



## Avoid These 8 ETFs & Funds Most Exposed to Valeant

Valeant Pharmaceuticals (VRX: \$33/share) fell 51% yesterday and the stock [still has further to fall](#). While direct share holders stand to lose the most, certain fund investors face significant downside risk as well. These investors may not realize the risk they're taking due to the [shortcomings of traditional fund research](#), which doesn't focus on fund holdings.

By analyzing each holding of a fund, we provide investors with deeper insight into the risk/reward of funds. Our [predictive ratings](#) for ETFs and mutual funds give investors a different perspective as they are based on the [quality of the fund's holdings](#). Figure 1 shows the eight ETFs and mutual funds that allocate significantly to VRX and could pose a risk to investors' portfolios.

**Figure 1: Funds With Exposure To and Risk of Decline from Holding VRX**

| Ticker | Fund                                   | Allocation To VRX | Rating          | Last Holding Update |
|--------|--|-------------------|-----------------|---------------------|
| SEQUX  | Sequoia Fund Inc.                      | 19.3%             | Neutral         | 12/30/15            |
| ALFA   | AlphaClone Alternative Alpha ETF       | 6.3%              | Neutral         | 3/15/16             |
| DHTAX  | Diamond Hill Select Fund               | 5.2%              | Dangerous       | 1/31/16             |
| PPH    | Van Eck Market Vectors Pharmaceutical  | 4.0%              | Neutral         | 3/15/16             |
| NICSX  | Nicholas Fund, Inc.                    | 3.9%              | Very Attractive | 1/31/16             |
| VFPIX  | FundVantage Private Capital Management | 3.9%              | Very Dangerous  | 12/31/15            |
| GURU   | Global X Guru Index ETF                | 3.6%              | Attractive      | 3/15/16             |
| INSAX  | Catalyst Insider Buying Fund           | 2.7%              | Dangerous       | 12/31/15            |

Sources: New Constructs, LLC and company filings

Sequoia Fund (SEQUX) allocates just below 25% of its assets to Valeant. Diamond Hill Select Fund (DHTAX), FundVantage Private Capital Management Value Fund (VFPIX), and Catalyst Insider Buying Fund (INSAX), earn a Dangerous-or-worse rating in part because of their poor holdings like VRX, but also because each fund charges investors high [total annual costs](#).

It's not all negative though. Nicholas Fund (NICSX) and Global X Guru Index ETF (GURU) earn an Attractive-or-better rating because the quality of the entirety of holdings makes up for their allocation to VRX.

The takeaway is: Buying a fund without analyzing its holdings is like buying a stock without analyzing its business and finances. Those who bought VRX based on trust in the company [non-GAAP earnings](#) did not understand the firm's true finances, which showed Valeant was not a good business. Without analyzing each holding, investors are taking on unnecessary risk when investing in ETFs or mutual funds.

### What Makes VRX Such A Poor Holding?

Valeant had been in a bit of a limbo lately, as investors awaited the long delayed 4Q15 results. The company finally released its earnings today and the results were to be expected [if you heeded our previous warnings](#).

In the release, the company recognized the significant issues it faces after the termination of its relationship with Philidor, the cancellation of almost all price increases, and underperformance in several of its business lines. Not only did Valeant report weak results for 4Q15, but looking forward, the company guided for revenue (\$2.3-\$2.4 billion vs. \$2.8-\$3.1 billion expected) and earnings ( \$1.30-\$1.55/share vs. \$2.35-\$2.55/share expected) to come in significantly below expectations.

