WAVERTON

INVESTMENT MANAGEMENT

Why do we believe in Bitcoin?

In December 2017 we cautioned that Bitcoin "*possesses many of the characteristics of a speculative bubble*", and over the next year the price fell by over 80%. However, in our second piece on the subject in 2019 our stance had shifted, and we stated that "*if its brand and liquidity continue to strengthen, it could become the go-to asset for those seeking investment exposure to the industry*". The price has more than doubled since then and we believe the investment case for Bitcoin has strengthened, so what has changed?

Wider adoption

US corporates – On August 10, 2020 MicroStrategy, a $2bn US software developer, became the first listed company to invest some of its cash reserves in Bitcoin ($250m, and an additional $200m a few days later). The CEO stated: "*This investment reflects our belief that Bitcoin, as the world's most widely adopted cryptocurrency, is a dependable store of value and an attractive investment asset with more long-term appreciation potential than holding cash*". The market applauded, and MicroStrategy's stock price increased by more than 10% on the initial announcement, and again on the second.

A few weeks later, Square, a $90bn payment processing company with $2bn in cash, announced it had purchased $50m of Bitcoin, believing that it "*has the potential to be a more ubiquitous currency in the future*". Again, shares rose on the announcement. We think other CEOs, under pressure to find innovative ways of increasing share prices, may start to diversify some of their reserves into the cryptocurrency.

Institutional investors – There are currently only limited ways institutional investors can gain exposure to Bitcoin. They could buy shares in the US-listed Grayscale Investment Trust which invests 100% of its proceeds in the cryptocurrency. The 2% management fee and it's 20% premium to net-asset value (NAV) has not deterred investors, and by the end of Q3 it had invested over $2.5bn in the cryptocurrency and has since launched further trusts which can invest in other cryptocurrencies. These too are quickly raising assets (figure 1).

Grayscale cumulative quarterly inflows since inception. September 25, 2013 – September 30, 2020

