock selection processes out there, there is also a lot of indiscriminate buying.

We are all reasonably familiar with how a stock market index works. Essentially an index is a portfolio of stocks that in aggregate will either rise or fall on any given day. In a conventional stock index, the more valuable the company the greater percentage of the index it represents. Canada's largest bank – Royal – represents about 6.5% of the value of the S&P TSX Composite Index, also called the S&P/TSX. The largest oil and gas company – Suncor - represents about 3.3%, and our largest telecom, Bell, clocks in at around 3%. The S&P/TSX represents the aggregate value of our largest publicly traded companies and in part a representation of our economic engine. The index is also held out as a basket of ideas, so if you want to buy the Canadian market but are not overly interested in stock selection, you can either buy a highly correlated basket of stocks or you can buy them all. Every so often a particular stock becomes the "story" of the market and that brings us to a Canadian pharmaceutical company that was the darling of the market in early 2015.

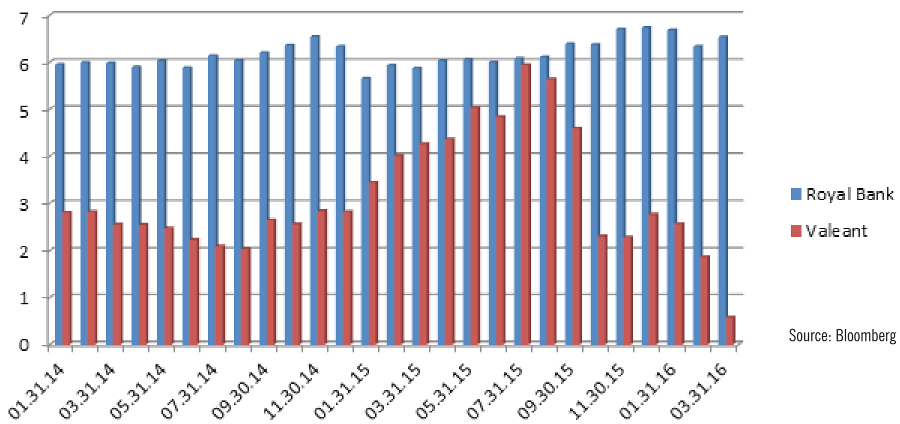
Valeant started 2015 at $166.33 per share, and at this price the company sported a total equity value of over fifty billion dollars. At this size, the company represented 2.88% of the value of the S&P/TSX. Their business model revolved around buying distribution channels for their drugs, and once they had that in place they began buying drugs. Valeant had become a giant in the Canadian pharmaceutical space, representing nearly eighty percent of the Canadian Healthcare sector. While many questioned the sustainability of their business model, they began to attract attention from several large hedge funds. Precisely when Pershing Square, Brahman Capital, and Paulson and Company accumulated their equity stakes in Valeant – each worth more than a billion dollars is not knowable with any precision, but there were buyers out there with big appetites.

January saw the stock close higher seventeen of twenty-one trading days. February had fourteen up days in twenty. The stock closed up ninety dollars, an immodest 54%, in only nine weeks, before settling in for a fairly sideways March. In three short months Valeant trade had added over forty billion dollars in market capitalization, and now represented 4.26% percent in the S&P/TSX. The spiral had begun. Each tick higher, investors both reluctant and willing paid the premium to own Valeant, there were more buyers than sellers, and on it went. Until it stopped.

Valeant traded at an all-time high of $346.83 on August 5th, its weight in the index topping out at 6.1%, trailing only Royal Bank's weight of 6.2%. For a brief moment, Valeant was the second largest publicly traded company in Canada. The must-own stock was now owned by everyone who wanted to own it for investment purposes and everyone who had to own it through their index strategy. And suddenly, for reasons that may have been quantitative or qualitative – valuation or sentiment - there were more sellers than buyers. The stock gave up forty dollars in August, over sixty in September, and had fallen to $238.20 and 4.6% of the index. The index-linked buyers were now index-linked sellers. Valeant would give up nearly one hundred dollars in the fourth quarter, and would close at $140.56. The S&P/TSX would finish down 11% on the year, Valeant shareholders saw an annual loss of 16.4%, but the actual amounts lost by shareholders in 2015 would be in the tens of billions of dollars.

On March 31st 2016 Valeant closed at $34.05, a price not seen since 2011, ranking as the 44th largest weight in the S&P/TSX at 0.58%. The once must-own now trades for less than a tenth of its August 2015 highs, and is down more than one hundred dollars since the start of 2016. The indexers will have trimmed their stakes, to replicate the new weight Valeant holds in the index; the hedge funds have been adding to their holdings, trying to average their costs in an attempt to salvage their trade. At a mere $34, is there value in Valeant? Now we can circle back to why we pick stocks for client portfolios; perhaps it is equally as important to review why a name might be excluded.

Percentage Weight in S&P/TSX Index, monthly



We come not to bury Valeant, nor do we come to praise it. It has murky accounting, has high-leverage, has turned over executives, and carries a credit rating of B- from Standard and Poor's. Valeant shares many characteristics with the type of company that will likely never find their way into a client portfolio. Owning companies that earn their cost of capital, that keep their debt manageable, with long-life assets and sustainable competitive advantages are attractive to us. Competent, transparent, and aligned executives are essential in our decision making. We are prepared to let the hedge funds and indexers trade and rebalance, while they chase returns in their versions of 'must own' securities. We already know our must own stocks - we own them.

Stock picking, depending on how you approach it, is either very mindful art or very careful science. There will be missteps along the way, but a prudent Portfolio Manager will sidestep many and quickly eliminate most others. Being different than the index is the only way to be better than the index. Being disciplined in our approach helps us to stay the course and avoid being enticed by the next market darling.