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Investing in Bitcoin: Opportunities & Risks

Bitcoin continues to generate the interest of investors and its use as an investment asset has recently gained even greater popularity. Although the future of digital currency seems promising, the market is extremely volatile. In this episode of Choate's Family Office Podcast Series, Tamer Alamuddin, managing director of ChoateIA, and Erin Kerr, a portfolio manager at ChoateIA, explore the broader landscape of blockchain and the basics of Bitcoin, including key advantages and risks for investors.

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Transcript

Welcome to the Choate Family Office Podcast Series. On this show, we explore important topics related to wealth management, investing, and managing risk across generations.

Erin Kerr: Hello, I'm Erin Kerr, a portfolio manager at Choate Investment Advisors and I'm joined today by Tamer Alamuddin, managing director at Choate Investment Advisors. Thank you for speaking with us today as we discuss something that is generating a lot of investor interest recently: Bitcoin. So before we dive into Bitcoin more specifically, maybe you could give us a very high-level overview of blockchain and the technology that underlies Bitcoin.

Tamer Alamuddin: Thanks Erin and pleasure to be here. So, blockchain is best understood as a form of database. Many of us are familiar with databases in terms of a table of data that we can navigate. Blockchain is a specific type of database that stores data in blocks and then chains those blocks together in chronological order. Different types of information can be stored on a blockchain but the most common use is as a ledger for transactions.

EK: So how does blockchain work as a cryptocurrency?

TA: So blockchain is the foundation behind cryptocurrencies. Taking a step back if you think of what a bank is, it's just a ledger. When you deposit money, the bank credits your account and records it on its ledger. When you transfer money the bank debits your

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account also on its ledger. The bank avoids double-spending because it's the only entity that can modify the ledger. Blockchain is a technology that enables simultaneous verification in a decentralized system. So many users have a copy of that ledger and because blockchain gets added to in chronological order, people can verify which transactions happened first and therefore that avoids double-spending. The other benefit of a decentralized blockchain is that they're immutable. For Bitcoin, that means that transactions are permanently recorded and viewed by everyone and because of these qualities, Bitcoin can provide secure and private transactions without any central authority.

EK: So it sounds like Bitcoin has a lot of really attractive qualities as a replacement or as a substitute for some banking. How should investors think about what value Bitcoin is worth?

TA: When we talk about Bitcoin, we think about it as having acquired what we call monetary premium. A monetary premium is a value that's ascribed to something that has additional value, more than intrinsic value, tied to it being used as a means as a currency. When we think about what has a monetary premium, first you start with a collectable. If you look at a painting for example, clearly some paintings cost a lot more than the paint that it took to paint that painting. Why? Because it's a collectable and it has a monetary premium. As store value like gold, it has value well beyond what we would ascribe to gold if it was just purely used in industrial applications. And then ultimately we think of a medium of exchange where you transfer something that has monetary value to someone else in exchange for either a good or service. Most commonly, we think that's what we think about as currency. Well, I have a hundred dollars and I buy something from you and you give me a good. And obviously, if you think about that hundred dollar bill, that has a lot more value than a piece of paper of similar size. Then lastly, when we're thinking of stuff that has a monetary premium, think about a unit of account. Other goods are priced in dollars and so with that as a framework, where does Bitcoin sit? It is not a unit of account, yes we know that some companies saying they're pricing stuff in Bitcoin, but that's very rare and is much more gimmicky. It's not truly a medium of exchange. People are not purchasing things with Bitcoin. What it is though is it is a store value. There are about a trillion dollars in Bitcoin and clearly, lots of people around the world think that Bitcoin has worth.

EK: So what can you say about the recent volatility in terms of the price of Bitcoin.

TA: If you think about Bitcoin as a store value and this is tied to the volatility behind the price, it's very hard to say whether Bitcoin is worth "x" or worth "y" and it's all dependent on the future adoption curve for Bitcoin. As more and more people invest in Bitcoin, the value for Bitcoin goes up. This is for two reasons. One, one of the attributes of Bitcoin is there are only going to be 21 million Bitcoins ever "produced" and so the supply of Bitcoins is finite and it's known. So, therefore, any increase in demand for Bitcoin will naturally result in an increase in price. The problem for an investor saying we don't know what ultimately the adoption is for Bitcoin if we look fifty years in the future, will Bitcoin be more ubiquitous than where it is right now? If so, then the price of Bitcoin will likely go up from here, but it could be just as likely that Bitcoin will be seen as a passing fad like other collectible items and if that's the case then the value of Bitcoin will decline significantly from here. And investors wavering between these two outcomes is why the volatility in Bitcoin is so high.

