



QUARTER 3, 2017

WHAT'S ALL THE FUSS AROUND BITCOIN?

IZAK ODENDAAL & CRAIG WHITFIELD,
OLD MUTUAL MULTI-MANAGERS

The price of Bitcoin has increased by a staggering 50 000% over the past five years (yes, you have read that correctly) from \$12 to almost \$6 000 attracting rising interest from investors. However, the price of Bitcoin has also suffered several sharp declines over this period and is clearly very volatile. We are not going to pretend to be experts on this rapidly emerging technology, but there are some very important investment principles to consider (the first of which is to avoid investing in something you don't fully understand, even if it has made other people a lot of money).

WHAT EXACTLY IS BITCOIN?

Bitcoin is the best known of the so-called cryptocurrencies (although it is only one of thousands). According to its creator, Satoshi Nakamoto (probably a pseudonym), Bitcoin is a "purely peer-to-peer version of electronic cash" allowing online payments "to be sent directly from one party to another without going through a financial institution". It relies on an emerging technology known as blockchain, a digital, decentralised and public ledger.

Blockchain advocates regard it as a more efficient, cheaper, quicker, safer and transparent way of transacting, compared to traditional banks. Transferring money is one of many applications of blockchain technology. Processes which place a cost on enforcing trust (such as transferring money, exchanging derivatives, enforcing legal contracts and verifying audits) can be made significantly more efficient using blockchains.

HOW BLOCKCHAIN LEDGERS WORK

Currently, a transaction between two parties typically involves two ledger entries, one at party A's bank and then one at party B's bank. With blockchain technology, the transaction appears simultaneously and publicly on both parties' ledgers for verification, making it quicker and more transparent while eliminating the need for a central authority to guard against manipulation. All transactions are cryptographically (but not centrally) confirmed, stored and protected.

WHY ALL THE HYPE?

The hype is driven by three factors: firstly, as mentioned above, the more the price of Bitcoin rises, the more attention it attracts. Secondly, it does appear to be a fundamentally useful technology. Thirdly, post the global financial crisis, many have lost faith in the traditional financial institutions and in the central banks that manage the system. Bitcoin is seen as an alternative that is outside of government control and interference.

CAN BITCOIN REPLACE TRADITIONAL CURRENCIES?

Economics textbooks ascribe three characteristics to a currency: a means of exchange, a unit of account, and a store of value. Bitcoin (and its cousin cryptocurrencies) tick the first box but the second two are questionable. We are very far from a point where companies or individuals measure their income and expenses in Bitcoin (and since Bitcoin's value is expressed in dollars, it is the dollar that would remain the unit of account). Its volatility means that it is unlikely to be seen as a store of value.

Moreover, currencies are backed by a lender of last resort (the issuing central bank) to step in when trust between market participants and liquidity evaporates. With Bitcoin, the trust lies in the fact that transactions are cryptographically protected. The fact that there is no central authority backing Bitcoin and that it is largely outside government reach is seen by its fans as a plus. But who will step in if trust in Bitcoin has been breached? The global financial crisis showed not only the importance of authorities stepping in to put out fires, but also the inherent instability of unfettered markets revealing that financial activities need a form of regulation. The US dollar remains the world's reserve currency because of the strong US legal system, the backing of their government, the credibility of the central bank (the Fed) as lender of last resort as well as the very deep, liquid and open capital markets where dollar assets can be traded.

IS BITCOIN A BUBBLE OR THE REAL DEAL?

There is no standard financial definition of a bubble, but broadly speaking it has the following four elements which are all present:

- A compelling story, usually of a revolutionary new technology (e.g. railroads, automobiles, the internet) or an almost infinite new source of demand (Chinese demand for commodities) or a severe supply restriction (peak oil).
- Rapid price increases completely divorced from any measure of intrinsic value.
- A frenzy of euphoric speculative activity, attracting non-professional investors. Over-exuberance can very easily turn into fear and therefore prices can re-rate extremely quickly.
- The availability of cheap credit.

The lesson of the 1990s internet bubble (and earlier iterations) is that although the hype of the new technology was justified – the internet has transformed our homes, businesses, and social connections – investors were simply prepared to pay way too much for IT companies. For instance, Microsoft's share price took 16 years to regain and surpass its December 1999 level despite the widespread use and profitability of its software. Too much good news was priced in. A different example: smartphones are ubiquitous today, but buying shares in Blackberry, the first smartphone maker, would have been a terrible investment (Blackberry's share price fell from a peak of \$319 in June 2008 to \$24 today).

Source: Datastream

WHAT ARE THE RISKS?

The first main risk is simply valuation: Bitcoin's price surge means any growth will have to take place off an already-high base.

The second risk area is a regulatory one. The more widespread cryptocurrencies are used, the more likely governments are to step in to limit tax evasion, money laundering, bypassing of capital controls (a big issue in China), and all manner of illicit activities.

The third risk area is competition: it is often argued that Bitcoin's price is supported by its limited supply (that has to be "mined"), but there is virtually no limit to the amount of competing cryptocurrencies. Blockchain technology will likely reshape global financial (and other trust-based) processes, but this is no guarantee that Bitcoin will maintain a leading position (remember MySpace came before Facebook, eBay was dominant before Amazon, Hotmail used to be more popular than Gmail and at least five major search engines came before Google's domination). There are already cheaper, faster, more efficient and more anonymous cryptocurrencies available.

Traditional institutions will not stand by if their lucrative core business areas are under threat, and many are already making big investments in new technologies, including blockchains. Many major global banks, multinationals, governments and leading universities have been building blockchain-based systems and applications across a variety of valid use-cases. These institutions have both resources and client bases which exceed the current reach of Bitcoin.

WILL MY FUNDS INVEST IN BITCOIN?

No, firstly because Collective Investment Schemes may not, at this stage, invest in cryptocurrencies. But more importantly, while blockchain might turn out to be a game-changing technology, the speculative nature of Bitcoin means that we cannot reasonably build conviction in future price expectations. Fiat currencies can be assessed by their fundamentals (economic growth, inflation, monetary policy and governance), but Bitcoin's intrinsic value is almost impossible to pin down. While supply is known (limited coins are created at a rate that can reasonably be assessed by mining 'hash' power and transaction rates), demand varies widely – hence creating the characteristic volatility we see in the Bitcoin price – and is subject to the risks discussed above. Also, since Bitcoin pays no interest, future returns depend entirely on price increases, instead of compounding income over time.

In summary, it is an exciting technology, but not an exciting investment opportunity.

