



OSBORNE PARTNERS
Capital Management, LLC

Time To Bet On Bitcoin?

By: Jay M. Skaalen, CFA

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In the past two weeks I have received the same question from my mother, one of my neighbors and my best childhood friend: what do you think of bitcoin? It has been my experience that multiple inquiries like this often reflects broader mainstream hype around an investment or idea. In this case, there is no doubt that the level of excitement surrounding bitcoin has reached a fever pitch. The popular cryptocurrency (digital currency that uses scrambled code or cryptography for security) has captured the attention of traditional market participants and casual investors alike who have been attracted by the incredible returns. At the time of this writing, bitcoin has returned over 420% year to date. And if you think that is impressive, consider the fact that \$100,000 invested in bitcoin on January 1, 2015 would now be worth just over \$1.3 million dollars. Figures like these are staggering and explain why it has been getting so much attention. Given the increased curiosity around bitcoin, we thought it would be a good idea to explore this topic by offering a brief overview, the pros and cons, as well as our opinion around the viability of bitcoin as an investment.

WHAT IS BITCOIN?

From a conceptual standpoint, bitcoin can be thought of like a global currency, where the peso is the local currency for Mexico, bitcoin can be thought of as currency for the internet. Bitcoin is a pure digital currency meaning it does not exist in a physical form and has no central authority that governs it. All records keeping track of ownership and ongoing transactions are stored on a massive network of computers in a digital ledger called a “blockchain”. Each new bitcoin transaction is recorded and validated by the network of computers and then updated in the blockchain for everyone to see.

HOW WAS BITCOIN CREATED?

The idea of Bitcoin originated from a whitepaper that was written in 2008 by an individual under the pseudonym Satoshi Nakamoto. In the paper, Nakamoto describes a digital currency that would allow safe payment for goods and services without ever having to go through traditional financial institutions.

WHERE CAN YOU GET BITCOIN?

As of today, there are two main ways one can obtain Bitcoin. The first, is via exchanges where you can use U.S. dollars (or nearly any other currency) to acquire them. The second, more confusing way you can acquire bitcoin is through a process called “mining”. Bitcoin mining is essentially a process whereby very powerful computers attempt to solve a computationally challenging problem and if they do, they are rewarded with Bitcoin.



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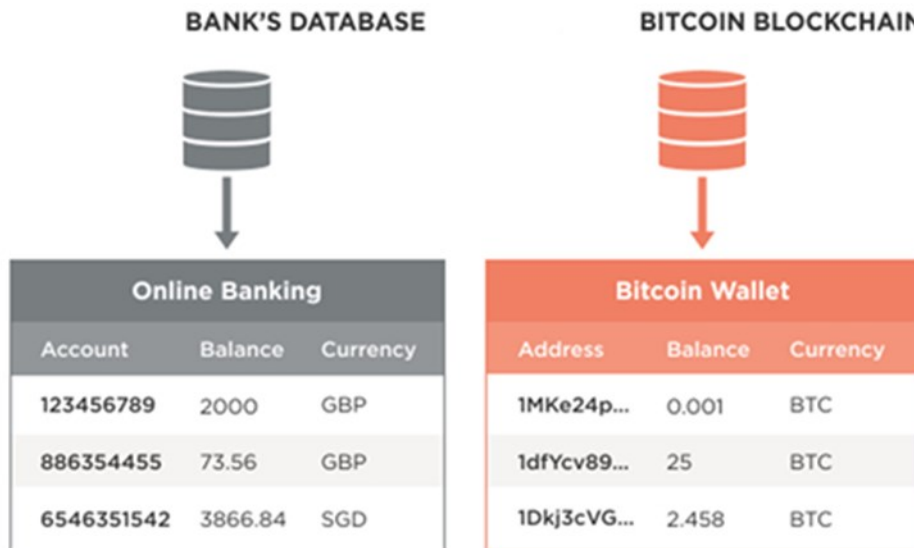
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WHO DETERMINES THE PRICE OF BITCOIN?

Similar to stock market exchanges, there are a variety of bitcoin exchanges that exist across the world that determine the price of bitcoin on a daily basis.

IF BITCOIN IS A DIGITAL CURRENCY, HOW IS IT “HELD”?

