Bitcoin: A Viable Currency Or A Speculative Asset?

By

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The market is in a craze over Bitcoins (BTC). Year-to-date, BTC has increased in value by almost 1000 percent. Truly amazing! But what exactly are investors buying? Are they buying a peer-to-peer currency that has the potential of changing the way we financially interact with each other, or are they buying an asset whose market value has diverged from its actual value? This question is vitally important to anyone interested in BTCs.

Let's frame the question this way: can BTCs be adopted across the board in the marketplace as a currency, but lose value as an asset? The short answer is yes! To see the logic, consider a similar situation of Amazon (AMZN) stock and how the market establishes the price of a high growth stock. With the total value of BTCs representing only 2.4 percent of world currency, its growth potential is also quite high. BTC and AMZN are similar in terms of potential growth and risk.

The P/E of AMZN is almost 300. This P/E says the market is paying $300 per share for every $1 of AMZN earnings per share. At a time when the average P/E in the market is approximately 20x with an implied growth rate of 6-7 percent, AMZN's P/E ratio appears out of line with reality. Investors who buy AMZN at such a high P/E are betting the company's future earnings will grow well in excess of 6-7 percent. With the expectation of high growth comes high risk, but is the high price of AMZN stock irrational?

Many professional investors (including myself) argue that high P/E ratios are not irrational and that the market pricing mechanism is efficient; that the price one observes in the market reflects the true underlying value of the stock. This belief, however, is not universally accepted. Thousands of actively managed mutual funds whose managers continually search for mispriced securities attest to the fact that many investors believe the market pricing mechanism is inefficient.

The question of market efficiency is important for BTC investors to understand what they are buying. To address this question, we can divide BTC's future value into two distinct components: its economic value as a currency and its market value as an asset. Efficiency would say the two move in tandem, whereas inefficiency would say they could diverge with the market value becoming a bubble.

History teaches us many lessons about bubbles, which are easy to see after-the-fact but difficult to detect before-the fact. Media hype confuses the situation. In the famous case of the Dutch tulip bulb bubble (say that 10 times real quickly!) in the early 1600s, the price of one tulip bulb peaked at more than six times the average person's annual salary. When the bubble eventually burst, investors left holding the bag suffered devastating losses.

In hindsight, we clearly see that the value of a tulip bulb took on a life of its own totally independent of the bulb's underlying economic value. Bubbles were also observed in 1929, again in 1987, and more recently in the housing market debacle of 2008. These instances clearly teach us that bubbles exist. Is that happening now with BTC?

Investors who purchase BTCs may be expecting growth in its global acceptance to convert equally into growth in its market value. After all, BTCs are being increasingly accepted in the market place across the world. Japan recently passed legislation embracing BTC as a legal form of payment. Estimates are that over 300,000 retailers in Japan now accept the digital currency as legal tender. My guess is that the USA will soon pass similar legislation.

But growth in acceptance as a currency does not necessarily mean equal growth in its market value. The two are not the same, and thinking they are the same can lead to a repeat of an historical calamity. The risk is that the current value of BTC already reflects its future growth potential just like the price of AMZN reflects its future growth.

Let's be clear: even if the whole world were to accept BTCs as a legal currency (which may happen), that does not necessarily mean the market value of a BTC would grow by the same magnitude. Stated somewhat differently, the value of BTC may be getting ahead of itself. If so, a significant devaluation could occur at any moment. Bubbles eventually burst!

Another significant risk is that the US Government could create its own digital currency. William Dudley, president and CEO of the Federal Reserve Bank of New York, recently said the Fed is exploring this idea.

This discussion points out that investing in BTCs in a retirement account is inappropriate due to the extreme risks involved. The advisers at Copley Investment Management strongly believe this. We further believe that if someone wishes to make such an investment, they should do so outside their retirement account with funds they can afford to lose.

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