

INVESTING IN CANNABIS

THE NEXT GREAT
INVESTMENT OPPORTUNITY

DAN AHRENS

WILEY

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Investing in Cannabis

***The Next Great Investment
Opportunity***

Dan Ahrens

WILEY

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

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Library of Congress Cataloging-in-Publication Data

Names: Ahrens, Dan, author.

Title: Investing in cannabis : the next great investment opportunity / Dan Ahrens.

Description: First edition. | Hoboken, New Jersey : John Wiley & Sons, Inc., [2021] | Includes index.

Identifiers: LCCN 2020034694 (print) | LCCN 2020034695 (ebook) | ISBN 9781119691013 (hardback) | ISBN 9781119691006 (adobe pdf) | ISBN 9781119690993 (epub)

Subjects: LCSH: Marijuana industry. | Cannabis--Economic aspects. |
Marijuana--Economic aspects. | Investments.

Classification: LCC HD9019.M38 A47 2021 (print) | LCC HD9019.M38 (ebook) |
DDC 338.4/763379--dc23

LC record available at <https://lccn.loc.gov/2020034694>

LC ebook record available at <https://lccn.loc.gov/2020034695>

Cover Design: Paul McCarthy

Cover Art: © Getty Images | Lalita Chaudhari / Eyeem

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Preface

book about investing in cannabis was not even possible just a few short years ago. There wasn't enough to invest in! Publicly traded and exchange-listed cannabis stocks have exploded onto the scene with legalization in Canada and a constantly growing list of locations in the United States. Cannabis includes both medical and recreational adult-use marijuana, but also hemp-based CBD (cannabidiol) and other cannabinoids with a long list of potential uses. Pharmaceutical and biotech companies are just scratching the surface of cannabis-based applications. Marijuana dispensaries are quickly opening all around the United States, Canada, and in countries across the globe. Cannabis based products are everywhere – lotions, oils, beverages, food – wellness products of all types for humans and for pets.

This book will focus of investing in cannabis through publicly traded stocks that are available to everyone. The opportunity is substantial. The new business of cannabis will have great success stories but will also have abysmal failures. As a new industry, the ups and downs will be extreme. A lot of companies won't make it. Some may be downright fraudulent. We will discuss the state of legalization and name the top cannabis operators in the United States and Canada, in biotech and pharmaceuticals, CBD, and all the other associated businesses. I'll tell you what to look for, and what to avoid.

Acknowledgments

his book and our cannabis funds would not have been possible without contributions from a great number of people. I would like to thank AdvisorShares CEO Noah Hamman for his ideas and for his drive to get the first cannabis focused, actively managed, exchange-traded fund launched in the United States. And to everyone else at AdvisorShares, thanks for all you do. Managing Director of Distribution James Carl helped with some great data and charts. Thanks to Lynn Brautigan and Mackenzie Peterson in our marketing department for all their constant work on content. Lynn created some nice-looking charts for the book. Investment Consultant Lance Davidson – keep up the great communications. Thanks to our Chief Compliance Officer Stefanie Little. And thank you to Ryan Graham, a Vice President at JConnelly PR, for your good work with the press.

For the launch of my firm's cannabis-related funds, a great many people at partner firms and servicing firms were involved. There are too many to name but include people at trading firms, swap dealers, market makers, authorized participants, legal firms, tax and audit, and of course the fund distributor, fund administrator, and the stock exchange.

All of the people in various groups at Bank of New York Mellon and BNY Mellon Asset Servicing for Exchange Traded Funds have been great to work with. We've been fund clients of BNY Mellon for more than 10 years and brainstormed with them about cannabis stocks for well over a year before launching our fund. I appreciate their understanding of what's legal and what's not, and how to handle our cannabis investments properly.

The Exchange Traded Products team at the New York Stock Exchange have been great partners and helped us launch dozens of funds quickly and efficiently. They've also helped us get some great ticker symbols.

Our outside counsel at Morgan, Lewis & Bockius LLP have represented AdvisorShares since our founding and always aided us in being an innovative fund company. They are the best in the business of exchange-traded funds.

The team in Global Securities Finance at Cowen Execution Services LLC / Cowen and Company LLC have been instrumental in our fund's investment process and in our access to the US multi-state operators we invest in. Cowen has been an essential firm in North American cannabis expansion.

Thanks to Kevin Harreld, senior acquisitions editor at John Wiley & Sons, for seeking me out and for support all along the way.