EK: That makes sense, so if you had to summarize, what is the bull case or what is the opportunities that investors are considering when thinking about investing in Bitcoin? How would you explain that?

TA: I think that many people who talk about Bitcoin like to go to an end state where Bitcoin has supplanted the U.S. dollar. We think that's highly unlikely and actually, we don't think that's necessary to believe in that to think that Bitcoin can be a good investment and a good part of your portfolio. We look at Bitcoin and compare it to its closest substitute right now which is gold which is also a store value. The opportunity for Bitcoin is that it takes a share in people's portfolios from gold. So there's about $10 trillion of gold that used as a store value in the world today and as I mentioned, there is $1 trillion invested in Bitcoin. If you think that Bitcoin will gain an additional trillion dollars of market share from gold, and I've mentioned that the supply of Bitcoin is finite, that would basically mean that the price of Bitcoin would double and that's the opportunity. Further adoption of Bitcoin as an alternative store value versus gold.

EK: That sounds very compelling and very interesting as an investment opportunity. Can you discuss some of the risks that investors should consider?

TA: So there two major risks with Bitcoin. Number one is regulatory, in the sense that we don't really know how governments will view Bitcoin in the future and whether they will take action to promote or dissuade the adoption of Bitcoin. Right now it's sort of been

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neglected and in fact, the U.S. government has largely been on the sidelines and if Bitcoin becomes more prominent you could imagine the U.S. government taking action and dissuading people from investing further in Bitcoin. They don't need to clamp down on Bitcoin itself, they just need to tax Bitcoin differently than other asset classes if they wish to dissuade people from investing in Bitcoin. I think that could happen. We don't know. So the fact that regulations are in flux is a risk for investors in Bitcoin. And then secondly, Bitcoin has had in the past very violent swings in price and price is the only measure of value for Bitcoin again. So if Bitcoin declines by 50 or 60%, which it has done in prior periods, what does that mean for an investor. Well as a comparison, when you invest in a stock, you can look at the company's cash flows and you can make an assessment on whether you thought the company's cash flows were impaired and if they weren't impaired and the stock prices declined by 50%, this could be a buying opportunity. But what would an investor do if Bitcoin price declined by 50%? Does this mean that the future adoption of Bitcoin is in doubt, in which case the price could decline even further and never recover, or is this some temporary phenomenon? We think it's really very hard for any investor to differentiate between these two outcomes, and therefore, buy the dips so to speak, in relation to Bitcoin, and ultimately, that's the risk for an investor, so how do you size Bitcoin appropriately? How do you benefit from the speculative fervor around Bitcoin, but also how do you navigate an asset that really has no other way of valuing it apart from its popularity with other adherents in the investment world?

EK: It certainly sounds like there are a number of moving parts and a lot of evolution occurring in real-time in this space. How are we thinking as investors about getting exposure to either Bitcoin or broader trends that Bitcoin represents?

TA: We tend to prefer what we call bottom-up investing which is investing in assets that actually throw out cash flows via government bonds or corporate bonds that have a coupon or companies that have real earnings or cash flows. So, historically we have not been big proponents of gold. So when we look at Bitcoin, we're going to use the same approach that we would use for gold which is the old adage, "don't mine for gold but sell picks and shovels to the gold miners." With Bitcoin that means don't invest directly in Bitcoin, however, invest in companies that have exposure to Bitcoin. So either payment processing companies or semiconductor chip companies that benefit from the developments of both Bitcoin as well as the broader Blockchain technology. It's important also to highlight one of the other things that Bitcoin has, which is Bitcoin consumes an enormous amount of energy and if Bitcoin is going to be further adopted this would require a rethinking of how that energy is produced and might provide opportunities in alternative energy space such as wind or solar and so that's another opportunity set that potentially linked to Bitcoin as well.

EK: Well thank you, Tamer. I found this really helpful and understanding some of the broader landscape around blockchain and Bitcoin and how investors can think about this as both an opportunity for future returns but also a risk.

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