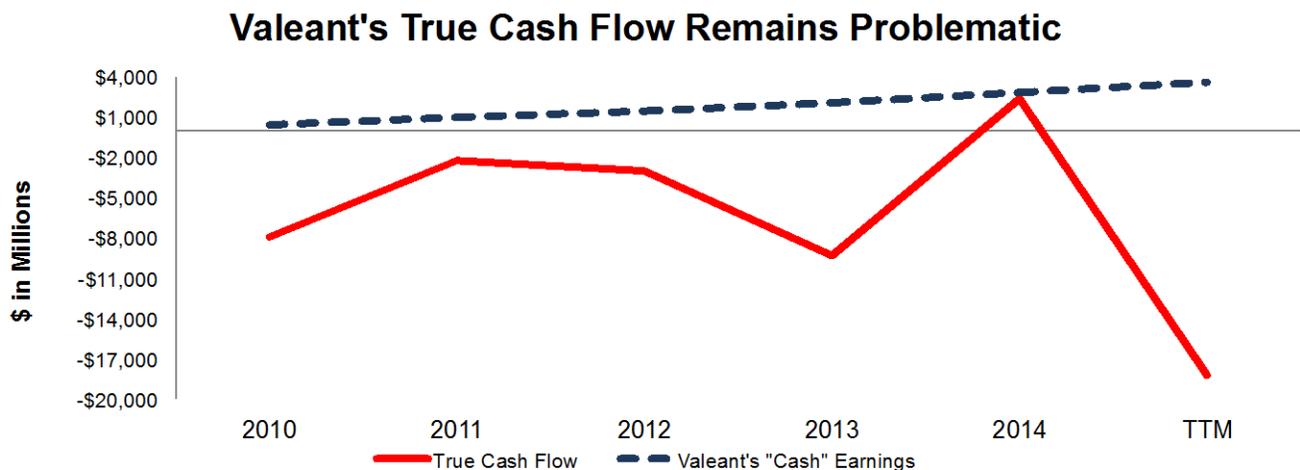
Adding even more uncertainty, Valeant also revealed that it faces a risk of default if it is unable to file its 10-K with the SEC by April 29, which would break its reporting covenant in its bond indentures. The initial filing was due February 29 but has been delayed while Valeant investigates its business relationship with Philidor. Valeant is already in the process to extend deadlines for filing its 10-Q for the first quarter of 2016.

## Has The House Of Cards Finally Collapsed?

As early as [June 2014](#), we pointed out Valeant was presenting itself in a misleading way. Ultimately, the company was relying on non-GAAP metrics to present its cash flow as highly positive, when in fact, the true cash flows of the business have been highly negative. This contrast between cash flow calculations is a [topic of much debate between bears and bulls of Valeant](#) and really gets at the heart of why non-GAAP metrics continually fail investors when analyzing a company. Analysis using Valeant's reported "Cash Earnings" weren't getting a true picture of the company, as can be seen in Figure 2.

The company's non-GAAP "cash earnings" have grown from \$421 million in 2010 to \$3.55 billion over the latest trailing-twelve months (TTM). In reality, [free cash flow](#) has been highly negative with a cumulative -\$38.4 billion in losses over the same time frame. Cumulative non-GAAP earnings during the same time are \$11.2 billion.

**Figure 2: True Cash Flow Provides True Picture of Valeant**



Sources: New Constructs, LLC and company filings

Valeant uses [non-GAAP metrics](#) to make its business look better than it is according to corporate accounting rules (i.e. GAAP) while burning through cash at an unsustainable and alarming rate.

## Non-GAAP Doesn't Pay Down Debt

As seen above Valeant's true cash flow is not only much lower than Valeant would have investors believe, it is also largely negative. While management can prop up shares by touting non-GAAP results, those results don't help pay debt covenants because the true cash flow is not available. Debt covenants may soon become just another issue in the already long list if Valeant defaults on its bond indentures. We already know Valeant has raised significant capital, as its debt has increased from \$372 million in 2009 to \$30 billion over the last twelve months. Without a sale of assets, one has to wonder how well Valeant can service such debt because it won't be happening with non-GAAP "cash earnings."

## Warning Signs Were All Around

The warning signs at Valeant have long been in clear view, if you looked past the positive analyst sentiment, excellent non-GAAP results, and management rhetoric.

