The Rise of 

Bitcoin is on a roll. By far the largest of the digital “cryptocurrencies,” Bitcoin has increased in value by about 1,000% in the last year. The total market value for all outstanding Bitcoin is over $1 trillion, greater than the value of Mastercard, The Home Depot and Exxon combined. And Bitcoin may be reaching an economic tipping point. Companies such as Microsoft, The Home Depot, Starbucks, Whole Foods and Tesla now accept Bitcoin. Visa will soon issue a Bitcoin debit card. And the world’s largest cryptocurrency platform company, Coinbase (symbol COIN), just went public in April, with a market valuation of over $65 billion on the first day of trading.

So, what is Bitcoin? Developed by Satoshi Nakamoto, a pseudonym for an unidentified, mysterious individual or group, Bitcoin is a digital currency. Such currencies are stored in and transacted through designated software, applications and networks in digital form. Bitcoin can be stored, sent or received by anyone or anything through a decentralized network of computers. It is the most successful of hundreds of attempts to create a virtual currency through the use of cryptography (hence “cryptocurrency”), which is the science of making and breaking codes. Transactions are recorded on a shared, distributed ledger, called a “blockchain,” once they are validated by independently operated computers, known as “miners,” who compete to solve cryptographic puzzles. Miners earn newly minted Bitcoin and a share of transaction fees for their work.

Digital currencies have perceived benefits when compared to traditional “fiat” currencies managed by governments throughout the world. Decentralization is one such benefit. No person or authority controls the currency or the blockchain. Many users also value the perceived anonymity of participants in a transaction. Bitcoin’s scarcity is another key attraction…the supply of Bitcoin is limited to 21 million, by design. About 18.7 million Bitcoin are currently in existence, leaving about 2.3 million left to mine.[1] Compare this to governments that are constantly “printing” new money, potentially inflating their currencies. And once digital accounts are set up, transacting in virtual currencies is cheaper and faster than with conventional credit card systems, especially across borders.

Digital currencies have their drawbacks as well. Energy use is clearly one such drawback, given the immense computing power required to both manage the network and mine the currency. B of A Securities estimates that the global Bitcoin network now emits 60 million tons of carbon dioxide annually, and uses enough electricity to power the whole country of Sweden.

Governmental intervention is an ongoing risk. Governments throughout history have consistently quashed challenges to their currencies and monetary policies. China has recently announced its intention to create a digital version of its currency, the Renminbi. Many consider this a threat to other virtual currencies, as well as to the U.S. dollar status as the world’s reserve currency. And while users consider Bitcoin a form of currency, as a means to transact business, governmental taxing authorities do not. Bitcoin and other digital currencies are considered capital assets, not unlike stocks. Owners are obligated to track the cost of Bitcoin at each receipt and disbursement. A capital gain or loss must be calculated and recognized for every sale of, or purchase made with a digital currency, with appropriate capital gain taxes due.

Bitcoin is often used for criminal activity, and is rife with fraud. Blockchain analytics company Coinfirm estimates that cryptocurrency crime totaled more than $10 billion in 2020. And crime is not the only way to lose Bitcoin; another blockchain analytics company, Chainalysis, estimates that 20% of existing Bitcoin supply may be sitting in lost or stranded accounts. As reported in the NY Times, Stefan Thomas, a German-born programmer living in San Francisco, has only two of 10 guesses left to figure out the password to his account to unlock 7,002 Bitcoin, worth approximately $400 million.

Certainly, the most vexing question is the appropriate value for Bitcoin, especially after recent, outsized gains. Carmen Reinhart, Chief Economist of the World Bank has expressed concern. “How bubbly is this market? I think it’s very bubbly. It may not take any melodrama in a thin market to reverse most or all of the price gains. It’s not like the Treasury market. We have to expect huge price volatility in Bitcoin.” Willem Butler, the former Chief Economist for the European Bank for Reconstruction and Development agrees, calling the recent runup “…purely a speculative bubble.” Despite its $1 trillion total outstanding value, Bitcoin is “thinly traded.” 95% of all Bitcoin is controlled by 2.4% of accounts, according to B of A. Most of the Bitcoin that has been mined is owned by long-term HODLers – those who “Hold on for Dear Life.[2]”

But Bitcoin has its supporters as well. Elon Musk recently invested over $1.5 billion on behalf of Tesla. Over 30% of Financial Advisors recently interviewed by Bitwise Asset Management predict that Bitcoin’s price will be greater than $50,000 in five years; half of those expect a price greater than $100,000. The price of Bitcoin as I write is $56,300. And Morgan Stanley recently recommended adding Bitcoin to investment portfolios.

For most, investing in Bitcoin has meant setting up a “digital wallet,” which is actually just a software application to store your public and private “keys,” send and receive digital currencies, monitor your balances and interact with various blockchains. Digital wallets can be held directly, or they can be held at a cryptocurrency exchange. Trading in Bitcoin futures and related stocks is just now gaining momentum as financial companies invent new ways for investors to gain exposure. Fidelity Investments, VanEck and other fund sponsors are trying to persuade federal regulators to approve a Bitcoin exchange-traded fund, which will allow investors to invest in Bitcoin directly and efficiently. Before long, cryptocurrencies may very well become an accepted “alternative investment” widely held in many portfolios…or not. As Stanley Druckenmiller, renowned investor and hedge fund manager said, “Bitcoin is like anything else: it’s worth what people are willing to pay for it.” Lately, investors are paying a great deal more.

Sincerely,

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[1]https://www.buybitcoinworldwide.com/how-many-bitcoins-are-there/
[2]Fonda, D. (2021 April 14). Bitcoin is Making a Splash. What to Know Before You Test the Crypto Waters. *Barron’s.*

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