



Why Is This Cannabis Fund Manager Sounding the Alarm on Pot Stocks?

Description

The manager of a cannabis mutual fund said recently that he was expecting a “steep pullback” in cannabis shares, driven in large part by “off-the-chart valuations.” Bruce Campbell, who manages StoneCastle Investment Management Inc., also said in an interview that he expects “scary down times” in the sector as a whole.

At first, Campbell’s statements may seem strange. Cannabis stocks have been riding high lately, and despite a slight pullback in recent weeks, are mostly holding strong. And if that weren’t enough, we’ve got legalization coming around next month, which promises to breathe new life into cannabis sales.

And yet, when we look closer, there is quite a bit of sense to what Campbell is saying. Cannabis companies are running at sky-high valuations with negative earnings and growing losses. While the losses are mainly attributable to investments, there are still many who question whether cannabis makers will become profitable any time soon. This problem can be illustrated by looking at the performance of one Nanaimo-based pot company that is, in many ways, a microcosm of the broader pot industry.

The strange tale of Tilray ([NASDAQ:TLRY](#))

Earlier this month, Tilray was on an epic tear in the markets. After debuting on the NASDAQ for just \$17 in July, the company shot up as high as \$263 by mid-September — a +800% gain!

But despite all these gains (which are rapidly reversing), one fact remains: Tilray has [not been able to generate](#) a positive net income. While its negative earnings are not as large as those of **Canopy Growth**, they’re still there. This presents a problem because, with cannabis companies investing massively in future growth, it’s hard to say what their earnings will look like once they get costs under control. Valuing such companies is practically a guessing game.

Legalization: the part nobody wants to mention

The problems with cannabis stocks could arguably get even worse once legalization is in effect. The reason is that legalization could potentially put [downward pressure on prices](#). In Colorado, where weed

was recently legalized, pot prices fell dramatically, as black market vendors cut their prices to compete with legal vendors. The end effect was that legal cannabis suppliers had to cut their prices to remain relevant.

And we're seeing much the same starting to happen in Canada. According to Statistics Canada, the price of cannabis has fallen 10.6% since 2016. That might not seem like a huge decline, but remember that cannabis companies are already in negative earnings territory. If legalization drives prices down further, we could reach a situation where cannabis companies struggle to profit *even after* reducing their investment costs. If that happens, the "scary down times" Campbell is predicting may go on longer than he expects.

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