



▶ CRYPTOCURRENCIES: A NEW ASSET CLASS OR KRYPTONITE?

Christine LaGarde said they are “too volatile, too risky, too energy intensive, and... too opaque for regulators”¹ Warren Buffet thinks they will come to a “bad ending”²; Alan Greenspan says they are “not a rational currency”³; Robert Schiller says the value is “exceptionally ambiguous”⁴; and Steven Mnuchin thinks they could become the next Swiss bank account.⁵ Yet Bitcoin and cryptocurrencies are proliferating with more than 1300 different issues recently counted.⁶

Cryptocurrencies are digital currencies designed to be secure and anonymous and represent a mobile store of value accessible anywhere through a public and private key code via the internet. They are decentralized and belong to no government or financial institution and have no borders. Bitcoin is the best known, but others are also popular: Ethereum, Ripple and Monero, as examples.

Many worry about regulating an extra-territorial exchange and payment system based on anonymity. While the transactions are public, who is behind them is not.

WHAT ARE CRYPTOCURRENCIES GOOD FOR?

At this early stage of its life, with Bitcoins still being issued (up to a maximum of 21 mn), most of the interest has been speculative investment. Indeed, Bitcoin’s trading volume and price changes suggest a bubble with little downside price protection. There have already been sharp corrections and sell-offs.

Proponents of the cryptos suggest that as a hedge, they may offer an extra-governmental means of holding value and making payment for the estimated two billion who are underbanked⁷ or billions living under controlled capital systems, such as those in China, Argentina, Russia, Taiwan, Indonesia and Brazil.⁸ Still another group of potential buyers are the many disgruntled citizens who may have access to global banking and capital markets but don’t trust the institutions⁹ which govern them, especially after the GFC.

While there could be some advantages to owning a currency decorrelated from a specific government’s budget, the cryptocurrency market is not properly regulated yet, and that generates important concerns regarding the investment and reputation risks related to such instruments.

As a payment system, Bitcoin is not succeeding. While some claim it reduces payment transaction

costs,¹⁰ Morgan Stanley wrote “bitcoin acceptance is virtually zero and shrinking,” in a July 2017 research note.¹¹

The site Digiconomist estimated that each Bitcoin transaction currently required 80,000 times more electricity to process than each Visa credit card transaction, while the computer power needed to create each digital token consumes at least as much electricity as the average American household burns through in two years, according to figures from Morgan.¹²

SECURITY, WHAT SECURITY?

Bitcoin’s network has not been successfully hacked since its founding in 2009 and most of the tech community considers it to be mostly secure. Credit Suisse suggests that it would take a lot of computing power and energy to hack into Bitcoin’s network and that as a participant owner, a hacker might find it self-defeating.¹³

However, both cryptocurrency exchanges as evidenced by the Mt Gox bankruptcy in 2014, Bitfinex theft in August 2016¹⁴ and Coincheck in Japan in January 2018, which lost USD 534 mn of investors’ money¹⁵ and digital wallets are vulnerable. On the digital wallet front, Tether in 2015, and Bitstamp in 2017, providers of dollar-

backed digital tokens, were hacked.

In fact, researchers from Ernst & Young found that more than 10 percent of funds from initial coin offerings (ICOs) have been lost or stolen by hackers. That’s about USD 400 million from USD 3.7 billion in funding between 2015 and 2017. The firm looked at 372 ICOs that were hit by attacks, highlighting cryptocurrency’s risky market.¹⁶

Because the cryptocurrencies are not regulated, there is no KYC or AML function associated with participation. This suggests the potential for both “dumb” and illicit funds to pile in.

HOW PEOPLE INVEST IN CRYPTOS

There are several options for those who do want to invest in cryptocurrencies. One can buy them outright through downloadable smart wallet apps available for smartphones. Crypto assets have grown from USD 20 bn at the start of 2017 to about USD 316 bn in December 2017. There are an estimated 2.9 to 5.8 mn crypto users according to Deutsche Bank, which believes cryptocurrency could develop into a new asset class.

As of the time of writing, there were 130 crypto currency exchanges globally doing about USD 10 bn in volume over a 24-hour period.¹⁷

ICOs, initial coin offerings, allow investors to



get in at the beginning of the life cycle and they raised a total of USD 4 bn in 2017, according to Autonomous Research, a financial research company in London. That's compared to USD 226 mn in 2016, and to USD 14 mn in the year of their inception, 2014.¹⁸ More than 180 new ICOs are scheduled to launch in 2018, according to ICObench listing.¹⁹

ICOs raise money to help cover the issuing entity's operations but do not represent a position on the capital structure of the issuer. However, ICOs are democratizing both access to capital (for issuers) and access to deals (for investors).

You may also be able to "mine" cryptocurrency which requires solving complex math problems on a network using trillions of calculations. The successful computer receives cryptocurrency units in return and this is how new ones are released into the system following the ICO.

