

Ready to Invest in Cannabis? – Or is the Grass Greener Somewhere Else?



The rapidly developing legal cannabis industry has become much talked-about investment trend in the last few years. Investment writers continue to talk about an “end to prohibition” moment, and the argument for investment in the cannabis industry looks great on paper when viewed from the top down.



The bullish view is that legalisation of cannabis is like the repeal of prohibition of alcohol in the United States on 5th December 1933.

Following repeal, the huge black market created by prohibition quickly showed itself and became a legal private sector industry. The almost global black-market supply of cannabis, the bulls argue, will quickly become a new legal private sector supply chain, providing investors with a fantastic opportunity to invest in the legal cannabis industry.

A glance at the data seems to support the bulls' view. The global market today for legal cannabis is worth an annual \$18billion (2019) and the market is said to be growing at some +26% per year, and likely to reach \$32 billion by 2022.

However, once you've had a closer look through the smoke, cracks start to appear in the legal cannabis industry.

Legal Cannabis Spending (In Billions)



While the legalisation of cannabis may well be a once-in-a-lifetime moment, it is probably not the best investment opportunity.

It does seem possible that in the long-term, a legalised cannabis industry should see significant growth, and ultimately match the scale and profitability of the alcoholic beverage and tobacco industries.

But this mature industry vision is in the distant future, and market expectations for legal cannabis are too high. There will certainly be disappointments, with inevitable declines in share prices of legal cannabis stocks.

If you are not convinced yet, these are some of the worst performers;-

Insys Therapeutics (NASDAQ:INSY)	Down 99.7% from \$44.92 on 31/7/15 to \$0.12 on 31/10/19.
TILT Holdings (OTC:SVVTF)	Down 90% from \$2.93 on 8/1/19 to \$0.285 on 30/10/19.
FSD Pharma (OTC:FSDDF)	Down 95.1% from \$126.63 on 24/9/18 to \$6.16 on 31/10/19
MariMed (OTC:MRMD)	Down 81.4% from \$5.38 on 5/10/18 to \$1.00 on 31/10/19
Green Growth Brands (OTC:GGBXF)	Down 73.9% from \$4.67 on 14/1/19 to \$1.22 on 31/10/19
Tilray (NASDAQ:TLRY)	Down 89.6% from \$214.06 on 19/9/18 to \$22.31 on 31/10/19.

As many students (and quite a few others) can confirm, there is already a well-established illegal and easily accessible market for cannabis.



There is, however, huge potential demand for legal cannabis.

The United States and other governments have so far considered cannabis an illegal drug, with no medicinal benefits but the potential for misuse.

Increasingly, with a growing body of research indicating that there are medicinal benefits to cannabis use, governments globally are beginning to legalise. A year ago, Canada legalised its' recreational use.

Cannabis is a fast-growing plant which contains two sought after constituents: THC (Tetrahydrocannabinol) and CBD (Cannabidiol).

THC is a psychoactive inducing a "high" feeling, whilst CBD is a non-addictive pain killer - calmer and relaxant with few - if any, serious side effects.

The market potential for using the drug legally in consumer products is huge. Growth in the legal cannabis market is entirely dependent on legislation of course, which never happens quickly. An important milestone came in December 2018 when the United States passed The Hemp Farming Act, allowing cannabis (in the form of hemp, which has a low concentration of the psychoactive chemical THC, which is what produces cannabis's mind-altering effect) to be farmed as a normal crop.

This generated both a growth in the supply of hemp and a surge of interest to research the medicinal qualities of CBD.

In large parts of the United States, CBD cannabis-infused products are already being sold at retailers like Walgreens across large parts of the USA. This mainstream acceptance of cannabis-based products has helped drive the hype around the potential investment returns from legal cannabis.

Note also that a whole host of other countries have passed legislation legalising the use of medicinal cannabis with various limitations and conditions - https://en.wikipedia.org/wiki/Legality_of_cannabis

It seems reasonable to assume that the rate of growth of the new legal industry will be determined by the speed at which demand can be transferred from the illegal recreational market to the legal recreational market.

This is where you must consider the possibility that the 'prohibition parallel' used by legal cannabis bulls, is flawed.



When the prohibition of alcohol in the United States was lifted in 1933, the infrastructure to produce high volumes of alcoholic drinks legally was already in place, and had been for decades, since before 1920. Prohibition started in 1920 and in the period before repeal in 1933 organised crime syndicates took over the defunct breweries, distilleries and bars to create an alcohol black market.

