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Bitcoin and friends: a load of hype or the next big thing in investments?

Bitcoin has hit the headlines this year with a six fold jump in its price, with some other cryptocurrencies rising much more sharply than that. So what are we to think? Are these the beginnings of a new investment idea or will this particular party soon be over?

Cryptocurrencies are digital means or “coins” of payment that individuals create out of thin air. Cryptographically secure protocols and decentralised data storage allow payments to be made digitally, obviating the need for a central repository such as a bank. The first cryptocurrency, Bitcoin, was invented in 2009 by a group of **developers, who drew on a paper by the currency’s “godfather”** Satoshi Nakamoto. They appear to have been driven by a combination of intellectual curiosity and an urge to play around. Bitcoin was initially seen as a means of transacting payments between the various electronic participants in the cryptocurrency. Nowadays, however, it and other virtual currencies can be bought on exchanges using standard currencies such as US dollars, euros or Swiss francs. People can also earn bitcoins from selling goods and services if the cryptocurrency is being used as a means of payment. There are now over 3,000 other digital currencies of this kind, the vast majority of which are still in their infancy.

The technical and technological aspects of these cryptocurrencies are complex and hard for the layperson to understand. The block chain technology on which Bitcoin is based clearly boasts such amazing properties that it is also attracting interest from the banking establishment. Central banks could conceivably one day use this technology to generate their own, more or less official cryptocurrency.

The fundamental question is whether these cyber currencies have what it takes to supersede or replace existing currencies. If we cast our minds back a few years, when an ultra-loose monetary policy prompted suggestions that the end of the currency system was nigh, might Bitcoin be an option if the international exchange rate system were once again to attract waves of scepticism?



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A currency needs to be three things: it must be generally accepted without reservation as a means of payment, it must be an arithmetical unit for valuing goods and services, and its value must be stable over time. Cryptocurrencies fall short on all three fronts. One thing that unites all currencies is their lack of backing (e.g. convertibility into gold). In the case of a traditional currency, however, so-called fiat money does have an implicit intrinsic value that can be determined based on **the nation's** infrastructure, mineral deposits, inflation track record and other factors. Cryptocurrencies have no links to any variables whatsoever from which a valuation could be derived, making their intrinsic value zero. Their price expressed in a traditional currency reflects the market situation at that precise moment. Longer-term demand for a cryptocurrency will chiefly depend on whether it spreads successfully and is seen as credible by its users. There is also a criminal consideration in play as cryptocurrencies work anonymously.

The use of bitcoins for capital flight, tax fraud and drug and arms dealing is a latent danger and obviously against the current political mood of complete transparency. However, efforts at regulatory intervention have so far been pulling in different directions. Whilst Japan has elevated bitcoins into a legal means of payment, China has banned cryptocurrencies from being issued. The different interests being pursued by the two countries are obvious: the Japanese want to lead the field in this new financial technology, whereas the Chinese have declared war on corruption and financial crime. One thing seems crystal clear, however – if these private currencies do unexpectedly go the distance and threaten the government monopoly on money, they will be met with a regulatory straitjacket. Put another way, cryptocurrencies have no chance of ousting the existing national currencies, at least not those with firm foundations.

Bitcoins and other digital currencies like Ethereum and Ripple have become targets for speculators. Unsurprisingly, the temptation is there to seize the moment to mine (issue) additional coins. This happened with Bitcoin not so long ago and brought a windfall for those who held

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any at the time. We believe that a bubble is well and truly forming and it is only a matter of time before the price plummets and dreams are shattered. In the longer term, the biggest certainty will be that the technology will survive to be developed further. It is also highly likely that various cryptocurrencies will perform useful tasks in the payment system provided that they are able to prove their credibility in the long run.

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