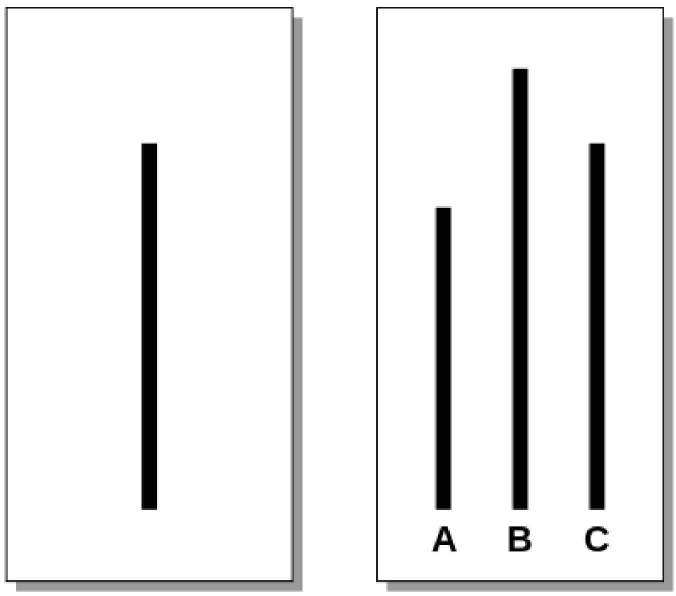
07/18/2021: (H)Asch(ish) Paradigm...

In 1951 Solomon Asch carried out one of the more revealing social experiments.

He brought in a group of eight college students to participate in a “perceptual task”. He sat them all together at a table across from a series of large cards with vertical lines on them, like in the image below.



The task was a very simple one. Each student was asked to identify which of the vertical lines on the right (A, B, or C) matched the length of the line on the left. But there was a catch… 7 of the 8 students were in on the experiment. And they were each told to give the same wrong answer. So for example, in the above image, they’d all pick A instead of C.

The mark, or the subject of the experiment, didn’t know this. And he had to give his answer *after* seeing the others in the group all agree on the wrong one.

You can probably see where this is going. Given a task as simple as identifying which line is equal in length, roughly a third of subjects would agree with the consensus, whom were clearly wrong. You can watch a video of the experiment here.

These findings have been verified numerous times since. The most recent one, which hooked subjects up to fMRIs, found that subjects went with the group’s wrong answer 41% of the time.

These are startling results for such an unambiguous task. What's most revealing is that it isn't just peer pressure that pushes subjects to pick the wrong answer.

In fact, the group often influenced the subject's *perception* of reality to the point that they honestly believed they were giving the correct response. Asch bucketed this distortive power into two groups.

1. **Distortion of perception.** This group is unaware that the majority distorted their estimates.
2. **Distortion of judgment.** These subjects conclude that their perceptions are inaccurate and the group is right.

There's a great line in Rory Sutherland's terrific book "Alchemy" where he writes:

> *The human mind does not run on logic any more than a horse runs on petrol.*

Oh so very true…

A preoccupation of mine is understanding our inherent irrationality. Our inborn stupidity. Or the logic behind our illogical minds.

One heuristic I've found to be useful in understanding why we do many of the things we do is to remember that we humans are only two chromosomes away from being pant-wearing monkeys.

It's a powerful explanatory preceptory filter.

Turn on CNN and see a group of anchors in a screaming match about some culture war nonsense… What do you expect? We're only slightly advanced Hominoideas.

Baffled by the popularity of Instagram where people spend countless hours scrolling through duck-faced selfies of strangers and food porn? Apes do the same thing, here's a video (link here).

Amused by the confidence in which so-called rationalists point to the "scientific consensus" as proof that the lab-leak theory is pure conspiracy…or that we actually *know* a lot of things when it comes to infinitely complex systems such as managing the global economy, "fixing" climate change, etc… arrogance spawns from ignorance and us upright monkeys are still damn ignorant about the world.

