

Have Your Cake and Eat It Too Investing

Relative Strength at Work, Vol. 2: Valeant Pharmaceuticals

February 28th, 2017

Introduction

In this edition of Relative Strength at work, we are going to dive into one of the more controversial stocks in the Canadian marketplace – Valeant Pharmaceuticals (VRX).

There is no better poster child for a Boom and Bust investor experience than Valeant (see below). From \$20 in 2010, to \$340 in 2015, then back to \$20 today speaks volumes as to the wild and devastating ride for Valeant shareholders.



As mentioned in our initial report [Relative Strength Defined: How This Simple Process Can Change Your Life](#) we want to assess whether using relative strength would have added value in this specific situation.

In other words:

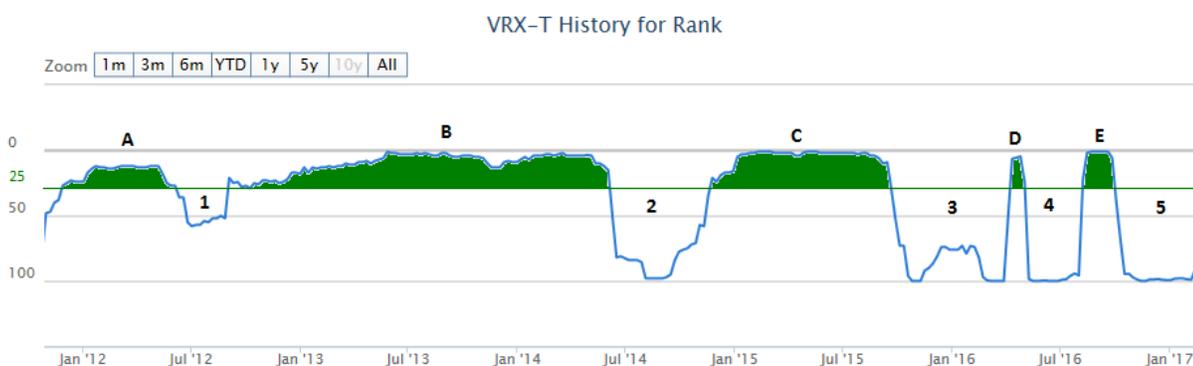
1. Would it help us to make money?
2. Would it help us to avoid large losses?
3. Is the process simple to apply?

We will also look at the consensus analyst recommendation on Valeant and compare the results of using a fundamentally-driven approach versus a price-based relative strength strategy.

Relative Strength Test: Valeant Pharmaceuticals

Below is a chart⁽¹⁾ showing Valeant's relative strength within a custom-made index we call the TSX Composite Core 100. It is an index of the 100 largest non-cyclical (no energy or mining) stocks pulled from the Canadian TSX Composite Index. A ranking of #1 would mean Valeant is the strongest stock within the index, and a ranking of #100 means Valeant is the weakest stock.

TSX Composite Core100



When making our buy/sell decisions, we want to own stocks that are *in-demand* and avoid stocks that are *in-supply*. To qualify as *in-demand*, they have to be ranked anywhere from #1 to #25 (the areas highlighted in green), otherwise known as the top 25th percentile.

Valeant in-demand Test

Following this simple process would have led us to taking the following actions:

Period	Buy Date	Buy Price	Sell Date	Sell Price
A	Dec 5, 2011	\$47.12	May 28, 2012	\$49.17
B	Oct 29, 2012	\$57.94	Jun 2, 2014	\$146.17
C	Nov 24, 2014	\$161.02	Sep 21, 2015	\$303.54
D	Apr 11, 2016	\$40.43	May 2, 2016	\$40.85
E	Aug 8, 2016	\$29.51	Oct 3, 2016	\$32.01

If we had started with \$10,000, using this approach we would end up with \$54,389, or a **440%** gain. So buying and holding Valeant when the stock was *in-demand* produced a very profitable outcome.

