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Three investing lessons to be learned from Valeant's stunning fall from grace

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The most amazing aspect of the troubles at Valeant Pharmaceutical International Inc. is that they are anything but amazing for those who have been following the company.

Analysts, most notably **Dimitry Khmelnitsky** at **Veritas Investment Research** in Toronto, started sounding alarms about the drug-maker's accounting as far back as 2011.

The catalogue of Valeant critics grew and, by last year, included well-known short sellers, such as John Hempton of Bronte Capital, as well as journalists such as my colleague David Milstead.

Yet none of that prevented Valeant from briefly becoming the most valuable company in Canada during the summer of 2015.

Since then, of course, the Laval, Que.-based business has lost 90 per cent of its value. On Thursday morning, U.S. police arrested a former Valeant executive, as well as the former chief executive of an online pharmacy, in connection with what prosecutors say was a multimillion-dollar fraud scheme.

For folks who believe the market is an efficient machine for processing all available information, investors' apparent gullibility is hard to explain. How could shareholders ever have been so enthusiastic about a company with so many problems pointed out for so long by so many people?

The answer has a lot to do with the fragile psychology of this bull market.

Investors place an undue amount of faith in a few star money managers, ignore traditional accounting measures and are so eager to find growth that they are willing to overlook even obvious dangers.

These days Valeant is operating under new management and may yet prosper in its much reduced form. For now, though, people can learn at least three lessons from the drug-maker's stunning fall from grace.

The first is to avoid assuming the smart money is really all that smart.

Much of the enthusiasm for Valeant stemmed from the celebrity appeal of some of the company's most important shareholders, such as Bill Ackman of Pershing Square Capital Management LP.

The Manhattan-based hedge fund manager had achieved big returns with his investment in Canadian Pacific Railway Ltd. Back in the summer of last year, it was tempting to think he could do the same with his bet on Valeant.

More conservative investors were lulled by the presence of Ruane, Cunniff & Goldfarb, a long-established money manager with an impressive track record and a history of praise from Warren Buffett. At one point, Valeant stock amounted to more than 30 per cent of Ruane Cunniff's flagship Sequoia Fund.

Smart investors like Mr. Ackman and Ruane Cunniff were led astray, in part, by a big, sexy idea – the notion that Valeant could supercharge the standard drug-maker business by buying all the innovation it needed rather than indulging in messy, expensive, time-consuming research of its own.

If you believed in the concept, it seemed obvious Valeant could expand at a breakneck pace by acquiring other companies, cutting their research budgets and boosting the price of their products.

Nothing is more attractive in a plodding, slow-growth economy than a company that can swell its revenues at a dependable, double-digit clip. So big-name investors were happy to sign up.

The painful outcome suggests a second lesson: Be very suspicious of companies that use aggressive acquisition strategies to generate growth far in excess of their underlying industry.

Profitable growth usually comes from inventing a fundamentally better product or service, not through financial engineering or simply by buying other companies.

The odd thing, though, is that you didn't need to do any particular sleuthing to diagnose Valeant's problems well before its epic slide. A look at its financial statements showed a company with mountainous debt and weak profitability.

Mind you, the company didn't dwell on those standard numbers. It preferred to emphasize an alternative set of "adjusted" figures that airbrushed away the problems. For years, **Mr. Khmelnitsky of Veritas** detailed how those legal but questionable numbers ignored inconvenient realities, such as discontinued products or losses on the sale of some investments.

The final lesson here for investors? Realize that the adjusted accounting figures produced by many companies are designed to present the best possible picture of reality.

Treat them accordingly and focus instead on the standard figures. The picture they paint will be nowhere near as exciting as the adjusted numbers but may be considerably more accurate.

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