

**“The first thing I heard when I got in the business - not from my mentor - was, ‘Bulls make money, bears make money, and pigs get slaughtered.’ I’m here to tell you I was a pig. And I strongly believe the only way to make long-term returns in our business that are superior is by being a pig. I think diversification and all the stuff they are teaching at business school today is probably the most misguided concept everywhere.”**

Stanley Druckenmiller

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We really like the quote above from one of the world’s greatest fund managers, Stanley Druckenmiller, who gained notoriety when he worked for George Soros and made a fantastic trade: shorting the pound sterling.

I’ve had the pleasure of attending a conference where he was the main interviewee and he told what really happened. After analyzing the market and seeing what had happened to the Italian lira, Druckenmiller came to the conclusion that the next domino to fall would be the pound sterling.

He put together an elaborate presentation to show his boss, Soros, explaining why he was selling the pound – and why he was selling so much. Druckenmiller believed in this trade so much that he bet 100% of the Soros fund on it. After his presentation, he said that George Soros stared at him in astonishment, really confused, and Druckenmiller panicked and thought his arguments would be destroyed in 5 minutes by his boss.

Now comes the funny part. Soros was really amazed by the trade, but not for the reasons we might think. In fact, Soros liked the idea so much that he didn’t understand why Druckenmiller had “only” bet 100% of his fund on it. His advice: “go for the jugular”, in other words, leverage to the fullest and take advantage, because opportunities like this don’t happen every day.

We wanted to start this essay with Druckenmiller’s quote to show the importance of taking advantage of special opportunities. We always focus on looking for asymmetrical investment opportunities, with great return potential and low risk – and there aren’t many out there. Uranium was, without a doubt, one of the best trades we’ve ever made. Was it the most profitable? Definitely not, bitcoin has gone up a lot more. However, uranium had a risk-return ratio that was impossible to ignore.

Knowing this, we created a new class of shares in our fund and we want to take advantage of this opportunity. We believe that there is a very favorable risk-return ratio in this market and we remain focused on looking out for asymmetrical investment opportunities

## Cannabis

We are starting a new investment cycle, this time in cannabis. Just as with Petrobras in 2015-16 and uranium in 2018-19, we think the opportunity is too good to pass up and, as we have done on the other occasions, we want to focus on it.

First of all, let's eliminate some prejudice most of us have always held regarding cannabis. By its very definition, "prejudice" is a judgment made before having relevant and objective data about some subject in hand. Many of us think that the plant has only one use, and not the most noble, but this is not true.

Without getting into the definitions and concepts of species and cultivation, it is worth mentioning that cannabis today is known for the two most common active ingredients, CBD (cannabidiol) and THC (tetrahydrocannabinol). There are several others, such as CBN, CBG, and CBDA, however the most famous are still CBD and THC.

Both are used for therapeutic treatment of various types of pain, nausea, multiple sclerosis, osteoporosis, insomnia, anxiety, depression, Tourette's syndrome, glaucoma, epilepsy, and various other conditions. There are studies for the effectiveness of some products in the treatment of various types of cancer, Parkinson's disease, menopause, and others.

The other version of cannabis, known as hemp, is used commercially, in things such as in paper manufacturing, clothing, biodegradable plastics and biofuel, amongst other uses. As we can see, this plant has much wider applications than popular knowledge would suggest.

Furthermore, the advantages of cannabis over alcohol are numerous. It helps combat depression and anxiety, while alcohol, on the other hand, can cause these illnesses. Its use lowers blood pressure, does not harm the liver and reduces inflammation, while alcohol tends to raise blood pressure, attack the liver and cause inflammation.

On the growth side, cannabis is second to no other sector or segment of the economy. Many think that tech (technology companies) will grow the most, however, by the end of the decade, growth in the cannabis sector should leave all other sectors behind. Knowing this, the cannabis industry gains importance as a strong employer, especially in times of crisis. Today more than 420,000 people work in this industry, and this number is expected to grow even further in the coming years.

