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Is Bitcoin for Real?

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Investors have been salivating over the financial market's shiny new thing: bitcoin. And for good reason: the price of one bitcoin shot up about 300% in 2020 and has nearly doubled again in 2021 (as of March 19, 2021) to near $56,000. In fact, bitcoin has been the top performing asset in 8 of the last 10 years but has only recently caught the attention of mainstream investors. The digital token's meteoric rise has led to the question on many people's minds: *is bitcoin for real?* Let's explore some of the arguments to determine whether bitcoin deserves a place in investor portfolios.

What is Bitcoin?

To the uninitiated, bitcoin is a highly volatile, speculative, esoteric financial invention that cannot be touched or seen. In its early days (2009-2013), bitcoin developed a shadowy reputation as a mechanism for illicit criminal activity. Bitcoin was created as a decentralized digital currency whose value would be stored on a network of independent "digital ledgers" known as a blockchain which would ensure its validity and would be free of central banks' manipulation of their own money supply. Bitcoin's unique features – its limited supply, lack of centralized control, immutable recordkeeping, portability, divisibility, and complete transparency – are proving to be valuable attributes to those concerned about the ongoing debasement of fiat currencies.

Opportunities Abound….

The opportunities for bitcoin to emerge as a disruptor to the global payments system and as a store of value are significant. 230 million people around the world rely on an antiquated and expensive remittance system to transfer approximately $500 billion per year, with costs ranging from 5 to 20% of the transfer. There are roughly 2 billion individuals without access to the global banking system but could use their mobile phones to transmit cryptocurrency. Bitcoin transactions typically settle in 10-30 minutes while traditional electronic transfers can take days. Fees are a fraction of the cost of traditional money transfer mechanisms. And all transactions are completely transparent: cryptocurrencies exist on a publicly available ledger so that transactions can't be manipulated by a person, organization, or government. Every bitcoin transaction that has ever occurred is maintained on this digital ledger.

As the price of bitcoin has soared, institutional investors have become more appreciative of its unique attributes and have moved toward adopting it in their own businesses. Consider: 1) Visa has stated that they are working to enable purchase of bitcoin using Visa credentials and allowing bitcoin to be used for purchases through the Visa network; 2) Morgan Stanley is rolling out 3 bitcoin funds for use by their wealth management practice, recommending maximum 2.5% allocations for clients with an "aggressive risk tolerance" and who have at least $2m with the firm[1]; 3) a number of public companies including Tesla, Square, Guggenheim, and Mass Mutual have announced plans to acquire bitcoin for their own portfolios; and 4) even vocal skeptics of bitcoin, such as JP Morgan CEO Jamie Dimon have acknowledged the transformative potential of the blockchain, while remaining somewhat skeptical on bitcoin itself.

As Do Risks……

Skeptics of the digital currency point to its extreme volatility (average **daily** price movements range from 3 to 11%[2]) as a disqualifying factor for bitcoin to act as a reliable means of exchange. Blockchain technology, the digital infrastructure upon which bitcoin resides, is still in its very early days, and questions remain about its susceptibility to hacking. Investors may recall the hacking and collapse of Mt. Gox in 2014, at that point the world's largest bitcoin exchange, which held 850,000 bitcoins from thousands of users. Customers of Mt. Gox are still fighting to recover a portion of their capital.

Governments are struggling with how to regulate this rapidly evolving space. While bitcoin cannot be shut down, regulators may impose harsh new regulations on exchange transactions to enhance protections for investors. Governments may adopt new disclosure requirements to crack down on the use of bitcoin for illegal purposes, which has been declining over the past 5 years. In fact, Bitcoin's transparent public ledger makes it a rather poor choice for would-be criminals. The US Treasury Department has considered imposing KYC/AML (Know Your Customer/Anti-Money Laundering) requirements on digital currency wallets, a cornerstone of the crypto ecosystem.[3] At the same time, many governments are planning to launch their own central bank digital currencies (CBDC's). All these conditions have the possibility of reducing, or even destroying, the demand for bitcoin.

Recently, attention has swirled around the large amounts of energy that is consumed through the process of validating the bitcoin network, known as mining. Bitcoin mining is increasingly shifting towards renewable energy sources but has some work yet to do. Electricity consumption is a notable negative externality for Bitcoin. That must be weighed against the benefits of maintaining a censorship-resistant digital store of value that has been life changing for people in countries with high inflation or oppressive monetary regimes.

Adding Bitcoin to a Diversified Portfolio

Bitcoin has been described by some as "digital gold" because of its use as an inflation hedge and its ability to add diversification to a multi-asset class portfolio. In fact, bitcoin's transferability, portability, and scarcity provides it with some inherent advantages even over gold. While the historical track is short, bitcoin has demonstrated very low correlation to most traditional asset classes, including US stocks and bonds, broad commodities, the US dollar, and even gold itself.

