Bradley, Foster & Sargent, Inc.
Quarterly Market Commentary

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Bitcoin Redux:
Should Bitcoin be Viewed as a Valid New Asset Class?

> Of course, I hate the Bitcoin success. I don't welcome a currency that's so useful to kidnappers and extortionists and so forth.
>
> Charlie Munger, May 2021

> We [at Tesla] do believe long term in the value of Bitcoin. So, it is our intent to hold what we have long term and continue to accumulate Bitcoin from transactions from our customers as they purchase vehicles.
>
> Elon Musk, Tesla CEO, April 2021

In January, 2018, we wrote an investment commentary entitled: *A Primer on Bitcoin: Bubble or Bonanza?* Triggered by the recent price action and calls from our clients about Bitcoin, we decided it would be timely to review what has transpired in the cryptocurrency markets during the past 3½ years. In our previous essay, we wrote that it was "quite possible that Bitcoin, unlike other manias, might have a more enduring future." But we also advised investors that investing in Bitcoin (which in this essay we are using as a rubric for all cryptocurrencies) was no different than gambling in Las Vegas, and that investors should be prepared to lose every penny of their speculation. After all, Bill Miller, the superstar money manager who managed to outperform the S&P 500 for 15 years in a row ending in 2005 and later made a fortune investing in 2012 and 2014 in Bitcoin, was quoted in 2017 as saying, "There is a nontrivial chance that Bitcoin goes to zero."

Unlike our previous essay, which was a primer on both blockchain technology and Bitcoin itself, our purpose here is solely to discuss the growth of the cryptocurrency markets, the increasing involvement of major financial institutions in Bitcoin, and the possibility that Bitcoin has become a valid new asset class. Has Bitcoin become, in fact, digital gold? The market cap of gold in all its forms is approximately $10 trillion. The market capitalization of all the cryptocurrencies currently is $1.48 trillion. Clearly there is a lot of demand for Bitcoin, and not just from kidnappers and extortionists. The chart below shows the price of Bitcoin since January, 2018, when we published our last essay:

Price of One Bitcoin
January 1, 2018 – June 30, 2021

Source: Bloomberg

The Mainstreaming of Bitcoin?

Bitcoin began trading at the start of 2013 at $13.40. Currently it is trading at approximately $32,500. We use the word approximately because Bitcoin is extremely volatile, with moves of 5% or more in a single day. In April this year the price hit $63,347. According to CoinMarketCap, a company specializing in cryptocurrency data, there are currently nearly 11,000 different cryptocurrencies in circulation trading on 380 different crypto exchanges worldwide. As mentioned earlier, the current market capitalization of all cryptocurrencies globally is approximately $1.48 trillion. Bitcoin accounts for $654 billion of that total. The following is a list of the top ten cryptocurrencies and their percentage of the global cryptocurrency market capitalization:

Ten Largest Cryptocurrencies Globally

Cryptocurrency	% Global Cryptocurrency Market Capitalization ($1.48 trillion)
Bitcoin (BTC)	44.20%
Ethereum (ETH)	18.70%
Tether (USDT)	4.30%
Binance Coin (BNB)	3.50%
Cardano (ADA)	3.10%
XRP (XRP)	2.10%
Dogecoin (DOGE)	2.00%
USD Coin (USDC)	1.80%
Polkadot (DOT)	1.10%
Uniswap (UNI)	1.00%

Source: CoinMarketCap.com

These ten cryptocurrencies account for 81.8% of the global market capitalization and Bitcoin and Ethereum make up almost two-thirds of the market (62.9%). Although Bitcoin is the largest cryptocurrency by market cap and the best known, Ethereum has been gaining market share. Ethereum was invented by Vitalik Buterin, a Russian-Canadian teenager who released his white paper on the subject in late 2013. Nineteen at the time, Buterin set out to craft a system that could do more than record static quantities. His vision was of a blockchain that could host what came to be known as smart contracts — self-executing agreements in which a chain of actions could flow from defined conditions and contingencies. Ethereum is based on blockchain technology, like Bitcoin, but it can be used to facilitate a multitude of financial transactions including initial coin offerings (ICOs), decentralized finance (DeFi), and NFTs (Non-Fungible Tokens). Investors who are interested in learning more about these types of transactions are encouraged to explore them on the internet where detailed explanations can be found.

A number of well-known public figures, such as Bill Miller, the Winklevoss twins, and Peter Thiel, bought Bitcoin in the 2013-2015 period when its price was in the hundreds of dollars. But what is less well known is that there is a growing number of institutions which have taken steps to invest in this speculative asset class. For example, *Bloomberg* reported recently that the $55 billion London-based hedge fund Marshall Wace is raising a new fund to invest in digital assets. Marshall Wace joins the likes of giant U.S. hedge funds as Millennium Management, Point72 Asset Management, George Soros, Matrix Capital Management, the Rockefellers through their venture capital arm, Venrock, and

Paul Tudor Jones, which are all at various stages of setting up cryptocurrency-focused trading funds. Perhaps more importantly, Coinbase Global, the largest U.S. cryptocurrency exchange, went public in April and advertised broadly that individual investors could trade cryptocurrencies and custody them on their platform. And it can all be done digitally on a mobile phone. PayPal also announced that it would soon be offering cryptocurrency trading and custody services as well. Thus, there are clear indications of mounting interest by both institutional and retail investors in this asset class.