Valeant in-supply Test

What about when Valeant was in-supply (showing relative weakness)?

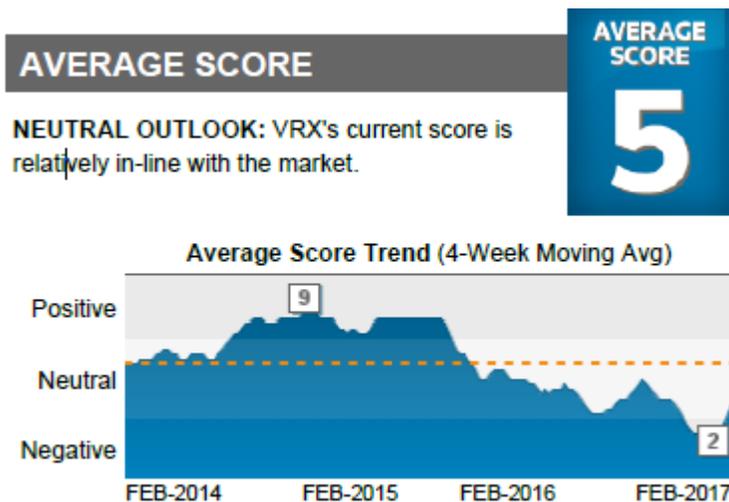
If we had owned the stock during the periods of time when Valeant was ranked #26 or lower in our TSX Composite Core 100 Index, what would the results be?

Period	Buy Date	Buy Price	Sell Date	Sell Price
1	May 28, 2012	\$49.17	Oct 29, 2012	\$57.94
2	Jun 2, 2014	\$146.17	Nov 24, 2014	\$161.02
3	Sep 21, 2015	\$303.54	Apr 11, 2016	\$40.43
4	May 2, 2016	\$40.85	Aug 8, 2016	\$29.51
5	Oct 3, 2016	\$32.01	Feb 27, 2017	\$21.94

If we had started with \$10,000, buying and holding Valeant during periods of relative weakness would leave us with \$856, or a **-91% loss**.

Valeant Fundamental Test

For a final comparison test, let's look at whether using fundamental research would have helped or hurt us as a potential Valeant investor. Shown below is the consensus analyst recommendation⁽²⁾ on Valeant going back to Feb 2014. You can see on the left hand side of the chart that there are three broad classes of recommendations: Positive (Buy or Strong Buy), Neutral (Hold), and Negative (Sell).



In 2015, when things were still looking rosy for Valeant (at prices north of \$300), the consensus was Positive or 'Buy'. For reference, the bulk of Valeant's price collapse occurred from Sept 2015 through May 2016 (about an -80% loss). Although the consensus recommendation was reduced from a Buy to a Hold, at no point were investors advised to Sell.

Using a tool such as relative strength helps to avoid large losses in situations where sell recommendations can be hard to find.

Conclusions

Earlier we asked whether applying our relative strength process would add value to a Valeant investor:

1. Would it help to make money? Buying and holding Valeant while it was *in-demand* returned +440% over the last five years.
2. Would it help to avoid large losses? Avoiding Valeant while it was *in-supply* prevented a -91% loss over the last five years.
3. Is it simple to apply? Just follow the signals. These results were achieved by using the 25th percentile as the demarcation line for our buy-sell process. No fundamental research required.

P.S. What if you did nothing? Buy and hold would have achieved a -65% return over the last five years.

As we mentioned earlier, there is likely no better real-life drama than the Valeant story to illustrate why we are advocates of relative strength investing in our portfolios.

Send us your questions and feedback – we'd love to hear from you. We can be reached at dcameron@pifinancial.com and jwoods@pifinancial.com, or Toll-Free at 1-877-405-2900.

Footnotes

- (1) Chart created via Dorsey Wright and Associates.
- (2) Based on the average of 7 analyst recommendations; source Thompson Reuters Stockreports+, Feb 27th 2017.

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