WHAT WE KNOW ABOUT BITCOIN INVESTING

Source: Bank of America/ Financial Times Jan. 29, 2021

We are often asked for opinions on various investment or security types. One that is constantly recurring is Bitcoin. Recent articles heralding the rise of Bitcoin prices to shocking new heights has rekindled interest. Never has trading on the forex (foreign exchange) been more exciting.

While we don't think direct investment in Bitcoin is appropriate for clients who are retirees and non-profit organizations, cryptocurrency is likely here to stay, and we have made some client investments in companies that provide technical services to the industry.

Bitcoin Is a digital form of Currency (Cryptocurrency)

Bitcoin is purposely designed to be a currency that is not backed by a global power or sovereign nation. It's *"mined*" by high powered computers. Unlike gold, silver, or some other precious metal, Bitcoin is not a tangible object you can hold in your hand. It's data on computer servers and it's secured by a new technology called "blockchain." This is an immediate barrier for investors who are reluctant to store some of their wealth in a digital format on their computers.

A bitcoin-mining computer complex at Bitminer Factory in Florence, Italy. Source: Reuters

Bitcoin is traded via a *forex* transaction. As a currency, Bitcoin trades 24/7. *Forex* is short for *foreign exchange.* It is a decentralized trading platform for converting one currency to another. Taking US dollars and turning them into Canadian dollars is an example of a forex transaction. The investor's gamble or hope is that during the holding period the value of the Canadian dollar will rise by comparison to the US dollar. Thus, when it is switched back, the ending US dollar amount paid for the Canadian dollar is higher.

Forex itself can be an extremely risky form of "investing" that requires a lot of specialized knowledge and a great deal of luck. Bitcoin and other cryptocurrencies ramp this risk up many notches. Bitcoin is not backed by any major power, has a limited supply, and cannot be easily used in everyday commerce. So, it has no mooring to a specific price point or discernable value and for that reason is subject to wild swings.

You don't actually "invest" in Bitcoin--you convert your money into it. You can't put a Bitcoin in your pocket or hold it in your hand, but you can put it in a (virtual) "wallet." *More on that later*.

The problem here is that Bitcoin's value is only worth what someone else (a greater fool?) is willing to give for it at the moment. As such, it becomes a poor measure of real-world value with its rapid price movements compared to the US dollar. The price volatility only helps bolster the argument against its wide adoption. Imagine selling your home for a quantity of Bitcoin only to see your new currency's value drop or rise 30% in less than a week.

In 2010, a man celebrating a birthday traded 10,000 fledgling Bitcoins for two Papa John's pizzas worth about $30. As of March 17, 2021, 10,000 bitcoins are valued at $549,500,000 USD. That would buy a lot of pizza.

There was a time in mid-1600's Holland in which tulip bulbs became currency. Being an exotic import from Turkey, tulips were quite a sensation. Speculation drove the value of tulip bulbs up and up. By 1636, the demand for tulip bulbs was so large, they could be purchased on the Stock Exchanges of Amsterdam and other towns. At the height of the demand, from 1634 to 1637, according to a Scottish journalist Charles Mackay, in his famous 1841 book *Memoirs of Extraordinary Popular Delusions and the Madness of Crowds*, one tulip bulb could purchase a mansion on the Amsterdam Grand Canal.

By the end of 1637, the bubble had burst. Buyers announced they could not pay the high prices previously agreed upon for bulbs and the market collapsed. While it didn't devastate the nation's economy, it did undermine the social structures. It destroyed relationships built on trust and hindered people's willingness and ability to pay their debts.

The risky nature of Bitcoin means one day you are worth millions in US dollars, and the next you've lost your shirt. This is not something most retirees should be involved in. What retirees need is a stable and steady source of income, something Bitcoin is not likely to offer.

Bitcoin Does Not Produce Functional Wealth

Currencies like US Dollars, Canadian Dollars, Japanese Yen, are all static forms of wealth. Their value may change but they do not produce additional wealth themselves. Bitcoin depends on wild swings in value. It's not paying interest or delivering dividends that can increase real wealth or pay the bills.

