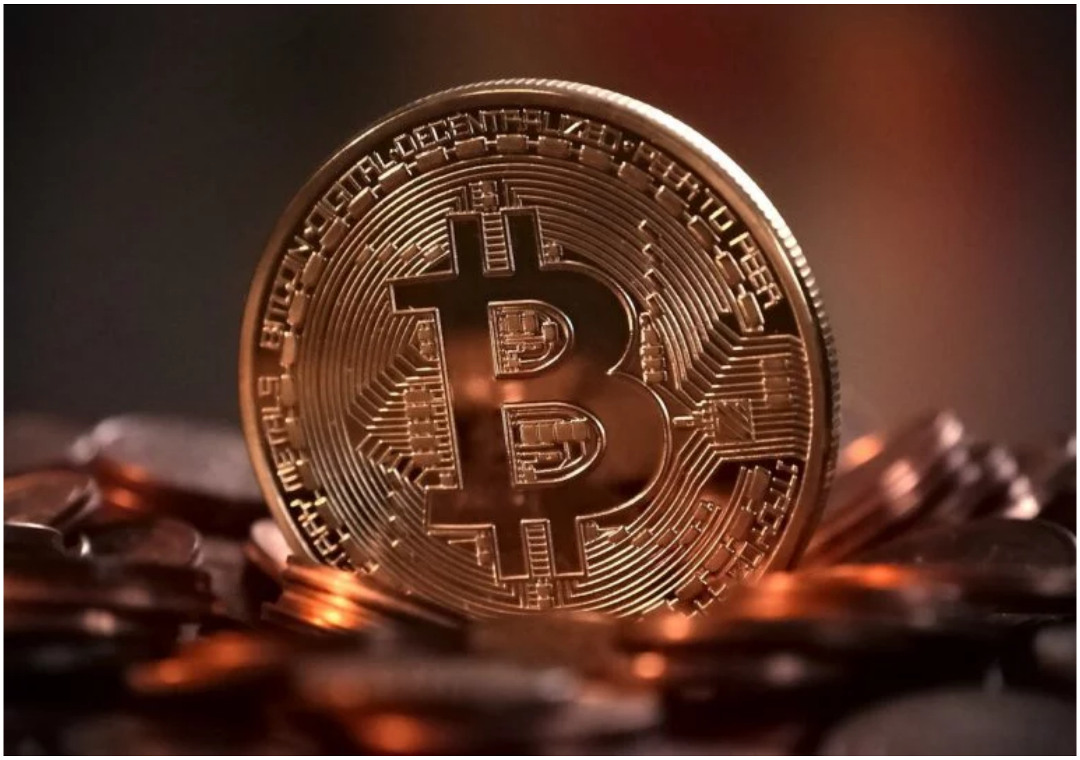
THE RISE OF BITCOIN: HOW TO UNDERSTAND IT AND WHERE TO LOOK TO NEXT

Zain Jaffer - Feb 17, 2021, 8:53 am



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Bitcoin is officially sailing in uncharted waters. Beginning with a pre-pandemic low of $4,000, where Bitcoin sat in mid-March of last year, home-bound observers have watched the chart make an impossible 900% rise. 'Observers' here is not restricted to the normal crowd of investors, industry analysts, financial advisors; a 900% rise is the textbook definition of a 'skyrocket,' and everybody around the world with a computer screen and an Internet connection has been watching that squiggly line climb.

The Rise Of Bitcoin

The last year makes up only one chapter of Bitcoin's ongoing story, and public interest is nothing new. In 2017, when Bitcoin first exceeded $20,000, the Internet trends started following the charts. By 2018, searches for "bitcoin" on Google hit 30,000—a record high. The curiosity is nothing newsworthy. But the story has gotten a lot more interesting in the past few months.

Since October, open interest in the Bitcoin futures market has increased *threefold*. Data from ~~blockchain.com~~, the frontier bitcoin wallet provider, shows that 10 million new wallets have been created for the purposes of trading in the past 3 months. That's about as many wallets as were created in the 12 months prior.

More than a social media trend or a front-page headline, interest in Bitcoin is tangible. The steep rise begs important questions: who's buying, why, and at what risk? Below are the answers toward which the data point, allowing space for the parts of Bitcoin's plot that haven't yet been written.

Who's Buying?

Let's rewind to last May. Paul Tudor Jones made a modest announcement, musing that one of his funds might invest a low, single-digit percent of its assets in Bitcoin. With this, the billionaire hedge fund manager caught the attention of the crypto-crowd.

But Jones' announcement doesn't even top the charts. Over the past 12 months, ~~institutional interest~~ has flocked toward the Bitcoin market in new numbers. In the wake of new regulation that permits offering products and custody solutions, institutional interest reached new heights. The *Wall Street Journal* reported Mutual Life Insurance Co.'s 100mn Bitcoin purchase. Guggenheim Funds Trust cleared an investment of up to 10% net asset value of one of its funds.

