Marijuana Investing – An investment blazing a trail for future growth or one that will go up smoke?

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Alright, so now that we have gotten our pot references out of the way, we can dive into the weeds (I did it again!) of marijuana investing and whether it's a good investment or just a good story.

There are several reasons we are seeing overall growth in the marijuana industry. For one, according to the National Conference of State Legislatures, the most recent tally shows that ten states and the District of Columbia have legalized small amounts of marijuana for adult recreational use while in 2018, an additional 21 states considered bills for legalization. In short, pot smoking does not have the same stigma it once had and there are entire industries (both new and old) trying to take advantage of this trend.

For the purpose of this piece, our focus is on the review of public investments (mutual funds and ETFs specifically). While we acknowledge there are other direct, non-public ways to invest in the marijuana industry, we would argue that each of these opportunities deserve their own review, keeping in mind many of the points made in the paper may still apply.

Like any investment, understanding the economic rationale is critical before investing. Marijuana investing is expected to be a growth industry, which clearly has some appeal. However, it is critical to look at the actual holdings of the available pooled-vehicle (i.e. ETF) investments. Similarly, as this is a niche investment, having appropriate risk and return expectations is important as well.

Currently, there are only two marijuana-related ETFs available today in the United States, MJ and YOLO.

MJ (ETFMG Alternative Harvest ETF) has an inception date of 12/3/15 and has over $1B AUM. But there is a catch. Prior to December 26, 2017, the fund was called the Tierra XP Latin America Real Estate ETF, obviously something very different from what it is today. A cynic could argue its distributor changed course due to lack of success in real estate (and low AUM) and instead created this marijuana ETF in order to gain first-mover advantage, something that has traditionally been pretty helpful in the ETF industry. It is a relatively concentrated portfolio with roughly 40 stocks, with only eight holdings comprising just over 50% of the portfolio weight (source: etfmj.com, 4/24/19). It's also more of an indirect way to get exposure to the marijuana industry, with its investments in pharmaceutical, tobacco and even fertilizer companies. In addition, it is a passively managed product and while East Bay is generally a large proponent of passive investing, we question if this is the right approach in an ever-changing landscape.

YOLO (AdvisorShares Pure Cannabis ETF) is brand new to the marketplace with an inception date of 4/17/19; therefore, it has no track record and very few assets. It does, however, have a few positive attributes going for it. For one, it is more of a pure-play cannabis investment as it is expected to hold securities with at least

50% of their revenue coming from the marijuana and hemp business. In addition, it is an actively managed product, so the goal would be for the portfolio manager to be able to successfully maneuver through the fast-paced changes of the industry. Finally, BNY Mellon is serving as the custodian for YOLO, lending some legitimacy to the holding as it's the first major custodian to support a marijuana ETF.

In looking at the marijuana industry and its growth potential, there are several risks and other items to consider before investing, some of which we have already mentioned. One key point to remember is that marijuana is still an illegal and federally banned substance. Without having the blessing of the federal government, there are still potential legal ramifications associated with marijuana-linked companies. Other considerations include the pace of growth in this industry (some have likened it to the wild west) as well as the fact that it's a niche investment, something we don't often promote at East Bay.

We also spoke to major ETF and fund providers including SPDRs, BlackRock and Vanguard about their potential for investment in this industry. Not surprisingly, due to their need to be invested in large and liquid markets, along with the fact that marijuana is still federally illegal, there doesn't appear to be any new marijuana ETFs likely coming from a major provider in the near future. Other providers believe the current attention on marijuana investing is being driven more by sentiment than valuation and would argue the current valuations for marijuana-related holdings are too high (again, sorry for the pun).

What is the East Bay opinion on marijuana ETFs? I'll be blunt (I promise, this is the last pun). While this is clearly an interesting story and one that we will continue to monitor as it develops, we currently recommend sitting on the sidelines and waiting for some maturity, from a regulatory, product, and industry standpoint. If you read this position statement and determine that an investment is still right for you or your clients, we would suggest keeping it a relatively small portion of any growth-oriented portfolio.

As always, please let us know if you have any comments or questions.

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ICE BofAML 5-10 Year US Treasury, Corporate and Municipal Indexes are subsets respectively of ICE BofAML US Treasury, Corporate and Municipal Indexes including all securities with a remaining term to final maturity greater than or equal to 5 years and less than 10 years. ICE BofAML 10+ Year Treasury, Corporate and Municipal Securities Index are subsets respectively of ICE BofAML US Treasury, Corporate and Municipal Securities Indexes including all securities with a remaining term to final maturity greater than or equal to 10 years. Bloomberg Barclays Global Aggregate Bond Index provides a broad-based measure of the global investment-grade fixed income markets (one version shown with its currency hedged back to the USD and is noted as such). Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. 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