OP-ED by Sowell Affinity Co-CIO Greg Lai

What is Bitcoin? It's FOMO. (Fear of Missing Out)

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What is Bitcoin? It's FOMO.

by Sowell Affinity Co-CIO Greg Lai
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I find that this question is coming up often these days, especially within and outside the halls of Sowell Financial. One finds oneself wondering if this is that "canary in the coal mine" moment? In fact, I fight the urge to ask my Uber driver what his analysis of Cryptocurrency, Ethereum or the next hot blockchain tip. At Sowell, it is our responsibility to answer far more important questions like "When can I retire?" or even "Can I retire?" or finally "What should I invest in and how should I invest? "What is Bitcoin" or even 'What is crypto" is a far more intricate answer and that already may be telling. The answer involves concepts around trust, blockchain technology, public distributed ledger system secured by cryptography on a peer-to-peer network. Huh? Not to be outdone, there are "mining" and "wallets" though not the kind that come to mind, taxed as property by the IRS, tool of choice for criminal activity like ransomware, and an inventor with the nom de plume Satoshi Nakamoto. There is so much here that we can't cover in this piece but what we will focus on are the words and assumptions that people are making when thinking about how Bitcoin would play into an investment portfolio designed to be there at retirement. Simply not what is Bitcoin, but what does it replace or how does it fit based on its description?

First thing we hear, Bitcoin is a currency. **Even better a "digital currency."** Currencies have been around for millennia and have taken many forms—starting with shells and beads, easily traded items, and then coins with specific values. The key value was that this agreed upon and standardized form allowed for an exchange system rather than trading items and services through barter. But an allocation to currency doesn't fit into a long-term investment portfolio as a means for returns in most scenarios. In fact, given quick and easy access to your currency, rather than the lost opportunity cost when you "invest" it, there is no requirement for a return, think time value of money (TVM). In this case, we see no basis to invest long term in a currency, digital or otherwise, "cash is trash." More importantly, current currency is used to pay bills and purchases through the "exchange system" and stability is paramount. In its short history, a decade roughly, Bitcoin's value has been far from stable and far from integrated into the "exchange system" like the dollar.

Context is needed here, the US dollar is not "some" currency, it's the world consensus reserve currency and is backed by a $21 trillion economy. The US dollar's intrinsic value is indisputable when compared to Bitcoin's currency attributes - which are established through computer code and maintained in a digital world powered by, at this point mainly oil. Lastly and ironically, liquidity is still sought through cryptocurrency exchanges whose sole purpose is to convert cryptos into dollars. In fact, Coinbase, the largest, just went public.

Bitcoin is a commodity and thus an inflation hedge. A lot to unpack here when talking about inflation, none of which here essentially correlates with some 4000 crypto currencies we see today. A few short years ago there were less than 100. Let that "inflation" sink in for second, while we delve into the commodity aspect of Bitcoin. Here again we have a great set of comparisons, like gold or oil. Let's focus on gold. Gold has established uses in industry but more importantly, a long history of value as a commodity throughout history. Its safe haven status has weathered the rise and fall of civilizations, world wars, civil wars, regime changes, even the creation of a new currency, the Euro. Gold is mined and not invented, check the periodic table, where its supply is relatively known and fixed. Gold has a cost of carry and could have a place in an investment portfolio, but in most scenarios a very small allocation. The value of gold is often highly dependent on the prospects of inflation rather than those aforementioned principles of TVM and required compensation for lost opportunity. Gold has predominantly been used as inflation hedge. It seems to us, Bitcoin needs a much longer history before it can replace gold. Ironically, blockchain technology creates the transparency and ability to create efficiencies that exactly work against inflation.

When we look at Bitcoins' relationship to Gold, we'd typically run regressions to see the correlation between the two. Forget about the fact that Bitcoin doesn't have enough data points to even start that comparison, and the fact that Bitcoin has literally been around during a period of only "prosperity" compared to the actual "safe haven" scenarios that have played out over the history of gold. If you did the calculation the correlation would be laughable, and a more logical conclusion would be that Bitcoin is more correlated to stocks. Gold, not Bitcoin, is negatively correlated to real interest rates and this is because during periods of high inflation and negative real rates, investors want to preserve the purchasing power of their capital. Bonds in this scenario are a loser. The theory makes sense that Bitcoin could be a store of value, but that doesn't explain Bitcoin's meteoric rise today, or the volatility that we don't or haven't seen in such dramatic fashion with gold.

Back to oil. One word… petrodollar, when they call it petro Bitcoin let me know. On a more serious note, oil also has a higher correlation to gold than Bitcoin. But oil's price volatility has been more essentially linked with supply and demand issues. This supply/demand issue is lacking in gold and uncertain with Bitcoin – despite the hungry appetite for an instrument whose price is 'halved' every so often. One might further conclude that blockchain itself, and indirectly Bitcoin, create supply/demand forces which would favor a lower price for Bitcoin and blockchain. The result of higher use and acceptance is more supply. Can we run out of Bitcoin? We've already seen massive growth in the number of cryptocurrencies and should expect even more.