Reasons to Own Bitcoin

As a virtual currency, Bitcoin is independent of regulation by government or any other centralized authority. Ownership of Bitcoin is significantly safer from confiscation by the state than holding funds in a bank account. There are certain groups of people who find this enormously attractive. These include those who are distrustful of the intrusive power of the state and with good reason. The last century has seen many examples of communist, socialist, and totalitarian governments confiscating wealth and private property. Bitcoin's anonymity and independence from any central authority is very appealing to these people (including some in the U.S. and Western Europe who are increasingly fearful of the unchecked power of their own governments, the so-called deep state). Another group of people who use Bitcoin are the type of people that Charlie Munger spoke about at the start of this essay — kidnappers, extortionists (primarily through ransomware), and drug dealers. They believe they can squirrel away their ill-gotten gains without detection, although governments have ramped up their cybersecurity units and are apparently having more success in seizing these illicit funds.

Another group of people attracted to Bitcoin comprises those who fear the debasement of their own country's currency. For example, inflation has eroded the value of $1 in 1968 to approximately 13 cents currently. Bitcoin appeals to this group because, as with gold, there is a finite quantity — 21 million units. Currently there are 18,750,000 Bitcoins in circulation, leaving less than 2.3 million units remaining to be mined. And it gets progressively more difficult to mine Bitcoins because of "halving." Halving is the process whereby the reward for mining new Bitcoins, by verifying transactions, is cut in half every four years. Accordingly, the estimates for when the last Bitcoin will be mined (issued) is almost 120 years away in 2140.

A final group of people attracted to Bitcoin are speculators. A secular bull market has been underway since March, 2009 — more than twelve years. In a powerful bull market such as this, many people become momentum investors. When a stock or other type of security regularly appreciates in price, people will jump on the train, not analyzing the fundamentals, but merely because of the upward spiral in the price. Speculation in cryptocurrencies has surely increased dramatically with the advent of the COVID-19 pandemic, as retail investors in the U.S. had both cash from stimulus checks and time on their hands. This is surely one of the reasons that Bitcoin rose in price more than sixfold from September, 2020 to over $63,000 in April, 2021. This type of speculative behavior has existed for centuries with one of the prime examples being the famous "tulip bulb mania" in Holland in the 1630s. As we have related before, many speculators, or momentum investors, who are currently buying Bitcoin, may be indulging in the "Greater Fool" approach to investing. This theory describes investors who believe that it is possible to make money buying an overpriced security and selling it at a profit to a greater fool who is willing to pay an even higher price. This approach works until the bottom drops out of the market — as it did when Bitcoin dropped 50% in price between April and June this year.

Bitcoin as Digital Gold?

Bill Miller, the renowned Founder and Chief Investment Officer of Miller Value Partners, has made a great deal of money in Bitcoin. He started buying Bitcoin around 2014 and 2015 at $350 per unit, and he continues to be a big promoter of it. In a CNBC interview in April this year, he maintained that Bitcoin is firmly entering into the mainstream as a valid asset class, stating "the supply [of Bitcoin] is growing at 2% a year and demand is growing faster. That's all you really need to know, and that means it's going higher." He also opined that Bitcoin was easily transportable and able to be sent anywhere in the world if you have a smart phone, making it a much better store of value than gold. Clearly one needs to pay attention to an investor with a record like Bill Miller. Another key reason for his belief that Bitcoin was becoming a mainstream asset class was institutional adoption. Firms like Goldman Sachs and Morgan Stanley are taking steps to provide wealth management clients with access to Bitcoin. Then there is Tesla CEO Elon Musk, who had Tesla buy approximately $1.3 billion in Bitcoin this year at a price of around $31,500 per unit. And many successful hedge funds are getting into the game, arguing that Bitcoin is an asset class like gold, which is not correlated to the stock market and can be seen as a hedge against equity exposure. Finally, there is the argument that Bitcoin is a store of value, like gold, simply because others think that it has value. While it does not look shiny and appealing like gold and does not have the thousands of years of history that gold has, it acts as a store of value because enough people think it has value.

Bitcoin: A Valid Asset Class?

There is a case to be made that Bitcoin and other digital assets have become a valid asset class. But there is a plethora of negatives to be considered as well. Bitcoin has no intrinsic value. There are no tangible or intangible assets backing it up. No cash flow is produced by the sale of products or services. It is highly unlikely that any major country will accept Bitcoin as legal tender for the payment of debts or taxes, for it would lose control of the money supply and cede its governing authority through its monopoly on legal tender. Bitcoin is also hugely volatile, with daily price fluctuations of 3-5% daily and 50% or more over several months. Thus, it is not suitable as a payment mechanism or reliable store of value. Then there is the problem of hacking. Various private and national actors (such as North Korea and Russia) are known to be skilled at hacking, and hackers have stolen large amounts of Bitcoin. Another issue is the enormous amount of electricity that must be used to power the computers that are used to mine Bitcoin. There are estimates that half of one percent of global electricity production goes to mining Bitcoin, which has a negative effect on the environment. This is why Elon Musk announced that Tesla will no longer accept Bitcoin in payment for a vehicle. Finally, there is the very real threat that governments will ban the trading and/or ownership of Bitcoin. China and South Korea have already introduced regulations in this regard.

Conclusion

At Bradley, Foster & Sargent, we continue to see Bitcoin as speculation. Those who have the appropriate assets with which to speculate and the urge to do so can purchase shares in Grayscale Bitcoin Trust, a passive investment vehicle whose sole asset is Bitcoin, or open an account at Coinbase. But we do not see Bitcoin as a valid asset class. Gold has been a store of value since the beginning of civilization; Bitcoin for less than 10 years. Buyer beware!

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