This black market was supplied by the same infrastructure that was legally in place well before 1920.

After 5th December 1933, it was simply a matter of legitimate companies acquiring that supply infrastructure from the mobsters, and then re-badging black market supply as legal supply, all using pre-existing infrastructure.

There is no equivalent situation for cannabis, which is where the comparison to prohibition falls down.

Alcohol had a long history as a legal product before prohibition, but cannabis has no history of ever being legally supplied by the private sector. The legal cannabis industry must be built from the ground up - a long and capital-intensive process.

That's a very different and far longer process than simply taking control of pre-existing infrastructure and ramping up supply.

Beyond recreational use, medicinal use is a major market for cannabis, since the drug is a natural painkiller which is non-addictive. Given the ongoing opioid crisis in the US, there is enormous interest in alternatives and that is also driving enthusiasm for cannabis and further supporting the hype around predictions of growth and profitability in the cannabis supply chain.



This medicinal interest is worldwide, but legislation is keeping it in check as governments slowly change laws.

Within the USA, individual states can legalise cannabis, but the federal government, which sits above them, continues to regard it as an illegal drug.

This means US banks cannot provide banking services to foreign investors in cannabis production, creating a huge barrier to investment in new legal cannabis production capacity, vital to the legal industry being able to compete with the illegal supply.

The US, the world's largest legal cannabis market and the market with the most potential, is unlikely to see its legal cannabis market match the scale and profitability of, say, tobacco or alcohol for some time. Legal cannabis is still more expensive than illegal cannabis to produce, not least because legal production costs, and paying taxes on profits is currently far more expensive than black-market cannabis production. And the black market is already well established, not only in the US but virtually everywhere in the world.

The cannabis black market has had a long time to develop an efficient and low-cost supply chain!

The only way to drive parity in price between legal and illegal cannabis is for the legal supply chain to achieve economies of scale similar to the legal tobacco and alcohol industries.



Illegal production of beer, for example, would struggle to come anywhere near the low cost of production of large established breweries. This process of the legal industry scaling up will happen in cannabis production, but it will take time and a lot of capital investment.

When legal cannabis finally becomes cheaper than its illegal equivalent, we will see a wholesale transition of demand into legal supplies.

This price differential clearly restricts quick uptake of legal cannabis on the market, and applies anywhere that has an established black market in cannabis, which seems to be just about everywhere, not just the US.

And beyond the economies of scale, there is another major issue for the legal cannabis industry.

How should legal cannabis be allowed to market itself?

Legal tobacco and alcohol have enjoyed decades of being able to build brands and spend millions on advertising without restrictions. Advertising restrictions on those products have only started to appear in recent years. Any cannabis product requires FDA approval in the US, with similar approvals needed in other markets, and would certainly face restrictions on advertising, severely limiting brand-building, in the way that tobacco and alcohol brands have done for decades.

The Strategic Approach

If you are determined to buy into the rush of legal cannabis, but don't like the potential of huge downsides seen by many of the stocks in this market, there are a few ETFs, though their cannabis holdings are, of course, limited to what is available in the market.

Here are a couple of ETFs.

The first ever pot-based ETF debuted a little more than two years ago: the **Horizons Marijuana Life Sciences ETF** ([OTC:HMLSF](#)). Today, it holds nearly five dozen pot stocks with various weightings, and it has about 934 million Canadian dollars in net assets. However, it was on a high at \$19.52 back in January 2018, but is now (31/10/2019) trading at \$7.90.

Whilst the Horizons Marijuana Life Sciences ETF was the first to market, the **ETFMG Alternative Harvest ETF** ([NYSEMKT:MJ](#)) has a larger asset value. With cannabis stocks becoming more popular, this ETF now holds increasing amounts of the cannabis producers, including Tilray (mentioned above), and Aurora Cannabis.



However, as usual - A word of warning!

This market is still limited, with the relatively few players still investing for the longer term. There is little doubt that some of these companies, and therefore some ETFs, will make exceptional returns in the legal cannabis market as it develops, but the old English saying 'The grass is always greener somewhere else' comes to mind.

I can't help but think it may be a good idea to look at this market when it is a little more mature, or you may find your money going up in smoke!