Bitcoin is an equity. Traditionally a stock represented an ownership position in exchange for the money whereby the company can use that money to build a future cash flow supporting the value of that exchange. For sure, equity shares represent some value behind the business that these companies represent and also the supply and demand of these shares from buyers and sellers. Bitcoin has this for sure. It's meteoric rise in value is driven by supply and demand, arguably solely this dynamic. Equity investing is best deployed by using the power of diversification and so Bitcoin as a representative holding within a portfolio of stocks could make sense however, what would be the expected return over time? What is that return expectation based on? Typical stocks have corporate and fiduciary responsibilities to shareholders enforced by interested parties like the SEC. Bitcoin has none of these properties and actually we have to trust in "uninterested" parties to maintain the integrity of the blockchain ledger. Should I be skeptical that certain parties would be more interested in an economic incentive of developing the next new Bitcoin? When looking at Bitcoin through the lens of an equity investment, can I imagine it continuing at a 408% annualized return in the future? Highly unlikely. So that means it's something you trade and is as risky as any other single stock and should be sized accordingly.

In fact, let's actually take a look at what other notable experts define Bitcoin or Blockchain technology as. A notable but not well known firm is Solactive. Solactive, dwarfed by big brother S&P 500, is the renowned expert and key partner in almost all other Index creation and development. Their indices cover almost every thematic exposure to various strategies, including ESG, hedged, long and short, currency/countries/sectors, even volatility. They recently launched an Index to track the performance of blockchain technology. Not surprisingly, the top names in the Solactive Blockchain Technology Index at an average of 6% each, are:

1	Nokia
2	Facebook
3	Alphabet (Google)
4	Accenture
5	Fujitsu
6	Cisco
7	Visa
8	IBM
9	MasterCard
10	Paypal

My takeaway is that the best way to get exposed to Bitcoin is through stocks like these and thus Bitcoin is more an equity than anything else and all of us already "own" Bitcoin in our stock portfolios.

Let's actually look at the numbers and see what kind of picture that paints as we seek some relative framework to assess Bitcoin. In fact, this last quarter, Bitcoin was down a whopping 40.7%, but take a look at NYDIG's Global Head of Research Greg Cipolaro's work below, and notice that of the mere 42 quarters of Bitcoin performance, down 41% is not unexpected by past performance. Clearly owning and profiting from Bitcoin depends on when you enter and exit the investment. These returns below exhibit very high volatility with very few quarters driving huge returns in excess of 500%+. This reminds me of when I go to Vegas and see the slot machines or progressive bets where all the payoffs are printed in neon lights, 1000 to 1. That said, bitcoin's year to date performance of 20% plus for 2021 is still below REITS, US Small Cap Value, Commodities and Micro Caps.

Quarterly Return Rankings

Rank	Quarter	Quarterly Return	Rank	Quarter	Quarterly Return
1	2Q11	1952.1%	22	4Q12	8.3%
2	1Q13	626.2%	23	2Q15	7.5%
3	4Q13	479.8%	24	1Q12	7.0%
4	4Q17	220.8%	25	3Q18	3.3%
5	2Q19	174.4%	26	1Q16	-3.8%
6	4Q20	172.5%	27	4Q11	-5.0%
7	1Q11	161.5%	28	2Q13	-6.9%
8	2Q17	130.4%	29	2Q18	-7.8%
9	1Q21	100.8%	30	3Q16	-8.9%
10	3Q12	84.9%	31	1Q20	-9.4%
11	4Q15	82.4%	32	3Q15	-10.0%
12	3Q17	75.5%	33	4Q19	-13.7%
13	2Q16	61.1%	34	4Q14	-17.9%
14	4Q16	58.9%	35	1Q15	-23.9%
15	2Q20	41.1%	36	3Q19	-26.3%
16	3Q13	41.0%	37	1Q14	-37.9%
17	2Q14	41.0%	38	3Q14	-39.0%
18	2Q12	34.9%	39	2Q21	-40.7%
19	3Q20	17.2%	40	4Q18	-43.3%
20	1Q17	10.8%	41	1Q18	-50.1%
21	1Q19	9.4%	42	3Q11	-70.1%

NYDIG Source: NYDIG

Bitcoin is debt? Nope. Bitcoin a new and distinct asset class. Nope. Our conclusion is that Bitcoin is not yet any of the above which doesn't mean that it wouldn't be fun to trade a little. Be certain, however that its place as a significant investment is not advisable.

And fear not, even if Bitcoin is the "most disruptive technology invented in the form of payments and currency exchange" you won't be missing out because any one or all other stocks will benefit from that disruption and those efficiencies created.

In much the same way that one dreams in one's native language, the financial markets of the world will still dream in dollars, US Dollars.