Making Sense of Bitcoin

By Nicole Rutledge Regilio

Bitcoin is now the hot topic of conversation after taking a backseat to GameStop and Reddit a few weeks ago. Bitcoin recently traded higher than $50,000 per coin! Five years ago, one coin was worth closer to $400. Anytime an asset's price moves like that, it will generate headlines.

If you follow an evidence-based approach to investing, you may be skeptical of claims that this is a new normal. But skepticism does not mean outright dismissal, so let's explore.

What is Bitcoin?

Bitcoin is currently the dominant "cryptocurrency." Unlike traditional money, there are no paper notes or metal coins. No central bank issues the currency, and no regulator or nation-state stands behind it. Instead, cryptocurrencies are a form of code made by computers and stored in a "digital wallet." In the case of Bitcoin, there is a finite supply of 21 million coins, of which more than 18.6 million are currently in circulation. A public ledger called blockchain records all transactions. The most common way people take ownership of bitcoins is by buying them with traditional fiat currencies.

Bitcoin and other cryptocurrencies remain relatively specialized. Despite the recent boom, the total value of all cryptocurrencies is less than one-half of one percent of the worldwide value of all stocks and bonds.

Should Bitcoin Be a Part of My Portfolio?

When it comes to any investment in a portfolio, first consider your goals. Most commonly, people want to grow their wealth for greater future consumption. Next, consider the various investment vehicles available such as stock, bonds, cash, etc., to help you reach your goals.

Corporations issue stock and bonds as a way to generate capital from investors to finance projects. The price of a stock or bond reflects what investors are willing to pay today for an undetermined (but hopefully larger) amount of cash in the future. These securities then allow investors to share in the future profits earned by corporations globally.

With that framework, let's explore if Bitcoin is a fit.

Long-Term Expected Returns

Holding cash does not provide an expected stream of future cash flow. One U.S. dollar in your wallet today does not entitle you to more dollars in the future. The same logic applies to holding other fiat currencies. We should not expect a positive return from holding cash in one or more currencies unless we can predict when one currency will appreciate or depreciate relative to others. This expected appreciation is what makes Bitcoin speculative.

A speculative investment is not a good candidate for a permanent long-term holding in a portfolio. Academic research overwhelmingly suggests that short-term currency movements are unpredictable, implying there is no reliable and systematic way to earn a positive return just by holding cash, regardless of its currency.

Substitute for Cash

The purpose of cash is to provide a "store of value" for near-term expenditures. You know that the dollar you have in the bank is going to be worth a dollar tomorrow. Many of those owning Bitcoin do so with the idea that it is the future of cash. We won't necessarily dispute that – it may or may not be – but it certainly has a long way to go before it gets there. There are two main issues with this idea.

First, Bitcoin is not accepted as payment for most goods and services. If you want to pay for something with Bitcoin, it likely has to be converted into a local currency, which can come with high transaction costs.

Second, and more importantly, it's not a consistent store of value. We mentioned earlier that Bitcoin recently climbed to $50,000. A few weeks prior, Bitcoin dropped 23% in value from $42,000 to $32,000. Using something with that much volatility as a store of value for near-term expenses is too risky.

Hedge Against Inflation or the Dollar's Collapse

One of the arguments frequently made for Bitcoin is its limited supply. It was designed to have a finite supply with the idea the value should rise with inflation as the supply diminishes. However, this ignores the possibility of other cryptocurrency substitutes, and several already exist today. Even if cryptocurrencies change the future of money, there will probably be even more substitutes in the future, thereby reducing Bitcoin's perceived value.

As for the dollar's collapse, that's a speculative guess driven more by ideology than evidence. Speculation of this magnitude could lead to an opportunity for profits, but only because it's *very* unexpected. What are the actual odds that happens? And, how sure would you be that Bitcoin would necessarily be the benefactor? Would the world's financial systems rush to digital wallets if this happens, or would they rely on fiat currency or gold instead? You can never entirely rule out any scenario, but the odds would appear to be very low.

Conclusion

The potential of the underlying blockchain technology that enables the trading of cryptocurrencies is exciting. It has significant implications for banking and other industries, but these effects may take years to emerge. The reality is that it's hard to know what the future holds for Bitcoin as an asset. Like any new thing, you should be skeptical until the evidence starts to bear fruit one way or another. Again, remember your goals. Objective evidence shows that a well-diversified portfolio of stocks, bonds, and traditional currencies has always been the best way to help investors pursue their goals.

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