I wanted to kick off this note on marijuana with the Asch paradigm mainly because, well, the title and I thought it too clever to not. But also because it helps explain our backwards federal policy towards the "Devil's Cabbage" over the last 84-years.

Before we get into what I believe is about a clear-cut example of obvious positive asymmetry with inbound catalysts as investment opportunities come. I want to first run through some history so we can understand the illogics of present-day policy and why this opportunity exists in the first place.

Cultures, including western Europeans, have prized cannabis for its medicinal benefits for thousands of years. Herodotus wrote of the Scythians inhaling the smoke to wind down as far back as 2,500 years ago.

Its cultural demonization is a recent phenomenon that not so coincidentally began in the early 20th century as a result of a flood of immigration into the US stemming from the Mexican Revolution.

Eric Schlosser, the author of *Reefer Madness: Sex, Drugs, and Cheap Labor in the American Black Market*, describes this era in a 1994 article published in *The Atlantic* (link here) writing.

> *The political upheaval in Mexico that culminated in the Revolution of 1910 led to a wave of Mexican immigration to states throughout the American Southwest. The prejudices and fears that greeted these peasant immigrants also extended to their traditional means of intoxication: smoking marijuana. Police officers in Texas claimed that marijuana incited violent crimes, aroused a "lust for blood," and gave its users "superhuman strength."*
>
> *Rumors spread that Mexicans were distributing this "killer weed" to unsuspecting American schoolchildren. Sailors and West Indian immigrants brought the practice of smoking marijuana to port cities along the Gulf of Mexico. In New Orleans newspaper articles associated the drug with African-Americans, jazz musicians, prostitutes, and underworld whites. "The Marijuana Menace," as sketched by anti-drug campaigners, was personified by inferior races and social deviants.*

This bit of xenophobic hysteria culminated in the Marijuana Tax Act of 1937 which essentially banned the substance at the federal level.

Funnily enough, this came just a few years after the end of prohibition and just one year following the release of the widely popular movie "Reefer Madness" which was financed by a concerned church group. Give the trailer a watch (link here) to see how *bizarro* the American perception of cannabis — or as the movie calls it "the burning weed with its roots in hell" — was at the time.

33 years later the Marijuana Tax Act was repealed and replaced with a more tyrannical one in the Controlled Substances Act of 1970, which was signed into law by Nixon. This listed cannabis as a Schedule 1 drug, right up there with heroin, LSD, meth, and crack cocaine.

I grew up in the era of D.A.R.E where I was taught by DAREen the Lion that weed was a dangerous and highly addictive gateway drug. While perfectly legal and culturally acceptable alcohol was and remains a booming industry.

For fun, let's do a quick comparative analysis on the social and economic costs of the two drugs.

Alcohol:

- Worldwide, **3 million deaths every year** result from harmful use of alcohol, this represents **5.3 % of all deaths** (WHO)
- Overall **5.1 % of the global burden of disease and injury** is attributable to alcohol, as measured in disability-adjusted life years (WHO)
- Alcohol consumption causes death and disability relatively early in life. In the age group 20–39 years approximately **13.5 % of the total deaths are alcohol-attributable** (WHO)
- **36% of those under correctional supervision** were drinking at the time of their conviction offense (NCADD)
- Alcohol is a factor in **40% of the 3 million violent crimes** that occur in America each year (NCADD)
- In 2010, the **total estimated economic burden of alcohol misuse in the US was $249bn** (NCADD)

Cannabis:

- **Total deaths due to overdose: 0**
- Link to violent crime: **tenuous to none**
- Health impact: possible links to psychological disorders amongst young people if misused over long periods of time. Though, **positive health benefits are numerous** (ie, helps with inflammation, treats epilepsy, PTSD, depression and anxiety, regulation and prevention of diabetes, etc…) (NIH)

The graph below, put together by researchers in the UK, shows the "Harm to users" and "Harm to others" score of every intoxicant. Alcohol takes top spot for being the most harmful known drug, with heroin a distant second. Cannabis is in the middle, two spots below tobacco.

