**Even the Great Can Make Yuuuge Mistakes**

Bill Ackman. Glenn Greenberg. Lou Simpson. Jeff Ubben. Bob Goldfarb. What do these people have in common?

You may have heard some of these names and rightly concluded that they are all highly successful money managers with decades of experience managing billions of dollars.

> Bill Ackman, the best known of the bunch, is the founder and Chief Executive Officer of hedge fund operation Pershing Square Capital Management. An activist investor, Ackman has been very vocal about a number of his investments, such as McDonald's and Herbalife. At the end of 2015 Pershing Square managed more than $12 billion.
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> Glenn Greenberg may not be well known outside investment circles, but he is one of the best investors of the past 3 decades. From 1984 to 2009, he and a partner ran a firm called Chieftain Capital, where they produced extraordinary returns. During 2009, Greenberg and his partner split the firm up into two smaller firms, with Greenberg renaming his operation Brave Warrior Advisors. Brave Warrior currently manages more than $2 billion.
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> Lou Simpson ran the investment portfolio at auto insurer GEICO for three decades. From 1980 to 2004 Simpson generated annualized returns of 20.3% at GEICO, compared with a 13.5% return for the S&P 500. At the end of 2010 Simpson retired from GEICO, but he quickly found that he couldn't stay away from the investment game. Simpson soon un-retired, founding SQ Advisors to manage money for his family and friends, as well as outside charities. SQ Advisors currently manages more than $2.5 billion.
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> Jeff Ubben is the co-founder, Chief Executive Officer, and Chief Investment Officer of ValueAct Capital, a hedge fund firm based in San Francisco. ValueAct was initially formed in June 2000 to manage the capital of its founders and a limited number of outside investors. It currently manages more than $10 billion.
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> Bob Goldfarb was, until very recently, Chief Executive Officer of Ruane, Cunniff & Goldfarb and co-manager of the firm's flagship Sequoia Fund. Sequoia opened in 1970 after Warren Buffett closed his partnership and asked his friend Bill Ruane to set up a fund in which his former partners could invest. The fund has recorded one of the best long-term track records on Wall Street and currently manages more than $6.5 billion.

Another common characteristic among these investors is that they all follow a similar investing philosophy. They are all value investors running concentrated portfolios. But while they share a common framework on picking stocks, their portfolios tend to differ in their composition of those individual stocks. That is generally true, but there has been one great exception in the recent past: they have all held substantial stakes in a company called Valeant Pharmaceuticals (NYSE: VRX). And it is this dreadful commonality that is the focus of this article.

**How the Mighty Have Fallen**

Valeant Pharmaceuticals is a multinational pharmaceutical company based in Canada. It manufactures mostly generic and over-the-counter products in areas such as dermatology, eye care, gastrointestinal, and oral health. Under the leadership of its former CEO Michael Pearson, the company grew quickly through a large number of acquisitions, including the $8.7 billion deal for Bausch & Lomb in 2013 and the $11 billion purchase of Salix Pharmaceuticals in 2015.

When Valeant purchased a company, it often cut the acquired firm's research and development (R&D) budget, while hiking, sometimes very aggressively, the price of its drugs. This led to increased profits, and Wall Street *loved* this strategy. From the beginning of 2013 to mid-2015 Valeant became the largest company in Canada by market cap, as its stock rose more than 4-fold, from $60 to a high of $263.

Our group of investors also loved the story, and they bet on it in a big way. And not just big in its everyday connotation, but in real Donald Trump style: "yuuuge." The chart below shows the size of the Valeant position for each, ranging from 12.5% at Lou Simpson's firm to a whopping 37% at Glenn Greenberg's fund.

| Investor | VRX owned ($ millions) | VRX owned (% of assets) |
|---|---|---|
| SQ Advisors | 384 | 12.5% |
| ValueAct | 3,331 | 17.5% |
| Sequoia Fund | 2,506 | 28.7% |
| Pershing Square | 4,326 | 29.9% |
| Brave Warrior | 1,266 | 36.5% |

*Source: SEC 13-F filings, Sequoia semi-annual report, all figures as of 6/30/15*

But, alas, all was not rosy in the Valeant love story. Shortly after the stock hit its all-time high, several politicians started criticizing and questioning Valeant's strategy of significantly raising drug prices, and other investment analysts began raising questions about its use of a specialty pharmacy to distribute its drugs. The backlash was brutal, and the stock collapsed over the next few months. On one day in March 2016, Valeant's stock dropped a staggering 51%.

