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To Bitcoin or not to Bitcoin?

Can you explain Bitcoin? Should we buy some? Clients have frequently asked some version of these questions. As students of the financial markets, and generally curious, one might think we would have this cryptocurrency phenomena solved – we do not.

A recent Barron's article did a nice job of describing the origins of Bitcoin. "The story starts with Satoshi Nakamoto, a mysterious figure—or group—who developed a digital currency that anyone could send and receive through a decentralized computer network. Transactions are validated and recorded by independently operated computers, known as miners, who compete to solve cryptographic puzzles, known as "proof of work" (hence the term cryptocurrency). The miner who solves the puzzle first shares the results across the network. . . In return for running the network miners earn newly minted Bitcoin and a share of the transactions fees."

With that knowledge, the next logical question is what purpose does it serve? Here the investment community is divided. Positive perspectives include those who see Bitcoin as a currency, ultimately rivaling all fiat currencies in the world (including the US dollar) - and those who view it as a store of value or "digital gold." Alternative viewpoints are that Bitcoin is something ranging from a manic bubble to a giant ponzi scheme. We will examine the "positive perspectives."

A currency is most simply a system of money shared by a group of people such as the US Dollar, Euro, or Yuan. Money is often defined as having six characteristics: durability, portability, divisibility, uniformity, acceptability, and limited supply. In this context, durability is the notion that money can be used repeatedly without being destroyed. In this sense Bitcoin is even more durable, it is digital and therefore does not wear out. In addition to being durable, it is infinitely portable. It exists in the internet and can be accessed from any location with an internet connection. It is also divisible to 8 decimal places so it definitely checks that box. Uniformity, as it relates to money, is the idea that people can readily and easily identify the denomination of currency that is being used. For example, everyone knows what a \$100 bill looks like and how much value it represents. That is a little harder with Bitcoin as it is digital and if you were handed a flash drive containing \$100 in Bitcoin that would require significantly more effort to verify. This leads into acceptability where Bitcoin is still rarely accepted as a form of payment. The underlying code that validates Bitcoin acts as a hinderance here as the Bitcoin network today can only process about 14,000 transactions an hour. Visa on the other hand processes 236 million transactions an hour. Lastly, Bitcoin clearly passes the limited supply test. It is limited to 21 million coins and the last one will be mined in 2140. **Looking at it objectively, Bitcoin would appear to pass four of the six tests. Good but not great, particularly when considering that acceptability seems to be an important issue!**

Even if Bitcoin never becomes a readily used medium of exchange, perhaps it could still serve as a unit of measurement or a store of value. Units of measurement are often used in reference to the price of a good or service. Consider the example 'Remember when a candy bar was a nickel. Well now they are a buck'. These are units of measurement denominated in the same currency that inform our understanding of relative value at different points in time. We will let you decide if the dollar became worse or the candy bar became better. Being virtually infinitely divisible, Bitcoin clearly could potentially serve this purpose.

But can Bitcoin really be a store of value? We think not. If a Tesla Model S plaid+ cost 5 Bitcoins in January, 2 Bitcoins in April, and 5 Bitcoins in June measuring the price in Bitcoins is not very helpful. Bitcoin enthusiasts would point out that as Bitcoin becomes more accepted as a store of value, the volatility of its price would decline and thus it would become more useful in this regard. That is a fair point, however, the underlying assumption is that people desire or want an alternative store of value. To the extent that is true, it is likely a direct result of the monetary liberties central bankers have taken over the past decade. **Collectively, they have violated the “limited supply” characteristic of currencies.** Perhaps individuals seeing this abuse of the printing press have collectively decided that they would rather have a fixed supply alternative.

If Bitcoin were able to attain price stability there would be potential for its use as a store of value and as a result more acceptance. Will Bitcoin ever have a stable value? Having no underlying physical properties or alternative uses, it is hard to envision its price as ever being described as stable.

Stability requires a tether of some sort. For example, like Bitcoin, gold is not controlled by any one government. However, people that possess gold in its alternative uses such as jewelry may see the price of gold skyrocket and choose to melt the gold to exchange it for another good. Conversely, when the price is low people may perceive it as a good time to buy a necklace. It is tethered by competing alternative uses and perceptions of value. This helps stabilize the swings in price and has allowed it to serve as a store of value for centuries. Bitcoin currently lacks any tether or alternative use to help inform price. Famed investor, Bill Miller said that bitcoin gets less risky the higher it goes. This is analogous to saying it has value because it has value! It is the Kardashians of currency. If this is the case, the outcome is eventually a pool of tears. The history of asset bubbles tells us they all end the same way, eventually the crowd gets bored and leaves.

Having explored both sides of the coin, pun intended, our view is that this conversation would not be happening were it not for the monetary experiment that global central banks have undertaken. **When the cost of speculation is zero, people will speculate.** If the experiment continues cryptocurrencies in general - and potentially Bitcoin - may become the new global reserve currency or unit of measurement. Or maybe Elon Musk was right when he said on Saturday Night Live “Yeah it’s a hustle.” With both outcomes as possibilities, **we ultimately consider this to be a speculation.** There have been many profitable speculations that became excellent investments. Perhaps this is one. What we know for certain is that we are investment managers and not speculation managers. Thus, we are not compelled to sit at this particular table.

As always, if you have any questions or would like to catch up, please give us a call. In the meantime, enjoy the summer!!