In 2020, global legal cannabis sales were \$23.7 billion, \$20.3 billion of which was in the US alone, the market we will focus on from now on. According to Equio, a consultancy specialized in the industry, the legal cannabis market will reach \$51 billion by 2025, which means a growth of 16.6% per year until then. The illicit market is multiple times larger and, according to estimates, is over \$400 billion today. The interesting thing is that as cannabis becomes legal and its use is widespread, part of the illegal market migrates to the legal one - and this migration hardly ever occurs in reverse, i.e. from legal to illegal.

Can you imagine what it would be like if each time you drank a Coca Cola and it tasted different? The standardisation of the product, which gives the user the certainty that he will always get a product identical to the one he consumed last time, is an important factor in this choice. This builds customer loyalty and has contributed to the reduction in consumption from illegal sources.

The cannabis market is exciting, and one would expect that shares of companies in this sector would trade at a significant premium to the market, since growth is strong and prospects are even better - but this is not the case.

As we have said before, whenever we see a discrepancy between reality and the story that is presented to us, we believe that there is an investment opportunity. That is why it is important to investigate.

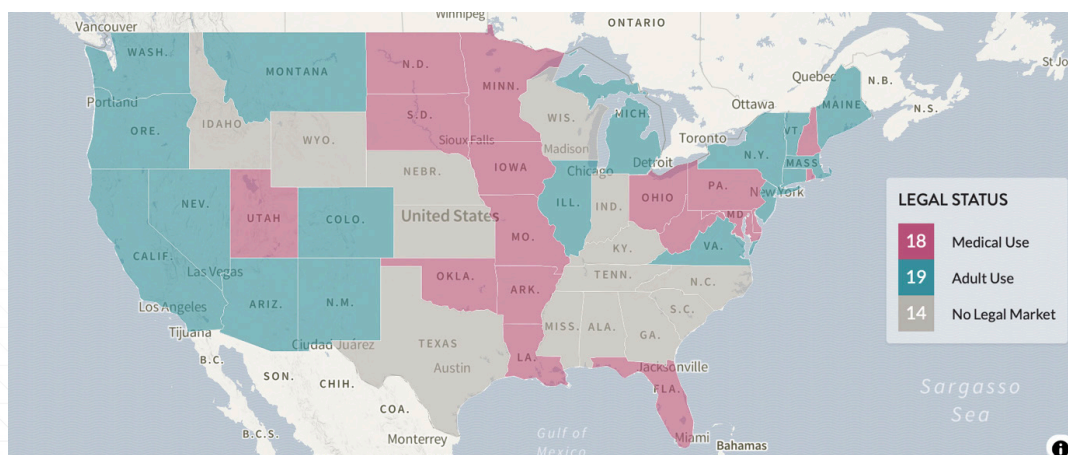
In the case of cannabis, the narrative is that the major laws impacting cannabis, which we will talk about later, will not pass congress and that this sector will be sidelined for many years, perhaps decades. It is interesting to see how the mind of investors work. A little more than a year ago, the comment was exactly the opposite: all these laws will pass quickly. At the time, the stock price was 4-5x higher than it is today, i.e., these stocks have already dropped 60-80% since the highs last year and are today trading at historic lows, even though their products are selling like water and all the ones we are analysing are growing well above the market average.

Buying shares of companies that grow more than 30% a year, with some moat, in a new, vibrant and booming market such as cannabis, which we believe is just at its beginning, at a steep discount to what we believe to be a fair price, is an opportunity that we cannot ignore.

You all know our investment strategy: find a solid investment thesis, with low risk, high return potential, in which the narrative diverges from reality and in which we can have an asymmetric and very favourable level of information - and focus on it. We “discovered” uranium in 2018, shortly after our investment in Petrobras. Since then, we were looking for another opportunity and finally found it.