Thanks to my beautiful wife, Lana Ahrens. Forced to read a few of the early chapters in development, she claimed that she actually found the book interesting. Owen Ahrens and Arden Ahrens – thank you for being born and for being generally great kids. Keep making those good grades in school.

Chapter 1

Like Investing in Alcohol at the End of Prohibition

“Prohibition has made nothing but trouble.”

—Al Capone

On December 5, 1933, at 3:32 p.m. local time, Utah became the 36th state (the required three-quarters of the 48 states) to ratify the Twenty-First Amendment to the United States Constitution. Prohibition ended. Only 16 years earlier in 1917, the Eighteenth Amendment had been proposed in Congress to establish a ban on the manufacture, transportation, and sale of “intoxication liquors” in the United States. Circumstances made Prohibition a failure, and the Eighteenth Amendment was the first Constitutional amendment in the history of the United States of America to be repealed. The primary reason – money.

The 1920s (the roaring twenties) were a boom time for the US economy. Life was good. Following victory in World War I, the United States was becoming a true world power. New consumer goods spread into households with the advent of mass production, and the modern automobile and airline industries were born. The US financial system was thriving without the legal sale of alcohol. But the Eighteenth Amendment had actually done little to curb the sale and consumption of liquor. It was simply transported and sold illegally. It was done with a wink and a nod among many Americans. The Volstead Act (formally named the National Prohibition Act) was a law that became effective on January 17, 1920, to provide enforcement for the Eighteenth Amendment. It created a special enforcement unit of the Treasury Department (Bureau of Prohibition), and formally

began Prohibition. For the wealthier, more powerful, or simply “connected” individuals among American society, drinking came easy. It almost turned into a game of enjoying smuggled alcohol and visiting speakeasies. In another interesting side effect of Prohibition, increasingly strong distilled spirits surged in popularity. The appeal of beer and wine was diminished. Distilled spirits were more profitable to produce, cheaper to transport, and easier to smuggle into the country.

Despite policing efforts of the Treasury Department and other law-enforcement agencies, organized crime reaped the real benefits of the illegal alcohol trade. Organized crime flourished. Organized crime became more organized. With America enjoying good fortune in the twenties, many people weren't concerned with crime – especially crime involving alcohol. Gangsters often became glorified celebrities. Everything was fine until the economy suddenly and violently came crashing down. America's Great Depression began with the Black Thursday stock market crash of October 24, 1929. The Great Depression happened for a host of reasons. The stock market crash followed a period of gross overconfidence and overproduction of goods. A panic in the stock market sparked a panic at the banks. A weak banking system allowed banks to fail and close. Bankruptcies and job losses snowballed.

While the United States was navigating through the Depression, the federal government desperately needed revenue if it were to help set the economy on a correct path and put jobless Americans back to work. Federal income taxes had only been created a few years earlier with the Sixteenth Amendment of 1913. It was a major shift in the federal government's revenue system. Prior to creation of the income tax, alcohol taxes had generated as much as 40% of the federal government budget. With Prohibition, the government had quickly become incredibly dependent

on income tax as its primary revenue source. The Depression changed that. Incomes suffered and income taxes suffered. Income tax revenue dropped 60% from 1930 to 1933. The legalization and taxation of alcoholic beverages was an easy target. In the 1932 presidential election, the Governor of New York, Democrat Franklin D. Roosevelt (FDR) campaigned against the financial failures of President Herbert Hoover's administration. The repeal of Prohibition was an important part of Roosevelt's Democratic Party platform. He easily defeated the incumbent Hoover in a landslide victory on Tuesday, November 8, 1932. Just three months later in February of 1933, Congress would propose the Twenty-First Amendment to repeal Prohibition.

The end of Prohibition was a major financial victory for the federal government. Millions of dollars collected in alcohol taxes helped to finance President Roosevelt's New Deal programs in the years that followed. Alcohol helped to financially heal the country as it slowly recovered from the worldwide economic crisis – the most severe in the history of the industrialized world.

Any long-term investor putting money in a diversified group of alcohol stocks near the end of Prohibition would do very, very well. The performance numbers from 1933, or anywhere around that time, up to the present day, are rather remarkable.