Retirees Need Recurring Income to Meet Recurring Needs

Retirees have recurring expenses - power, water, internet, cell phone - that will require recurring income streams to match those expenses while leaving your asset base relatively stable. Holding products that produce zero functional wealth squanders the opportunity to produce needed income. Chasing potential spikes in Bitcoin's price cannot provide the reliable and recurring income to pay the power bill. A similar logic can be applied to growth investing. With growth stocks, at least you are investing in a real company with tangible assets. With Bitcoin, you are buying a digital currency with no backing and no guarantee it will exist tomorrow.

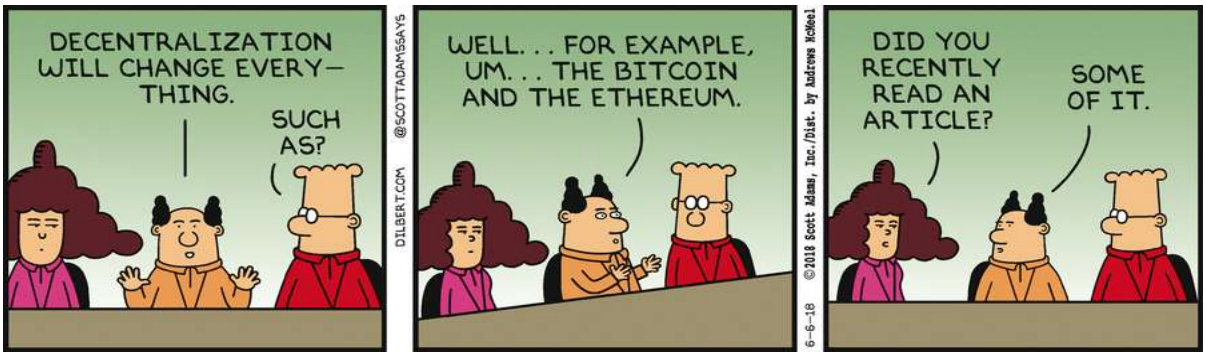
What's in YOUR wallet?

Here's probably the biggest "deal killer." If you get locked out of your virtual *Bitcoin wallet*--your currency is gone. German-born programmer Stefan Thomas made headlines recently after a lost password rendered his bitcoin stash worth today nearly $385 million inaccessible. Business Insider reported that the secure hard drive, on which his 7,002 bitcoins were stored, was an IronKey device. It gives owners 10 chances to guess their password before encrypting the contents and sealing them forever. Thomas only has two attempts left. After his story went viral, he said in a subsequent television interview that "time heals all wounds" and that he had made peace with his likely loss. He added: "It was actually a really big milestone in my life…I sort of realized how I was going to define my self-worth going forward. It wasn't going to be about how much money I have in my bank account." *Nope!*

In another case, a Welsh man says he threw away a hard drive loaded with 7,500 bitcoin in 2013. He is offering his city council $70 million to dig it up from the city dump. What cryptocurrencies desperately need is oversight. Currently, Bitcoin is bought and sold on unregulated exchanges. If Bitcoin is found to be appropriate for most investors — it should be sanctioned and regulated by the Securities and Exchange Commission.

Bitcoin transactions depend on a developing security technology known as Blockchain. Blockchain technology has potentially far-reaching applications across many industries. Blockchain is already used to facilitate identity management, smart contracts, supply chain analysis, and much more. The full potential of blockchain technology remains to be discovered and may prove to be a much smarter investment bet than bitcoin. Stay Tuned…

DILBERT ON CRYPTOCURRENCY



Source: Scott Adams & Dilbert

The Market is Not a Linear Activity

When it comes to the market, investors often ask us, almost on a daily basis, the “reason” for the market’s behavior. When these questions arise, we are often reminded that John Train, author of The Money Masters and The Midas Touch, describes the market as “a terrified Great Dane on a leash, dragging an attached small boy through the gutter.” Warren Buffet’s mentor Ben Graham described daily market behavior as “manic-depressive.” Of course, the most accurate explanation is “Supply and Demand.” There were more buyers than sellers today or vice versa.

