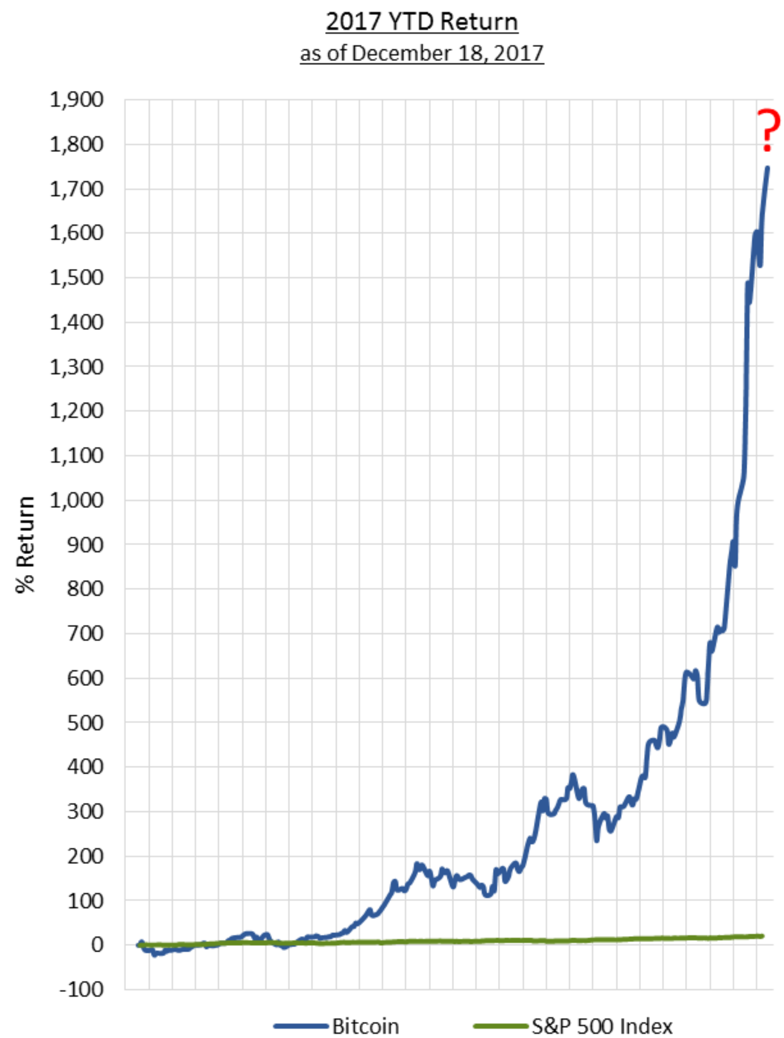
Tiptoe Through the Tulips

QAM Perspectives – December 2017

Quadrant's regular newsletter that highlights topics we believe will affect markets or are important in understanding them.

At this point it is almost impossible to make it through the day without hearing about Bitcoin, blockchain, or cryptocurrency. Whether it be the newspaper, television, radio, social media, your friend, or your brother-in-law, it seems that everywhere we turn there are people talking about it. Given the chart below, this mass popularity is no surprise.

Does Bitcoin really have any fundamental value? Is Bitcoin just a repeat of "tulip mania" of the 1600s? The following discussion explores our thoughts.



Source: Bloomberg

The price of Bitcoin has increased by a mind boggling 1,700% in 2017 alone, rising from just under $1,000 to over $18,000 per Bitcoin (as of December 18, 2017). For comparison purposes, the S&P 500 Index (broad U.S. equity market), which has had an objectively strong year so far relative to the past decade, has returned approximately 23% in local currency (U.S. dollars).

"Know what you own and know why you own it."

- Peter Lynch (Renowned investor and previous manager of the Fidelity Magellan Fund)

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Whether this meteoric rise of Bitcoin is justified or not is up for debate. Supporters of Bitcoin believe that it is the new paradigm that will transform money and the economy as we know it. Skeptics of Bitcoin argue that it is a fraud and an entirely imaginary concept with no intrinsic value. It seems for the time being that supporters of Bitcoin are winning, if one is "keeping score" by mere price appreciation alone. Holders of Bitcoin likely view the price appreciation as an affirmation of the future potential and fundamental value it possesses, but it is also possible that the seemingly unstoppable price appreciation is due at least in part to speculation and emotion. Some people may be watching the rise of Bitcoin and decide to "get in on the action" without any real understanding of its characteristics or consideration of the risks involved.