Time to Buy

Using US publicly traded stock price data from the well-known and publicly available CRSP (Center for Research in Security Prices) library of Dr. Kenneth French, Tuck School of Business at Dartmouth College, we looked at the exchange-listed securities of the US stock market broken down into 30 industry portfolios. Among a myriad of

available data points for stock prices and dividends going back to 1926, the database provides monthly investment returns for each industry grouping. We chose to begin in 1933 – the year that Prohibition was repealed in the United States. We're certainly not the first to study this industry data. Numerous case studies have been completed and articles have been written using various timeframes and methods for crunching the data. The results are the same. From the lows of the Great Depression, alcohol stocks outperformed the other industries and outperformed the general market.

Beer and alcohol total return of \$10,000



Source: AdvisorShares, based on data from the CRSP library of Dr. Kenneth French, December 31, 1932, to December 31, 2019

Admittedly – compounded investment performance over a long period of time (like more than 85 years) can cause a

very exaggerated graph. The early years of a long-term compound return chart usually look almost flat. The stock performance of alcohol in the 1930s was anything but flat. It was extremely volatile. But the fact remains that since 1933 alcohol stocks have outperformed other industries such as chemicals, communications, construction, financials, healthcare, oil, and retail. As we started our calculations in 1933, annualized industry performance numbers may look better than expected, but please remember that we're calculating from a seriously low point in the years following the stock market crash in 1929. Another industry performed almost as well as alcohol. It was tobacco. If you're thinking of similarities to marijuana or cannabis, you're right. But there is much more to follow.

30 industries listed in the CRSP library, annualized performance December 31, 1932, through December 31, 2019	
Industry	%
Automobiles and Trucks	11.00
Beer and Alcohol	13.54
Printing and Publishing	9.45
Business Equipment	12.87
Aircraft, Ships, and Railroad Equipment	12.89
Chemicals	11.27
Apparel	11.13
Construction and Construction Materials	10.99
Coal	7.82
Electrical Equipment	12.54
Fabricated Products and Machinery	11.75
Banking, Insurance, Real Estate, Trading	11.65
Food Products	11.85

Recreation	12.57
Healthcare, Medical Equipment, Pharmaceutical Products	12.67
Consumer Goods	11.53
Restaurants, Hotels, Motels	12.66
Precious Metals, non-Metallic, and Industrial Metal Mining	9.02
Petroleum and Natural Gas	11.80
Everything Else: Sanitary, A/C, Irrigation, Cogen	9.46
Business Supplies and Shipping Containers	11.45
Retail	12.48
Personal and Business Services	12.92
Tobacco Products	13.13
Steel Works	8.64
Communication	9.97
Transportation	10.41
Textiles	10.69
Utilities	9.60
Wholesale	12.06

Source: Performance calculated by AdvisorShares Investments, LLC.
Average value weighted returns from monthly performance data from the CRSP library of Dr. Kenneth French.

In October of 2018, an article was published by *Barron's*, "What Alcohol Stocks During Prohibition Say About Marijuana Stocks Today," by Al Root. The article's main point was that the value of alcohol stocks dropped after Prohibition was lifted. While factually correct, I feel the premise of the article was all wrong. The article was pointing out that alcohol stocks were a lousy investment in the year that followed the end of Prohibition. Alcohol didn't automatically go up beginning on December 5, 1933. What

the article failed to mention was that alcohol stocks had already gone up more than 350% following Franklin D. Roosevelt's (FDR's) presidential victory in November of 1932 and the Twenty-First Amendment being proposed in Congress in February of 1933.



