EFFICIENT GROUP

ECONOMIC COMMENTARY

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THE ALLURE OF BITCOIN

Most investors understand that diversification is important. Research has shown that investors can produce better risk-adjusted returns by diversifying between, and often even within, different asset classes. Someone who uses traditional financial instruments to save for retirement will typically invest in a balanced portfolio. Depending on many factors, they will have around 40% to 60% equity exposure (local and global), 15% to 30% fixed-income exposure (mostly local but also global), and then some listed property, commodity, and cash exposure.

Unfortunately, the South African financial industry has not developed sufficiently to allow for investing in alternatives like consumers in the developed world can. In South Africa (SA), there are one or two hedge funds that seem promising but retail private equity funds have yet to come up with a sustainable solution. Access to alternatives can do a lot for long-term investor returns. One of these "asset classes" is, once again, making a lot of noise: Cryptocurrencies (also known as cryptos).

Before we delve deeper into cryptocurrencies, it is important to note that this is not financial advice. At most, we are trying to keep you informed about global developments in this alternative asset class. The crypto world is still dominated by Bitcoin (BTC), which many consider the digital alternative to gold: A store of value, with limited supply, that can potentially hedge against inflation. For this reason, we will focus on BTC.

Since 2011, BTC has been the top-performing asset class (by far) every year, except for three. The reason for the current hype is because BTC is four months away from another halving cycle, at which time the number of BTCs that can be released (mined) will once again halve. In the past, this has solidified the crypto bull cycle and led to astronomical returns (compared with traditional asset classes). Crypto bull runs are usually very volatile and last two to three years.

Is BTC something that we believe you should have exposure to? From a return perspective, probably. It is, however, difficult to understand from a risk perspective if you should be involved. For one, more regulation will be needed; something we believe will be finalised in SA in 2024. Recently, the crypto world was shaken by the LUNA and FTX cases, which destroyed billions of dollars through unethical practices. But this is something that happens to large, listed companies, like Steinhoff and Wirecard, too. Regulation, and the transparency that it entails, might at least have softened the blow.

To understand the risk better, think of investing in BTC in the following way: BTC was founded in 2008 but the first transaction was only done in 2010. If a company had been around, under intense public scrutiny for 13 to 15 years, while gaining popularity, you would probably trust their products/services. Since 2008/2010, BTC has been gaining more users (consumers), which now range in the millions worldwide. Recently, even institutions like BlackRock, the world's largest asset manager, started to get involved.

The problem for many is trying to understand where cryptocurrencies derive their value from. Unlike equities, there are no future cash flows that can be discounted to determine the value of a stock. There are no yields which bonds have, and no interest which fixed deposits have. And so forth. But as a product/service, there is clearly utility, that is, the satisfaction that individuals derive from consuming cryptocurrencies. Even if the utility is driven by hype, hype is what drove ticket prices for the Rugby World Cup too. Scarcity (another form of hype) might also have played a role but it was not frowned upon when it drove up Land Cruiser prices after the pandemic. As such, price (economic value) can be determined and as utility (the number of users and the amount of hype) increases, so too does price.

Cryptocurrencies might then simply be "assets" that derive value (earnings) from utility, and if there is a willing buyer and willing seller (a requirement for all other asset classes too) then the value will remain. But to simply believe that a business (BTC) that has been growing exponentially for 15 years will disappear overnight, especially one that is decentralised (owned by everyone who uses it), is probably unrealistic.

For these reasons, we see BTC (and a few other cryptos) as high-risk alternative "assets", something between venture capital investments and private equity investments. If you do start investing, we would caution you to limit your exposure to 2.5% to 5% of assets under management, and to always speak to your financial advisor first as appropriate financial principles must always be applied.

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