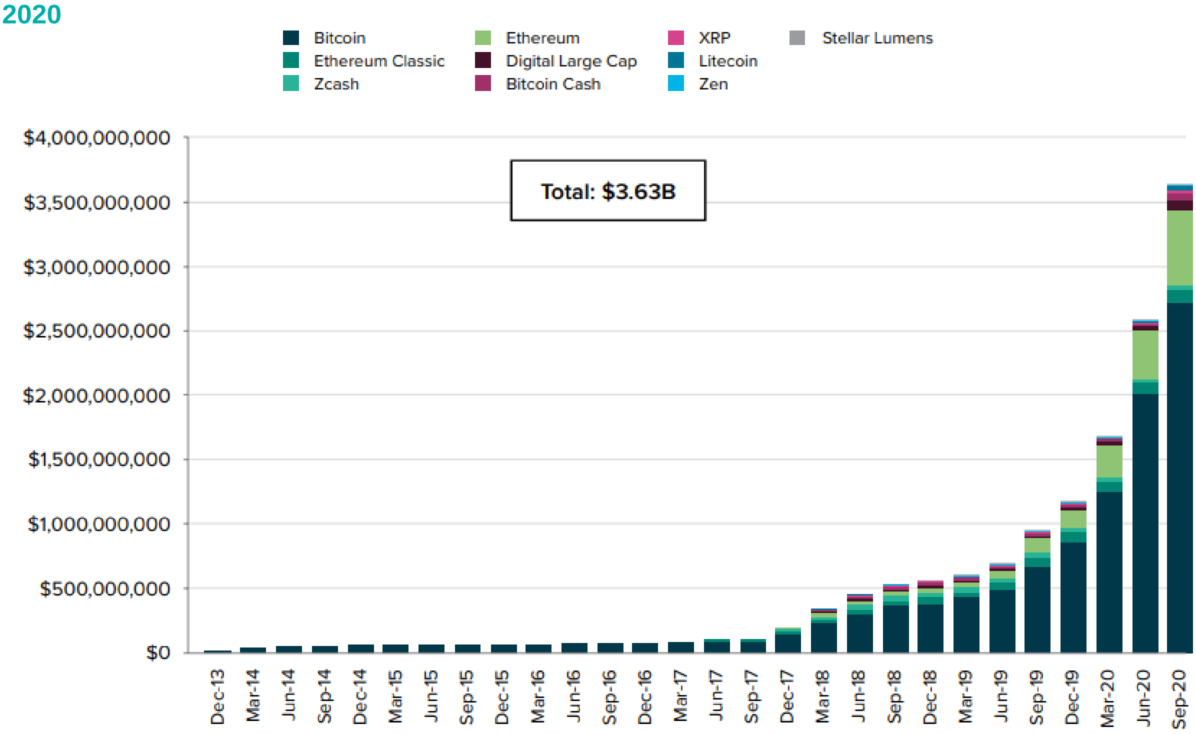

Figure 1. Source: Grayscale Digital Asset Investment Report Q3 2020

The scale of the purchases is particularly striking. In Q3 2020, Grayscale would have absorbed 77% of all the new Bitcoins being produced, or 'mined', during the quarter. Furthermore, the Bitcoins it buys are locked up indefinitely: buyers of the trusts can sell their units, but these sales do not result in any Bitcoin being sold as Grayscale "*does not currently offer a redemption program*".

Unsurprisingly, others want in on the action. In August Fidelity, with $3.3 trillion under management, announced the launch of a Bitcoin fund and we expect more institutions will follow.

Means of access

In 2018, The UN published "Africa could be the next frontier for cryptocurrency". The article talks about how adoption has been accelerating, driven by the continent's countries suffering from high levels of inflation, low banking penetration and high levels of political uncertainty. Furthermore, the payment processing company PayPal significantly expanded the distribution network of Bitcoin when it rolled out cryptocurrency trading and transfers to its 350 million users.