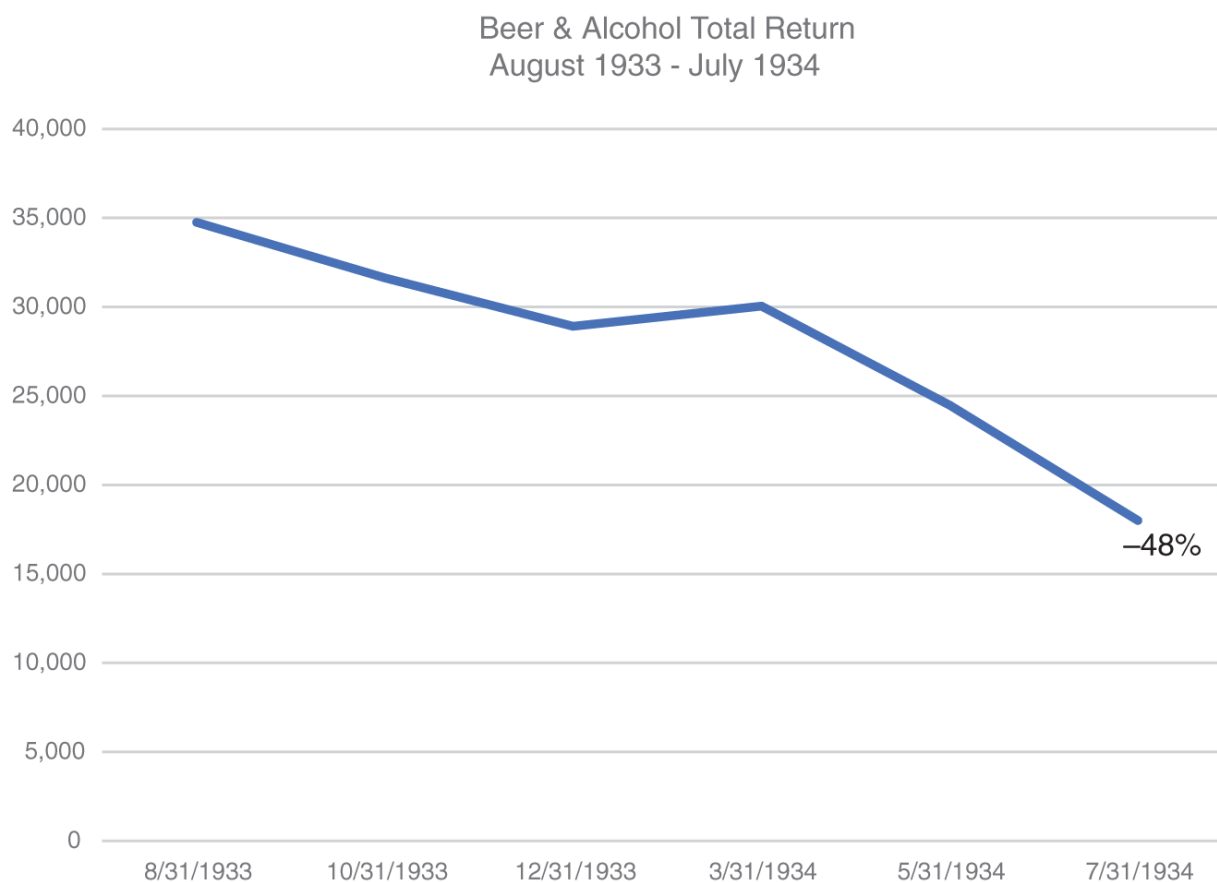
Beer and alcohol total return, February 1933–August 1933

Source: AdvisorShares, based on data from the CRSP library of Dr. Kenneth French.

While alcohol's manufacture and sale had “only” been illegal for 14 years, it was once again a new industry in the United States that required hard work to recreate operations and infrastructure – and to replace the alcohol black market that had been operating since 1920. Extreme stock price volatility followed.

From a high point in August of 1933 to a temporary low around July of 1934, alcohol stocks as a group dropped

almost 50% in value. As the *Barron's* article described – a poor investment.



Beer and alcohol total return, August 1933–July 1934

Source: AdvisorShares, based on data from the CRSP library of Dr. Kenneth French.

When investing, it's very important to understand the psychology of investing. What makes a stock go up or down? More than anything, it's about supply and demand. When investors have demand for a stock, that demand means there's more buyers than sellers. There's buying pressure. The stock price goes up. I'm pointing this out now because in June or July of 1934 there wasn't any buying pressure on alcohol stocks. After a great run-up following FDR's victory and in anticipation of Prohibition coming to an end, alcohol stocks turned terrible again. Investors were sellers. Alcohol stocks went down in almost every month

over an 11-month period. Some investors may have been selling to lock in their gains from the previous year. Other investors probably thought they were too late and had missed the boat on investing in alcohol stocks.

By October of 1935, alcohol stocks gained almost 100% from the lows in the summer of 1934. What changed? I don't know. Some wise investors must have decided that alcohol was undervalued once again and had the long-term vision to buy at low prices. Once stock prices reversed, other investors joined in. Plenty of ups and downs followed.



Beer and alcohol total return, July 1934–October 1935

Source: AdvisorShares, based on data from the CRSP library of Dr. Kenneth French.

Through truly extreme volatility at the end of alcohol's Prohibition, even the years 1933 through 1935 provided terrific investment performance to early investors.



Beer and alcohol total return of \$10,000, 1933–1935

Source: AdvisorShares, based on data from the CRSP library of Dr. Kenneth French.

