Has bitcoin come of age?

Bitcoin has been the world’s best performing currency in the last two years. More investors are diversifying into the cryptocurrency as confidence in fiat money wanes and new infrastructure is put in place.

By Kuek Ser Kwang Zhe

Bitcoin has been gaining acceptance among investors, businesses and regulators since it was first introduced almost a decade ago. Today, the cryptocurrency is entering a new phase, thanks to its low correlation with other asset classes, increasing recognition by central banks and supportive infrastructures globally.

The outlook for bitcoin is bright. Prices are expected to continue rising due to the number of investors diversifying into the cryptocurrency. Well-known investors who have gone into bitcoin include Marc Andreessen (co-founder of Netscape and private venture capital firm Andreessen Horowitz), Blythe Masters (former managing director of JP Morgan Chase & Co) and David Rutter (founder and CEO of financial innovation firm R3).

"Bitcoin prices have been trending up over the past three years. It was also the best performing currency in 2015 and 2016. This has driven more people to invest in it and the trend will continue," says Amarjit Singh, a consultant for one of the world’s largest bitcoin mining companies.

Bitcoin prices surged more than 120% last year, by comparison, Brazil’s real — the world’s second-best performing currency — grew nearly 21%.

The demand for bitcoin is also being driven by concerns about the long-term value of paper currencies. "The value of traditional currencies, which are backed by governments, will always drop as economic crises are bound to happen and central banks pump billions of their currency into the market in response," on the other hand, the supply of bitcoin is limited and the demand for it is rising," says Amarjit.

There are currently 16 million bitcoins in the market. Based on the algorithm that determines the bitcoin supply, the number of the market in the number will be capped at 21 million by June 2020.

According to Alvin Yong, CEO of EquitiesTracker.com, a regional equities research portal, there is a lack of confidence in the long-term value of paper money in the light of the central bank’s monetary policies. "The general sentiment is that there is a lack of checks and balances on the amount of paper money being printed, causing it to not store value very well. Naturally, investors will seek assets that give them a better hold on value," he says.

During the 2008 global financial crisis, central banks began expelling monetary policies in an effort to revive their economies. But the huge amount of liquidity that flooded the market caused the values of traditional currencies to drop.

US President Donald Trump’s plan to roll back the Dodd-Frank Wall Street Reform and Consumer Protection Act could further dampen investor confidence in traditional currencies. This has prompted some investors to look at bitcoin, says Colbert Low, founder of bitcoinmalaysia.com and one of the earliest investors in the cryptocurrency in the country.

The Dodd-Frank Act, signed into US federal law in 2010, is aimed at preventing the next financial crisis and protecting consumers from fraud. It requires investment banks to have a higher capital requirement to limit their ability to leverage. It also stopped banks from conducting proprietary trading and set up the Consumer Financial Protection Bureau to provide consumer protection in the financial sector.

However, Trump thinks that the Act has limited banks’ ability to lend, causing the US economy to experience slower growth. "But some people think that rolling back the Act is like going back to the Stone Age," says Low.

There are signs that bitcoin is emerging as an asset class. In a recent white paper published by Ark Investment Management and bitcoin start-up Coinbase, titled Ringing the Bell for a New Asset Class, the cryptocurrency fulfills all the criteria of a traditional asset class, such as investability, political-economic features, correlation with returns, price independence and a risk-reward profile. US-based Ark Investment Management was reportedly the first public fund manager to invest in bitcoin in 2015.

As investability is defined as "providing ample liquidity and opportunity to invest," the white paper notes that "at Dec 30, 2016, bitcoin’s average daily liquidity for the trailing three months was more than threefold the SPDR Gold Shares ETF and nearly 10 times that of the Vanguard REIT ETF... In our opinion, the superior volume with a fraction of the assets under management underscores that bitcoin is punching significantly above its weight in providing retail investor liquidity."

While many find the use of bitcoin as a speculative instrument alarming, the paper says "when compared to fiat currencies, bitcoin strikes a closer balance between trading and transaction." This means that when people use bitcoin — as opposed to fiat currency — they are more likely to use it to transmit value for goods and services than as a speculative instrument.

Bitcoin’s price movements have been separate and distinct from those of other asset classes in the last six years, according to the white paper. "Bitcoin is the only asset that consistently maintains low correlations with every other asset. Remarkably, the maximum correlation, positive or negative, that bitcoin exhibited with each of the other assets is near the minimum correlation, positive or negative, that any of the other paired assets displayed with each other."

Although bitcoin has been extremely volatile historically, when its returns are adjusted to account for the volatility, its Sharpe Ratios have been superior, says the white paper. "US equities, bonds and real estate delivered better Sharpe Ratios over the three-year period, but bitcoin has outperformed in every other period. Over the past year, it has compensated investors nearly twice as much as US equities relative to the risk taken, as defined by the Sharpe Ratio."

