INVESTMENTS:

Cryptocurrency Investing What is it?

by **Christopher Miller**

Over the last several years, Cryptocurrencies, or "digital assets" such as Bitcoin have been in the news quite a bit – mostly due to their huge volatility and sky-high values. Is this a viable new investment opportunity, or another version of "Tulip Mania?" (Tulip Mania was a financial bubble in the Netherlands during the early 1600s where the price of tulip bulbs, fed by frenzied speculation, rose to astronomical heights. At it's peak, 12 acres of land were offered for one tulip bulb. [1])

For the purpose of this article, I will focus on one cryptocurrency: Bitcoin. I have chosen this one because it is the only one I had heard of prior to starting research on this article and is likely, in my estimation, to be recognized by the greatest number of my readers.

WHAT ARE CRYPTOCURRENCIES?

What we would recognize as currency first appeared in Mesopotamia around 3000 B.C. as the shekel. One shekel was worth a specific weight of barley and an equivalent amount of silver, bronze, copper or other precious metals. As it is today, one way to "make money" was to grow some barley and trade it for shekels. Alternatively, one could dig for precious metals to trade for shekels.

Cryptocurrencies operate in a similar way, except there is nothing physical that "backs" their value. Cryptocurrencies such as Bitcoin are "mined" by a process in which very expensive computers perform calculations to produce currency. This currency can then, (theoretically), be traded for goods or services in an electronic marketplace.

HUGE VOLATILITY

Bitcoin has made the news a lot recently due to its large price swings, or volatility. Volatility is a measure of how much an investment can change value over time. This price movement can be great for speculation because it provides the potential for an investment to rise (or fall) in value over a period of time. An investor can earn or lose large amounts of money in a relatively short period

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1 Mackay, Charles (1841), *Memoirs of Extraordinary Popular Delusions and the Madness of Crowds,* London: Richard Bentley, Chapter 3.

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of time when owning an investment with high volatility. Investing in the stock market can have high volatility, while holding cash in bills or in a money market account will have low volatility during normal times. (Note that, due to the effect of inflation, even holding hundred-dollar bills under your mattress has volatility. Absent any hyperinflation, however, this volatility will be very low.

On April 1, 2013, one unit of Bitcoin traded for $89.80[2]. On January 29, 2018, that same unit traded for $11,287. So – this could be a great place to make money, right? Well, not so fast: remember that volatility has the power to work both ways. Between January 28 and 29th, 2018, Bitcoin's value ranged from $11,000 to $12,194. That's a swing of 10% in just a few hours. That would be great for investors if it swung upwards. In reality, however, the price swung down: an investor who put $100,000 in at $12,194 would have $90,208 left at the low price only a few hours later. That's a lot of money to lose in a day. On January 7, the price hit a high of $17,200. Imagine someone who bought in at price high 3 weeks ago?

THIS VOLATILITY MAKES IT A POOR CURRENCY

Some years ago, I wrote an article about the hyperinflation episode in Zimbabwe. During the height of this crisis in 2008, prices were doubling every 24 hours. Things got so bad that the government printed $100 trillion notes. For this example, let's think of a worker earning the equivalent of $1,000 US per week. He has children to feed and rent to pay. On payday, this worker would immediately cash his check and convert all his cash to a more stable currency such as (for example) the Euro. When his rent was due at the end of the month, he would convert his Euros back into Zimbabwe dollars and immediately pay his bill. He would do this for every bill that he pays.

Let's say that there is a nation today that has Bitcoin as their national currency, and that the worker in our previous example lives there, instead. If he earns the equivalent of $1,000 U.S. every week and spends most of that supporting his family – he can't afford to lose any value of his $1,000. He'd be very happy if the value doubled, but he wouldn't be able to pay rent if it was cut in half. This worker would do the same thing on payday that he did in the previous example: He would immediately convert all his Bitcoin to a more stable currency so that he could ensure all his bills got paid.

Can we really call Bitcoin a currency if few people would ever use it as one? Would you accept a paycheck drawn in Bitcoin if you couldn't be sure it would pay your bills at the end of the month? Is Bitcoin a rational investment to make? Your answer to these three questions should all be the same – I know what mine are.

2 All Quotes from https://www.tradingview.com