Following other events of this kind, the *Financial Times* called 2020 'The Year Bitcoin Went Institutional.' Mainstream adoption grew in tandem. In October of 2020, buying and owning Bitcoin became easier than ever when PayPal featured Bitcoin, Ethereal, Bitcoin Cash and Litecoin. PayPal account holders could buy, hold, and sell any of the above cryptocurrencies as easily as they could send cash to family and friends. This year, the company has plans to do the same on the Venmo platform.

In summary, purchase interest for Bitcoin is coming from both institutional and retail investors. As a result, the cryptocurrency is simultaneously gaining traction and mainstream attention. To avoid depending on the wisdom of crowds, the question follows: why are people buying?

Rise Of Bitcoin: Why?

Certainly, there are reasons to believe that Bitcoin is an attractive investment opportunity. A lot of investors are using the adoption of the Internet as a proxy for the Bitcoin discourse. The Internet started as an obsession of the few and quickly expanded to be a cornerstone of our modern society. And while the final use case of Bitcoin remains uncertain, it’s easy to see similar opportunities as the world continues to accelerate in its digital transformation. From a ‘peer-to-peer electronic cash system,’ to ‘digital gold,’ to a fully decentralized global settlement system, the imagination doesn’t have to work too hard to get excited about the potential ahead.

A recent report by UBS pointed toward two other purchase drives that deserve recognition. First, there’s the fear that emergency expenditure programs used by central bank money will create a high inflation, or a hyperinflation. If the purchase power of existing currency diminishes, cryptocurrencies—still limited in their supply—could be important stores of wealth. Second, and not to be diminished, is the fear of missing out; large price increases are almost humanly impossible to ignore. As long as Elon Musk is making waves in the crypto space, young investors and next-gen thinkers will be paying close attention.

But there’s a deeper way to approach the debate around whether or not Bitcoin is a bubble. Bitcoin’s intrinsic value is hard to understand, almost by design; there are no existing models to look toward. So, the question around whether or not to invest is the question of future use cases. Frameworks of understanding that count on cryptocurrencies being a method of storing wealth are relying on an increasing user count; more people would need to adopt cryptocurrencies for wealth storage, and there would need to be buyers to absorb new units.

People with different probability calculations, or different levels of belief in the above, will arrive at different answers to the question of the bubble. Without a future to compare it to, many experts have defaulted to the age-old adage that only time will tell.

Last but not Least: At What Risk?

Without concrete answers to use case questions, a crucial consideration for investors is whether or not a Bitcoin investment can diversify a portfolio. The UBS report indicates that empirical evidence is still mixed. But looking at a larger picture of Bitcoin's activity, beyond 2020, the experts at UBS prove that Bitcoin's correlation with other asset classes—bonds, stocks, and gold—is low overall. This suggests that Bitcoin would certainly be a source of diversification for a financial portfolio.

Naturally, investors need to have the confidence that they'll be rewarded for taking the Bitcoin risk. The same UBS report shows historical evidence is similarly mixed. During less extreme periods, when prices stagnated or declined, the overall risk-reward of a portfolio that included Bitcoin would not have increased. Using monthly log returns between the start of 2018 and the end of 2020, the UBS experts suggest that Bitcoin was only useful for portfolio diversification if prices were rising quickly.

Volatility is no stranger in the crypto space. Cryptocurrency prices are sensitive to new supply, and regulatory change is ongoing. The volatility of Bitcoin is expected to continue, especially compared to the traditional currencies and stores of wealth to which the public is accustomed. All of this is part of the Bitcoin evolution, which is certainly deserving of the recent attention it's received. Investors, whether established or just beginning, should consider their beliefs regarding future use cases, plan an exit strategy, and limit their investments to whatever they can afford to lose. From there, they can think about how they want to fit into the next chapter of the story. Regardless of outcomes, it's a story that will be told for a very long time.

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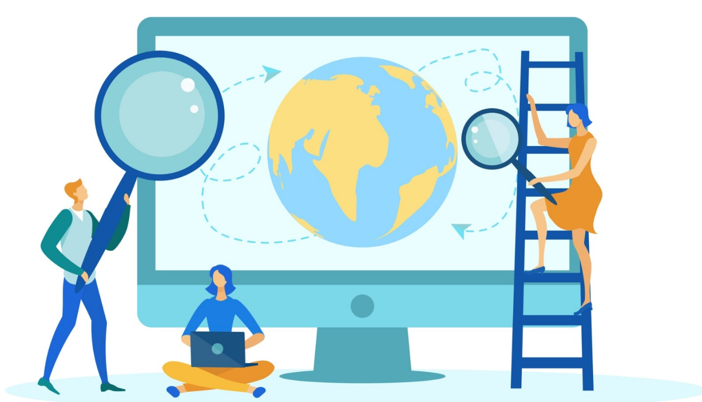

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