

FINANCIAL
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Bitcoins: investment or mirage?

There are up to 21 million reasons why the crypto currency Bitcoins are catching on as an alternative to credit cards, Paypal or regular bank transfers.

The popularity of Bitcoins has grown exponentially since its launch back in 2009 and for those in at the beginning, fortunes have been made – and lost.

As a result of the gains, a minority of commentators are suggesting Bitcoins may be considered as an alternative investment. But like any investment, it's important to understand the asset and its risks.

What are Bitcoins?

Bitcoins are an electronic global currency that offers the benefits of both anonymity and transparency. Unlike conventional currencies they are based on mathematics rather than gold or silver.

Bitcoins do not physically exist. There is just a record of all Bitcoin transactions listed on a public ledger called a block chain. Anybody at any given time can know where each Bitcoin is located but they do not know who actually owns them.

The Bitcoin concept has been likened to owning a glass treasure chest – everybody can see what is inside, but only the person with the private key can open the chest.

Another perceived benefit of Bitcoins is there is no centralised control of the electronic currency. On the flip side, there is no regulatory body if something goes wrong. And things can go wrong. Mt Gox, once the most widely used Bitcoin exchange based in Japan, recently went to the wall after its system was hacked, and many of the Bitcoins held at Mt Gox were lost.

How does it work?

While it can be reasonably straightforward to use Bitcoins as currency, understanding the algorithms and processes that go behind it can be mind-boggling.

Snapshots



Say Susie wanted to pay Daniel in Bitcoins. The transaction has three elements – an input, an amount and an output. The input is the Bitcoin address Susie received her Bitcoins from. Let's say they came from her friend Marcia. The amount is the number of Bitcoins used in the transaction. The output is Daniel's Bitcoin address.

Susie sends the money from her Bitcoin wallet to the Bitcoin network at which stage miners (third parties) verify the transaction.

Miners? Yes, miners. Bitcoins are not issued by a central body, but are created digitally by miners whose job is to "mine" the internet using computing power to verify the Bitcoins by solving increasingly complex algorithms.

In an interesting twist, small time Aussie miner Macro Energy has morphed into DIGITALBTC and is now listed on the Australian Stock Exchange. It now mines Bitcoins rather than traditional resources.

Is it a good investment?

There will only ever be a maximum of 21 million Bitcoins in the world. Unlike normal currencies, the limit has been set so Bitcoins are a finite resource. Currently just over 12 million Bitcoins have been mined (discovered) and the full 21 million is not expected to be in circulation until 2040.

As a result, a scarcity element will come into play and this is one of the reasons why Bitcoins are being considered by some as an investment. The other reason for growing interest in the concept is the rapid rise in value

of Bitcoins since their launch. In early 2013 Bitcoins were trading at about \$US20 each and then shot up to a high of \$US1,147. Now they are back around \$US600.

It's that volatility that makes Bitcoins a very risky proposition.

Between late 2010 and November 2013, Bitcoins were 7.5 times more volatile than gold and more than eight times more volatile than the S&P500.

The volatility of Bitcoins, and the fact that they do not generate any investment income, implies that it should be treated as a speculative purchase rather than an investment in a normal asset class. You might think of it as an alternative investment along the lines of wine and art except with Bitcoins there is nothing to hold onto or enjoy.

Weigh the risks

As with all speculation, you should not invest real money in Bitcoins that you cannot afford to lose completely.

As the buzz around Bitcoins spreads, a number of managed funds have been launched to exploit the trend. Just recently the Pantera Bitcoin Partners hedge fund was launched and the Winkelvoss twins of Facebook fame also have a fund in the pipeline.

Bitcoins are a fast-growing new concept that may be the way of the future, although the world's most successful investor, Warren Buffet dismisses them as a mirage.

Even so, the crypto currency is attracting fans who like the 21 million reasons for its existence.



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