Asset Management

News or Noise: Are Bitcoins Money?

By David Fisher, Chief Investment Officer

When we use the term "money," we are usually referring to the cash in our pockets or the value of funds in our checking account. In this case, however, "money" refers to currency. True currencies meet three requirements: they are mediums of exchange, can be units of accounting, and are stores of value. Across history, many things have been used as currency: livestock, seashells, tobacco, silver, gold and other precious metals. Today, most major economies use what are called fiat currencies—which are considered money simply because the backing government says they are.

In this era, money really has no tangible value. Instead, it is completely reliant on confidence in the issuing government. When the Internet brought about a new open-source, non-government-regulated ecosystem, it was just a matter of time before a new form of money was created. Bitcoin was first theorized in 1998 as a form of crypto-currency, then created in 2009 by an alleged computer programmer known as Satoshi Nakamoto. However, very little is known about Nakamoto—including whether or not he actually existed. Now that Bitcoin is gaining popularity, the questions are: Will it replace government-backed money? Is it an investment or a currency? Will it survive?

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How Are Bitcoins Created?

There are three ways to gain access to bitcoins. First, and most simply, you can buy them. You can create a virtual wallet on one of the Bitcoin websites, deposit dollars or other currency into your account and exchange these for bitcoins. Second, you can enter into a transaction for goods or services with another party and settle in bitcoins. In fact, there have been recent news stories about people buying and selling houses for bitcoins. Finally, and most interestingly, you can mine for bitcoins. "Mining" refers to the verification of bitcoin transactions, which in turn yields the creation of additional bitcoins—a self-sustaining and self-regulated system. Twenty-five newly created bitcoins are awarded to computer programmers who are able to verify the authenticity of a series of bitcoin transactions.

The creation rate of new bitcoins, however, is limited. They are currently awarded at a rate of 25 every ten minutes. Beginning in 2017, this rate will be cut in half and each transaction will be worth 12.5 new bitcoins. Additionally, with technology constantly expanding and the number of miners growing at a rapid rate, the effort required to earn new bitcoins is increasing exponentially. In fact, the difficulty rate—defined as the number of attempts needed to find a key (a number that allows bitcoins to be spent)—is 1,000 times higher than just one year ago.

Bitcoin advocates are quick to point out that the total number of bitcoins in circulation is growing at a deliberate and steady rate compared to government-controlled currencies, which have seen significant intervention from central banks. But the total value of bitcoins in circulation is tiny compared to traditional currencies or other alternatives, such as gold. Fewer than 12,400,000 bitcoins currently exist—and at today's value, that equates to about $7 billion of total capitalization. For comparison, the value of all bitcoins currently in existence is less than a week's worth of sales by Wal-Mart.

Challenges Ahead

The Bitcoin universe has both strong advocates and opponents. It is clear that bitcoins aren't going away any time soon, but the virtual currency will almost certainly face larger challenges as it gains notoriety and increases its impact on the economy. According to Nicholas Colas at Bitcoin Exchange Company ConvergEx, 2014 will bring three new forms of challenge: regulation, adoption and volatility.[1]

With hacking attacks on the rise and concerns about illicit activity, governments are increasing their regulation of Bitcoin exchanges. In fact, just last week, New York's top banking regulator held hearings regarding bitcoin usage. One main regulatory focus involves requiring Bitcoin operators to adhere to Bank Secrecy Acts that are designed to stop drug and money laundering operations.[2] Other countries, notably China and Russia, have severely limited or even banned bitcoin transactions altogether.

Adoption is an additional challenge, though one that may be overcome more easily. If the total number of bitcoins in circulation grows as expected, major companies will certainly get on board. In recent weeks, Overstock.com became the first major retailer to directly accept bitcoin payments. Currently, sites like gyft.com allow for the conversion of bitcoins into gift cards for major retailers.

The volatility challenge, however, is potentially more severe. During much of 2013, the price of bitcoins ranged from $100 to $200. For a currency, that amount of volatility is relatively high—but in November, the real rollercoaster began. Between November and year-end, bitcoin prices surged from $200 to more than $1,200. Prices then dropped to $600, rebounded to $1,000 and then, with all the hacking attempts and regulatory challenges, fell again last week to under $600. With a chart that looks more like a penny stock than a currency, most mainstream users will continue to steer clear.

The Future of Money

We suspect that bitcoins are with us for the long haul—and may end up being the first iteration of massively disruptive technology that impacts global financial markets. In fact, bitcoins could eventually have all three attributes of true currencies—but it will take a long time and they will certainly face more setbacks. The bitcoin was initially created with the libertarian ideal of limiting the power of the government, and it "has gained a following partly because it seems to show us how we can do without money issued by the state. Currency could be nationless."[3] However, one should never forget that money and power are always intertwined. We doubt that governments will willingly allow the use of bitcoins to grow unchallenged.

Sources

1. Vigna, Paul. "Bitcoin's Three Key Challenges in 2014." *The Wall Street Journal*. January 24, 2014.

2. Henning, Peter J. "More Bitcoin Regulation Is Inevitable." *DealBook/The New York Times*. February 3, 2014.

3. Williams, Mark. "A Dangerous Mistake Lies at Bitcoin's Intellectual Core." *The Financial Times*. February 10, 2014.

What Is News or Noise?

Like most of you, we are inundated with information on our phones, in our email inboxes and on the Internet. Clearly, the world doesn't need a new investing blog to re-process stale information or reformat the day's useless headlines. Thus, we are calling our investment blog "News or Noise." We've taken up the challenge of sorting through the infinite bits of background noise and seeking the few truly newsworthy nuggets of information. What are the stories today that are likely to be meaningful for investors in the future? A very small number of headlines are important and of those, many are immediately processed by investors. Only a tiny fraction of all the new data is truly relevant and underappreciated.