BITCOIN – WILL THIS TIME BE DIFFERENT?

Global Financial Private Capital

SYNOPSIS

- The attention around Bitcoin and other digital currencies has taken the world by storm
- The media frenzy brings back memories of the last big bubble of the late 1990s
- Heed warning to the four most expensive words in the English language

WHAT IS A BITCOIN?

I frequent a coffee shop down the block from my apartment because it opens early and sells a quality product. The issue is that this establishment only accepts cash because they do not want to pay the fees required to accept credit cards, so I have to remember to carry dollar bills on mornings when I don't feel like making my own coffee.

This transaction is simple. I pay the coffee shop $3 from my wallet and they hand me a cup of coffee. It requires only the buyer and seller, and once I leave, neither of us could ever see each other again. Furthermore, there is no record of this transaction that could ever tie me to the sale. If I was not happy with the quality of their coffee, I would have no recourse to get my money back.

Since the dawn of time, cash transactions have worked this way. The buyer hands over cash, gold, or whatever physical form of payment to the seller in exchange for goods or services. While this simplistic means of commerce may seem obvious, the reality of today's world is that the overwhelming majority of transactions occur digitally.

For example, when I bought my apartment, I did not arrive at closing with a bag of cash for the down payment. Instead, I brought a cashier's check from my bank that guaranteed the funds were available. Carrying around a lot of cash is not just heavy but also risky. If I get robbed, I am out of luck. A check provides some level of safety knowing that only the seller can use it. Once cashed, my bank then wired the money electronically from my account to the seller's.

Banks facilitate these transactions because they can charge hefty fees. There is also a record of this transaction that allows the government to tax gains and lawyers to get involved in the event that the seller misrepresented the apartment.

> **"... it's one thing to label bitcoin a bubble, but it's an entirely different thing to try to guess if/when it will end. "**

Another reason why sellers often prefer third parties is because cash that is stored digitally can be manipulated. Consider how easy it is to copy text in Microsoft Word document and then paste it over and over again. Funds stored electronically can be "copied" just as easy as a digital picture (think of this as printing counterfeit currency but doing so on a computer). Hence, our society uses these trusted third-parties to prevent fraud.

Bitcoin is a "digital currency" and was invented to solve for two challenges. The first was to conduct cash transactions without cash. I could buy coffee using bitcoin stored in a digital wallet on the internet instead of dollar bills in a physical wallet. I preserve my anonymity and neither party could ever prove the transaction occurred.

The second was to eliminate the middleman. The coffee shop does not want to sacrifice a percentage of the sale to credit card companies, but they also do not want to subject themselves to the risk that I could commit fraud. By using bitcoin, the coffee shop owner could sleep well at night knowing that the bitcoin received is not counterfeit.

Simply put, bitcoin is a form of currency that was intended to facilitate cash transactions in a digital world. The technology supporting bitcoin and other “cryptocurrencies” is incredibly complex, and while it has the potential to change the world in many ways, it is beyond the scope of this discussion.

For now, just think of it as any other form of currency whose value fluctuates relative to other currencies in the same manner that the U.S. dollar moves up and down against the Euro and/or Japanese yen. This constant change in value has attracted the attention of speculators and created a wild ride over the last few years for those who own bitcoin.

BLOWING BUBBLES

The attention around bitcoin and other digital currencies has taken the world by storm. Its meteoric rise and volatile price fluctuations bring back memories of the late 1990s when dot-com companies sprouted up like weeds and fueled a bubble of biblical proportions.

The excitement surrounding the early days of the internet was immeasurable, and any idea that tapped into this revolution received attention (a.k.a. “funding”). A company that lacked a viable business plan could sell their stock for huge sums as long as they had a good story to tell.

Inexperienced management teams would then take this capital and use it to give away products and services to the public for free. Might as well. None of these companies were being valued on profits, so there was little reason to waste time trying to make any money.

Watching how the rise of the internet led to such misery inspired my interest in behavioral finance and eventually led me to William Bernstein’s seminal masterpiece *The Four Pillars of Investing*.

This book is a must read for so many reasons that it’s hard to know where to begin, but when it comes to the subject of bubbles, this is my bible. In it, the author highlights four necessary conditions that must exist for a bubble to develop.

The first is either a major technological revolution or a shift in financial practice. Think about the impact of the light bulb, automobile, steam engine, etc. These products changed the world and created a level of excitement that could not be contained.

Next, we need easy access to credit. If money is cheap and accessible, then fewer barriers exist for people to put not just their money behind an idea, but more dangerously, someone else’s in the form of margin debt (borrowing money to invest elsewhere).

The third condition is that people must have already forgotten about the last bubble and/or bear market. Since the bursting of a bubble tends to leave permanent emotional scars, a new crop of investors must exist that were not around the last time things got really bad.

The fourth is, as Bernstein puts it, “a complete abandonment from time-honored methods of security valuation.” As bubbles begin to form, inexperienced investors who are less skilled at estimating the value in an investment eventually take control of the market.

These four conditions lead to an environment where investors buy simply because the price keeps rising. It’s akin to throwing gasoline on a flame, and what makes matters worse is that timing when the fuel goes out is virtually impossible.

DOT-COM VS. BITCOIN

In order to determine the efficacy of Bernstein’s criteria, let’s apply it to the dot-com craze to see if it would have picked up the presence of a bubble.

Condition 1: There is no question that the internet was a major technological revolution. The internet made visionaries re-think how the world would operate now that we all could truly be connected, but few knew how to translate this into profitable ideas.

