

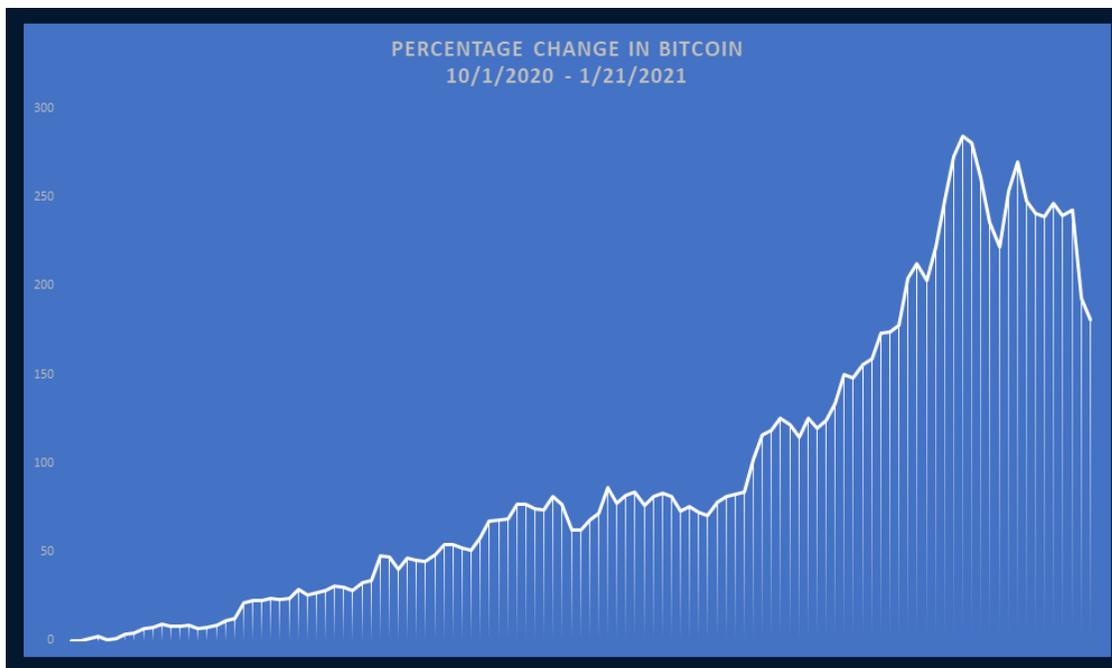


PRATO CAPITAL

Bitcoin and Cryptocurrency

February 2021

The chart below shows the percentage change of Bitcoin over the last 4 months. The gains have been covered extensively in the financial news sector. Is this an investment that should be included as part of a balanced long-term portfolio?



Bitcoin started in 2009 and is considered the original cryptocurrency. As a cryptocurrency, there is no paper money or coins and there is no central bank to issue or back the currency. Instead, it is based on computer code and stored in a digital wallet (a software-based system that securely stores users payment information and passwords ..and not without its own problems) and the price is set strictly by supply and demand. It has brought terms into the financial sector like “mining” and “blockchain” as the popularity of cryptocurrencies have increased. Bitcoin is now just one of thousands of cryptocurrencies available today.

Forgotten passwords to digital wallets have been in the news lately. A man in San Francisco lost the password to an encrypted drive holding the keys (passwords) to about \$220 million in Bitcoin. Estimates are 20% of the available Bitcoin, about \$140 billion, are lost due to incorrect or forgotten passwords.¹

What is the value of a Bitcoin?

Interest in Bitcoin as an investment coincides with price increases being reported by the financial news services. 2017 and 2020 saw Bitcoin price increases and investor interest increased as well.

Since Bitcoin is not tied to a traditional or fiat currency², the value is based entirely on supply and demand. As the news media coverage has increased, more investors are drawn to purchase Bitcoin. This has the self-fulfilling effect of increasing demand and increasing price.

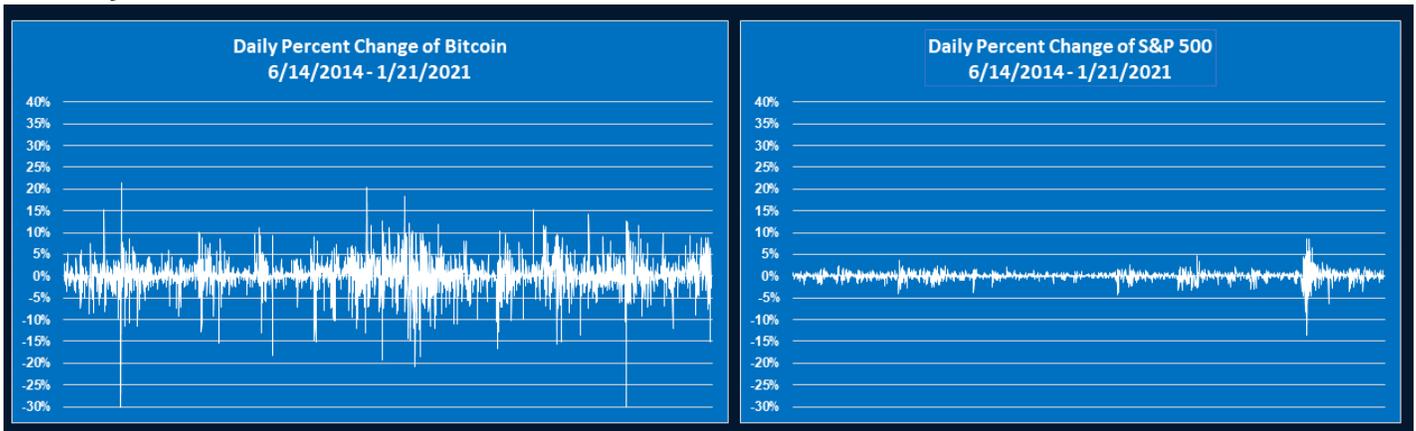
Since the price of Bitcoin is based on supply and demand, how should it be valued as an investment? What type of investment is it? As a cryptocurrency, should it be valued as a currency like a Dollar or Euro?