There are also derivative investments, such as Bitcoin futures contracts traded on the Chicago Mercantile Exchange since 18 December 2017²⁰ and the Chicago Board Options Exchange since 10 December. However, The Futures Industry Association (FIA) published an open letter to the CFTC before the launch of bitcoin futures, airing concerns over the process in which cryptocurrency futures have come to market. Big banks and brokers including JPMorgan Chase, Citigroup, and Royal Bank of Canada as well as Merrill Lynch have all denied clients access to bitcoin futures.²¹

In the asset management arena, there are many funds, trusts and hedge funds investing in bitcoin and other digital currency. However, so far, we are not aware of any mainstream fund management firms involved. The current players seem to be new entrants or specialists in exotic strategies.

WATCH THIS SPACE: EXPECT REGULATION TO MAINSTREAM DIGITAL CURRENCY IN TIME

In order for large institutions to feel more comfortable with cryptocurrency, more regulation will be needed for the exchange licensing

process, the issuance process, investor protection, tax considerations and custody regulations to safeguard the assets. Those who currently value cryptocurrency for being extra-governmental may not welcome regulation, loss of anonymity and standardization.

China has banned ICOs and crypto exchanges altogether and has announced that it plans to crack down further on trading. Other countries, such as Russia, the US and Korea are also taking measures, in some cases, banning ICOs and warning citizens of the dangers of investment.²² The US SEC has said no to several cryptocurrency ETFs (exchange traded funds), citing valuation difficulty, the potential for market manipulation and lack of recourse in the all too frequent cases of digital wallet hacks as reasons.²³ Both Hong Kong and the US have said that ICOs may be classified as securities, in which case they would be regulated accordingly. Japan has perhaps been the most forward in accepting cryptos and therefore yen has attained the highest global volume of bitcoin transactions.

OUR VIEW

At this stage, Eastspring does not recommend Bitcoin or other cryptocurrencies as suitable assets for investment, especially for long-term investors, primarily because of the lack of regulation and heightened volatility of the trading markets. We will continue to monitor developments in cryptocurrencies.

Sources: ¹<https://www.imf.org/en/News/Articles/2017/09/28/sp092917-central-banking-and-fintech-a-brave-new-world> ²<https://www.youtube.com/watch?v=YWMmd7hlwNI> ³<https://www.cnbc.com/2017/12/06/greenspan-compares-bitcoin-to-colonial-america-currency-that-eventually-became-worthless.html> ⁴<https://www.cnbc.com/2017/12/19/robert-shiller-bitcoin-valuation-is-exceptionally-ambiguous.html> ⁵<https://www.bloomberg.com/news/articles/2018-01-12/mnuchin-warns-against-bitcoin-becoming-next-swiss-bank-account> ⁶<https://www.youtube.com/watch?v=J-Vjgx75GXQ> ⁷<http://uk.businessinsider.com/the-worlds-unbanked-population-in-6-charts-2017-8/#the-vast-majority-94-of-adults-in-oecd-high-income-countries-said-they-had-a-bank-account-in-2014-while-only-54-of-those-in-developing-countries-did-the-middle-east-had-the-lowest-proportion-of-account-holders-with-only-14-on-average-1> ⁸<https://themerkle.com/top-6-countries-enforcing-capital-controls/> ⁹<https://www.nytimes.com/2018/01/21/technology/bitcoin-mining-energy-consumption.html> ¹⁰<https://www.nytimes.com/2018/01/22/opinion/irs-bitcoin-fear.html> ¹¹<http://www.businessinsider.com/bitcoin-price-rises-but-retailers-wont-accept-it-7-2017> ¹²<https://www.nytimes.com/2018/01/21/technology/bitcoin-mining-energy-consumption.html> ¹³<https://www.credit-suisse.com/corporate/en/articles/news-and-expertise/is-bitcoin-safe-201701.html> ¹⁴<https://www.credit-suisse.com/corporate/en/articles/news-and-expertise/is-bitcoin-safe-201701.html> ¹⁵<https://www.japantimes.co.jp/news/2018/02/04/business/victims-massive-cryptocurrency-theft-eye-suit-coincheck/#.WnfBT66WaUk> ¹⁶<https://www.cnet.com/news/hackers-stole-15-million-a-month-from-cryptocurrency-funds/> ¹⁷<https://cryptocoincharts.info/markets/info> ¹⁸<http://money.cnn.com/2017/12/18/news/companies/overstock-ico-ceo-byrne/index.html> ¹⁹<https://cointelegraph.com/news/icos-raised-4-bln-in-2017-what-2018-has-in-store> ²⁰<http://www.cmegroup.com/trading/equity-index/us-index/bitcoin.html> ²¹<https://www.reuters.com/article/us-bitcoin-futures/jpmorgan-citi-not-willing-to-support-launch-of-bitcoin-futures-ft-idUSKBN1E21QP> ²²<https://www.theguardian.com/technology/2018/jan/17/bitcoin-continues-slide-drop-russia-china-regulatory-fears-cryptocurrency> ²³<http://fortune.com/2018/01/19/sec-cryptocurrency-etfs-bitcoin/>

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