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Coin Toss

by Andrew Hardy, CFA

Digital gold or "index for money laundering[1]"? Fiat currency hedge or irrational mania? Bitcoin divides opinion more than most, but the bulls are in the ascendency at present and the 12-year old cryptocurrency is gathering many new followers as a result. Its 6-fold increase in price in the last year has been the driver; creating a FOMO (fear of missing out) effect whilst also increasing the size of its market, which reached $1 trillion over the weekend, to a level where institutions begin to consider it more seriously. While we expect that cryptocurrencies will become more mainstream over the coming years, we've never held Bitcoin in portfolios, nor do we have any plans to include it. I'll provide a few thoughts around this here.

Bitcoin cannot reasonably be considered as a reliable store of value, at least not yet. After twelve years of existence and accelerating adoption, its prospects for longer-term success are growing, but there's still every chance that it gets overtaken by other cryptocurrencies or technologies in time, or that increased adoption forces regulatory action by governments around the world. Indeed, the existence of so many competing digital currencies also undermines one of the key arguments made in support of Bitcoin: that of truly fixed supply. Amidst such huge uncertainty its price has proven to be exceptionally volatile as it can only be viewed as a speculative asset for now, which cannot compete with far more established asset classes like gold and inflation linked bonds for reliability in a portfolio context.

There have been some well publicised first-time buyers in recent months, including the UK asset manager Ruffer and Elon Musk's Tesla, but like with so many holders they've only invested a very small percentage of their cash. Very few businesses or portfolios have substantial allocations at this point, nor is it being widely used for transactions. Bitcoin and other cryptocurrencies still have a very long way to go before becoming at all entrenched. Energy consumption is one of the areas where on the face of it Bitcoin remains strikingly uncompetitive, especially in an increasingly environmentally conscious world, with estimates that the average energy required for just one transaction is equal to that of around 500,000 Visa transactions[2], due to the electricity used in 'mining' the coins.

This latest surge in price has come over a period when the value of many other risk assets have also soared, when there have been several other signs of exuberance in markets, and for Bitcoin has been accompanied by very high turnover, all of which hints at the gains having been driven by speculative forces.

Bulls argue this reflects rising fears of fiat currency debasement, due to central banks pumping liquidity into markets, but if that was the case one would expect to see a rapid increase in inflation expectations also being priced into other markets. Monetarist economic theory supports higher inflation and currency devaluation in time, but actual results of over twenty years of unconventional monetary policy in Japan – which have failed to ignite inflation and led to a stronger currency – highlight it's by no means a given.

It was just over one year ago when most risk assets began a pandemic induced plunge. When Bitcoin bottomed a few weeks later around the end of March, at the same time as most equity markets, it had fallen over 70% from its previous high. If one believes in Bitcoin as a diversifier and store of value, one must question why it had so few friends back then but is so popular now at many multiples of that price. When there are no fundamental characteristics – assets, cashflows, recurring demand etc – to base price estimates around, or a management team to discuss the way forward with, it's easy to lose confidence during times of crisis, and be shaken out of a position, something holders need to consider given the huge volatility that is likely to persist in its price. In contrast, there are many other companies linked to accelerating digital and virtual activity who have seen their share prices leap higher at a similar rate since then, several of which we and many other investors did have the confidence to add to around the market lows, because it's possible to build confidence in a fair value range.

Of course, there are many valid arguments in favour of investing in Bitcoin, but it's clear to me that becoming a buyer today requires a massive leap of faith. All investments come with a degree of risk and require one to take a view on future scenarios, but in the case of Bitcoin it is much harder to know how it will perform in any environment or build confidence in estimates of long-term value. While cryptocurrencies are likely to become more mainstream, it is by no means assured that Bitcoin would be the long term winner; there have been many examples in recent decades where the earliest pioneers in new technologies eventually saw most of their market share taken by new competition. We will follow the maturing cryptocurrency markets closely and be on the lookout for appropriate investment opportunities, but for now we are very comfortable watching from the sidelines and instead focusing our attention on the myriad other technology related opportunities around the world.

1 Larry Fink, Blackrock CEO. October 2017.
2 Statista data, provided by Deutsche Bank. February 2021.

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Important notes