1. In [June 2014](#), we noted that Valeant was presenting its business in a misleading way to bolster its takeover attempt of Allergan.
  - a. Valeant claimed it was undervalued passed on P/E ratios when in fact the company was comparing its adjusted P/E to the unadjusted P/E of industry and market peers.
  - b. Additionally, Valeant claimed its previous acquisitions were value creating when in fact the company's return on invested capital (ROIC) has been in decline for quite some time. From 2009 to the last twelve months, Valeant's ROIC has fallen from 15% to 5%.
2. In [July 2014](#), Valeant made our list of companies with the most misleading [non-GAAP earnings](#). According to GAAP, Valeant lost \$866 million in 2013, but by their non-GAAP metrics the company earned \$2 billion. This disconnect stems primarily from excluding the costs related to its acquisitions.



Does it make sense to exclude the costs related to how you grow your business from how you measure profits? We find that fishy.

3. We revisited the non-GAAP red flag again in [November 2015](#), and the story had only gotten worse.
4. In February 2016, we placed [Valeant in the Danger Zone](#). After today's share price decline, VRX is down 57% since our report.

### **Stock Remains Overvalued, Even After 40% Decline**

After such a drastic price decline, one might think VRX is a bargain. Not even close. Those purchasing Valeant now would be buying a highly overvalued stock with a long history of misleading accounting. These are not exactly the characteristics of a quality investment.

In order to justify its current price of \$36/share, the company would need to [grow NOPAT by 15% compounded annually for the next 8 years](#). In this scenario, Valeant would be generating \$29 billion in revenue, greater than AstraZeneca's (AZN) 2015 revenue.

Even in an ideal scenario, in which Valeant focuses on internal growth and not destructive acquisitions, VRX still has significant downside. If Valeant can [grow NOPAT by 9% compounded annually for the next decade](#), the stock is worth \$23/share today – a 36% downside.

*Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, style, or theme.*



| Ticker | Fund                                   | Allocation To VRX | Rating          | Last Holding Update |
|--------|--|-------------------|-----------------|---------------------|
| SEQUX  | Sequoia Fund Inc.                      | 24.8%             | Neutral         | 9/30/15             |
| ALFA   | AlphaClone Alternative Alpha ETF       | 6.3%              | Neutral         | 3/15/16             |
| DHTAX  | Diamond Hill Select Fund               | 5.2%              | Dangerous       | 1/31/16             |
| DDDAX  | Northern Lights 13D Activist Fund      | 4.8%              | Very Dangerous  | 9/30/15             |
| PPH    | Van Eck Market Vectors Pharmaceutical  | 4.0%              | Neutral         | 3/15/16             |
| NICSX  | Nicholas Fund, Inc.                    | 3.9%              | Very Attractive | 1/31/16             |
| VFPIX  | FundVantage Private Capital Management | 3.9%              | Very Dangerous  | 12/31/15            |
| INSAX  | Catalyst Insider Buying Fund           | 3.9%              | Dangerous       | 9/30/15             |
| GROAX  | Catalyst/Groesbeck Aggressive Growth   | 3.8%              | Very Dangerous  | 9/30/15             |
| GURU   | Global X Guru Index ETF                | 3.6%              | Attractive      | 3/15/16             |

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### **How New Constructs Creates Value for Clients**

We find it. You benefit. Cutting-edge technology enables us to scale our [forensic accounting expertise](#) across 3000+ stocks. We shine a light in the dark corners of SEC filings so our clients can make safer, more informed decisions.

Our [stock rating methodology](#) instantly informs you of the quality of the business and the fairness of the stock’s valuation. We do the diligence on earnings quality and valuation so you don’t have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn’t fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?

ANSWER: They should not.

Don’t judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our [forward-looking fund ratings](#) are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating ([details here](#)) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

### **Our Philosophy About Research**

Accounting data is not designed for equity investors, but for debt investors. [Accounting data must be translated into economic earnings](#) to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. [Economic earnings](#) are what matter because they are:



1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

### ***Additional Information***

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