Breaking Down Bitcoin

Since we continue to get questions about bitcoin and crypto-currencies, we thought it would be a good time to provide an update on this timely and often contentious subject.

As a reminder, **bitcoin is the largest cryptocurrency** – or digital currency – worth approximately $131 billion in aggregate[1]. Bitcoin makes up about 47.8% of the total market capitalization of all cryptocurrencies, of which there are about 1,722 currently trading in the public markets. Ethereum (ETH), the second largest cryptocurrency, is only one-third the size of bitcoin. Bitcoin trades about $5 billion per day on more than 200 different market centers around the world.

Started in 2009, bitcoin was proposed as a form of digital currency or a medium of exchange. There are no physical bitcoins – only balances kept on a public ledger in the cloud. The mechanics of bitcoin are similar to that of a credit card, which digitally moves value from buyers to merchants. Unlike credit cards, however, bitcoin has no central authority, such as a bank, charging fees to the users of its network. The prospect of moving money across borders, without disclosing identities and without fees or controls, drove much of the early speculation of bitcoin.

One of the founding hallmarks of cryptocurrency was that it would be built with opensource software, available for anyone to use without transaction fees. Programmers quickly realized that with slight alterations to the bitcoin codebase, they could rapidly develop new coins with different characteristics than the original bitcoin. With each new "fork" of the code base came a new coin with its own special properties and proposed uses. Today, there are nearly 2,000 different versions, most of which trade in secondary markets that operate much like a traditional exchange.

Bitcoin's value comes from two sources: perceived scarcity and price speculation. Bitcoin was founded under a governing "rule" that allowed for the creation of no more than 21 million coins. As of today, 17.2 million of those coins have been released, with each subsequent release becoming more difficult as the market approaches the 21 million cap.

Should bitcoin be included in a portfolio?

With all the mystique and publicity surrounding bitcoin, investors may be wondering if they should get in on the action. There are a number of reasons why bitcoin may not be appropriate for use in an investment portfolio, however.

- **Regulatory clarity is still an issue**. It's not yet clear what type of asset bitcoin actually is, or which licenses are required to hold it in an advisor-managed portfolio. According to the IRS**[2],** bitcoin is a collectable, and taxes on gains are considered ordinary income (**not** capital gains or losses like stocks). According to the Federal Court in New York[3], however, bitcoin is a commodity to be regulated by the

[1] Coinmarketcap.com, "Top 100 Cryptocurrencies by Market Capitalization." (https://coinmarketcap.com/)

[2] IRS release: "IRS Virtual Currency Guidance: Virtual Currency Is Treated as Property for U.S. Federal Tax Purposes; General Rules for Property Transactions Apply." March 2014. (https://www.irs.gov/newsroom/irs-virtual-currency-guidance)

[3] U.S. Commodity Futures Trading Commission release: "Federal Court in New York Enters Preliminary Injunction Order against Patrick K. McDonnell and His Company CabbageTech, Corp. d/b/a Coin Drop Markets in Connection with Fraudulent Virtual Currency Scheme." March 2018. (https://www.cftc.gov/PressRoom/PressReleases/pr7702-18)

Commodity Futures Trading Commission (CFTC) and should be used only in client accounts that are authorized to hold commodity positions (and taxed like commodities). The SEC[4] has ruled that some crypto-currencies are certainly securities, while others are not. While the markets expect to receive a ruling at some point in the future, the lack of certainty and consistency around regulatory issues may be highly disruptive for crypto-currency markets until these questions are resolved.

- **The bitcoin markets are highly manipulated.** In a release at the end of July[5], the SEC commented on the inability for markets to detect and prevent price manipulation in bitcoin markets. Furthermore, a recent study by professors at the University of Texas[6] finds that another digital asset called Tether has been used to prop up the prices of bitcoin over the past two years.

- **Speculation is not always a bad thing, but it must be recognized for what it is.** The prospect of a new emerging internet technology in the form of distributed ledgers (the basic construct of bitcoin) is exciting and draws huge amounts of speculative capital, which could result in a situation where there is too much money chasing too few opportunities. In almost all cases, the purchase of a cryptocurrency is not the same as owning an equity interest in a company, and token owners do not have rights to revenues generated by the sponsoring company. According to a recent PricewaterhouseCoopers report[7], more than $21 billion has been raised by companies issuing new crypto tokens, with $13.7 billion of that raised in 2018 alone.

- **There will be winners.** It's easy to make the case that rampant speculation has driven an unsustainable investment bubble, but this emerging technology is here to stay – and it will reform existing business models. Applications in financial services, healthcare and medical records, and digital identity could be the next generation of investment stars.

- **Bitcoin as a digital currency may or may not be "the one."** Improvements in the core operation of the bitcoin blockchain have been developed, and there are already more efficient versions in existence today. Bitcoin was clearly first, and profits from its name recognition, but it may not be the ultimate winner in the space. (Think Betamax, MySpace, or any number of internet browsers that pre-dated Chrome or Internet Explorer.)

The cryptocurrency space is clearly still young and emerging. We hope this piece provides useful background and insight so you can better understand bitcoin and other digital currencies.

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[4] U.S. Securities and Exchange Commission, "Investor Alert: Bitcoin and Other Currency-Related Investments," July 2014 (https://www.sec.gov/oiea/investor-alerts-bulletins/investoralertsia_bitcoin.html)

[5] U.S. Securities and Exchange Commission release, "Order Setting Aside Action by Delegated Authority and Disapproving a Proposed Rule Change, as Modified by Amendments No. 1 and 2, to List and Trade Shares of the Winklevoss Bitcoin Trust," July 2018 (https://www.sec.gov/rules/other/2018/34-83723.pdf)

[6] Griffin, John M. and Amin, S. "Is Bitcoin Really Un-Tethered?" June 2018 (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3195066)

[7] Diemers, D. et al. "Initial Coin Offerings: A Strategic Perspective." June 2018. https://cryptovalley.swiss/wp-content/uploads/20180628_PwC-S-CVA-ICO-Report_EN.pdf