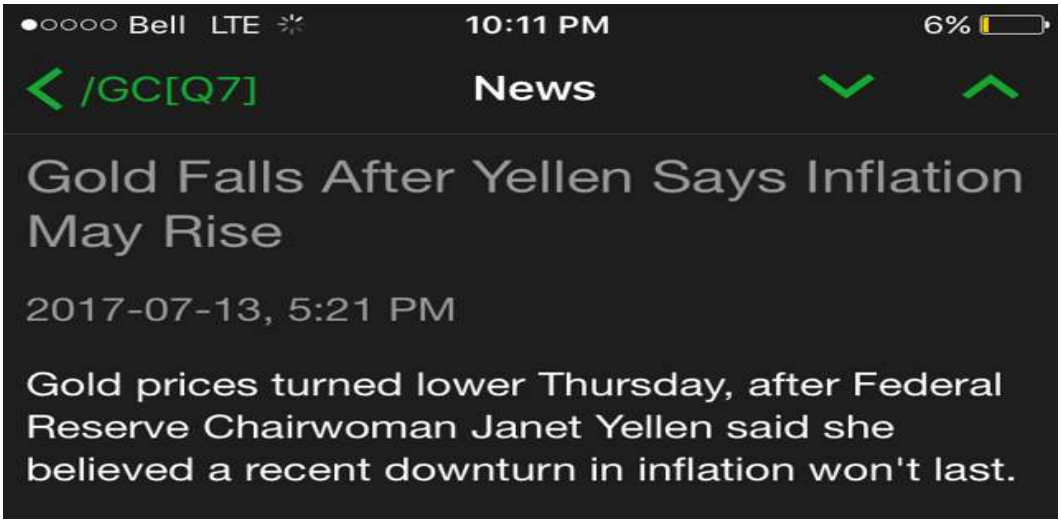
We are led by the financial entertainment media to assume that the “talking heads” have an understanding as to why a market dropped or rallied in the past few days. Simply because there is a newsworthy event that occurred during that time period, it is superficially assumed that is what caused the market movement. These factors are in reality, exogenous to the market.

Source: CNBC

“What the Heck is Going On?????

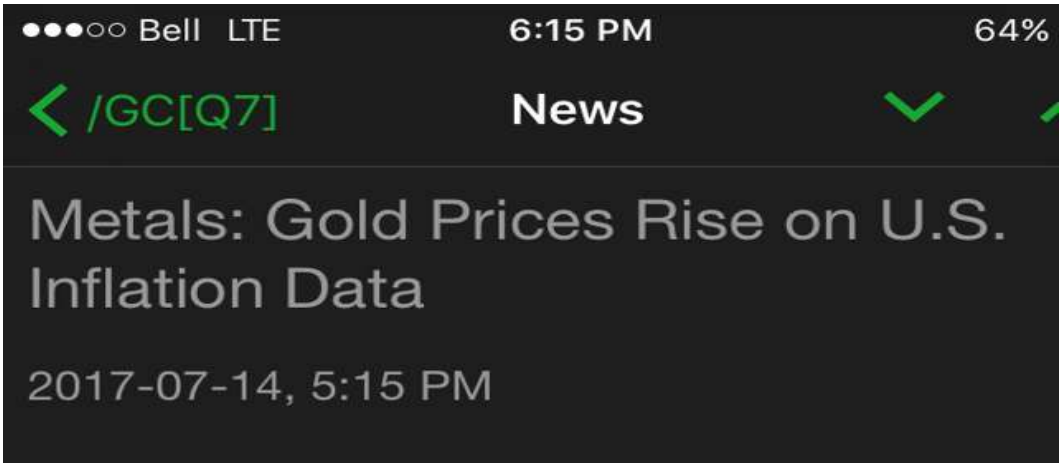
To provide you with an extreme example that we recently experienced, just think back to the March 2020 time frame (one year ago). As the worst of the Covid-19 death rates were being reported, unemployment was hitting record highs, and localities throughout the country were being ordered to lockdown, based on the headlines it was expected that the market would continue in its decline until economic activity began again. Yet, the market has almost doubled off those lows while the economy was still technically in a recession.

The main point is that the market is not a linear activity. So, when the “talking heads” attempt to glean the “reason” for a market move, and then attempt to extrapolate that “reason” to suggest further market action, they are guessing at best. One cannot utilize a linear perspective to prognosticate the direction of a non-linear environment. It is not unusual to see the exact same news event seemingly “causing” opposite reactions in the market.



