Are We Seeing a Cannabis Bubble Begin to Form?

Description

The cannabis industry has been taking off this year, and giants like **Canopy Growth Corp.** (TSX:WEED) and **Aurora Cannabis Inc.** (TSX:ACB) have seen their share prices double recently.

There's a lot of excitement in the industry, and the danger for investors is that this could create a bubble. Valuations are getting out of control for stocks that haven't even turned a profit, and investors are jumping on a bandwagon of hype and enormous expectations. It's tempting to get on board for the ride and hope for a great return, but the investment is not without risk.

Cannabis investors need to look no further than another high-flying stock on the TSX, **Shopify Inc.** (TSX:SHOP)(NYSE:SHOP), which saw its share price decline nearly 20% just on a report questioning its business model.

Stocks that are based on hype can be very sensitive to news, and if tomorrow we find out that marijuana legalization is delayed indefinitely, then we would likely see cannabis stocks come crashing down. The industry is riding high today, but there's no guarantee that it will be able to continue that way.

Using statistics to measure risk

Let's take a look at the numbers to see how volatile these stocks have been over the past year. One way that you can measure the level of risk a stock has is by evaluating how volatile its stock price is, and you can do that by looking at its standard deviation.

The standard deviation gives you an idea of how far from the average the stock price has moved over a period of time. The higher the number, the higher the degree of variation. The one problem in using the standard deviation with stocks is that prices are not all the same, and so stocks that trade at higher dollars will have higher standard deviations.

For this reason, I am going to evaluate these stocks based on their coefficient of variation (CV), which divides the standard deviation by the average. This will turn the variance into a percentage of the average and will eliminate the impact of price differences.

I'm going to use **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) as a benchmark, since most investors would likely agree that bank stocks are as close to risk-free investments as you can find on the TSX without looking at indexes or ETFs. Over the past year, TD's CV has been 4% and just 1% in the last month. This suggests a lot of stability in the stock price, which is what you would expect from a bank stock.

Canopy had a CV of 24% in the last year and 19% in just the last month. Aurora Cannabis has been in the news lately, so its results are skewed, but in the past month its CV has reached 26%. By comparison, Shopify has seen a CV of 30% in the past year, although this is largely attributed to the bad press it saw back in October, as in the past month it has dropped to just 3%.

Bottom line

Cannabis stocks certainly present much more risk for investors and in return will offer much greater potential returns. As tempting as it may be to buy the stocks, investors might want to exercise some caution given the rapid rate of increase we've seen in just a short amount of time, which is not likely to be sustainable.

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2. NYSE:TD (The Toronto-Dominion Bank)
3. TSX:ACB (Aurora Cannabis)
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