

Bitcoin's Wild Ride, and It May Not Be Over!

By

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Bitcoin is an interesting and exciting adventure into the internet-based world of cryptocurrencies. While Bitcoin is only one of many digital currencies, it is the most popular. Created in 2009 by a person with a Japanese name, over the past year one Bitcoin has skyrocketed in value from \$700 to over \$7,000 for an astonishing return of almost 900 percent. An investor who purchased \$10,000 worth of coins November 1, 2016 would have accumulated a staggering worth of over \$100,000 as of this writing.

The train has left the station, but nobody is sure of its destination. We do know, however, that the trip will be through the mountains. Is Bitcoin a real locomotive or just a soapbox hoax?

Transactions in Bitcoins involve no bank, no fee, and are anonymous. Merchants who accept Bitcoins as payment include many well-known firms such as Subway, Overstock.com, and Microsoft. The list is growing rapidly.

Unlike a fiat currency (paper medium of exchange such as the US dollar), the Federal Reserve does not print Bitcoins. Instead, coins are mined by hi-tech hardware and sophisticated software designed to solve a complex mathematical formula. The mining process is quite expensive taking up to several days and requiring a huge amount of electricity. The mining process, which is largely in China, limits the supply of coins coming to market.

Bitcoin's meteoric rise is due to high demand relative to a fairly fixed supply. The market has created a strong demand for two basic reasons. First, it appears to be a disruptive push-back against profligate governments who use excessive debt monetized by accommodating central banks. In addition, technological advances have made a global currency a reality. The technology on which Bitcoins rely is Blockchain.

Blockchain can be visualized as the vehicle in which Bitcoin is one of many passengers. Bitcoin depends on Blockchain, but Blockchain does not depend on Bitcoin. Blockchain is an enormous accounting ledger that can track every transaction in the world regardless of location. It has the potential to significantly alter global trade. IBM has devoted substantial resources to developing multi-industry applications for Blockchain (see <https://www.ibm.com/blockchain/financial-services>).

Back to Bitcoins! Bitcoins are not listed on any national stock exchange. One gains ownership either via the mining process, which is impractical for most people, or by way of a clearinghouse that matches buyers and sellers. A popular app is Coinbase.com. Merchants and individuals who transact in Bitcoins can easily use this app to link their bank account to a Bitcoin account.

Bitcoins present a serious challenge to global central bankers. Universal adoption of Bitcoins would create a monetary system similar to a gold standard. Although Bitcoins have no metal backing, neither does any fiat currency. Bitcoin's value is derived solely from a collective belief it has value. If that belief weakens, Bitcoin's value weakens and vice versa. Respected publications such as the Economist and Bloomberg have run positive articles touting its use.

Ultimately, a government could declare Bitcoins illegal, although I doubt that would happen. Without the full support of all countries, a declaration of illegality by one country would transfer trade to non-declaring countries at the expense of the declaring country. This is a case of "all or nothing"--possible, but unlikely.

Taxing authorities are watching. The IRS recently declared Bitcoin an asset. This is important because assets are taxed as either short-term or long-term capital gains or losses, depending on the time held. The IRS's action is a signal to the market that Bitcoins are legitimate.

On the other hand, Jamie Dimon, CEO of JP Morgan Bank, says Bitcoins are a fraud and that he would fire any employee trading the currency for being stupid. Dimon argues that governments will eventually crack down on digital currencies because they are used for illegal purposes. Anonymity makes Bitcoins attractive for that purpose. Dimon does, however, see Blockchain technology as having great potential as a method of optimizing financial transactions across the globe.

In an investment course I teach at UNCW, we recently devoted 50 minutes of class time to a discussion of Bitcoins. To say my students were interested would be an understatement. They were excited! Except for one knowledgeable fellow, the rest of the class knew almost nothing. Since then, several have expressed interest in conducting research on the topic.

Investing in Bitcoins is an extremely high-risk venture and should not be undertaken carelessly. Whatever amount of money one puts on the table should be done with the attitude it could disappear overnight. Bitcoin's spectacular rise in value could just as easily turn into a free fall. All the best, REC

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