Source: Wall Street Journal and Fox Business headlines

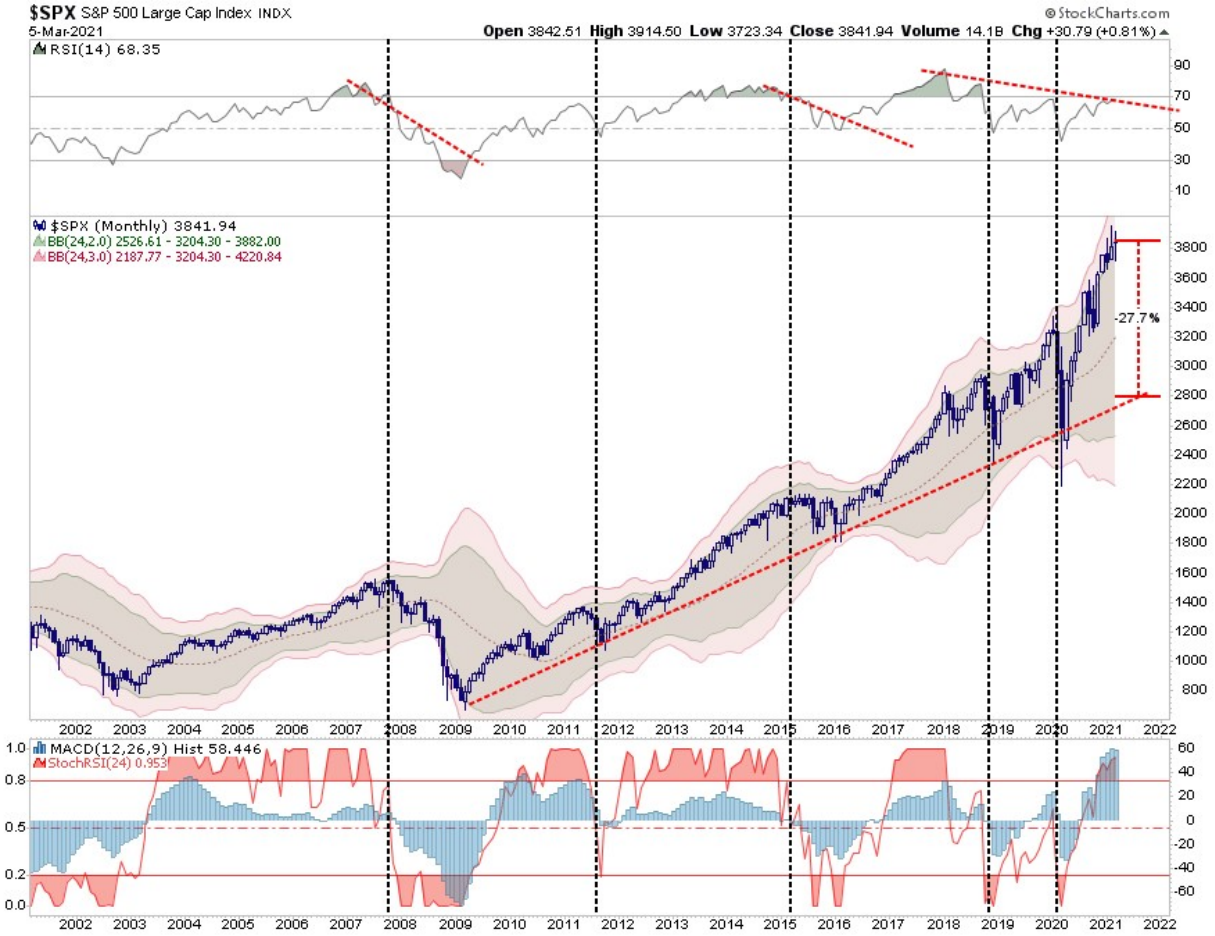
Anyone who provides “analysis” based upon events and news items has been caught in this intellectually dishonest loop many times.



In this 2017 example (above) news about inflation was reported on a Thursday to explain why the price of gold declined, whereas the same news was reported from another source on Friday explaining why the price of gold rose.

Confirmation bias, also called “my side” bias, is the tendency to search for, interpret, and remember information in a way that confirms one’s preconceptions or working hypotheses. It is a systematic error of inductive reasoning.

