



# Flash Update

## Portfolio Advice & Investment Research

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## Crypto-Currency 2: Caveat Emptor<sup>2</sup>

Since our last update on crypto currencies in June, a lot has transpired and then again nothing has changed. Most notably, the market price of crypto currencies has risen significantly. Since June, the quoted price of Bitcoin has moved from approximately US\$2,500 to a recent peak close to US\$18,674 on December 18, 2017, more than a sevenfold return. The question that anyone considering purchasing Bitcoin should ask themselves is: Why has this supposed currency changed in relative value so much in such a short period of time?

Let's re-visit our thoughts on crypto-currencies from June:

Although it is true that the Blockchain technology that underlies crypto-currencies has many potential applications in banking, retail transactions and securities trading, we have a number of key concerns regarding the legitimacy of these "currencies" as investment vehicles, including:

1. By definition, a currency is a medium of exchange that is in general use and acceptance or that has prevalence. The crypto-currencies are only exceptionally used as a medium of exchange (most predominantly on black markets), are not in general use, nor are they generally accepted. At this time, there are few companies that will accept crypto-currencies as payment and a number of countries where it is still illegal to do so. Although we do agree that the number of businesses accepting crypto currencies is increasing, acceptance is increasing at a very measured, even glacial, pace.
2. These "currencies" have been given their values primarily by speculative demand; they are not backed by physical assets or sovereign governments. Aside from speculation, demand is driven by their minimal adoption for use as a substitute for legal tender. Crypto-currencies have dangerously high volatilities. For instance, on June 12, 2017, Bitcoin plummeted by more than 16% in a matter of hours. Much of the price volatility is a result of pure speculation, from investors trying to make a quick buck off of the next big thing and not from inherent value.
3. While it is possible for a crypto-currency purchase to generate a 10% return in a day, it is equally possible for the value to decline 10% the next day. Profits and losses are a virtual random walk generated primarily from speculation.

Recently, both CBOE Global Markets, Inc. (CBOE) and the CME Group (CME) have both commenced trading options/futures on Bitcoin. These markets will allow individuals or institutions to take a long or short position in the underlying cryptocurrency. These financial instruments should aid in increasing the volatility in an already volatile position. The CBOE contract is targeted at smaller transactions at 1 Bitcoin per contract, while the CME contract is targeted at much larger transactions at 5 Bitcoins per underlying contract. Oddly enough, during the tulip craze in the Netherlands, cash-settled futures were introduced in 1636. In February 1637, the market crashed.

Until the adoption and applications of crypto-currencies for real world purposes becomes more tangible, we will continue to view these "currencies" as highly speculative. It would be unwise and irresponsible to consider these as investments. Caveat Emptor.

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However, with that being said, should a client have a position in a crypto-currency and has experienced a large unrealized gain, portfolio management prudence still applies. Existing positions should be managed to realize some levels of gains, extract initial capital and manage downside risk should the market implode. The adage of "No one ever lost money taking profits" applies here.