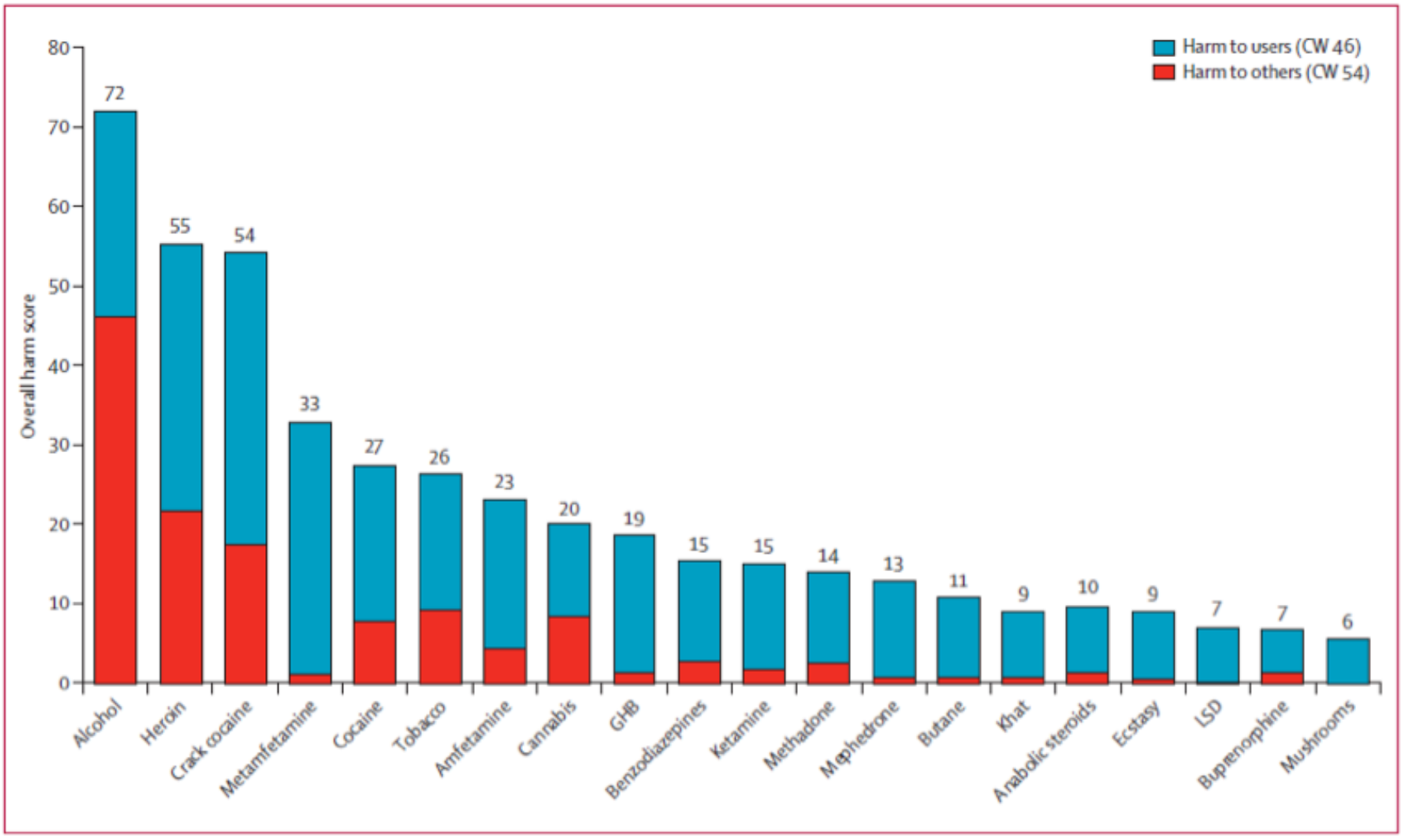


Figure 2: Drugs ordered by their overall harm scores, showing the separate contributions to the overall scores of harms to users and harm to others
The weights after normalisation (0–100) are shown in the key (cumulative in the sense of the sum of all the normalised weights for all the criteria to users, 46; and for all the criteria to others, 54). CW=cumulative weight. GHB=γ hydroxybutyric acid. LSD=lysergic acid diethylamide.