Large companies like Constellation Brands, Altria and British American Tobacco have already made investments in the sector - Canopy Group, Cronos Group and Organigram, respectively. Several others are studying it and may enter it at any time, although we believe that they will only do so after some legislation is passed in the US congress. Companies like Coca-Cola, Pepsico, Procter & Gamble, Diageo, Anheuser Busch and Mars are watching, but the image risk for them at this point is very high.

Turning our attention to the USA, we can note that practically the entire West Coast has already liberalized the adult use of cannabis. This is not to say that cannabis is legal everywhere, as there are some cities in which cannabis is not yet legalized, although it is at the state level. It's a minefield and we like that.



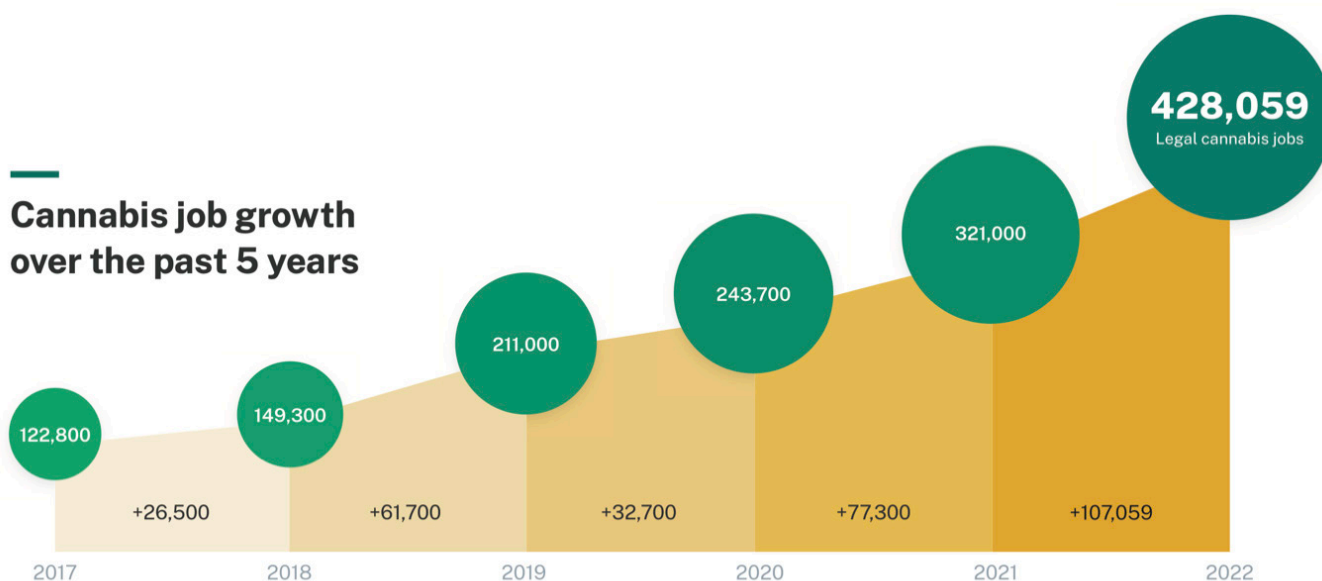
Fonte: Equio

However, we believe that it is only a matter of time before legalization happens in all states and in almost all cities. A poll done by YouGov a few weeks ago showed that the majority of the population is in favour of cannabis use and public opinion - and that of the electorate, of course - has a great deal of weight in conducting legislative matters.

Furthermore, many Republicans and the vast majority of Democrats and Independents are also in favour of legalization. In other words, in our understanding, the passage of laws favouring this market is a matter of time. As we like to say, it is a matter of "when", not "if".

Moreover, states begin with the approval of medicinal use, and soon after, release it for recreational use, which in this case denotes adult use. Once revenues (taxes) start pouring into the states' coffers, they realize how good and important cannabis is for everyone, and accelerate the legalization movement.