Bitcoins are stored in virtual wallets. Each “wallet” holds identification numbers or “addresses” (similar to a bank account number) which allows users to send bitcoins to each other using a password, called a “key”, which is unique to each address. These wallets are also connected to the bitcoin blockchain so they can continuously update and log ownership of existing bitcoin.



Source: www.bitsonblocks.net

PROS

Despite still being in its infancy, there are already discernable pros and cons to bitcoin and its potential to emerge as a prominent global currency. We will start with the pros. First, because it is digital, payments via bitcoin can be made to anyone, regardless of their location within minutes. The only requirement for a payment to be made is internet access. This is especially important in less developed countries that have weak or volatile currencies and/ or restrictive capital controls in place. Second, users of bitcoin are completely anonymous. Needless to say this opens the possibility of more nefarious usage but it can also serve to reduce the risk of identity theft and the hacking of personal information. Third, there are currently little to no transaction fees associated with bitcoin transactions. Unlike transfers made via a bank that often



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come with a variety of fees or charges, transfers and payments using bitcoin are frictionless and aren't assessed any fees. Fourth, there aren't any restrictive regulations (e.g. banking regulations) that either party needs to be concerned about. Fifth, because transactions are digitally verified using bitcoin's digital ledger (blockchain), the risk that merchants see fraud is greatly reduced.

CONS

There are also plenty of cons associated with bitcoin, some that will likely be addressed over time as the ecosystem develops and others that likely represent legitimate threats to its longer term viability. To start, bitcoin's ability to be perceived as a legitimate currency is significantly impaired by how volatile it is. Stability is imperative for any currency and the wild swings we see in bitcoin undermine its ability to be viewed as a valid store of value. Second, in theory the value of most currencies is determined, in part, by the health of the underlying economy (or economies) that it represents. If the U.S. economy is healthy and growing in excess of other countries, the U.S. dollar should appreciate (all else equal). This type of conventional analysis is not practical when it comes to bitcoin. Third, and arguably the most serious threat to bitcoin, is the potential for regulatory intervention. Without any government oversight, bitcoin can be viewed as a threat to governments and their underlying economies. Some governments are already taking some serious steps to intervene. In China, where an estimated 70%+ of bitcoin trading takes place, the government recently announced that all bitcoin exchanges need to stop trading by the end of October. Just prior to that, the South Korean government clamped down on the number of new virtual currencies that are allowed to be traded on exchanges in the country. Lastly, the threat of alternative digital currencies challenging bitcoin is unlikely to abate. As of now, there are estimated to be over 900 digital currencies in existence and the list is growing rapidly. Bitcoin has the advantage of being the first mover, but it is impossible to say that alone will guarantee its long term survival.

IS BITCOIN A SOUND INVESTMENT?

Evaluating the merit of bitcoin as an investment is a completely different proposition. Bitcoin has no underlying cash flow to evaluate, no strategic competitive advantages to consider and no superior management team to guide it. The thesis for investing in Bitcoin is that it will become a (or the) prominent global currency and, importantly, that other individuals will continue indefinitely to believe that it is worth more than it is today. The fact that it is currently being viewed as an "investment" is part of the problem because the vast majority of bitcoin holders aren't using it to transact, they are hoping to make a quick buck. This is not inconceivable, but it is speculative and fraught with risk. In our opinion, blockchain, the underlying technology that facilitates the usage of cryptocurrencies like bitcoin, may be more enduring than the



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cryptocurrencies themselves. Blockchain's usage will likely expand far beyond cryptocurrencies due to its ability to serve as a safe and permanent digital record of data. Already we are seeing blockchain being researched for potential use in areas like banking, digital cloud storage, identity records (birth certificates, passports, driver's licenses, etc.), digital voting and many others.

Both bitcoin and blockchain are new technologies that are still being developed and refined. It is far too early to declare bitcoin, or any other digital currency, a winner or a loser. Just this week (10/3/17), the CEO of Goldman Sachs stated that the company was researching bitcoin and remarked that, "Folks were skeptical when paper money displaced gold." His comments are probably intended to be read less that he believes bitcoin will replace the U.S. dollar and more that he is trying to keep an open mind while learning about the topic. Our investment team, too, likes to keep an open mind when approaching any new investment or idea but especially a complex topic like bitcoin. We will continue to follow bitcoin, blockchain and cryptocurrencies as they continue to develop, but for the time being we consider bitcoin more of an intriguing emerging technology than a sound investment.

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