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Bitcoin: Buy Or Buyer Beware?

Bitcoin—the digital currency barely a decade old—has reached a record high this year. Although not without its drawbacks, it may have merit in our growing digital-based economy. This month, we examine how bitcoin has risen to be a hot topic for advisors, the advantages it offers, and its prospects for becoming a viable and global medium of exchange. We also explain the risks, the most important being buyer beware.

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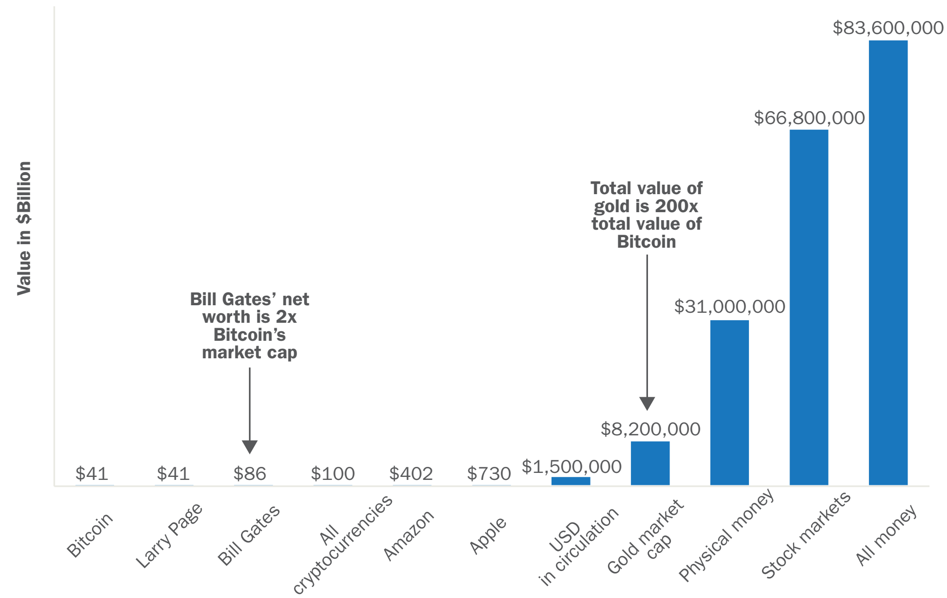
Bitcoin – the controversial new-ish digital currency that has been much in the news of late – had an eventful first day of August, when it was announced that henceforth there would be two versions of the cryptocurrency. How that will affect valuation remains to be seen, and for now, this is a small tempest in an even smaller teapot. After all, bitcoin has a total market capitalization of barely $45 Billion, which is a pittance compared to hundreds of trillions in stocks, bonds, and other financial instruments worldwide (Figure 1).

And yet, in speaking with clients, advisors report that questions about bitcoin are among the most prevalent curiosities of investors today. So with equity markets in a consistent uptrend (as of this writing at least) and bonds stuck in a narrow range with a slight bias toward higher rates, we thought to turn to the bitcoin conundrum.

Why bitcoin matters

In sheer dollar value, bitcoin may be small, but its impact is potentially large. It—along with a few other crypto or digital currencies—could

Figure 1:
How Big is Bitcoin?
Bitcoin vs. the world's money (in $Billion)



Source: Howmuch.net, June 2017. All money refers to money in any form including bank or other deposits as well as notes and coins. Physical money refers to money in forms that can be used as a medium of exchange, generally notes, coins, and certain balances held by banks.

become a new, global means of exchange. It is issued by no government; it can be used without the intermediation of banks; it does not require cumbersome custody arrangements; and it can be used for peer-to-peer transactions almost instantly, across borders, and between any two parties. Its algorithms, based on a complicated ledger known as the blockchain, make it uniquely secure from hacking and counterfeiting.

Bitcoin has also been on a tear of late, rising from barely $1000 at the beginning of the year to nearly $3000 in July. That may be one reason for such investor interest. Anything that runs that much quickly attracts attention and curiosity.

Not all of the attention has been positive of course. Famed investor Howard Marks of Oaktree Capital recently warned his clients that bitcoin was not only too risky but inherently flawed. The currency, he wrote, has “no intrinsic value,” and is worth only what buyers, sellers and traders will pay for it. The result, Marks argued, is that bitcoin is a bubble or a Ponzi scheme, and that it can only end badly for those who buy it or invest in it.

Perhaps. It is certainly true that a chart of bitcoin over the past few years would show both extreme volatility and a recent surge that looks like a typical bubble pattern (Figure 2). Based on past oscillations, it would not be surprising if the currency were to give up some of its recent gains in the near-term. The question for investors, then, is whether Marks is inherently correct, or whether the apostles of bitcoin—who claim that it will, over the next decade, become a viable global medium of exchange—are on to something that skeptics such as Marks fail to appreciate.

There are at least two reasons to challenge the skeptics: one is that bitcoin offers advantages in a globalized world that is still in the early stages of an emerging middle class, and the second is that it is too soon to write an obituary simply because these newfangled currencies have yet to gain widespread adoption.