Elections are great for getting politicians to vote on issues that the population cares about - and cannabis is one of them. This is, of course, in addition to the fact that it creates a lot of jobs - according to Leafly, more than 420,000 people are currently employed in the industry, and as the sector is growing, this number is likely to increase significantly in the coming years and gain even more importance.



Fonte: Leafly Jobs Report 2022

This growth is impressive - in just one year, the cannabis sector, which is present in only 11 states (adult use) and 27 states (medicinal use) has created almost the same number of jobs as the financial sector (145,000), which employs about 9 million workers, and the construction sector (165,000), which employs 7.5 million people across the country from coast to coast. The potential and importance of the sector is undeniable.



Furthermore, the illegal market, which today amounts to more than US\$400 billion per year worldwide, is slowly being legalized. The benefits for companies are also remarkable, since they can work legally and more smoothly, grow (mergers and acquisitions and other financial operations), and have a scalable, standardized, and high-quality product.

For consumers, the advantages are also numerous, as they will know exactly the quality of the product they are buying, and will be attended in stores by trained people who understand the subject and can suggest the best options for proper treatment or use.

Finally, legalization helps to reduce crime. In short, everybody wins. For the above-mentioned reasons, we hope that several laws, which we will talk about below, will be approved - we don't know when, and we won't even try to guess, but, as in the case of Petrobras and uranium, if the only doubt we have is time, our case is very interesting and promising.

Furthermore, the cannabis sector is highly fragmented, leaving room for consolidation. This is most blatant in the US, where legislation changes from state to state and the large operators have to set up a separate structure for each state in which they operate.

Historically, this sector has little access to capital. Many of these companies find it difficult to open a bank account and, for this very reason, their day-to-day operations become much more difficult. Imagine operating a company, with dozens, hundreds or even thousands of employees, without a bank account. What to do on payday? How to pay suppliers, rents and suppliers? It is a challenge.

Private equity and venture capital funds usually cannot invest in these companies. Because big investors in these funds are pension funds that follow a federal agenda and because there is federal law classifying cannabis as a Schedule I drug, companies in the sector cannot attract the abundant institutional capital.

There has been a sharp drop in secondary offerings on the stock market for cannabis companies in recent months. This, in our understanding, is the result of a combination of two factors: first, companies do not want to sell shares at prices they consider significantly discounted, and second, investors are faced with uncertainty in the sector and would rather wait for firmer legislation that reduces or eliminates this risk. There was a financial squeeze that affected these companies in 2020, but what we are seeing now is far worse. To get an idea, secondary offerings are down 65% this year alone.

Another important point to keep in mind is the impact that the lack of proper legislation for the banking sector has on these companies. Many analysts believe that the bill that has just passed the US House of Representatives, the SAFE (Secure and Fair Enforcement) Banking Act, is a trivial bill, but we will talk about it and its importance later.

Moreover, legalization, which we believe is only a matter of time in other states and in the US in general (federal level), may generate more taxes for the government's insatiable appetite. Using Arizona data - and obviously this is only a sample - cannabis sales generated more tax revenue in March than tobacco (cigarettes and the like) and liquor sales combined. It was \$6.3 million from cannabis versus \$1.7 million from tobacco and \$3.7 million from alcohol. When other states realize the potential of this market, we may see a change in attitude quickly.

Speaking of the other states, cannabis sales in the US last year hit the \$25 billion mark (estimate). To put these numbers in perspective, the beer industry hit the \$94 billion mark, the wine industry \$78 billion, and the energy drink industry \$20 billion. Because of the high taxes, which we will talk about below, this sector generates much more revenue for the state via taxes than other “competitors”.

And investment in cannabis has been fireproof. The business proved resilient throughout the pandemic - in fact, it kept growing. Obviously, part of this was because of generous stimulus packages from governments, especially that of the US, but even now, in the midst of this huge crisis, the cannabis market continues to grow.

