5 Reasons to Avoid Marijuana Stocks (and 1 Huge Reason to Buy Anyway)

Description

It looks really close to becoming official.

All signs are pointing to marijuana being legalized in Canada sometime in 2017. Millions of Canadians who enjoy a puff or two every now and again are excited they'll no longer have to hide their habits from their friends, professional colleagues, and especially law enforcement.

But the excitement of the average smoker doesn't get close to the euphoria surrounding investing in the drug. There are thousands of investors convinced pot stocks are the next big thing.

There's certainly evidence that indicates legal marijuana will be a big market. Analysts are saying up to 30% of Canadians could be at least occasional users of cannabis once it's legal with the size of the market approaching $20 billion annually. Others are far less bullish, saying $8-10 billion is a more realistic size.

Still, that's a lot of marijuana. No wonder everyone is so excited about it.

But I think caution should rule an investor's decision, not the euphoria of potential. Here are five reasons why I'm avoiding the marijuana industry.

Valuation

Canopy Growth Corp. (TSX:CGC) is a perfect example of the overvaluation plaguing the marijuana industry. It trades at 41 times sales and 6.8 times book value. Analysts do think the company can turn a slight profit in 2018 of a penny or two per share, while the company trades hands at $9.85. That would put it at between 500 and 1,000 times earnings, approximately.

Most of the other stocks in the industry are equally overvalued.

Euphoria factor

Something happens when a stock moves away from fundamentals. Logic goes away and emotion takes over. Investors aren't making calculated decisions. They're scared they'll miss out.

The problem with that kind of market is it can turn on a dime. If sentiment shifts, look out below. These falls can be especially nasty since there's no logical bottom. The opposite emotions take over, and the only thing more powerful than greed is fear.

Everyone already knows

One thing I've realized over the years is if I'm just finding out about something, Wall Street professionals and hedge fund managers have already known about it for years. It's just the way the industry works.

When retail investors start getting really excited about something, the so-called smart money starts to sell. I'd rather bet with those folks, not against them.

Buy the rumour, sell the news

Many traders follow a simple adage. They buy the rumour and sell the news. In other words, the hype is often the most successful part of any investment.

It's only a matter of time until marijuana gets legalized in Canada. And if the adage speaks true, all of the marijuana stocks will fall when the government announces such an event.

Short exposure

Now that shares have settled down a bit, many short sellers are rushing in to bet against pot stocks. Investors collectively sold short more than three million Canopy Growth shares at the end of December.

Short sellers can be particularly nasty. Just look at the folks who have shorted some of Canada's riskier mortgage lenders over the years. They've become the narrative, while the underlying company results became secondary. If these people move their focus to marijuana stocks, it could shake the confidence of the entire industry.

Why all of this doesn't matter

After saying all of that, I have a revelation. None of this could matter.

Canada's marijuana stocks come down to this: yes, they are risky, overvalued, and so on, but they also represent the best growth opportunity in today's market. Nothing else comes close.

They will be volatile in the short term. That much is obvious. What isn't so certain is how they'll react over the long term. A patient investor could end up very rich if they buy a collection of these stocks and hold for a decade or more.

It'll be a bumpy ride, but it could end up being worth the risk. But as the car industry taught us a century ago, it's tough to pick a winner in a very competitive field. Investors looking for exposure should be extremely cautious and position their portfolios accordingly.

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