Meanwhile, some companies are looking to introduce mainstream products that invest in bitcoin. US entrepreneur Tyler and Cameron Winklevoss, who run cryptocurrency exchange Gemini, applied to the US Securities and Exchange Commission (SEC) three years ago to offer a bitcoin ETF called the Winklevoss Bitcoin Trust. The SEC is expected to decide on the proposal by March 11.

"It is a big thing to watch out for. If the ETF is approved, it can drive up bitcoin prices. Also, it means that bitcoin will be recognised as an asset class," says Amarjit.

Asia to be the driving force

Governments in Asia have begun to recognise and regulate the cryptocurrency. This will drive bitcoin prices forward and boost investor confidence, says Amarjit.

The Japanese government recently tabled a bill to amend several Acts, including the Payment Services Act, to impose regulations on virtual currency exchange services. The new laws will come into force in April.

According to news reports, bitcoin trading volumes in Japan are among the highest in the world.

This month, the Philippine central bank imposed new rules on the country’s bitcoin exchanges, signal-
The Tokyo-based exchange had handled 70% of the world’s bitcoin transactions before its collapse, due to
several hacking attempts and its own mismanagement. Some US$460 million worth of bitcoin was stolen by
hackers while another US$27.4 million went missing from exchange’s bank accounts.
Other bitcoin exchanges were also impacted by this event. According to Bitstamp’s historical price chart, the
cryptocurrency plunged from US$880 to US$310 in 2 Mt. Gox, it hit a low of US$214 in January 2015 before reaching a
new high of more than US$1,000 today.
At some bitcoin exchanges, the cryptocurrency dipped below US$200. Seeing an opportunity, Amarjit
bought into a bitcoin mining company. “I have made a handsome profit from this investment,” he says.
While many expected bitcoin to fade away after the Mt. Gox collapse, the development of new bitcoin infra-
structure has proved them wrong, says Amarjit.
STILL A RISKY INVESTMENT
Yet, there remain concerns about bitcoin. Devan Linus, a Malaysian trader, comments, “It remains speculative.
While some investors see bitcoin as a means of diversification, others warn of speculation.”
“Diversification aims to reduce investment risks. But bitcoin is extremely volatile and is not backed by
a country’s real economic activity and real products and services. It is prone to speculation as it is not based
on fundamentals,” says Devan.
On the rally that saw bitcoin prices surge more than 120% last year, he says it was probably due to specula-
tion, which also happens in other asset classes. “It is not a new phenomenon. For instance, some penny
stocks worth $1 suddenly spike within a few months. The Mt. Gox does not reflect its fundamentals and could be
due to speculation.”
Cybersecurity is another issue Devan is concerned about, even though some central banks have introduced
regulations for bitcoin. Last August, Hong Kong-based bitcoin exchange Bitfinex was hacked and bitcoin prices
plunged 20%. The hack led to the loss of $580 million, according to news reports.
Bitfinex determined that the losses were generalised across all its accounts, so each client incurred a loss of
36%. This was despite bitcoin prices almost recovering to pre-hacking levels after a week.
Astronomic exchange rate changes better equipped now and safer for investors? Devan does not think so. “It takes a large
investment to improve cybersecurity. Banks, which are regulated and have huge capital, have invested a lot of money
in this and there is still no guarantee that breaches will not happen. How do these exchanges with less
capital invest in their systems and make them safe?”
Surya says is totally possible that another cybersecurity breach could happen at bitcoin exchanges and
cause the cryptocurrency’s prices to plummet. “It is possible. What happened to Mt. Gox could happen again. Investors should know the risks and be prepared to lose more than 50% of their investment. Do not invest in bitcoin if you do not have a high risk appetite.”
Daniel Goettfert, chief operating officer of Fanned-Byme Malaysia and a bitcoin investor, says investors should
have some knowledge of cybersecurity issues before investing in bitcoin. Not only can exchanges be hacked, but also
bitcoin wallets, mobile applications for storing bitcoin, he points out. “This investment is not for everyone,” he says.
Devan says bitcoin is still in its infancy and its future remains to be seen. It will survive if it is more widely
accepted and used by people around the world to make payments for goods and services. This will allow the
cryptocurrency to have more interaction and a deeper correlation with real economic activities.
“Yes, bitcoin has continued to survive. There is probably a group of anti-establishment people who are
passionate about technology that is supporting it. There are also some tech giants that have started to accept
bitcoin as payment. But I doubt that it is here to stay. The previous rallies seem more like speculative activ-
ities,” he says.
Government regulations, which seem to be happening globally, do not guarantee that bitcoin will continue
to survive, says Devan. “It is like when Uber first took off in different countries. Governments have to
regulate it to protect their citizens when there is a boom. The same goes for bitcoin. This does not mean, however, that it will take off in the future.”