Condition 2: Access to capital was frictionless. Companies with no earnings, cash flow, or even sales being run by freshly-minted MBAs were commanding huge dollars for selling their shares in initial public offerings (IPOs). Investors who bid up these stocks only incentivized other start-ups to follow suit.

Condition 3: A generation had certainly passed. Most investors were too young to experience the pain and misery of the 1973/74 bear market, which was one of the worst in U.S. history.

Condition 4: In April 2000, right around the time the dot-com bubble burst, here are just a few of the companies that were trading at valuations that look like typos[1]:

- Terra Networks priced at 1,200 times sales
- Akamai Technologies priced at 3,700 times sales
- Telocity priced at 5,200 times sales

For scale, even the most egregious growth stock in today's market sells for 20 or maybe 30 times sales. A more realistic valuation for a growth company is closer to 3-5 times sales, and even this range could be debated amongst conservative investors. Oh, and none of these companies had any earnings.

Add it all up, and each of the four necessary conditions were most certainly present during the dot-com craze. Now let's do the same test against bitcoin today.

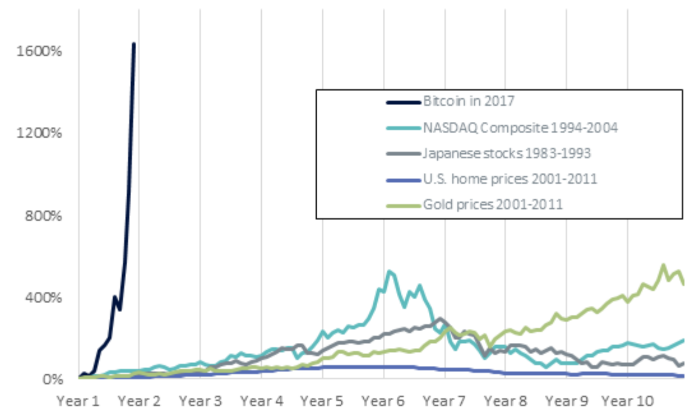
Condition 1: The underlying technology most certainly has the ability to change the world. Some of the largest financial institutions recognize the potential for disruption and are currently testing its use.

Condition 2: Thanks to ultra-low interest rates, access to capital is abundant. Furthermore, companies like CoinBase allow consumers to link their bank account and purchase bitcoin and other digital currencies in a similar manner to buying stocks online.

Condition 3: Many bitcoin owners were in grade school during the dot-com bubble burst. Much of what has been discussed here would read as a history lesson rather than a reminder to what it feels like to own stock in Pets.com, a dot-com darling that liquidated just 268 days after selling its shares to the public for the first time back in 2000[2].

Condition 4: Valuation for a digital currency that is a decade old and used more for money laundering and evading capital controls than it is for purchasing goods and supporting international trade is practically impossible. Any attempt to value bitcoin will be as untested as the currency itself.

To put bitcoin into perspective, the chart below compares bitcoin in 2017 to other big moves in asset prices in recent history.



Source: Bloomberg

Add it all up, and it looks like this could very well be the next big bubble. However, it's one thing to label bitcoin a bubble, but it's an entirely different thing to try to guess if/when it will end.

IMPLICATIONS FOR INVESTORS

Charles Mackay wrote *Extraordinary Popular Delusions and the Madness of Crowds* in the 19th century, which chronicled famous bubbles over time. It's a fascinating read because of the underlying consistencies portrayed across each example.

Without question, my favorite is the "tulip mania" that almost destroyed the Dutch economy in the 17th century. Back then, tulips made their way to the Netherlands, and long story short, some species became so popular that by 1693, they sold for more than 10-times the annual income of a skilled craftsman. Yes, tulips. Those pretty flowers that last about a week in a vase.

This bubble eventually burst and destroyed the lives of those who traded their land, life savings, and anything else they could liquidate to get more tulip bulbs. Ultimately, the panic forced the government to step in and support the market, which unsurprisingly only made matters worse.

The whole story sounds a bit crazy, but switch tulip bulbs for dot-com companies, and it reads nearly identical. Only time will tell if the bitcoin story will follow suit, but for those who want to buy bitcoin or any other digital currency, I strongly suggest to only buy what you are comfortable losing. That way, if things go sideways somewhere down the road, you don't end up impacting your financial future.

The dot-com era was not a complete waste either, and the pioneers that ended up with arrows in their backs paved the way for today's crop of dot-com companies that are not only healthy but in many cases, some of the largest and most profitable enterprises in the world.

Perhaps the same will happen with Bitcoin. The underlying technology, referred to as the "blockchain" shows tremendous promise to potentially disrupt inefficient yet established financial practices (many of which cost consumers a lot of money each year). But for now, I plan to sit on the sidelines and heed Sir John Templeton's famous warning:

The four most expensive words in the English language are, "This time, it's different."

THE BOTTOM LINE is that I'm just an old-fashioned investor who prefers to own assets that generate revenue, earnings, cash flow, and/or pay interest over time. Since bitcoin and other digital currencies offer none of these, I view their price to be as arbitrary as the going rate for art, gold, Faberge eggs, or even Pokémon cards. In that, its value is purely based on the demand to own it rather than the value it generates over time.

SINCERELY,

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[1] Bernstein, William. The Four Pillars of Investing. 2003. Print.

[2] https://en.wikipedia.org/wiki/Pets.com