Now, if we were a fact-driven society (which, of course, we are not) that wanted to balance freedom with regulating actions that have high external costs, we would ban alcohol and legalize cannabis. There's no disputing the wide cost-benefit disparity between the two.

Tyler Cowen, the perspicacious economist and curator of the *Marginal Revolution* blog, is a teetotaler himself and often makes the argument for promoting a voluntary prohibition on alcohol. Tyler writes:

> *I favor a kind of voluntary prohibition on alcohol. It is obvious to me that alcohol is one of the great social evils and when I read the writings of the prohibitionists, while I don't agree with their legal remedies, their arguments make sense to me. It remains one of the great undervalued social movements. For mostly cultural reasons, it is now a largely forgotten remnant of progressivism and it probably will stay that way, given that "the educated left" mostly joined with America's shift to being "a wine nation" in the 1970s.*
>
> *...In part our guns problem is an alcohol problem. According to Mark Kleiman, half the people in prison were drinking when they did whatever they did. (Admittedly the direction of causality is murky but theory points in some rather obvious directions.) Our car crash problem – which kills many thousands of Americans each year — is also in significant part an alcohol problem.*

There are connections between alcohol and wife-beating and numerous other social ills, including health issues of course.

Now, this piece isn't making the argument that we should ban alcohol. I side with Benjamin Franklin who said:

Beer is proof that God loves us and wants us to be happy…

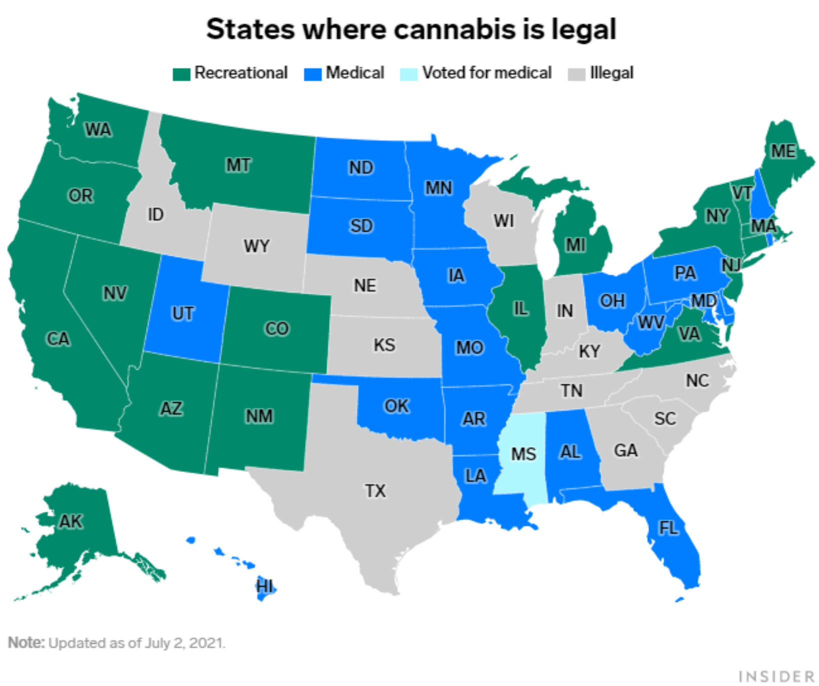
Besides, there's credible evidence that the use of alcohol in early religious ceremonies is what drove us to transition from hunter-gatherers to agricultural-based societies (we needed to grow that barley). So I'd never dare propose we ban the "Brew of the Gods" since we may very well owe civilization to that sweet elixir!

...But I digress... this piece is not about alcohol's societal costs nor benefits but rather about pointing out the blatant fallacies in our cultural and legal norms along with why cannabis stocks offer *deep* value and an incredibly asymmetric opportunity to the patient investor.