According to New Cannabis Ventures, the largest US companies, also known as MSOs (multi-state operators), raised almost \$1 billion early last year and are capitalized. This money, plus the cash generation, should also be used to acquire new companies in the sector, starting the consolidation process - this is our expectation for the coming years.

In fact, it is our view, as sceptics, that it is in the interest of the large companies in the sector, the MSOs, to keep the legislation the way it is, so that the prices of small companies remain low and allow the larger ones to gain market share through acquisitions at much lower prices. Yes, the larger companies are trading at prices far below what we think is ideal, however the smaller ones are overly discounted and are being swallowed by the larger ones at multiples of 3-4x EBITDA.

First of all, we have to be realistic. We expect that growth, which so far has been nothing short of spectacular (the revenue growth of the companies we are analysing was something between 34% and 134% last year), will slow down in 2022, but should accelerate from 2023 onwards. Companies are “cleaning up” operations after some acquisitions, improving execution, entering new states, and developing new products.

Thus, the gains this year should come from increased market share and industry consolidation, mainly through acquisitions of small players in a single state. We are following this closely in order to make the most of the movement. We are not expecting any laws to be passed that may help the sector - that is, if any surprises come, they will be very positive.

The wholesale part, is, in our opinion, the weakest link in the chain - it is unlikely that operators in this area will make significant profits. The same might happen with the so-called dispensaries, who ride the wave when the market is doing well, but expose themselves too much to uncontrolled risks, something that we believe is not worth it.

Thus, we have a preference for large operators with strong cash flow generation, solid position in several states, and already well established. We believe that the cannabis market as a whole will be very good over the next few years and that small companies will get a higher share price, but we will stick with the less risky ones - which nevertheless have huge potential.

## ESG

Before getting into the subject of ESG, it is important to differentiate between cannabis and hemp. They look alike, they are from the same family, but they have very different uses. Cannabis has a high TCH content, somewhere between 5% and 25%, and this is the substance responsible for the psychotropic effects. Hemp, on the other hand, has less than 0.3% THC content. There are several other differences such as time for growth and plant size, but this is the differentiation that interests us for the purpose of studying the ESG criteria.

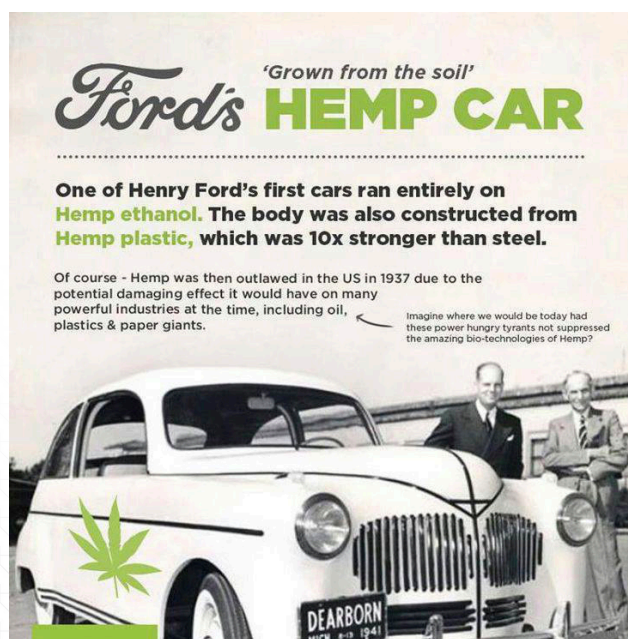
As it could not be otherwise, we have a different view from others regarding the famous acronym ESG, but we are aware that our opinion on this matter is a minority one and will not impact anything. So it is good to keep in mind how the cannabis sector is viewed from an ESG perspective.

