Why 2016 Was the “1999” for Marijuana Stocks: When News Trumps Fundamentals

Description

Any time a stock appreciates 20% or more in a matter of minutes on positive news, investors begin to get itchy. Marijuana stocks experienced industry-wide hyper-growth in 2016 with market sentiment reflecting much of the same sentiment that technology stocks provided the market in the late 1990s with promises of unparalleled growth potential with seemingly no end in sight.

Most analysts agree that while massive increases in valuations of companies based on expectations of future growth are common, these expectations can prove to be dangerous in the long run.

I’ll take a look at how last year’s hyper-growth environment for marijuana stocks compares to the late 1990s for technology stocks. We all know how that party ended. The question that many investors who have placed their trust in names such as **Canopy Growth Corp.** (TSX:WEED) is whether the party for marijuana securities will continue into 2017 or if the slide has just begun.

Examples from the late 1990s

In an excellent research paper on this topic from Douglas J. Skinner from the Sloan Business School in January 2000, earnings surprises (both positive and negative) were analyzed rigorously. I suggest marijuana investors read this paper, as it proved to be a timely piece in 2000 as prices for many “high-flying glamour/growth” stocks began to fall precipitously.

The paper analyzed a number of excellent examples; however, I will point to two examples highlighted in the paper to show how the tech bubble popped, or began to pop, in the late 1990s and into 2000 and 2001.

Example #1: Oracle Corporation

Oracle Corporation (NYSE:ORCL) was a darling of the late 1990s. The company's stock price increased rapidly from the $24 per share level in April 1999, closing the year on December 31, 1999 at $112 per share. Sound familiar? The company's stock price today trades at the $40 level and has yetto breach the $50 level since its spectacular collapse.

The paper notes the sensitivity to earnings surprises with which the stock traded, citing an example from Q2 1998. In this example, the company's price-to-earnings ratio (P/E) and price-to-book (P/BV) ratio were 12 and 45, respectively, qualifying this stock as a growth/glamour stock in 1998 terms.

Oracle announced an earnings miss in Q2 1998 of $0.04 on total earnings of $0.19 (meaning expected earnings were $0.23), resulting in a stock price decline of 29%, even though the company missed earnings by only 17%. The volatility of Oracle's stock price and sensitivity to earnings releases proved to be what drove the company's price up to the $112 level and was also what brought the company's stock price down to fundamentals very fast.

Example #2: Rainforest Cafe

Rainforest Cafe was yet another example of a growth/glamour stock in the late 1990s which experienced a massive stock price decline, despite a small earnings miss. This company announced earnings guidance of between $0.23 and $0.24 per share, missing estimates by $0.01 to $0.02 with announced earnings of $0.22. The company's stock plummeted 40% on the news, enticing an acquisition in 2000 by **Landry's Restaurants**, a privately owned corporation.

Moral of the story

The lesson learned here is, when times are good and expectations are high, earnings beats are common and acquisitions or earnings per share increase at abnormal levels, making growth or glamour stocks seem to be great plays. When the bubble starts to pop and earnings misses become the common trend, watch out.

Stay Foolish, my friends.

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