[1] https://www.cnbc.com/2021/03/17/bitcoin-morgan-stanley-is-the-first-big-us-bank-to-offer-wealthy-clients-access-to-bitcoin-funds.html
[2] Source: Bloomberg
[3] https://www.theblockcrypto.com/post/88347/treasury-crypto-wallets-reporting-rule

Recent studies based on historical data from 1/1/14 to 9/30/20 showed that a bitcoin allocation of 2-2.5% in a diversified portfolio added 1.7% annually to a traditional 60 stock/40 bond allocation, with little change in overall volatility[4] Despite its inherent volatility, bitcoin's low correlation to other portfolio asset classes does not result in more variability in overall portfolio return.

There are several ways for US investors to acquire a bitcoin position. A popular method to date has been to purchase shares of the Grayscale Bitcoin Trust (GBTC). GBTC operates like a closed end fund, with occasional offerings of new shares through a private placement to accredited investors. After six months, the holders of the private placement shares can sell them on an exchange, allowing individual investors to acquire them in traditional brokerage accounts. But GBTC is not a traditional exchange traded fund (ETF). ETFs have a built-in mechanism to maintain their value close to the value of its underlying holdings. GBTC carries a 2% management fee and often trades at a wide discount or premium to the value of the underlying bitcoin. There is no guarantee that GBTC will trade at the value of the underlying bitcoin, adding an additional level of risk to holders of this security.

The most reliable method for investing in bitcoin is buying the asset directly on a regulated US exchange such as Coinbase or Gemini. Other methods for gaining exposure to bitcoin include investing in long-only private funds that own bitcoin or acquiring stakes in companies that own bitcoin or operate a bitcoin-related business. Each of these approaches carry substantial fees or provide only indirect exposure to the digital currency. Recently, Canadian regulators approved three bitcoin ETFs primarily for Canadian investors, with lower fees than GBTC and better tracking to the coin itself, but these can be operationally challenging to access via US brokerage accounts. A more complete discussion of these approaches in beyond the scope of this article.

Bottom Line

Given the expanding acceptance of bitcoin by major institutional investors, the increasing avenues of access for individuals, a growing use case for bitcoin and blockchain applications, and attractive diversification characteristics, **we believe bitcoin has reached an inflection point in its evolution**. But it is still early. A 2020 survey from Statista found that just 6% of the US population have used or owned digital currencies.[5] We view bitcoin as a highly speculative investment and its role in a diversified portfolio to be largely untested. Indeed, professional investors attempting to apply traditional valuation metrics to bitcoin have struggled to establish a fair value: estimates range from a low of zero to a high of $400,000. Ultimately, like any asset, the value is determined by the price at which a willing buyer and seller can agree.

At present, we find few economical and convenient avenues for investors to own bitcoin. High fees, counterparty risk of purchasing through a third-party exchange, lack of liquidity, and premium/discount issues increase the friction of trading bitcoin. Several firms are awaiting approval for US regulators to launch a US-based ETF, which should address many of these shortcomings. In the meantime, we believe investors

[4] Source: Morgan Stanley
[5] https://www.statista.com/chart/18345/crypto-currency-adoption/

should carefully review any access vehicles other than direct ownership. We still believe in a cautious approach to this potential new asset class, but if bitcoin can deliver on its many promises, the potential rewards to investors are substantial.

Note: Ballentine Partners has produced a more detailed document on bitcoin and blockchain. Please contact a member of your client team receive a copy of this document.

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Bruce is a Partner and Director of Research at the firm. Bruce rejoined Ballentine Partners in June 2016 after more than 5 years as Chief Investment Officer of City National Rochdale, LLC, in Los Angeles. City National Rochdale, a wholly owned subsidiary of City National Bank, serves family clients across the United States with a staff of nearly 100 investment professionals. Before moving to Los Angeles, Bruce served as Chief Investment Officer of Ballentine in our Waltham office for three years. Prior to that, Bruce spent four years with Morgan Stanley Private Wealth Management in New York and eight years with Glenmede in Philadelphia as Chief Investment Officer and Portfolio Manager. In addition to working directly with a number of family clients, Bruce serves on Ballentine's Investment Management Committee, which is responsible for the oversight of all of the investment activities for the firm. Bruce received an MBA with a concentration in Applied Economics from George Washington University and a BS degree in Business Administration from Penn State University. Bruce holds the Chartered Financial Analyst (CFA) and the Certified Private Wealth Advisor (CPWA®) designations. He lives with his wife in Palm Beach Gardens, Florida.

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Andrew is a Senior Research Analyst at the firm and is responsible for research coverage of global equity markets. He is responsible for portfolio construction & manager selection for publicly traded equities. His research also contributes to our overall market outlook. Andrew joined in 2016 from Brown Brothers Harriman where he worked in Fund Accounting Services, generating net asset values for large mutual funds and resolving issues related to derivatives pricing, capital stock transactions, and manager performance fees. Previously, Andrew was an associate at PwC in their Risk Assurance practice where he audited investment industry clients' internal control and regulatory frameworks. Andrew graduated with a B.A. in Economics from Colorado College, where his senior thesis analyzed incentive structures surrounding public company boards of directors in relation to takeovers and acquisitions. He spent his junior year at the London School of Economics & Political Science studying Finance and Accounting. Andrew is a CFA Charterholder. Andrew resides in Cambridge and spends time golfing, snowboarding and watching F1 racing. He is also passionate about investing, technology and movies. He grew up in the mountains of western Colorado but has also lived in Chicago, Dallas and London.