While the alcohol industry in the 1930s was highly volatile, in the decades that followed it turned into one of the steadiest, most predictable industries around. The alcohol business is often referred to as recession-proof. People are going to drink no matter what's going on with the economy – no matter what's going on with the stock market. People don't stop drinking when the stock market drops. They may even drink more! The spread of coronavirus (COVID-19) in 2020 isolated people at home and caused a definite spike in alcohol sales across the board. In the longer term, when the economy slows or the overall stock market dips, investors traditionally shift to safer, more predictable investment sectors such as consumer staples – and alcohol.

The health of the alcoholic beverage industry is distinguished by three major characteristics:

1. Concentration
2. Profitability
3. Barriers to entry

Over the years, the alcohol industry has undergone considerable consolidation. The alcohol industry grouping in the CRSP library that we studied has contained as many as 26 constituents and as few as 4 in the periods since 1933. Alcohol has become a very mature industry, and breaking into the domestic market is very difficult for new companies. The industry is dominated by the largest players. The predominant alcohol companies employ large legal departments and undertake very significant lobbying efforts in Washington, DC, and in state legislatures all around the country. They are simply very accomplished at navigating a highly regulated and sometimes contentious industry. But – the alcoholic beverage industry is also a highly profitable business. Competition among the top beverage companies is fierce. Constant new product innovation combined with a fat advertising budget is paramount. The best companies have dominant distribution networks and are masters of promotion.

People may drink alcohol no matter what's going on in the world, but they don't always drink the same thing. In the United States and around the world, shifts in alcoholic beverage sales are caused by changing tastes, demographics, and disposable incomes. Along with rising incomes and a strong economy come sales of fine wines and high-end spirits. Mass-produced lower-end beers have been on a slow decline. Craft beers and, more recently, craft liquors have been on an upswing. Smaller startups in craft beer, small production wines, and designer distilled

beverages are often targeted for acquisition by their bigger competitors.

All of this brings me back to cannabis. In some circles, cannabis has been called a long-term risk to the alcohol industry. Top alcoholic beverage companies have even expressed concern in annual reports and investor conference calls about cannabis legalization cutting into alcohol sales. In a paper published in early 2018 and cited in numerous publications, researchers at three universities described a joint study covering a 10-year period in US counties with legalized cannabis sales. They claimed a 13.8% drop in beer sales following the legalization of marijuana. The study showed considerable overlap in the consumer base for legal marijuana smokers and beer drinkers. Overall, data showed that sales of alcohol were 15% lower on average in states with legalized marijuana. But another study showed just the opposite. A January 2019 report from the Distilled Spirits Counsel, and quoted in *Forbes* and other major outlets, stated that “there is no evidence that legalization has had any impact on spirits sales, nor is there any evidence that it has impacted total alcohol sales.” They studied the three states with the longest history of legalized recreational marijuana sales: Colorado, Washington, and Oregon. Per capita spirits sales actually increased since recreational marijuana legalization went into effect in each state. Wine sales were mixed – up in two states, down in the other. Per capita beer sales declined in all three states, but consistent with the national trend in beer sales and not isolated to just these three states. It is interesting that supposedly scientific studies can vary so much depending on who's doing the study.

Regardless of whether cannabis legalization has any real impact on alcohol sales, savvy beverage companies are quickly jumping into the cannabis business. Cannabis

companies and beverage makers are both investing heavily in the potential market for cannabis-based adult beverages.

Big beer company Heineken launched Hi-Fi Hops, a cannabis-only beverage available in California dispensaries under its Lagunitas brand. It tastes like beer but contains no alcohol. The world's largest brewer, Anheuser-Busch InBev, and a large public Canadian cannabis company are in a joint venture to produce cannabis-infused beverages. Canadian American brewer Molson Coors is in another. Diversified alcoholic beverage giant Constellation Brands invested over \$4 billion in 2018 for a 38% ownership stake in Canada's largest marijuana company. Canadian cannabis beverages just began to hit store shelves for the first time at the very end of 2019 - and in limited amounts. Beverage production and sales are expected to explode through 2020 and 2021. The cannabis beverage market alone is expected to be worth billions in the United States and Canada by 2022. But that is just one very small piece of the potential for total cannabis sales.

Will the overall cannabis business of the future look much like the alcoholic beverage business of past decades? Highly profitable. Concentrated. Innovative. Influential. Recession-proof? Time will tell.