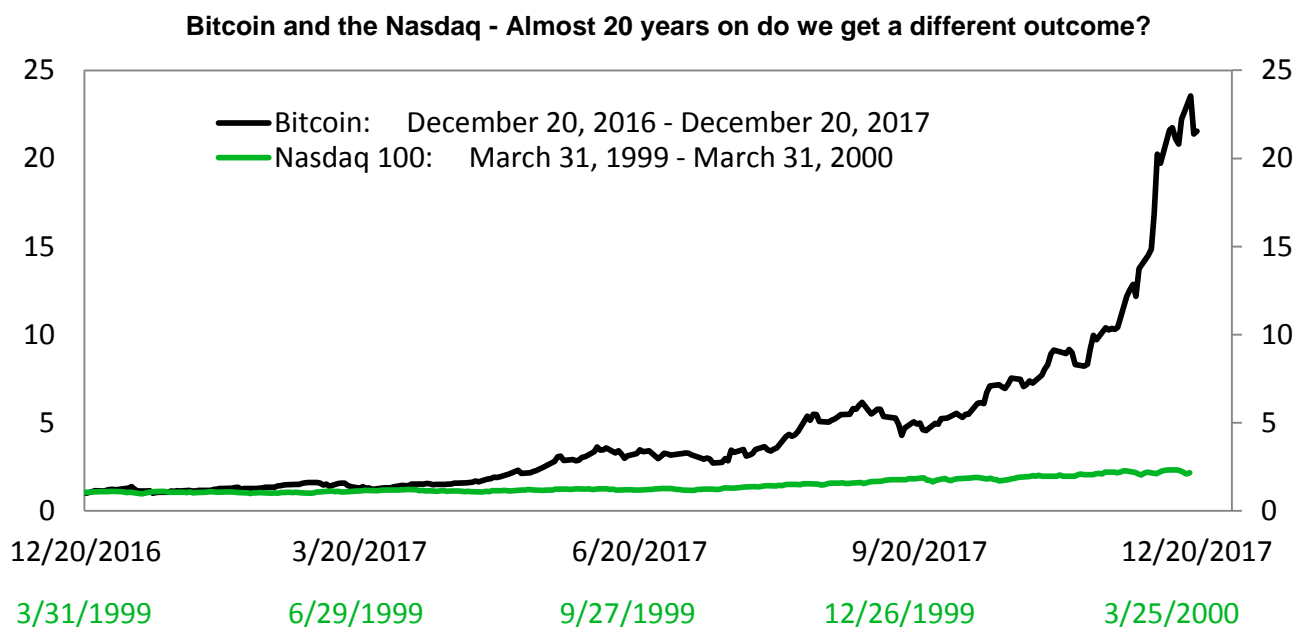
Many holders believe that profits in crypto-currency trading gains/losses are not taxable by the federal authorities. This is in fact false as all profits are taxable. In Canada, the Canada Revenue Agency (CRA) has issued a notice to crypto-currency holders advising them to report their gains and losses. For more specific tax information on your individual situation, please contact your local tax authority.

To conclude, other than the price, has anything really changed? – Absolutely not! The volatility remains a key feature of Bitcoin's valuation, which is driven by a combination of high demand and low supply. If this is to be an actual currency or medium of exchange, it needs wider adoption and higher price stability.

Another key functional problem with Bitcoin as a currency is its transaction handling. There are two problems: the first is capacity and the second is the length of time to confirm a transaction. According to Wikipedia, the Bitcoin network's theoretical maximum capacity sits between 3.3 and 7 transactions per second. Visa claims that its network, VisaNet, is capable of processing 56,000 transaction messages a second. Mastercard claims a 39,000 transaction per second processing capacity. Blockchain.com, a website specializing in all things Bitcoin, reports that as of December 19, 2017, it takes an average 78 minutes to confirm a Bitcoin transaction. This major stumbling block would have to be remedied before wide spread adoption is even contemplated.

Furthermore, there are rival crypto-currencies that function equally well if not better than Bitcoin. One of the better known alternate crypto-currencies is Ethereum, which can support roughly 15 transactions per second. While this is not enough to rival a Visa or Mastercard, it is better than Bitcoin. Certainly the concept behind Bitcoin – an electronic medium of transaction – makes sense. But these transaction statistics are not going to work in the real world: How long do you want to wait to leave the store with your goods?

Consequently, the only thing driving the value of Bitcoin is supply and demand. Right now people are buying and holding on to their Bitcoin. In order to do that, they are paying high fees for the privilege, and risking the loss of their Bitcoin either through hacking or through forgetting the password for their digital wallet (remember there is no such thing as a physical Bitcoin – even if there are pictures on the internet!). People are holding on hoping that a greater fool will come along and pay them an even higher price for their Bitcoin. That game works, until it doesn't. Let us leave you with a picture:



Source: Bloomberg Finance L.P.

The green line traces what has been referred to as the Great Bubble of Nasdaq in the late 1990s over the course of its final year. The black line (Bitcoin) works backward from December 20, 2017 to December 20, 2016. Both lines are re-based to a level of 1 at the start. If Nasdaq was the "Great Bubble", what is Bitcoin?

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