Currently, the *"bulls"* are still in control of the market.



The long-term running bull trend is remaining intact…for now.

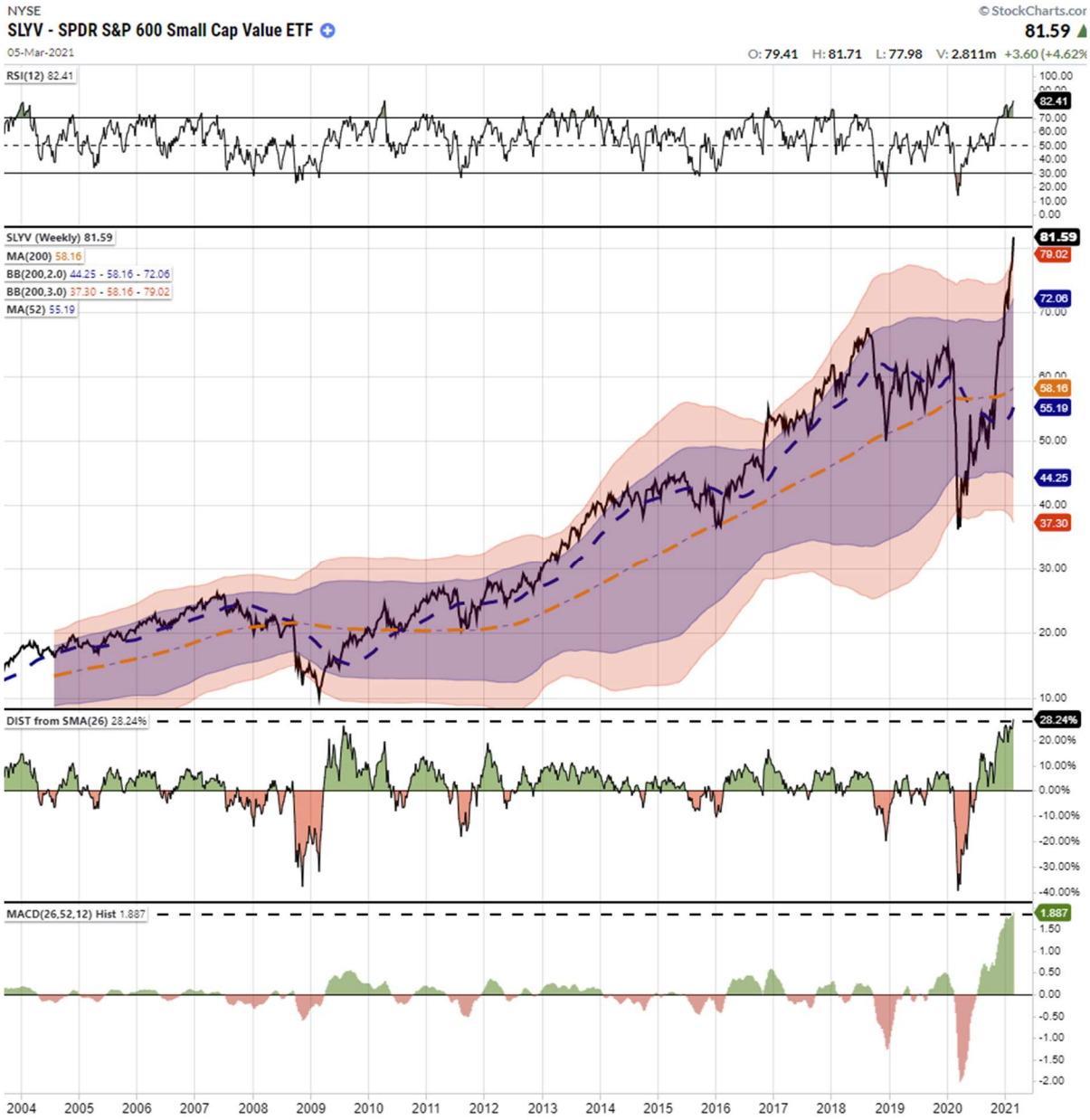
The chart from StockCharts.com (above) is a MONTHLY chart of the S&P 500. Importantly, the bullish trend that began in 2009 remains intact. Currently, from the March 2020 lows, (one year ago) the S&P has risen by nearly 60%. The trajectory of the S&P has also taken it 27% above the long-term trendline.

