

PERSPECTIVES

Tales from the Crypto: How to Think About Bitcoin

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“Everything you don’t understand about money combined with everything you don’t understand about computers.”—HBO’s Last Week Tonight with John Oliver, March 11, 2018

Bitcoin and related cryptocurrencies (now numbering in the thousands) are the subject of much debate and fascination. Given bitcoin’s dramatic price changes, it is not surprising that many are speculating about its possible role in a portfolio.

Exhibit 1
Bit Player

Price of bitcoin for the last 10 years, March 2011–February 2021



Past performance is not a guarantee of future results.

Note: Data from Investing.com

In its relatively short existence, bitcoin has proved extraordinarily volatile, sometimes gaining or losing more than 40% in price in a month or two. Any asset subject to such sharp swings may be catnip for traders but of limited value either as a reliable medium of

exchange (to replace cash) or as a risk-reducing or inflation-hedging asset in a diversified portfolio (to replace bonds).

Assessing the merits of bitcoin as an investment can be problematic. Adding it to a portfolio could mean paring back the allocation to investments such as stocks, property, or fixed income. The owner of stocks or real estate generally expects to receive future income from dividends or rent, even though the size and timing of the payoff may be uncertain. A bondholder generally expects to receive interest payments as well as the return of principal. In contrast, holding bitcoin is similar to holding gold as an investment. Even if bitcoin or gold are held for decades, the owner may never receive more bitcoin or gold, and unlike stocks and bonds, it is not clear that bitcoin offers investors positive expected returns.

Putting aside squabbles over the future value of bitcoin or other cryptocurrencies, there are other issues investors should consider:

- Bitcoin is not backed by an issuing authority and exists only as computer code, generally kept in a so-called “digital wallet,” accessible through a password chosen by the user. Many of us have forgotten or misplaced computer passwords from time to time and have had to contact the sponsor to restore access. No such avenue is available to holders of bitcoin. After a limited number of password attempts, a user can permanently lose access. Since there is no central authority responsible for bitcoin, there is no recourse for the forgetful owner: a recent *New York Times* article profiled the holder of more than \$200 million worth of bitcoin that he can’t retrieve. His anguish is apparently not unusual—a prominent cryptocurrency consulting firm estimates that 20% of all outstanding bitcoin represents stranded assets unavailable to their rightful owners.¹
- Mt. Gox, a Tokyo-based bitcoin exchange launched in 2010, was at one time the world’s largest bitcoin intermediary, handling over one million accounts in 239 countries and more than 90% of global bitcoin transactions in 2013. It suspended trading and filed for bankruptcy in February 2014, announcing that hundreds of thousands of bitcoins had been lost and likely stolen.²
- The UK Financial Conduct Authority cited a number of concerns as it prohibited the sale of “cryptoasset” investment products to retail investors last year. Among them were the inherent nature of the underlying assets, which have no reliable basis for valuation; the presence of market abuse and financial crimes in cryptoasset trading; extreme price volatility; an inadequate understanding by retail consumers of cryptoassets; and the lack of a clear investment need for investment products referencing them.³

The financial services industry has a long tradition of innovation, and cryptocurrency and the technology surrounding it may someday prove to be a historic breakthrough. For those who enjoy the thrill of speculation, trading bitcoin may hold appeal. But those in search of a sound investment should consider the concerns of the Financial Conduct Authority above before joining the excitement.

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1. Nathaniel Popper, "Lost Passwords Lock Millionaires Out of Their Bitcoin Fortunes," *New York Times*, January 12, 2021.
 2. Alexandra Harney and Steve Stecklow, "Twice Burned – How Mt. Gox Bitcoin Customers Could Lose Again," Reuters, November 16, 2017.
 3. "Prohibiting the sale to retail clients of investment products that reference cryptoassets," Financial Conduct Authority, June 10, 2020.

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