Referring back to the quote at the beginning of this article by legendary investor Peter Lynch, understanding what you own is a key investment tenet. So what exactly is Bitcoin? Or, alternatively, what is Bitcoin not?

Is Bitcoin a Currency?

In theory, Bitcoin is designed to serve as a currency. In reality, this classification is more uncertain. In "simple" terms, Bitcoin is a cryptocurrency that utilizes blockchain technology (essentially a complex algorithm-based method for recording transactions across many computers without the use of an intermediary). It is completely decentralized and is not associated with or influenced by any regulatory body, government, or central bank. This contrasts with typical fiat currencies like the U.S. dollar, Canadian dollar, or the euro which are backed by their associated governments and central banks. While there are no set rules as to what truly qualifies something as a currency, it can be argued that a currency needs to serve at least two purposes:

1. Medium of exchange

   Currency is used as an intermediary in the exchange of goods and services in order to avoid the inconveniences and inefficiencies of a pure barter system. To function properly, the currency needs to be widely used and accepted.

   While many companies do accept Bitcoin as payment, it is still a relatively small number and outside of the mainstream. For example, only three of the top five hundred online merchants accept Bitcoin as payment[1]. It is also difficult to gauge just how many holders of Bitcoin actually use it for purchasing goods and services as opposed to just holding it. Although Bitcoin use is not widespread enough at this point, assuming that Bitcoin becomes more readily accepted by merchants and people actually use Bitcoin to buy goods and services, it may not be unreasonable to consider Bitcoin a sufficient medium of exchange in the future.

2. Storage of value

   Established currencies are generally stable and provide a store of value into the future. This means that it can be saved, retrieved, and exchanged at a later time without a material change in purchasing power.

   From this perspective it is difficult to classify Bitcoin as a currency. The volatility experienced in 2017 alone has been unpredictable and large relative to other instruments, especially other widely accepted currencies. It is rare for the currency of a developed economy to move up or down by

[1] https://www.bloomberg.com/news/articles/2017-07-12/bitcoin-acceptance-among-retailers-is-low-and-getting-lower

more than 2-3% in any given day. Fluctuations (increases or decreases) in the price of Bitcoin during 2017, however, have reached up to 21% in a single day. It is difficult to classify Bitcoin as a currency in this regard as it is an unreliable store of value.

Overall, the evidence for classifying Bitcoin as a pure currency is, at best, inconclusive. While it may be useful as a medium of exchange on a limited basis at this point, the volatility and unpredictability associated with it makes it a poor store of value, even if the recent volatility has been mostly positive for Bitcoin holders. If Bitcoin does eventually reach widespread adoption as a currency, the price may continue to be volatile before finding an equilibrium which could be materially higher or lower than the current price.

It should also be noted that while Bitcoin is the first and by far the largest cryptocurrency in existence today, it is just one of many. There are now more than 1,300 separate cryptocurrencies which operate similarly to Bitcoin and which are based around blockchain technology. Like Bitcoin, all of these cryptocurrencies are decentralized, lack regulatory oversight, and are not backed by any government or central bank.

Is Bitcoin a Commodity?

Although commodities do not have an underlying business or cash flow attached to them, most do have intrinsic value as they can be consumed as raw materials in the production of goods or the generation of energy (oil, wheat, copper, etc.). Gold is slightly different in that much of its value is derived from its wide acceptance as a form of currency and its ability to retain value over time as opposed to its actual usefulness as raw material. While gold does have intrinsic value in its usefulness for jewellery and other industrial purposes (electronics, etc.), a substantial portion of the demand for gold is driven by its status as a generally accepted form of wealth and store of value. It has attained this status by being used as currency for thousands of years in many societies (prior to the creation of most modern currencies) and, given that gold has weathered many market environments and economic recessions, it has the track record that proves people consistently ascribe value to it.