We believe that it will be one of the most benefited sectors, especially on the social side. Several laws are being discussed at the moment to give a boost to what the Democrats call "social justice" - a debatable ideology, of course, but again, our opinion is irrelevant. The important thing is that this movement should gain even more momentum in the coming years and will be very positive for the cannabis industry.

Aid for small producers, community involvement - especially black and Latino communities - reparations for previously affected communities, more rights and protection for employees and users will give a good boost to the sector.

Moreover, on the corporate governance side, the industry is highly regulated in most countries/states where use is allowed. This gives us access to data that many other industries do not make easily available. Data security and privacy will also help.

On the environmental side, we can mention the many uses of hemp. An interesting fact that few people know is that Henry Ford created a car that used hemp, not only as a plastic that was lighter and stronger than steel and thus required less maintenance, but also to increase the efficiency of the fuel - which also used hemp oil.



In addition, several companies are launching hemp-based products such as footwear, clothing, canvas, frames, diapers, bags, oil-based paints, solvents, cosmetics, shampoos, food supplements, and more.

In short, cannabis passes the ESG test with flying colors, which should be one of the main drivers for market growth in the coming years.

## Legislation

This is perhaps the most important part of the investment. That's why we invest a lot of time in this topic, even though it is an educated guess, i.e. you can't predict exactly, but you can have an idea (the famous "we won't get the exact street number, but we will get the neighborhood").

First of all, it is important to know what happened in the past in order to understand the sector better. After the election results in 2020, several investors rushed to invest in cannabis. The idea was that since the Democrats came to control the White House, the Senate, and the House, bills that would favor the cannabis sector would pass swiftly.

With that, stock prices skyrocketed (using the POTX ETF as a yardstick, the rise in just 3 months was over 160%) and, of course, there was only room for disappointment. Now, with stock prices on the basement, we believe the risk has been greatly diminished. As we have said many times before, risk comes from many different parts and is unpredictable. The most consistent way we have to mitigate risk is to buy when it's cheap - and we think the sector presents a risk x return ratio like no other at the moment.

With the appointment of a black woman to the U.S. Supreme Court and the Russia-Ukraine conflict gaining ground in the news, few politicians have had the time and interest to talk about anything else. Now, with the confirmation of the first black woman to the Supreme Court and the beginning of Americans' discontent with the situation in Russia/Ukraine, we may have room for some approval - although this is not our baseline scenario. So let's talk a bit about the bills that are about to be voted on.

The first of these is the SAFE Banking Act (Secure and Fair Enforcement Act). Currently in the US, it is difficult for a cannabis company to open a bank account and enjoy the benefits of that financial relationship. This includes payment of employees, rents, suppliers, and other banking products such as insurance and the likes.

The SAFE Banking Act is designed to prohibit federal regulators from punishing financial institutions that do business with cannabis companies.

Being able to open a bank account and operate with financial institutions is extremely important these days, practically indispensable. In addition to making life easier for entrepreneurs, cannabis companies will be able to do business with credit cards, which notably increase the volume of transactions and product baskets.

Even more important is the impact that the new (SAFE) legislation will have on AML (anti-money laundering) processes, as well as providing greater peace of mind for companies such as institutional investors and insurance companies to do business with - and buy shares of - cannabis companies.



This will pave the way for cannabis companies to list their shares on US exchanges, where the volume of funds and scope of investors is significantly greater. Currently cannabis companies are almost all listed on second-tier exchanges in Canada and the difficulty of investing in them is a hindrance.

We have several cases of acquaintances who have invested in the sector and the banks or brokers did not want to custody the assets, so they had to sell their positions. We ourselves had difficulty in getting authorization to buy shares, even though they are listed on a stock exchange in Canada, a first-world country where the legislation allows this kind of investment.

Just imagine the flow of capital that must be attracted to a sector that is growing at high rates and trading at historic lows with low risk. Real money, which is controlled by pension funds, large mutual funds, hedge funds, private equity funds, and institutional investors in general, will enter this sector with incredible speed and force.