Through it all, our group of investors stayed invested in Valeant. Some even increased their position, convinced that the stock would recover. In the fourth quarter of 2015, with the stock already down 50%, Sequoia, Brave Warrior and SQ Advisors all increased their Valeant position. But the negative headlines about the company kept coming, and the stock kept falling. As of this writing, the stock has lost 90% of its value in a little more than a year, currently trading below $27 per share.

The financial damage to these investors and their clients due to their Valeant investment can be measured in the billions. Most, if not all, of these funds have recently suffered the worst investment performance in their careers. And while the financial damage can be quantified, the reputational damage is immeasurable. Bob Goldfarb, for example, had to resign from the firm that carries his name, capping a 45-year investment career.

**Don't Drink the Kool-Aid**

We can't help but ask how is it possible that all of these experienced, highly successful money managers lost so much money in the same stock? But please understand that we're not being critical simply because they owned a stock that went down in price. Everybody, even the most successful stock-pickers, will have some losers now and again. That is simply part of the game. What is baffling to us is that they all drank the Valeant Kool-Aid, made it a big part of their portfolio, and some of them even increased their already large holdings as more bad news surfaced about the company. We can understand managing a concentrated portfolio, but having a 30% position in Valeant—a company publicly referred to as a "sewer" by Berkshire Hathaway Vice Chairman Charlie Munger—flies in the face of prudent risk management and good old common sense.

We can think of two important cognitive biases that played a big part in the decision making of these investors. The first one is that they all succumbed to overconfidence. They were all overconfident not only in their own abilities, but in the ability of Valeant's management. After all, they had successfully invested many times before in companies that had declined in value, only to mightily recover. And Michael Pearson was considered a financial genius, bringing a new, profitable approach to the pharmaceutical industry.

But that overconfidence made them blind, or at least hesitant to act, when negative facts clouded the Valeant investment thesis. They probably rejected as unimportant, among other things, the worrying fact that as Valeant grew by acquisitions, so did its debt, to the detriment of the company's balance sheet. From 2011 to 2015, Valeant's long-term debt increased nearly five-fold, from $6.5 billion to $30 billion.

Another cognitive bias that we can observe from all this is that of social proof. The principle of social proof states that we determine what is correct by finding out what other people think is correct. The fact that all these highly successful value investors were highly invested in Valeant probably reinforced their thinking that their investment thesis was correct.

**Conclusion**

Investment mistakes are a great source of education. If they are your own mistakes, you can think of any loss you incur as a "tuition" payment on your road to investing enlightenment. Of course, we would prefer to avoid those losses, so we seek as much as possible to learn from the mistakes of other investors rather than from our own.

We owe a great deal to these investors for teaching us a few lessons through their disastrous Valeant investment. The first lesson is that one should not buy a stock just because some famous investor is buying it. You should only ever buy a stock because you have analyzed the business and have come to your own conclusion.

Another lesson involves portfolio diversification. We are advocates of running somewhat concentrated portfolios of, say, 20 to 25 stocks, with the notion that superior investment

performance comes from our best ideas. But we do not think this idea should be taken to the extreme. It is not prudent to be overly concentrated and have one investment represent a third of assets, especially if it's a complex company with a lot of debt.

Finally, the stock market can be a humbling place. The market doesn't care who you are or how many billions you have or what college you went to. If your analysis is flawed, the market will not hesitate to punish you for it.

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