



Decrypting bitcoin

Why the digital currency should be part of your balanced portfolio

BY ARTHUR SALZER

LAST SEPTEMBER, a client’s wire amounting to almost US\$1 million was being directed from a Canadian chartered bank to the private-equity division of a large global asset manager in Europe. As bad luck would have it, it was two days after a US\$3-trillion repo market spike, which caused overnight rates to quintuple to 10% on Sept. 17 from 2% the day before. What ensued was a 29-day odyssey. The French bank initially held our client’s wire for the apparent reason that it needed more information due to anti-money laundering purposes. This information was provided in less than three days. For the next 26 days, all sorts of delays were endured, with the French bank giving incoherent reasons for them. Fortunately, the U.S. Federal Reserve injected more than US\$400 billion into the repo market to reduce the volatility of these short-term interest rates.

The repo market has since calmed down, with the Fed and other central banks continuing to inject significant sums of money into this market in order to maintain stability. Many market observers gathered that banks had suffered a liquidity squeeze and needed to sit on client funds to improve their working capital ratios for the regulators. During my correspondence with the French bank and its counterparts, I kept mentioning that if we had used bitcoin to transfer this client’s money, the transaction would have been completed in less than an hour at a fraction of the cost. The banks didn’t appreciate such candor, but bitcoin is censorship proof and does not rely on banks directly nor the Swift international payment network (one of the world’s largest financial messaging systems).

This brings me back to a bold call I made in these pages last June that suggested bitcoin be considered a new asset class and that some exposure should be considered as a component of a balanced portfolio. At the time

of writing, bitcoin was trading at US\$5,000 and it soon ran up to almost US\$13,000. Bitcoin pulled back to around US\$6,000, but still ended the year as the best-performing asset class globally by gaining 90%.

Despite bitcoin’s headline-worthy returns and volatility, many investors still don’t understand it, especially when it comes to valuing it. Many in the financial industry, including Warren Buffett, focus on intrinsic value: an economic good produces cash flow or has overt utility such as stocks, bonds, real estate and consumable commodities. But bitcoin has monetary value, which exists despite an economic good not having intrinsic value. Monetary value usually arises from objects that are scarce, durable and relatively easy to divide. Since the dawn of civilization, societies have used rare seashells, wampum, glass beads and stones as money or a form of record keeping. Gold is an ideal example since it can be made into jewelry, coins and bars, but bitcoin is unique in today’s digital world since it is scarce, durable, has strong privacy characteristics and is a bearer asset.

As of early March, bitcoin was up more than 23% in 2020, dwarfing the small loss by the S&P 500, but there’s more to the story than just returns. Over the past year, there has been an explosion of market-ready institutional custody and investment solutions. For example, the Intercontinental Exchange Inc., owners of the New York Stock Exchange, created Bakkt, a futures and clearing marketplace for digital assets that also offers secure storage. Toronto-Dominion Bank is an investor in ErisX, a regulated exchange for cryptocurrency spot contracts and futures trading that is being offered to TD Ameritrade’s U.S. client base. State Street Corp., one of the world’s largest custodians, has teamed up with Gemini Trust Co. LLC (founded by the Winklevoss Twins of Facebook fame) to offer trading and custodial solutions for digital assets.

Elsewhere, Fidelity Digital Assets, a subsidiary of the namesake giant U.S.-based asset manager that oversees US\$2.7 trillion in assets, is offering a trading and custody platform for bitcoin. It has also had bitcoin mining operations since 2014, and the Fidelity Center for Applied Technology is a customer of Victoria-based Blockstream Corp. Inc., which mines bitcoin in Quebec and Georgia. Not to be outdone, Microsoft Corp. is taking advantage of the Bitcoin system’s trust-minimized features and security and building a decentralized identity platform aptly named Identity Overlay Network (ION).

In addition, billionaires, including PayPal Holdings Inc. founder Peter Thiel, are investing in and mining bitcoin. Jack Dorsey, the founder of Twitter Inc., is using a secondary layer to Bitcoin called Lightning, which lowers costs and increases speeds for his payment company Square Inc. Last, but not least, even legendary speculator George Soros is investing in or, shall I say, trading this asset class for his family office.

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What do these companies and sophisticated investors know that many do not yet? Research from Yale University showed that a 1% allocation to bitcoin improved a balanced portfolio’s return versus volatility, and that a 6% exposure created the optimal portfolio with regard to return versus risk. The reason: the low correlation of bitcoin returns compared to traditional asset classes such as stocks, bonds, bills and real estate. Put another way, it’s the diversification effect. **FPM**

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