Finally, as many of these companies have difficulties opening bank accounts, they keep a high volume of cash in the stores - besides the difficulties mentioned above, there is also the risk of robbery, and this is not low.

In 2020, stores selling cannabis experienced 27 armed robberies. In 2021 that number jumped to 34, which was even quite acceptable compared to the more than 70 this year so far. As the number of robberies and related crimes is increasing dramatically, the importance of this legislation is even greater, as it will protect lives and help maintain the physical integrity of workers, as stores will have less cash available at the tills and will be able to take out insurance.

As we mentioned above, this bill has already passed the House of Representatives (321 votes in favor and only 101 against) on April 19 and is now in the Senate. Senator and Democrat party leader Chuck Schumer has said that he will send the bill to be voted on before the August recess. According to the Senator, "Make no mistake, I'm working diligently with my Senate colleagues to make sure that the federal government catches up. This bill will be comprehensive, and I promise we will introduce this important legislation before the August recess."

Schumer and several other Democrats have been working on this bill for over a year, but we still prefer to wait and see if it actually happens. It wouldn't be the first time that he promises to put legislation to a vote and fails to deliver. Politicians have their own agenda and it would be naive of us to believe any of them.

In addition to SAFE, there is also the MORE Act (Marijuana Opportunity Reinvestment and Expungement Act). This bill is quite important for the industry and will remove cannabis from the list of controlled substances and eliminate penalties for already convicted offenders.

Despite support from both parties, Democrats and Republicans, this law, as written, will act retroactively. This means that anyone who has been convicted of cannabis use or trafficking in the past and is currently serving time can be "pardoned." And that is the big point of the debate between the two major parties.

The Democrats believe in what they call "social justice" and how much this law will favor minorities, while the Republicans want this law to be valid only as of the moment it passes - without retroactivity - and anyone who has committed a crime in the past has to pay for it. Of course, if passed, this will be a federal law, and states can still criminalize cannabis use and trafficking - although if this law is even ratified, it would be a huge step towards decriminalization.

Finally, of the more important bills, there is also the CAOA (Cannabis Administration and Opportunity Act). This bill aims to end the federal prohibition of cannabis and purge non-violent federal crimes by allowing individuals who are currently serving time to petition the Court to review their sentence. Further, this bill will create an "Opportunity Trust Fund," which will receive funds from legal cannabis sales, and invest in the communities most affected.

Cannabis is referred to as a Schedule I substance, along with heroin, LSD and the like. One big problem this causes is with regard to taxes. In the US Internal Revenue Code (IRC), more specifically in section 280e, we can see the impact of this.

According to this section, which is rather small, cannabis companies operating in states where its use is legal cannot deduct operating expenses from income. Consequently, the effective tax rate for these companies is extremely high, reaching almost 70%.

To summarize: all of the proposed legislation, by and large, is somehow supported by both Republicans and Democrats - the difference is that Democrats see these laws as a unique opportunity to be able to include "social justice," so we can conclude that the laws will eventually pass, with some changes in the wording, of course. We don't know when they will pass, but we have little doubt that they will.

## Opportunity

Anyway, as we mentioned, investing in cannabis is very simple in the end. It is about investing in a market with huge growth ahead, low risk - since it is an existing product, with valuations at historic lows, potential returns well above market returns, and several potential triggers for unlocking value.

In addition, it is a very fragmented sector and there are few players with the ability to consolidate. These companies are expected to grow more, faster and with less risk, and it is on these that we will focus at the beginning.

With the possibility of shares being listed on U.S. exchanges (or even the TSX), the flow of capital should propel the stocks - and a lot. We are entering the sector now knowing clearly that these triggers may not materialize in the short term, but we don't want to wait for any of them to happen in order to get in. Getting in early and being able to absorb the volatility always pays good dividends for us investors. The cost of being left out of such an opportunity is high.

