Much Ado About Cryptocurrencies

You cannot read the financial news these days without seeing headlines about cryptocurrencies, so we thought we'd take some time to mine the topic (pun fully intended).

In the simplest terms, a cryptocurrency (such as Bitcoin, Ethereum and Litecoin) is a type of money that uses software encryption techniques to create a secure environment for transactions.

By design cryptocurrencies are decentralized, meaning they are not controlled by a central bank or government, and do not require a financial intermediary since the transactions are done peer-to-peer. As well, cryptocurrencies have a finite and known supply — their purchasing power cannot abruptly deteriorate because of a sudden increase in supply which results in too much money chasing too few goods (new units are "mined" through complex computer and energy-intensive processes).

In this sense, cryptocurrencies are closer to a commodity such as gold than a typical currency. This is an appropriate comparison, as gold (also a finite resource whose supply is beyond the control of governments) has been used throughout history as a medium of exchange and a store of value. However, unlike physical gold, cryptocurrencies are easily transportable and thus far more practical.

Similar to transactions conducted with gold, there is no paper trail with cryptocurrencies, which means it can be used anonymously — while the records of transactions are maintained by the underlying technology called the "blockchain", it is impossible to analyze transaction flows. This characteristic explains why cryptocurrencies have been quickly adopted for criminal activity such as narcotics trafficking, money laundering, and evading taxes and capital controls.

This aspect of cryptocurrencies also serves as a drawback: it makes them bearer, meaning that should the computer storing the cryptocurrency be wiped out (or have its contents stolen by hackers), the money is lost just as if you were to lose your gold.

But for the purposes of our discussion, a more important contrast between cryptocurrencies and other financial assets is that, arguably, there is no fundamental value for the former — and here you need to separate the cryptocurrency and the technology that underpins it (the blockchain, itself having many possible uses and is being developed in a range of different industries).

An equity is a claim on the earnings of a company; a bond is a claim against its guarantor with the promise of repayment; even gold has an intrinsic value based on its use in jewelry and industrial purposes (gold is a very good, albeit expensive, conductor of electricity).

The value of a cryptocurrency is dependent on supply being limited and the expectation that demand will rise — which is speculation by the very definition. Cryptocurrencies provide no claims on assets and offer no cash flows. They are viewed as having value because there is a "greater fool" out there willing to pay more on the speculation that increasing demand will push prices ever-higher.

While there is scope for demand to rise, as cryptocurrencies become a more widely used medium of exchange, there are also very real risks that given their use in more illicit transactions, governments could clamp down and stifle their broader and more legitimate demand in the name of public good.

It is easy to get caught up in "irrational exuberance", to borrow from former Fed Chairman Alan Greenspan, with dreams of getting rich quick leading to chasing the market and buying an asset, despite its valuation and inherent risks, with the expectation of seeing the price rise even higher (and that is no doubt at play here, with the U.S. dollar price of a Bitcoin surging more than 2,000% in 2017).

History is replete with examples of why this approach to "investing" (read speculating) ultimately does not pay off — just ask anybody who bought tulips in January 1637, or tech stocks in March 2000. Buyers of cryptocurrencies should be aware that the true value of these investments might prove to be cryptic indeed.