OPINION

A finance professor’s advice on investing in bitcoin: Just say no

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With inflation reaching 30-plus-year highs, investors are looking to alternative investments to protect their capital from its erosion in case inflation is not “transitory,” but “permanent.” One popular alternative in recent years that has gained some currency is digital coins, such as bitcoin.

Bitcoin emerged in the wake of the 2008 financial crisis that led to an explosion of the liabilities of central banks. At the same time, debt issuance by private and public entities rose sharply. That brought into focus the realization that global economies had been living beyond their means. Inflation and devaluation of fiat currencies were feared.

The decrease in the trust of the banking system caused an increase in the demand for cryptocurrencies, like bitcoin because bitcoin provides the means to avoid governments and central banks.

Is this then what makes bitcoin valuable?

Bitcoin embodies two innovations: blockchain technology, a public ledger that contains all transaction records since inception, and decentralized governance. It is governed by “miners” who are incentivized to maintain a stable supply of bitcoin.

The theoretical roots of bitcoin can be found in the teachings of the Austrian School of economics and the writings of Friedrich von Hayek, who believed that private banks should have the right to issue their own currencies.

As with gold, central banks cannot print bitcoin. And, not unlike the rarity of gold, the supply of bitcoin is fixed to 21 million bitcoins and is determined by an algorithm. New bitcoins are created after performing computationally intensive tasks that are necessary for the bitcoin system to function. However, only a limited supply of bitcoins is “mined” every year.

In light of the increased demand for bitcoins, because of the hype, media reports of rising prices, fear of missing out and uninformed speculators and the feedback loop that ensues, a severe imbalance between demand and supply has been created. That has driven bitcoin prices skyward.

However, having said that, eventually, bitcoin investors will have to ask themselves the following questions:

First, what is the value of a bitcoin? Is bitcoin money? Is bitcoin an assets class? And finally, what does bitcoin give you a right to?

When I teach valuation in my classes at Ivey Business School, I define value as economic or fundamental value, which relates to the ability of an asset to produce a stream of after-tax cash flows.

What are bitcoin cash flows? None!

What is the value of bitcoin? Or better, what makes it valuable? Is it because many people think it is valuable? Is it valuable because it is cool, and we expect other people, especially those in the online community, to believe it is valuable? Does the dynamics of investor demand matter as much as fundamentals?

In a recent paper by Xavier Gabaix and Ralph Koijen, the authors argue, "Prices move because people do things independently of fundamentals." In their paper titled In Search of the Origins of Financial Fluctuations, they explain that the amount of money entering the markets can have a large impact on share prices regardless of fundamentals. They do, however, conclude that in the long run prices return to fundamentals. But how long is long run?

Is bitcoin money? Well, it is not as it fails the three key functions of money: store of value, unit of account and medium of exchange. Bitcoin is extremely volatile, very illiquid, and unable to handle a large volume of transactions.

Bitcoin is not an asset like real estate or a stock, as it generates no cash flows or expects to generate any cash flows, and it is not a bond for the same reason. It also has no inherent value like gold. Gold is perceived to be valuable because it has certain unique characteristics and attributes, such as being the best conductor, more malleable, able to be used to make tools and jewellery, and can be worn and so on – we cannot do this with bitcoins.

Bitcoin has no correlation with other markets, like the stock market. For example, the correlation coefficient between bitcoin returns and the returns of the S&P 500, Nasdaq, Russell 2000 and the S&P/TSX are 2 per cent, -3 per cent, -5 per cent and 4 per cent, respectively, none of which are significantly different from zero. And so, bitcoin cannot be used as a hedging instrument. Despite the bull market of 2018 and 2019, bitcoin's value collapsed.

Moreover, heavy regulation by governments weakens bitcoin's value proposition. Many central banks have announced that they intend to launch their own cryptocurrencies. And hostile government policies against bitcoin (for example, in China) increase the vulnerability of bitcoin and reduce its attractiveness.

Every generation must learn things the hard way. It is now the turn of millennials, who love everything digital. It's time to learn the risk of fads, be they digital or analog.