Note that a correction (or near correction) back to the trendline (lower dotted red line) on the chart has occurred repeatedly since 2009. At the current valuation, a return to the trendline (reversion to the mean) would encompass a nearly 30% decline.

The major question is the sustainability of the market at current levels given the rapid rise and the rather extreme deviation from the long-term trend.

An Unsustainable Trajectory

The chart below illustrates the rapid rise in small cap value stocks recently and can be viewed as a troubling perspective. It shows the recent massive rotation from growth stocks to value stocks, and the outperformance of small cap stocks vs large cap stocks. The same type of unsustainable trajectory can be seen in the weekly chart of the Russell 2000 index which picks up mid-cap exposure as well.



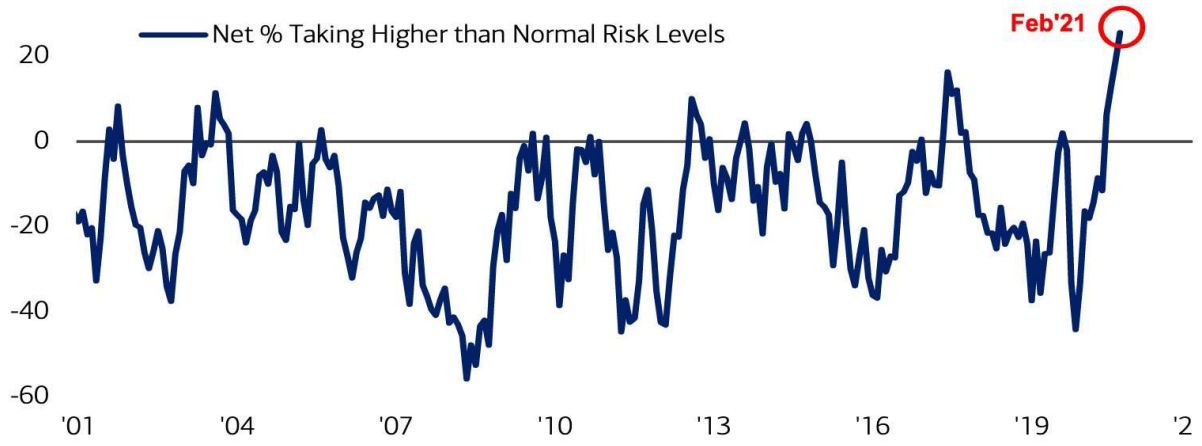
The massively overbought extremes are verified by the indicators above and below the small cap value index (central chart). The result of this rotation is likely going to be akin to *"jumping from the frying pan into the fire."* Most short-term focused investors will make assumptions the indicators are *"wrong"* this time. However, history tends to prove that such extreme market extensions rarely resolve themselves to the upside.

Euphoria Has Been Evident

There is little argument that *"euphoria"* has been evident in the market recently. From excessive levels of call-option buying by small traders to chasing the most shorted stocks in the market such as GameStop.

Exhibit 11: All-time high in investors taking "higher-than-normal" risk

Net % Taking Higher than Normal Risk Levels



Source: BofA Global Fund Manager Survey

BofA GLOBAL RESEARCH

What's even more concerning is that with an improving economic picture and stimulus checks in the mail, investors have apparently "thrown caution to the wind" ready to buy into the markets at any price as the Bank of America risk chart (above) indicates. Unfortunately, once the stimulus runs through the system, the markets will again face economic realities. Trying to predict the market is pointless.

While we are aware of the risks in the market currently, we remain in "risk-on" mode in most of our portfolios. Our indicators and signals remain positive at this time, and we want to participate in market gains when that is the case. Calling the top in a market or area of the market is impossible. The risk for investors is the *"willful blindness to changing conditions."*

The charts on some of the broad market indexes like the S&P 500 and certain sectors of the market still look healthy at this point. Things can change in a hurry and we are aware of the possibility of a deeper correction if something "spooks" the market. At times like this, having an exit strategy is essential.

As always, risk management will remain key to our investing.

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