The long era of prohibiting marijuana is coming to an end. Both technically, as more and more states move to legalize. And culturally, as the stigma around its use fades and its relative health benefits become known.

Cannabis is now fully legal for recreational use in 18 states including Washington, D.C. It's approved for medicinal use in 37 states in total. BDSA forecasts that all U.S. states will have medical cannabis by 2025 and nearly half will legalize recreational use. This is a *directional arrow of progress* that can't be stopped, to steal a phrase from Josh Wolfe. It's a matter of time before every state on the map turns green.

See all the states where marijuana is legal:

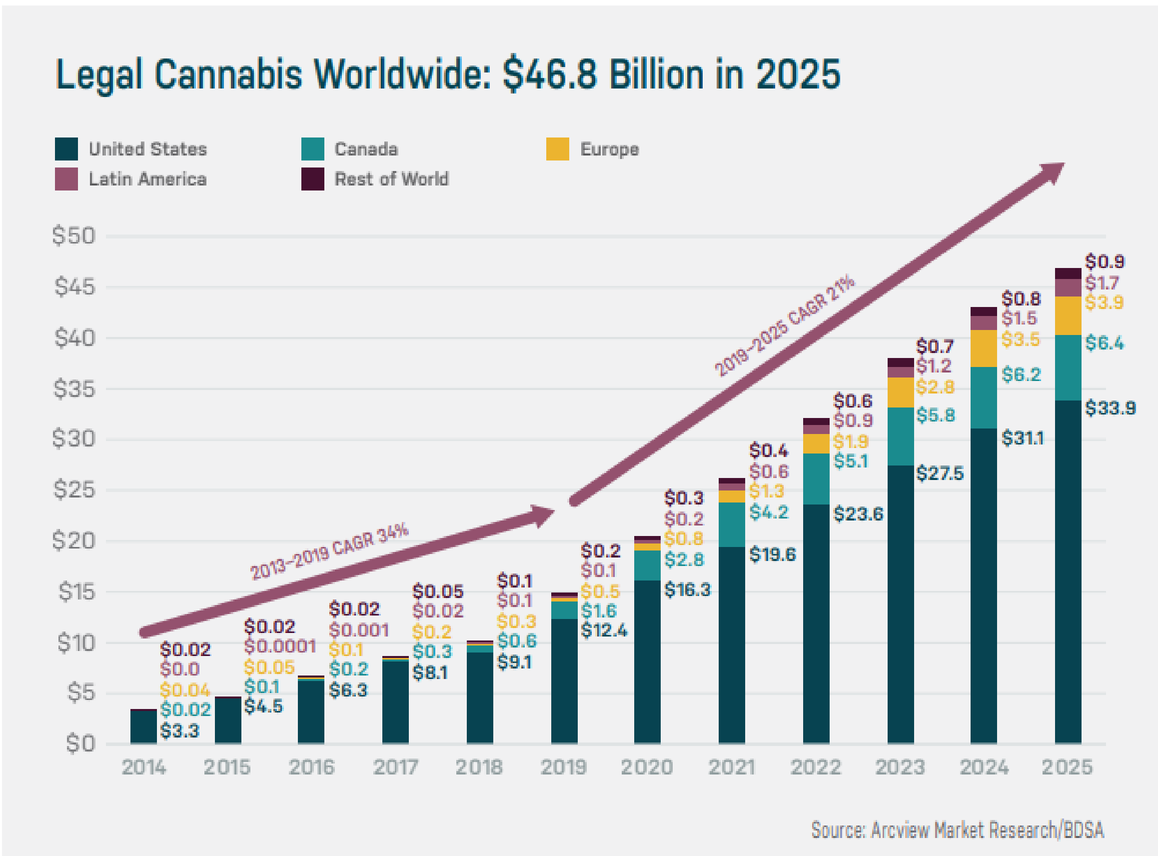


The trend is irrepressible for a number of reasons (1) voters are demanding it — according to Gallup 68% of voters want legalization (2) it's one of the few agenda items both parties support and (3) tax revenues, which is almost certainly the big driver behind reason 2.

