Is investing in bitcoin really a good idea? Question marks remain

The market capitalisation, including bitcoin and bitcoin cash, was estimated at close to $US100 billion as of October. **Bloomberg**

by **Stirling Larkin**

Many investors are scared to be on the wrong side of history when it comes to the nascent bitcoin and cryptocurrency phenomenon, simply because it provokes deja vu for those who dismissed the invention of the internet in the early 1990s as a passing fad.

Australian ultra-high net worth investors only have one real question they want answered at this moment: Is bitcoin's meteoric ascent in 2017 another tulip-mania frenzy or truly a new asset class emerging from the burgeoning digital transnational economy?

In answering this, a better understanding of bitcoin, including its uniqueness in the burgeoning cryptocurrency ecosystem and why 2017 has seen an unprecedented bull market, is required. Ultra high net worth (UHNW) investors are as confused as anyone on the subject.

The market capitalisation or network value of bitcoin, including both bitcoin and bitcoin cash, is estimated at close to $US100 billion ($130 billion) as of October 2017. The total value of all cryptocurrencies is about $US180 billion.

This ecosystem was valued at only $US12 billion at the end of 2016.

Bitcoin is an open source, "permissionless" software that anybody can be part of.

Its origins stem back to an academic white paper published in October 2008 during the height of the global financial crisis, by an author going by the nom de plume Satoshi Nakamoto. To this day Nakamoto's identity has not been confirmed.

The paper proposed an alternative to the banking system, whereby a peer-to-peer cash system could be conceptualised which did not require third parties, such as banks and clearing houses.

Public ledger of transactions

This proposition argued that everyday transactions could be cheaper and more secure because they were happening on the blockchain, a technology which is a shared, public ledger of transactions.

Purchasing a cryptocurrency is simply paying money to acquire a digital coin, whereas mining a cryptocurrency is a process whereby a computer solves complex math problems to verify the transactions happening on the blockchain, to digitally timestamp them in real time and ensure there is no double spending happening.

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One aspect that concerns UHNW and institutional investors, regulators and investment banks is that 86 per cent of all cryptocurrency mining is carried out in the People's Republic of China.

Given that the blockchain technology is being considered as a replacement option to existing clearing house architectures, it goes without saying that a wholesale replacement, whereby a majority of global transactions need to be verified in authoritarian China, raises legitimate concerns.

In essence, blockchain has created a network whereby anything can be digitalised and then traded between any two parties – analogous to emails but for transactions, not merely for communicating.

Every computer on the network has a copy of this ledger and every transaction gets updated on every ledger at the same time so that it can be verified, and that process puts everything out into the open, ensuring transparency. This makes banks unnecessary.

Unsurprisingly, politics has entered this fray, both within the cryptocurrency communities but also across finance and monetary policy authorities.

Within bitcoin, for instance, over the past five years there has been a dynamic where one group is adamantly anti-government and obviously anti-regulation, while another group wants to bring cryptocurrencies into the mainstream, believing they have value for people and commerce and embracing regulation to legitimise them.

Every regulator on the planet is figuring out what this is and what it means to their economy, and how they are going to address it.

There is fear across regulators in the developed world that might prevent innovation, so they are stepping lightly. But this is levelled against real concerns that it is a system which authorities cannot control – they don't control the currency within it, and they can't control who is using it and what they're doing it for.

These situations have been dubbed "dark net transactions".

Underlying economies

For bitcoin specifically, the two competing camps split, ostensibly over disagreements about how fees have changed over time.

One camp argued that fees were too expensive and that the network, whereby the blockchain verified transactions, became too slow.

Bitcoin transactions have always had a small fee and it has been voluntary, going to the miners as a reward for processing transactions.

Remembering that the capacity of bitcoin to process transactions is capped, in the early years capacity was not an issue, but as it rose in popularity, the design of the network constrained capacity, leading to bottlenecks.

With some offering miners a premium to front-run their transactions over others, tensions arose, leading to a split to what are now bitcoin and bitcoin cash communities.

Importantly, Nakamoto's white paper talked about "proof vs trust". The system we currently have relies on trust (we trust a bank to keep our money secure), whereas the bitcoin system is based upon proof because you have these networked computers solving complex maths problems to verify the transactions simultaneously and in real time.

A lasting concern UHNW investors have with bitcoin is that unlike fiat currencies, there is nothing anchoring it. The value of fiat currencies reflects their underlying economies' values, relative strengths and robustness.

Being battle tested almost every day, bitcoin is not a passing fad but its true and lasting value is still far from clear.

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