Regulatory environment improving

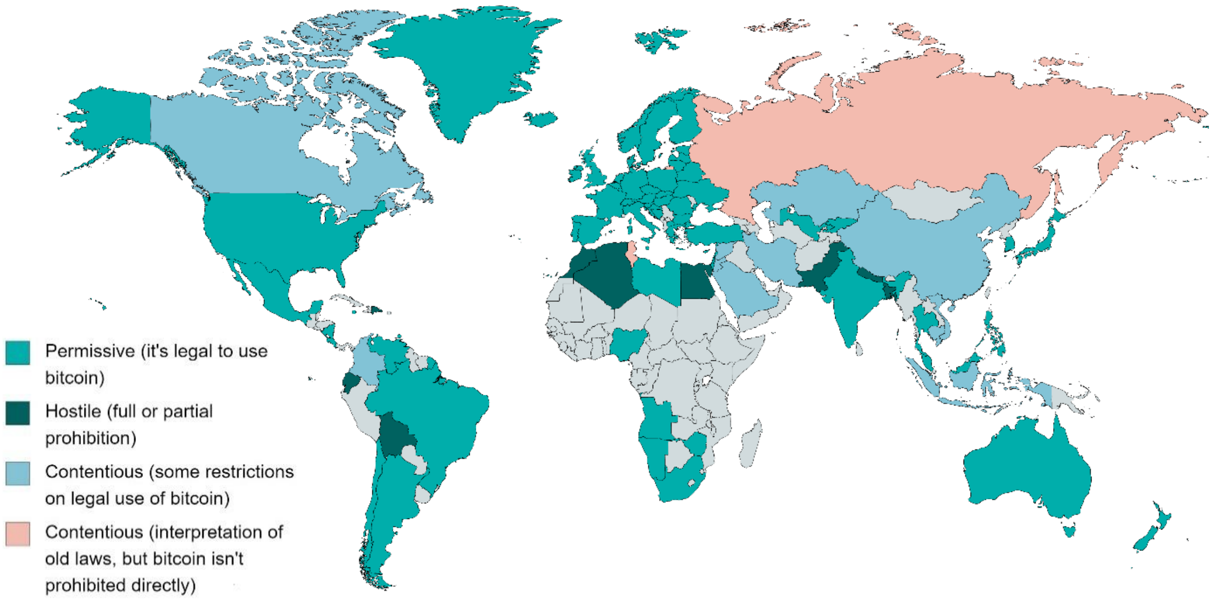

Figure 2. Source: Coin.Dance

The stance of regulators in the west has historically been unclear. However, we believe this is changing, especially given the announcement in June 2020 by the US banking regulator clearing the way for banks to hold cryptocurrencies on behalf of their clients. The SEC has also warmed, saying in October they were willing to look at tokenised products.

Sponsorship from industry figures

Hedge fund luminaries such Louis Bacon, Stan Druckenmiller, Paul Tudor Jones and Alan Howard, all billionaires, have come forward to state that they have significant holdings of Bitcoin. Along with the factors above, their ownership further legitimises the cryptocurrency.

A positive feedback loop

Together, we believe that these factors are resulting in Bitcoin developing a brand and that we are at the early stages of a positive feedback loop between its brand strengthening as price and adoption increase.

In his Theory of Reflexivity, George Soros put forward that there are occasions in financial markets when an asset's traded value can directly impact its intrinsic value, sometimes creating a feedback loop that results in dramatic price changes. In 1997 for example, Soros (and others) spotted that some Asian countries had significant dollar borrowings. As their currency weakened, these countries were less able to service this debt, which justified their currencies weakening further. The ensuing Asian Financial Crises resulted in some Asian currencies weakening by over 80% versus the dollar.

Figure 3. Source: Waverton

Digital gold?

While gold has returned 4.5% a year on average over the last century, its price has been characterised by a series of boom and bust cycles. The feedback loop would take hold on the way up, and then on the way down a reverse cycle of lower prices, decreased demand and weakening brand would exacerbate the fall. We expect Bitcoin to follow a similar path. However, there is one important distinction between Bitcoin and gold which is that the volume of gold supply will increase when the price increases, whereas for Bitcoin the supply is reduced every 4 years, regardless. Bitcoin, with a value of $340bn, is also still 35x smaller than the gold market.

A bumpy ride

There are likely to be many hiccups for Bitcoin, but one that we can foresee is the release of an estimated $3.6bn of coins by the administrator of Mt. Gox. In what can only be described as an upside-down bankruptcy, Japan-based Mt. Gox called in administrators in 2013 after a hacker made off with most of their clients' Bitcoin. Only 17% of their Bitcoin remained, but in the years that followed the price rose by over 45x and the creditors, who were once looking at receiving only a portion of their deposits, are now looking at a multiple of them. When and how the Bitcoin will be returned is scheduled to be published by the administrator on 15 December 2020. This could result in a temporary drop in the price.

Why might we be wrong?

There is another view that if Bitcoin gets too popular, governments and central banks will outlaw its ownership, just as President Roosevelt did for Gold in 1933. Our view is that while possible, this is unlikely. Governments would not want to risk driving it 'underground' and we believe this is supported by the current trajectory of regulatory inclusion.

Substitution

As we have covered in previous articles, there are other cryptocurrencies that have faster transaction times and cheaper transfer costs. However, we believe Bitcoin's adoption is not due to its use as a medium of exchange for everyday purchases. Instead it will be seen as a store of value for individuals, institutions and at some point even governments and central banks.

Sceptics corner

There will likely remain a significant portion of people who question Bitcoin's ability to gain widespread support. Questions over its intangibility, complexity, lack of government oversight and a fear that the "cyber punk" community that created it, could potentially destroy it mean they could never consider it an investment. While we have some sympathy with these concerns, we are firmly of the view they will quieten with time. The Bitcoin brand is likely to strengthen driven by increased regulation, further institutional sponsorship and more, potentially significant, price increases.

William Hanbury
Fund Manager
1st December 2020

Risk Warnings

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