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Answers to questions you may not even know you have.

NOBODY ASKED ME (ABOUT CRYPTOCURRENCIES) BUT…

This essay was originally published in Muhlenkamp Memorandum Issue 139, July 2021 by Jeff Muhlenkamp, Portfolio Manager.

I thought I'd share my thoughts on them anyway.

At a high level, cryptocurrencies are built on a distributed database, called a blockchain. The "distributed" part means that the database is replicated on a number of computers, not just one or two, and so no one really "controls" it. Bitcoin, the original cryptocurrency, is a token awarded to people who use their computers to run the ledgers of the database and record new transactions—it is their payment for doing the work the system requires. Bitcoin also has a maximum number of tokens, or coins that can be created, so it takes increasing amounts of computer processing to earn the next Bitcoin. The limitation on the number of Bitcoins that can be created is for some an attractive feature but while the number of Bitcoins that can be created is limited, the number of cryptocurrencies that can be created is not. Bitcoin has split three times since its creation as the rules governing it have changed, so there is now Bitcoin, Bitcoin Cash, Bitcoin SV, and Bitcoin Gold. Further, not all cryptocurrencies limit the number of tokens or coins that can be created as they have different rules and try to solve different problems. Ethereum, for instance, allows developers to deploy immutable contracts on it—ones that execute without further human intervention and can't be changed at a later date. The Ethereum blockchain also serves as the basis for other tokens using the ERC-20 protocol (ERC-20 stands for Ethereum Request for Comments 20). More on that a little later.

Cryptocurrencies have been suggested as replacements for other currencies ever since the original white paper published by Satoshi Nakamoto in 2008. The name itself is a marketing pitch for that idea. Cryptocurrency bulls, people who think the value of cryptocurrencies will continue to rise, justify their stance by asserting that as a given cryptocurrency is more widely adopted the value will inevitably increase. That is logical for cryptocurrencies with limits on coin or token creation, but not for cryptocurrencies without that limitation. Thirteen years after the original whitepaper and twelve years after the creation of the first Bitcoin how attractive are cryptocurrencies as currencies?

I think currencies in general perform three useful functions. They serve as a medium of exchange, a unit of account, and as a store of value. How do cryptocurrencies stack up in these areas?

- At this time, transacting in cryptocurrencies is less convenient than transacting in traditional currencies, either in cash or via electronic transfers. That may improve over time but right now the relative inconvenience is a barrier to wider use of cryptocurrencies as a medium of exchange. Additionally, very few sellers accept any cryptocurrency as payment for a good or service with the biggest exception being cyber attackers who demand ransom payments be made in a cryptocurrency (usually Bitcoin). The reason they require Bitcoin is because ownership is relatively anonymous. Finally, nation states have asserted the right to specify what will be considered legal tender within their borders. They guard that right jealously. China and India, for example, are restricting cryptocurrency mining and use. El Salvador, on the other hand, became the first country to adopt Bitcoin as legal tender in 2021. The government of El Salvador destroyed confidence in its old currency and is trying to rebuild trust in both the currency and the government. The El Salvadoran colon was legal tender in that country from 1892-2001, joined by the US dollar in 2001, and by Bitcoin in 2021. It's not yet clear if adoption of Bitcoin as legal tender has resulted in widespread Bitcoin use in El Salvador or improved the citizens confidence in their government. I think most countries will fight the widespread adoption of a currency they don't control and they have a lot of tools available to do that. I have a hard time envisioning a day when Uncle Sam pays my pension in Bitcoin, lets me pay my taxes in Bitcoin, and the Federal Reserve closes its doors because it no longer has a job. Honestly, I don't think governments are willing to relinquish control. Thus, I think there may be some legal hurdles to the adoption of cryptocurrencies as a medium of exchange.

- Unit of account is interesting - it's basically saying: "I will use this (a meter, a pound, a second) as the basis for measuring characteristics of things like distance, weight, or time." No one is pricing dollars in Bitcoin, they are pricing Bitcoin in dollars (or euro, or yen). The same is true of gold and silver—they are priced in dollars per ounce not ounces of gold per dollar. Thus, gold is not a unit of account. For a cryptocurrency to become a unit of account I think it would take a near simultaneous shift in how everyone measures value—to stop measuring it in dollars (or euro or yen) and start measuring it in Bitcoin (or Bitcoin SV or Bitcoin Gold). I think that could happen if fiat currencies become worthless—people no longer trust them to hold their value or accept them as payment. This is what happened in El Salvador where an untrusted currency has been replaced as legal tender by something else: first the dollar and now Bitcoin. It has happened before (anyone still use the pre-US revolution continental?) and will almost certainly happen again, but I don't think we are near that point now with the dollar.