The loss in tax revenues during the era of prohibition was one of the *major* reasons America ended its experiment with forced sobriety.

Going forward we're marching into an era of bigger government. This is going to require increasing sources of revenue. The opportunity to tax recreational cannabis is too good to pass up, let alone the costs of letting a neighboring state benefit from the interstate demand from not doing so.

Cannabis sales represent big money to both state governments and the young industry alike. Legal recreational cannabis sales in the US are expected to come in at roughly $20bn this year and grow to over $33bn over the next four. A projected CAGR of 21%.



But the US industry is barely a *budding* flower... BDSA estimates the illicit US cannabis market to be as large as $100bn a year. Meaning there's plenty of low-hanging illegal buds for the legal industry to make kosher once the government gets out of its way.

And as cannabis consumption becomes legal and more culturally acceptable, growth in new users as well as consumption rates should continue to increase.

Nielsen, the survey company, notes that out of those living in states where recreational use is legal, 43% consume cannabis. In Colorado where it's been legal the longest, 48% of residents above the legal age report using it regularly. That's a nearly 50% penetration rate of the total potential market. Alcohol is 60%.

Seeing as how we're still early days in the trend towards legalization and normalization, this implies there remains a *loooong* growth runway for the industry.

Considering the inevitability of country-wide legalization along with its impressive growth runway, you'd expect these multi-state operators, or MSOs as they're known in the industry vernacular, to be trading at SAAS level multiples. But that just ain't so…

Take the dominant four US MSOs for instance. Green Thumb Industries (GTII), Curaleaf Holdings (CURA), Trulieve Cannabis (TRUL), and Cresco Labs (CL).

Each has a 4-year revenue **CAGR above 140%**. Each is free cash flow positive and is expanding operating margins as it scales (current average is above 40%). Yet, as a group, **the average NTM sales ratio is only 5.5x and the highest NTM EV/EBITDA amongst them is 21x, the lowest 10x.**

This would be a total head-scratcher were it not for the very obvious reasons which have created the peculiar valuation. And it all has to do with federal laws and an outdated IRS tax ruling.

Back in 2017, I received a call from one of my old military contracting (aka. mercenary) buddies. He'd recently taken on a gig orchestrating the security and transport for one of the leading CO dispensaries. The gig paid a solid six figures and required driving around armored Suburbans in full battle rattle and a respectable collection of arms in order to move massive amounts of cash from secret counting facilities to small state-owned banks and credit unions.

The reason this circus was necessary was due to federal law that prohibited FDIC-insured financial institutions from touching "drug" money, including the normal armored trucks that typically move that type of cash. You know, because of the whole Tier 1 status and all that.

This contrast between state and federal law creates a host of difficulties and added costs for those operating in the space. These include but are not limited to:

- They are locked out of the debt markets so they *have* to issue shares in order to raise cash. This gives the industry a WACC that's north of 60%
- Prime brokers can't custodial weed assets preventing institutional investors from buying shares
- They can't list on US exchanges so they trade OTC or in Canada
- Limited access to business basics such as insurance and 3rd party payroll operators

This clip from an [NPR article] gives a good sense of the regulatory current these operators are forced to swim against (emphasis by me).

> *The estimated 300 U.S. financial institutions that serve the pot industry are small, state-chartered banks or credit unions. They're audited frequently, and transactions are monitored closely for suspicious activity.* ***A cannabis business pays thousands in monthly fees just to have an account.***
>
> ***Banks also won't lend to the industry*** *because if the federal government were to seize a company's assets, the lender would have nothing to collect on the loan.*
>
> *Yet that fear makes everything harder to access. He's been turned down by payroll companies, human-resource software firms, and insurance brokers.*
>
> *And, because of the extra risk, everything costs more. Canndescent invested $200,000 in an automated weighing machine that makes packaging six times faster, for example. The interest rate was 18 percent or nearly* ***three times the normal rate.***
>
> *Two years ago, an infection destroyed Canndescent's hydroponic beds of seedlings. But* ***crop insurance wasn't available for marijuana, so the company ate the $600,000 loss****.*

And then there's the asinine IRS Code section 280E.