With Bitcoin, there is no revenue stream like bond interest or stock dividends, there is no underlying asset like real estate or corporate income backing it, and there is no corporate profit or balance sheet to aid in valuation. As a currency, few merchants accept it as payment. There are also transaction fees associated with any buy or sell transaction. Would most investors invest in a currency and expect to beat the S&P 500 over the long-term? Why should investors have that long-term outlook with Bitcoin?

Volatility

After setting an all-time high of \$40,675 on January 8, 2021, it dropped almost 25% in less than 2 weeks. But volatility is nothing new to Bitcoin buyers and sellers. The chart below shows the daily percentage change in price of both Bitcoin and the S&P 500 since June 2014.

Volatility of Bitcoin vs S&P 500³



To put the volatility shown in this chart another way:

- Bitcoin gained more than 5% in one day 163 times, about 6.7% of the trading days. The S&P 500 gained more than 5% in one day 5 times, about 0.3% of trading days.
- Bitcoin lost more than 5% in one day 179 times, more than 7.4% of trading days. The S&P 500 lost more than 5% in one day 5 times, about 0.3% of trading days.
- Bitcoin has lost more than 10% in one day 45 times and lost more than 25% in 2 days. The S&P 500 has lost more than 10% twice in this 6 ½ year period and has never lost more than 25% since 1926, 95 years ago.

On January 19, 2021, during the nomination hearings for Treasury Secretary Janet Yellin, she was asked about cryptocurrencies. Part of her answer included, *"we know they can be used to finance terrorism, facilitate money laundering, and support malign activities that threaten U.S. national security interests and the integrity of the U.S. and international financial systems."* Bitcoin dropped over 13% the following day.

For the many investors that struggled with the stock market volatility of last spring, the daily price changes of Bitcoin could be too much.

As part of a Financial Life Plan (FLP)

At Prato Capital, our focus is on the long-term financial success of our clients with a written financial plan at its core.

Previous [newsletters](#) and [blogs](#) have covered our planning process and the importance of having a globally diversified portfolio to achieve a successful financial outcome. Core to our long-term investment strategy is using almost 100 years of market history as a guide in our planning and investment process. The study of the historical returns of stocks and bonds can be used to give a realistic expectation of long-term portfolio returns for use in an FLP. This documented history of market ups and downs allows our planning process to account for future bull and bear markets.

The planning process accounts for long-term disciplined investing, *not speculation*. We consider speculation everything from 'forecasting' short-term market price changes, guessing on which is the next 'hot' stock, and trying to 'predict' the future price of Bitcoin on hunches and feelings. Speculation increases risk greatly and over time undermines the validity of any financial plan. Speculation is *not* a long-term investment strategy.

Conclusion

What does the future hold for Bitcoin and other cryptocurrency pricing? It is impossible to say. There are many questions about Bitcoin as an investment, but there seem to be fewer answers. There is no yield or interest payment, there is no profit to be shared with owners, and there is nothing to support the price other than what someone is willing to pay. It looks like the price is driven purely by speculation.

We have said it many times before. A sound financial strategy starts with a Financial Life Plan. An *individualized* plan that sets financial goals for you built around a portfolio with *realistic* expectations of long-term growth, not guess work or speculating. Our balanced, diversified, and disciplined approach allows our clients to reach their financial goals now and in the future.

“You must never delude yourself into thinking that you’re investing when you’re speculating.” - Benjamin Graham

“The investor’s chief problem, even his worst enemy, is likely to be himself.” - Benjamin Graham

¹ Popper, Nathaniel, “Lost Passwords Lock Millionaires Out Of Their Bitcoin Fortunes”, The New York Times, January 12, 2021. www.nytimes.com/2021/01/12/technology/bitcoin-passwords-wallets-fortunes.html.

² Fiat currency is a term describing most traditional government issued currencies that are not backed by gold, like a US Dollar.

³ Data for Bitcoin and S&P 500 charts provided by YCharts.