Legacy Trust

Investment Perspectives

Bitcoin and Cryptocurrency as an Investment

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Key Takeaways

- BTC is designed to be a peer-to-peer electronic cash that allows payments to be sent directly from one party to another without the support of a financial institution or government, allowing users to remain anonymous.
- The dramatic rise in price and the subsequent volatility is a double-edged sword for BTC. While it increased visibility and attracted institutions, elevated volatility also undermines its use-cases as a currency for transaction and as a store for value.
- In addition to implementation issues, BTC exposes holders to significant regulation and ESG risk.

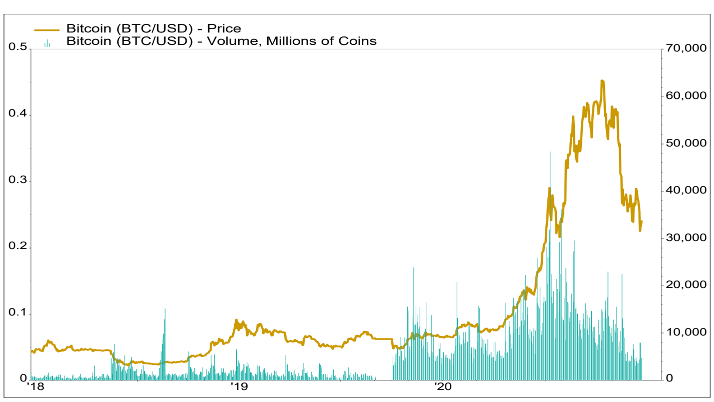
Price appreciation and increasing adoption of Bitcoin by institutions, merchants, and even some governments has captured the attention of investors globally. Investors who wish to have exposure to Bitcoin should remain disciplined in their core portfolio and consider cryptocurrency investments to be "other bets", separate and distinct from traditional portfolios.

Believed to be the first cryptocurrency offering, Bitcoin (BTC) was launched in 2009 and is currently the most valuable coin by market cap, $630 billion as of this writing, or just under half the value of all cryptocurrencies combined.

- BTC is designed to be a peer-to-peer electronic cash that allows payments to be sent directly from one party to another without the support of a financial institution or government.
- Blockchain is the underlying technology that allows BTC transactions to be verified and added to a public ledger that is accessible to everyone. Participants use extensive computing power to solve a mathematical puzzle to confirm each transaction and are rewarded with BTC as incentive for spending the necessary energy and computing power to support the blockchain. There is a hard cap of 21 million BTCs, set by the creator of the ecosystem. There have been 18.8 million coins produced so far.
- Participants on the blockchain remain anonymous – although transactions are posted publicly, the identity of those involved in the transaction is protected, with BTC wallets tied to a public key, with no name or identifying information attached or displayed. The level of information is similar to the level of information released by stock exchanges – time and size of trades are released, but without revealing who the parties were.

What was intended to be a platform for anonymous peer-to-peer transactions has morphed into a vehicle for speculation. As BTC captured the attention of investors and the media, trading volumes rose exponentially, and so did price volatility, with important results for the future of BTC and cryptocurrency in general.

The dramatic rise in prices and the subsequent volatility is a double-edged sword for BTC – on one hand, its rapid appreciation which saw a 500%+ move higher to more than $60,000 a coin attracted significant interest in the space and brought new participants into the market to speculate. This increased visibility brings it closer to adoption and given expanding popularity and the larger amount of assets tied to cryptocurrency, institutions and governments alike were forced to take notice.



Source: FactSet Research Systems

On the other hand, the surge in price and volatility likely invalidates several use-cases for BTC, including being used as a currency for transactions or as a store of value often compared to "digital gold".

1. Currency for transactions: given recent levels of realized volatility, it's unlikely that most merchants will be willing to accept BTC as a form of payment. Consider a business that operates on thin profit margins – any margin they've built into pricing could disappear in an instant without the ability to constantly hedge exposure back to US Dollars, which defeats the purpose.
2. Store of value: current levels of volatility are simply too high to use BTC as a store of value or a hedge for inflation. A reasonable, risk-neutral investor would not store a significant portion of their wealth in BTC knowing that the value halved in the last 2 months.

Do cryptocurrencies like Bitcoin deserve an allocation in a diversified growth portfolio? At current, the list of reasons against adding an allocation of cryptocurrency to a traditional, diversified portfolio is too long to ignore even if implementation were straight forward. Those reasons include, but are not limited to:

- Speculation and resulting wild price swings; prices have recently swung 5%+ based upon one-sentence tweets by Elon Musk.
- Environmental, Social, Governance (ESG) concerns related to the energy-intensive process of validating transactions on the blockchain and sourcing that energy from fossil fuels. It's estimated that a single BTC transaction uses the same amount of energy as the average U.S. household over a 55-day period and that in summation, the BTC blockchain uses more energy than the entire country of the Netherlands.
- Its role in recent ransomware crimes. Due to users' ability to receive payments anonymously, BTC has become the preferred method of payment for ransom. In the recent attack on the Colonial Pipeline, the group responsible for compromising the integral infrastructure received 63.7 BTC, worth $4.4mm at the time.
- Challenges presented by regulation as governments around the globe continue to work through implications for central banks and tax policy.

Investors who wish to have exposure to Bitcoin should remain disciplined in their core portfolio and consider cryptocurrency investments to be "other bets", separate and distinct from traditional portfolios. It's too early to know what role BTC or other cryptocurrency will play going forward. There are analysts who think BTC will trade to $1mm a coin and others who think it will go to zero. Investors who do want to have exposure to BTC should size their investment such that they're comfortable with elevated volatility and the unfortunate truth that their investment could go to zero. Investors should also be wary of implementation issues and should choose their vehicle carefully.

For now, whether BTC and cryptocurrency will become part of practical, everyday life is still up for debate. There is a real-world case study ongoing in a tiny surf town in El Salvador. Thanks to an anonymous donation of Bitcoin, workers in El Zonte, El Salvador now receive salaries and pay bills in Bitcoin, merchants accept it as payment for goods and services from tourists, and community projects are financed with Bitcoin donations. The result, whether a success or a failure, might be evidence for how cryptocurrency could be used on a larger scale in the future.