The law reads as follows:

> *No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I or II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.*

The bright minds in Congress put this law on the books during the 80s. It was in response to a court case that disallowed a convicted drug mule from claiming tax deductions from ordinary business expenses under federal tax law.

Which is in and of itself a pretty common sense thing. Unfortunately, the law's broad interpretation creates a few headaches for cannabis companies operating in legal states.

One of these being that these businesses are unable to deduct ordinary business expenses from their income taxes. This means that things like marketing and advertising costs, employee salaries, rent, and utilities, etc… Items that are typically deducted from a business's tax bill, aren't for weed companies. As a result, **the industry pays an effective tax rate of 70%...**

What's so extraordinary about some of these companies is how well they're doing despite everything, including the kitchen sink, that's been thrown at them due to dated ill-thought legislation.

From an investing standpoint, the thing that matters most is changing the banking rules so these US MSOs can uplist to US exchanges and prime brokers can custodial their assets allowing for greater institutional and retail participation.

The investment bank Jefferies summed things up quite nicely in a recent report, writing:

> ***Institutional driven sector re-rating to be material:*** *Despite compelling fundamentals (coverage avg. sales growth CAGR into 2023 at 50% GM's close to 60% EBITDA margins close to 40%),* ***institutional participation minimal at just 4% (global staples 45%)****. Most institutions cannot own currently due to federal illegality and a lack of capital market protections. Expect protection to be provided very soon (next 12 months) via either Schumer Bill/SAFE Banking. To gauge potential support: coverage combined market cap of $25bn is just 5% of US consumer staples AUM.*

As Jefferies points out, there are a number of bills in Congress to rectify this regulatory nonsense. Senate Majority Leader Chuck Schumer has said this is at the *top* of his legislative agenda.

Fortunately or unfortunately for these companies though, there's now a big push to tie a number of social justice reforms to these bills. This risks weighing things down, resulting in the legislative can getting kicked once again.

From a long-term investor standpoint though, the timing of federal reform almost doesn't matter. In fact, a number of these larger MSOs will just use the time to build out their competitive moats, brand equity, and regional dominance as they continue to gobble up positive cash-flowing dispensaries.

A further lag in the legislative process allows them to do so without having to face any competition from the big US CPG companies.

