

Bitcoin – hit or myth?

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One of the most published topics in the last few months has been the extraordinary rise in the value of the Bitcoin. The first question for many of us is – what on earth is Bitcoin?

Technically speaking, Bitcoin is a cryptocurrency. In layman's terms, it's simply a digital form of money.

Where Bitcoin differs from earlier cryptocurrencies is that, when it was created (only in 2009), it was the very first decentralised cryptocurrency. This means it exists and functions outside of the world's central banking systems. While a traditional currency, like a US dollar, is backed by the full faith and credit of the US Government, a cryptocurrency is not backed by anyone.

For generations, the global monetary system has been run and controlled by centralised banks, although hardly with an unblemished record of success. Adopting this system, many countries have suffered from imperfect policy settings, experienced periodic bouts of uncontrollable inflation, and endured bank corruption and even fraud.

Perhaps one of the attractions of Bitcoin is that it sits outside that centralised system. Bitcoin is controlled entirely by its users, transaction by transaction. How the transaction and ledger system supporting Bitcoin actually functions is beyond the scope of this article but, generally speaking, Bitcoin allows users to quickly and directly transfer digital cash to any address around the world without requiring the permission of any third party. And its sophisticated and highly encrypted transaction controls are seemingly able to overcome more traditional transaction ledger issues, such as double spending or fraudulent entries.

The first real world Bitcoin transaction was made on 22 May 2010, when a computer programmer from Florida used the technology to buy a pizza for 10,000 Bitcoin. At that time, the exchange rate for Bitcoin in New Zealand dollar terms was around 0.4 cents each. This priced the pizza at around NZ\$40.

Amazingly, only seven and a half years later, 10,000 Bitcoin are currently valued at NZ\$145 **million** dollars. That's right, million is not a misprint. The lack of any guaranteed backing certainly hasn't harmed Bitcoin's popularity.

It is, by any measure, a meteoric rise. It's no wonder so many people are suddenly asking – what is Bitcoin, and should I buy some?

We are not going to provide you with a recommendation to buy, or not buy, Bitcoin. However, we would urge you to be very cautious about automatically assuming the current Bitcoin price (around NZ\$14,500 per Bitcoin) is a fair reflection of its value.

Normally we are firm believers that the market price reflects all available information about a security, but, in the case of such a new and obviously 'fashionable' item such as a cryptocurrency, it's reasonable to have reservations that market participants know all there is to know about Bitcoin. We should also be mindful that the hype propelling prices upwards today, could swing just as forcefully in the opposite direction at a moment's notice.

Those of us who remember the dotcom internet mania in the 1990s might recall just how quickly bubbles can burst. There is no better example than pets.com, a retailer that sold pet accessories direct to consumers over the internet, which became a poster child for the dangers associated with jumping into a high priced investment without looking closely enough at the fundamentals. For investors in pets.com (and in many other internet companies), the story had a very unhappy ending. Pets.com went from a successful IPO on the Nasdaq to complete liquidation in just 268 days, wiping out US\$300 million worth of investment capital in the process. Some people, no doubt, made a lot of money speculating in pets.com shares in the early days, but we guarantee that no one who bought these shares towards the end of its 268 day listing period will have any happy memories about this 'investment'.

Perhaps the outcome might have been different if pets.com had a backer with deep pockets. History records that one of the main reasons the global banking system survived the Global Financial Crisis in 2008/09 was because, at the time of greatest stress, the US Government stood in the market and said to institutions and investors alike, "We will not allow this system to fail." Bitcoin does not have a Ben Bernanke or a Federal Reserve to stand behind it. Bitcoin hasn't been around for a decade yet, so it's not even clear why this specific cryptocurrency should be worth so much more than all the other 1,318 cryptocurrencies you've never even heard of (you can see the full list of these at <https://coinmarketcap.com/all/views/all/>).

Most concerning of all, however, given how much we really don't know about Bitcoin, is the staggering rise in its price.

In the last week, The Atlas Investor founder Tiho Brkan tweeted, "Bitcoin is rising faster than any asset class we have seen over the last 400 years. The sharp bull markets including the tech bubble of the late 1990s, US shares of the 1920s, oil in early the 2000s and even the famous South Sea Bubble do not even come close to the rise in Bitcoin." None of these prior events ended well for investors who were present at the end.

Some have even likened the rise of Bitcoin to the Dutch tulip mania of the 17th century, when, at its peak, 12 acres of land were supposedly offered to purchase a single Semper

Augustus bulb. Not surprisingly, tulip prices inevitably collapsed, and the whole sorry episode was popularised in 1841 by the book 'Extraordinary Popular Delusions and the Madness of Crowds'. We sincerely hope that book title doesn't have equal relevance to the Bitcoin buyers of today.

We freely admit, we don't know what a Bitcoin's true value is, but we suspect that very few people can honestly say that they do. Do you want a really scary thought? It's possible that no one knows. It would be worth pondering that thought for a minute before you consider spending NZ\$14,500 to acquire a Bitcoin. As the dotcom sharemarket bubble in the 1990s emphatically proved, buying any asset with a rapidly rising price, without having a good understanding of its intrinsic value, is usually a flawed strategy.

Whatever your reaction is to the current Bitcoin frenzy, just don't tell yourself it is an investment. It doesn't generate any income and no one in the world knows how to value it accurately, so we cannot classify it as an investment. Speculative? Absolutely. An opportunity to make some money? Maybe. But an investment? No chance.

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