Chapter 2

The Feds, the DEA, and the War on Drugs

"Drugs are bad."

– Mr. Mackey, South Park Elementary

The legalization of cannabis may present an amazing investment opportunity. But wait. Why is cannabis illegal in the first place? Most people just assume that marijuana or cannabis has always been illegal. It's a drug. Drugs are bad. But it's not as simple as that. Marijuana's criminalization is a convoluted story full of money, politics, racism – and conspiracy theories.

Federal level marijuana prohibition began just a few short years after alcohol prohibition was repealed. The Marihuana Tax Act of 1937 used an excise tax on all sales of hemp to effectively make possession or sale of marihuana illegal throughout the United States. (Notice that it was spelled with an "h"). Government sentiment against narcotic and other drug use began in the late 1800s and gained steam through the early 1900s.

Before it was made illegal, cannabis had been used in the Americas for hundreds of years. Land-owning American colonists of Jamestown, Virginia were expected to grow and export hemp plants to support their benefactors in England. George Washington grew hemp at Mount Vernon as one of his primary crops. Thomas Jefferson also grew hemp, as did many farmers of the day. Hemp was used as rope, fabric, and even a fuel source. In 1799, Napoleon brought other strains of cannabis from Egypt to France, and Europe began to learn of the medicinal qualities of

cannabis. By the 1840s and 1850s, cannabis extracts and tinctures were going mainstream in American and European pharmacies as a treatment for countless maladies. Separately, smoking hash was thought of as a fashionable and exotic habit among middle- and upper-class society. Hundreds of hashish parlors emerged in New York and other east coast cities. But the word marijuana or “marihuana” was little known to most Americans.

Which brings us to the supposed conspiracy to exterminate the hemp and cannabis business leading up to the Marihuana Tax Act of 1937. Our characters are newspaperman William Randolph Hearst, the Du Pont family and their DuPont chemical company, Andrew Mellon and Mellon Bank, and Mellon's relative by marriage, Harry Anslinger.

Hearst was the most powerful media mogul of the time. His vast array of newspapers and magazines were the most read nationwide. As a newspaper man, he was supposedly heavily invested in the timber industry for the development of paper products. Dupont was the maker of synthetic materials and had just invested nylon in 1927. Nylon could revolutionize the textile industry and begin to replace the use of natural fibers. Andrew Mellon was the nation's richest man when he was appointed Secretary of the Treasury in 1921. Mellon Bank was one of the most powerful financial institutions in the world, and Mellon Bank was also the financial backer for DuPont.

In 1930, as Secretary of the Treasury under his third president, Andrew Mellon was in position to appoint the founding commissioner to the Treasury's new Federal Bureau of Narcotics (FBN). He appointed Harry J. Anslinger. Mellon was uncle to Anslinger's wife. Remember that the Treasury Department was also the main enforcer for Prohibition. With the loss of alcohol prohibition as one

of the Treasury's main functions just a couple years later, it's thought that Mellon and Anslinger needed a new illegal substance to focus efforts and budgets on. That new focus was squarely on marijuana. Anslinger needed to justify his bureau's very existence. The Commissioner of the FBN became a very aggressive and outspoken critic of marijuana usage.

With Harry Anslinger fighting a war on drugs (before that term existed), others ostensibly joined in to demonize marijuana use. The rich newspaper baron Hearst used his influential portfolio of newspapers and magazines to sway public opinion on the evils of the mind-altering marijuana plant. Advertisements and articles pointed to the rise of crime, violence, and purported "sexual deviance" with marijuana use. Rhetoric from Anslinger, Hearst and other anti-drug propagandists primarily targeted non-white and lower-class communities. Extreme racism and class warfare ran rampant.

There's conflicting information about where the term marijuana even originated. US immigration from Mexico surged between 1910 and 1920 with individuals wanting to escape the violence of the Mexican Revolution. It's believed that Mexican immigrants in the southwest brought casual smoking of the marijuana plant along with them. We don't know if the word was spelled "marihuana" in government documents purposefully or by accident. We do believe that those looking to undermine marijuana chose a word that was foreign to most Americans and as a way to connect it to immigrants and minorities while dissociating it from socially acceptable hemp or medical cannabis.

While Hearst and Anslinger campaigned against marijuana on what they claimed were moral grounds, other conspirators possessed financial interests. The US tobacco industry was booming. Marijuana leaf could be a