- Store of value – the price of cryptocurrencies as measured in dollars moves A LOT, making it difficult to know what it will be worth tomorrow, much less a year from now. Currently they are not a good store of value.

In summary, I really don't think cryptocurrencies are on the verge of replacing any of the major currencies, so buying a cryptocurrency today in the belief that it is the currency of the future will probably require a lot of patience and you run the risk of having your cryptocurrency outlawed. If governments continue to abuse the trust people have placed in their currencies by debasing them (inflation is another word for currency debasement) then there will be an opportunity for cryptocurrencies to be adopted on a wider scale.

But viewing cryptocurrencies as a currency is not the only way to think of them. You can also think of them as a financial asset in the same way that some people think of art, classic cars, or other collectibles as an asset. You buy them with the expectation of selling them later at a higher price. Certainly, the meteoric rise in price of Bitcoin and other cryptocurrencies has encouraged this viewpoint and attracted both Wall Street and scammers. Let's talk about Wall Street first.

Wall Street loves to sell things. It has an enormous marketing arm and it's always looking for "assets" it can package and sell with the associated options, futures, etc. A year or two ago Wall Street declared cryptocurrencies an "asset class" and got busy finding ways to make it easier for both investment professionals and amateurs to invest in them. They have been successful in both creating new products and selling them to investors of all stripes. This additional demand has coincided with a rise in the price of cryptocurrencies. At some point Wall Street will saturate the market with cryptocurrency products and the inflows of cash into cryptocurrencies due to investor demand will slow, reducing the upward pressure on price.

Cryptocurrencies have also attracted their fair share of scammers. You may recall the headlines from March 2021 describing the New York Adjutant General's investigation into Bitfinex (a cryptocurrency exchange) and Tether (a cryptocurrency company) and the resulting settlement. Essentially Tether (the company) claimed that the Tether (their cryptocurrency) was 100% backed by dollars held by the company and therefor the value of 1 Tether was essentially pegged at $1. The New York Adjutant General demonstrated Tether's claims were false, that the reserves were only about 70% of the outstanding value of Tether and that those reserves had only recently been lent to Tether by Bitfinex. In other words, the peg was fraudulent. Interestingly, it appears that Tether is often used to buy Bitcoin. So, one might ask "What happens to the value of Bitcoin, the biggest of the cryptocurrencies, if Tether (the cryptocurrency) declines in value or Tether (the company) goes out of business." I suspect nothing good.

Coincidentally in early July I read two accounts of cryptocurrencies that were created on top of the Ethereum blockchain (using that ERC-20 protocol mentioned above) and then marketed and sold. One was created as a lark by a British guy, the other appears designed to funnel money into the pocket of the creator. The British guy, an internet personality, explained everything he was doing in a podcast as he did it – creating the token (very easy), creating the twitter account, creating the website, selling some tokens, etc. He was as upfront as he could be that he was creating his coin as a bit of whimsy, and yet some were purchased and established a price for the remainder, which he owns. Should he be able to sell his coins without destroying the price he would be able to convert his paper millions into actual wealth. The other guy was not at all transparent in what he was doing or why and seems to have simply created a coin with the intent of using interest in all things cryptocurrency to line his own pocket.

It seems to me there is a lot of speculation in cryptocurrencies—people see the price going up and they buy some hoping it will continue to go up and they can become rich. I'm also seeing an increasing awareness of scams and frauds in the space as described above. The scams are probably big enough now that when they collapse, as they likely will, legitimate cryptocurrencies will also decline in price and the damage will probably carry over into stock markets, transmitted by persons or organizations that hold both cryptocurrencies and stocks.

I have no doubt that blockchain technology will prove very useful in the long run and it is likely that some cryptocurrencies will as well. In the short term, however, the whole space looks increasingly hazardous to me.

Cryptocurrencies and blockchain systems could be vulnerable to fraud. Investing in cryptocurrencies is highly speculative and an investor can lose the entire amount of their investment.

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