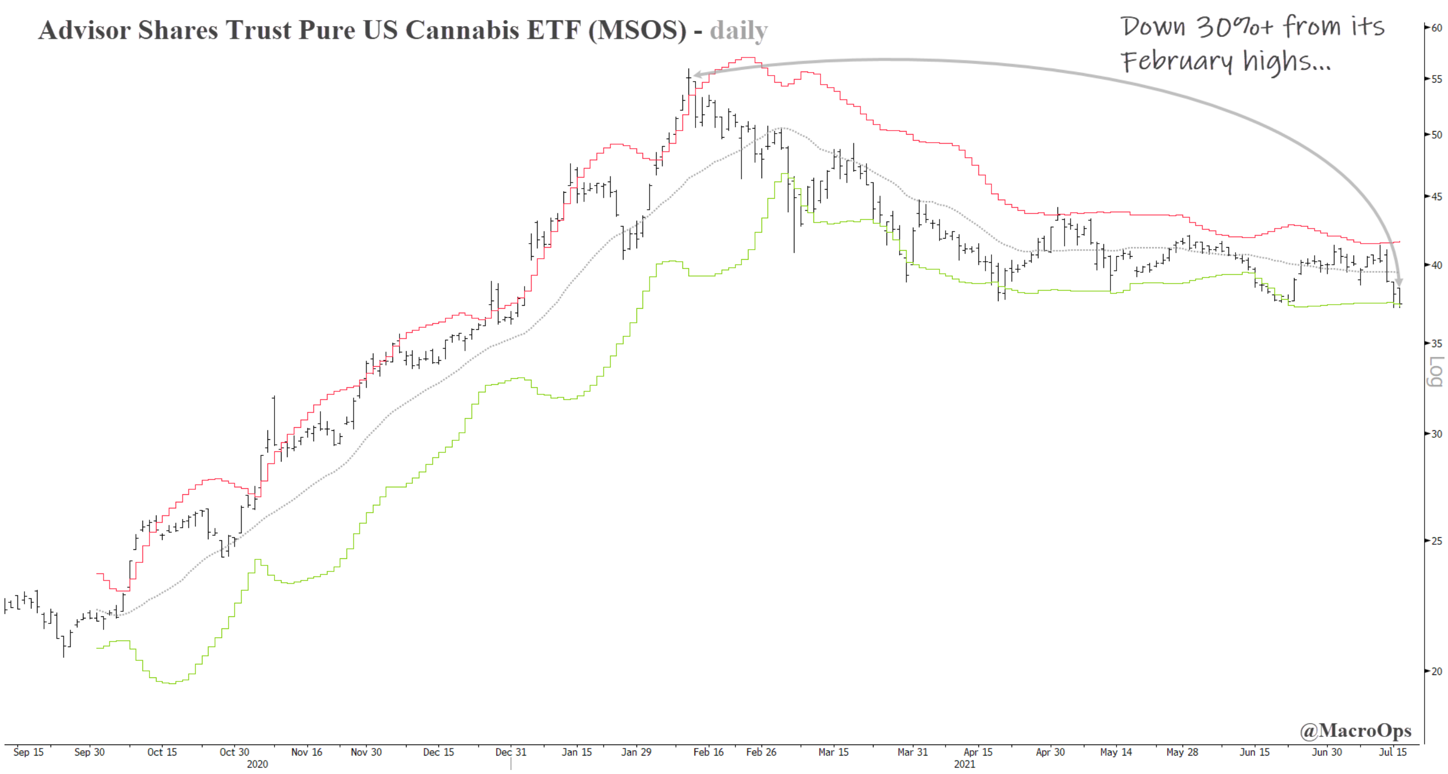
The absence of large inflows from US institutions and retail investors keeps these stocks trading at Dollar General level bargains. Something that surely won't last but is an incredible opportunity for those with foresight and patience.

One of my favorite investing legends, Richard Chandler of [the Chandler Brothers](), often says that he

Likes investments where the risk is time, not price.

If there's *any* industry that currently fits that bill, especially in these expensive markets. It's the cannabis space.

Our preferred way to play this thematic is through the Advisor Shares Trust Pure US Cannabis ETF (MSOS) which is heavily weighted to our favorite MSOs. We already own DOTMs on this and will consider adding some equity should space get even cheaper (which looks possible as these stocks continue to trade heavy).



Our favorite MSO of the bunch is Green Thumb Industries (GTII) — more on them in a future note. And Brandon will be out with a write-up this week on Village Farms (VFF), the largest vertically integrated greenhouse operator in North America; a grower of all types of produce, cannabis included.

Short-term we have no idea where cannabis names will trade. We also have no idea exactly when legislative reform will get passed. We only know that it's inevitable and it's coming. We *do* know that the leaders in the space are incredible businesses, run by tough and adaptive operators, in a secularly growing industry with a long runway.

Within a decade, smoking a joint, eating a macaroon edible, or drinking a THC/CBD infused health drink will be as ordinary as having a beer or sipping a ginger tea. The laws and regulations will get rewritten. Cannabis consumption will become normalized.

Eight decades of regressive laws and misinformed cultural ideas is long enough. We may not be far from being pant-wearing monkeys but given the passage of enough time, we tend to get things right. The directional arrows of progress march on... The time to load up on US-based cannabis operators is soon.

Your Macro Operator,

Alex