Perhaps it is appropriate to think of Bitcoin as a commodity similar to gold. Like gold, the supply of Bitcoin is limited and it is mostly valuable because other people accept it and believe it is valuable. If it is assumed that over time Bitcoin becomes less volatile and people reliably ascribe value to it, it could reasonably be thought of as something like "digital gold", although its volatility and newness does not allow for that classification currently.

As with all commodities, prices are set based on the forces of supply and demand. With limited supply, an increase in demand will result in an increase in price. Bitcoin has experienced a surge in demand recently, which has resulted in significant price appreciation. The difficulty is understanding where that demand is coming from. Is the demand coming from people who believe there is fundamental value in Bitcoin as a reliable store of value, or is the demand coming from speculators hoping to sell at a profit and make some fast money? The current answer is likely skewed towards the latter, given the current popularity and "buzz" around Bitcoin.

Is Bitcoin an Investment?

An investment is something that is purchased with the expectation that it will generate income or will appreciate in the future, providing the investor with a return. If an investment does not generate any income, the only possible way to earn a return is if the investment is sold at a higher price than it was purchased for. In order to do this, an investor must understand the current value of an asset and have a reasonable expectation of what the value may be in the future. For example, a stock investment represents an ownership stake in an underlying business. The underlying business sells goods or services and expects to grow its profits over time, increasing the value of the business. If the business grows over time, then the stock should appreciate and provide a positive return.

Given that Bitcoin does not generate an investor any income, it must be sold at a higher price than it was purchased for in order to earn a positive return. Bitcoin, however, has no underlying business that can generate cash or profits to increase its value organically. It is impossible to determine what a fair price should be because it has no logical basis for valuation. Given a fixed supply, the price is based purely on the level of demand, which is in turn based on the collective behaviour and emotions of people. Bitcoin is not an investment, it is pure speculation.

Is Bitcoin in a Bubble?

A bubble is a period of time in which the price of an asset strongly exceeds its intrinsic value, often fueled by speculation or irrationality. For example, the “dotcom” bubble that occurred in the late 1990s was characterized by the rapid rise in equity markets fueled by investments in internet-based companies. These were real companies with underlying businesses and some level of intrinsic value. The problem was that the prices of these companies rose to levels way beyond what the intrinsic value actually was. This bubble eventually “popped” when investors began to realize this extreme overvaluation.

Given that it is impossible to assess the intrinsic value of Bitcoin, there is no way to actually know if the current price constitutes a bubble or not. There are no fundamental investment characteristics so it is perhaps a misnomer to even consider it a bubble in the first place. A more appropriate term may be a “mania” or “craze” as it appears the only thing supporting the price of Bitcoin is excessive enthusiasm and a desire to get rich quick.

The current Bitcoin environment draws a comparison to “tulip mania” during the 1600s. During this time period tulips were brought from Turkey and introduced to the Dutch. The novelty and uniqueness of the flower made it widely sought after and fairly pricey. The tulip soon became a status symbol and a coveted luxury item which pushed prices higher and fueled popularity of the flower. Eventually, speculation in the tulip market became so rampant that people were trading their land, houses, and life savings for tulip bulbs in the hope that they could resell to someone else for a hefty profit. Tulip prices ultimately collapsed and the mania ended when people began to realize that they had traded their homes and possessions for a flower with essentially no intrinsic value (other than a pretty bloom). It is difficult to view Bitcoin any differently than tulips at this time as it appears that the overwhelming majority of people are simply speculating and trying to get rich quick. Anyone holding Bitcoin in the hopes of selling for a profit should take a step back and examine what it really is that they’re holding and understand the risks involved. It is possible that the price of Bitcoin will continue to rise for months or years to come, but sooner or later there will be a point when people realize that they have traded their savings for… what, exactly?

Is Bitcoin for Quadrant Asset Management?

Quadrant Asset Management ("QAM") and its managers maintain a long term perspective and invest based on fundamental risk and reward characteristics. While Bitcoin is certainly interesting to observe from the sidelines, it has no investment fundamentals and in QAM's opinion cannot be justified as a reasonable investment. Rather than speculate on Bitcoin, QAM and its managers focus on adding long term value through asset allocation policy, manager selection, and systematic rebalancing in light of each client's individual financial circumstances.

If you or someone you know could benefit from our services, please have them contact our offices at 204-944-8124 or email us at inquiries@quadasset.com.