The risk of investing in an expensive stock

In investments, the pain of losses is felt much more strongly than the joy of gains. And when those losses are due to views not commonly held by the investment community, the pain is even worse.

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"There is a sense of comfort in going with the crowd. We can all bemoan the fact that we are wrong over dinner parties, and pat each other on the back when we are right."

"I recall many an interaction with investors who felt worse about getting a penny stock wrong, even though it only formed one percent of their portfolio, than getting a large cap wrong at a 10% holding. The irony is that the impact on the portfolio of the penny stock, even if it goes bust, is less than that of the larger stock, but more painful," says Anet Ahern, chief executive officer, PSG Asset Management.

She recounts just such an example.

The tale of Valeant

A stock that captivated the hearts of investors over the past years, is Valeant Pharmaceuticals. Valeant is a pharmaceutical business built largely by acquisition rather than by research and development. Its chief executive, J. Michael Pearson, had in the past done an impressive job of acquiring a broad portfolio of prescription drugs across various medical disciplines.

He understood that developing drugs from scratch via in-house R&D had become a low-return proposition for many companies and that higher returns could be earned by acquiring products in attractive categories, using historically low interest rates to fund purchases with debt, and then taking out costs and utilising lower tax domiciles to house intellectual property. He had been aggressive and had attracted equally aggressive critics.

Shareholders saw the share price rise from below US$50 to well over US$300 in the space of less than three years. It became a darling stock, and a significant holding in many prominent funds, including the revered Sequoia Fund, Ahern explains.

Buffett's endorsement

Warren Buffett recommended the Sequoia Fund when it opened in 1970, and that proved to be a smart call. Up to 2012, the fund's performance beat the US stock market over four decades, in part because it had a lot of its money in Buffett's diversified and highly regarded company, Berkshire Hathaway.

That all changed in 2010, after Buffett warned that Berkshire wouldn't grow as fast as it once did. The managers of the then US$4 billion Sequoia Fund cut their exposure to the stock almost in half. That proved to be another good call. Sequoia delivered a 13% return in 2011, better than 99% of its value-stock fund peers, according to data compiled by Bloomberg.

"So a share that had an aggressive growth strategy, held by a fund endorsed by arguably the world's most astute investor and with a very impressive track record…It would be hard to go wrong, one would think," she says

The unthinkable happens

Then the unthinkable happened. Early in 2015, Valeant made an acquisition of a portfolio of older drugs, and ramped up the prices. A huge backlash occurred – two of the drugs were important cardiac medicines used by hospitals during heart surgery, prompting an emotional reaction from politicians, healthcare payers, hospitals and the public. A short-seller saw the opportunity and suggested fraud in a publication, comparing the firm to Enron. Even though this was refuted, the perceptual damage was done.

The share price plummeted from over US$300 to the current levels of US$35 - a decline of almost 90% in about a year. In October 2015, two of the five independent directors of Sequoia resigned in the wake of these developments.

Walking on water

"What really went wrong? One can debate the sustainability of management's strategy of aggressive acquisitions, but in the end, this was a case of being priced not only for perfection, but for walking on water," Ahern explains.

"At its peak, Valeant traded at a price-earnings ratio (flawed as this measure may be) of over 150 times, and at almost 14 times its book value. It could not put a foot wrong."

"Those investors who were conscious of not investing in this over-valued share at the time looked foolish for a while, but in the end their clients did better being out of the stock. It is so important to be aware what price is being paid for the future profits and asset growth in a company."

Paying too much seldom pays

"If you pay too much, especially when expectations are unrealistic and profits high, there is no amount of popular endorsement that will bail you out when reality hits. Paying too much seldom pays for investors, even though there may be short-term comfort in running with the crowd," Ahern says.