Is cannabis stock frenzy a case of “reefer madness?”

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Marijuana has traveled a long way down the road towards legitimacy and legality since the 1936 film. In the U.S., nine states, along with the District of Columbia, have legalized recreational use and 33 states allow medicinal use. Indeed, according to the Pew Research Center, ***more than 60% of Americans support legalization***.

While marijuana remains ***federally*** illegal in the U.S., the bipartisan “Strengthening the Tenth Amendment Through Entrusting States (STATES)” Act was recently introduced. If passed, STATES would exempt state-legal cannabis producers/sellers from federal prosecution and allow the current cash-only business access to the banking system.

On October 17, Canada became the second country to legalize recreational use (joining Uruguay). It’s clear the legal cannabis genie is out of the bottle. Estimates of a legal market of $100-150 billion by 2025 have set-off a gold rush mentality among entrepreneurs and investors not seen since the “dot com” boom of the late 1990s or Bitcoin/cryptocurrency boom of 2017, both of which ended badly.

Successful investing is a slow, painstaking and disciplined process that uses the power of compound interest to do the heavy lifting over a ***long*** period encompassing ***decades***. Done right, it’s boring as heck, but it’s a marathon, not a sprint, and “slow and steady” wins the race. On an intellectual level, most investors “get it.” Unfortunately, this runs counter to human nature, which demands instant gratification.

Bitcoin’s meteoric rise was partly fueled by a “whiff of legitimacy” from the Wall Street establishment. Similarly, liquor giant Constellation Brands (CTZ) acquired a 9.9% stake in Canadian producer Canopy Growth Corporation (CGC) last year and announced a partnership to develop cannabis-infused beverages. CTZ increased its stake in CGC to 38% in August, investing an additional ***$4 billion***. Additionally, Bloomberg reported Coca-Cola (KO) is also exploring drinks infused with CBD (Cannabidiol—the non-psychoactive ingredient in marijuana that treats pain, but doesn’t get you high) and is in in talks with Canadian producer Aurora Cannabis Inc. (ACBFF).

Another key ingredient to last year’s frenzy in Bitcoin was its scarcity, which by design is forever capped at 21 million coins. Similarly, because cannabis remains federally illegal in the U.S., cannabis-related companies with U.S. operations are prohibited from listing their shares on a U.S. exchange. Thus, investors are limited to U.S. companies listed in Canada or Canadian companies (with no U.S. operations) listed in the U.S.

The poster child for this scarcity effect is Canadian producer Tilray, Inc. (TLRY), one of the few “pot stocks” traded in the U.S. Privateer, a fund backed by billionaire investor Peter Thiel, invested about ***$40 million*** for what is now 76% of Tilray’s shares. U.S. investment bank Cowen made a bold reputational bet on the nascent Canadian cannabis industry when it took TLRY public at an IPO price of ***$17*** way back on July 18.

Tilray has a miniscule “float” (shares available for trading) of 17.8 million shares, which has led to spectacular volatility. TLRY closed Friday September 14 at $109 and reached an intraday high of ***$300*** on Wednesday September 19 on bullish comments from TLRY’s CEO. At the peak, TLRY (which Cowen estimates will do ***$42 million*** in sales, but lose money in 2018) was valued at ***$30 billion*** (briefly valuing Privateer’s stake at ***$23 billion***). By contrast, Cummins, Inc. earned $1 billion on $20.5 billion of sales in 2017 and is valued at $23 billion.

Cannabis may be the wave of the future, but that doesn’t mean the stocks are a good investment. Remember two investment adages. First, price is what you pay, but value is what you get. The “pot stocks” carry astronomical valuations. Second, as Warren Buffett says, “What the wise man does in the beginning, the fool does in the end.”