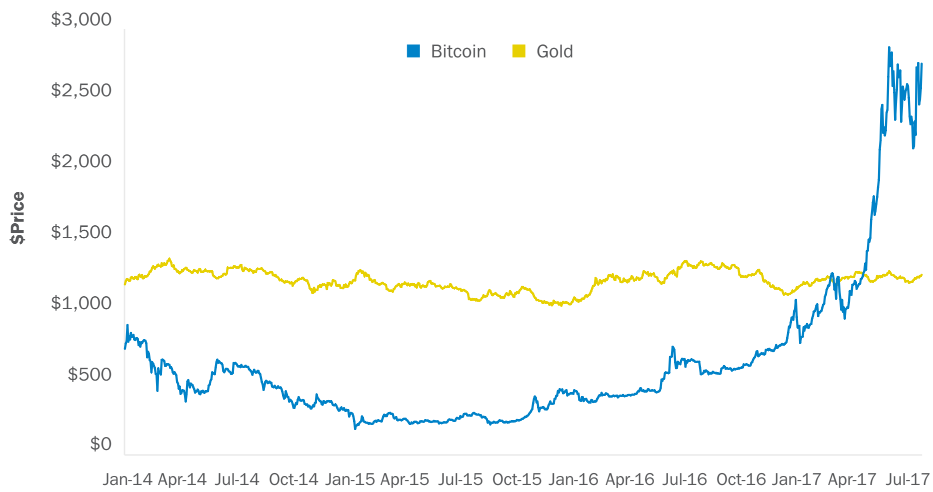
On the second, it should be remembered that no medium of exchange has intrinsic value. All monies, from gold to various metal coins to paper money and then fiat currency, are invented by humans who then assign value to them. Food, people, and maybe land have some "intrinsic" value. Everything else is made up.

In fact, the concerns about bitcoin bear more than a passing similarity to 19th century concerns in the United States about paper money, which also suffered from extreme valuation volatility and ubiquitous public skepticism. That money was at least backed in those days by gold (or sometimes by silver), yet it still made people nervous. Then, in the 20th century, government began to print money without the backing of gold or some hard-metal specie. The beginning of the fiat currency era in the mid-20th century still makes some traditionalists in financial markets nervous, believing that trusting governments to maintain and hold value in money is a mistake. They have often been proven correct in that distrust.

Figure 2:
The Meteoric Rise of Bitcoin
Bitcoin vs. the world's money (in $Billion)

Source: Bloomberg. Price data for Bitcoin from January 1, 2014 to July 28, 2017.

Figure 3:
Bitcoin vs. Gold
Traded at equivalent prices in March 2017; Bitcoin has since overtaken price of gold



Source: Bloomberg. Price data for Bitcoin and Gold from January 1, 2014 to July 28, 2017.

Yet, over time, people have come to accept paper money backed only by the full faith of whatever government is issuing it. It did not happen easily or quickly. Even today, fiat currency has critics, so it should hardly be a surprise that bitcoin, barely a decade old, has not convinced many of its value. But in a world where commerce is conducted evermore digitally, bitcoin has distinct advantages over fiat currency. It also has distinct advantages over gold as a possible repository of value.

Gold is an intriguing comparison for bitcoin. It too has no intrinsic value, though humans have ascribed value to gold for thousands of years, and that means something. Gold is what people have held when they do not trust a government to create or maintain the value of a currency. In today's world, however, gold has some real limitations: it is physical; it is easy for governments to locate and register; and it is difficult to use for transactions.

Bitcoin, however, solves many of those issues. It requires no physical security, only digital vaults. Although it can be traced by governments, it isn't clear how easy it would be for a government to seize bitcoin, given that it can be stored in any cloud anywhere. It is also easy to use for transactions, though as yet it is not widely accepted, and its primary use is for an investment.

For many millions outside the developed world, bitcoin also solves the problem of mistrust in governments and lack of access to banks.

If you grew up in Argentina, for instance, you have a healthy and merited distrust of what the government might do to the value of the peso, or even what it might do with your right to the title of your land. The same would be even truer of Zimbabwe. Holding some of your assets in bitcoin, which isn't susceptible to government meddling with its value, and which doesn't require you to have access to a bank, makes as much sense as owning some gold coins did from time immemorial.

The skeptics may, of course, be entirely correct. The best advice for those interested in owning or investing in bitcoin is truly "buyer beware." This is a high-risk, maybe high-return investment that should be treated as utterly speculative. That doesn't mean it is foolish, only that you should only invest money that you are prepared to lose entirely. You may one day see a huge return. You may also one day see whatever you invested go to zero.

The arguments against bitcoin, however, are often weak. Its newness is a risk but not a strike against it. Caution is imperative. And there are other risks. The technology could become compromised or less secure if computing power increases exponentially, or governments could attempt to interfere. But bitcoin and other digital currencies could prospectively become vital and powerful components of an emerging 21st century digital economy. Beware the risks, but don't ignore the potential. ■

August Takeaway:

Bitcoin has taken center stage in digital currency, tripling in value this year. Although some may liken it to a bubble or Ponzi scheme, others recognize the benefits of a cryptocurrency that requires no bank or custodian, is fairly secure, and whose use is relatively easy (although not yet widespread), across borders and between peers. History shows that all new forms of currency have had their skeptics, but in a world moving rapidly toward digital commerce, bitcoin has promising advantages over other forms of exchange, even gold. For investors who understand that bitcoin is a high-risk, speculative investment, and can withstand periods of extreme volatility, it could possibly generate high rewards.

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