The Value of Cryptocurrency Investing

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John Buckingham
Principal
Portfolio Manager

Jason R. Clark, CFA
Principal
Portfolio Manager

Christopher Quigley, CFA
Senior Research
Analyst

Zack Tart
Portfolio & Research
Associate

KEY TAKEAWAYS

- **Intrinsic value debate**: Cryptocurrencies do not produce cash flows like other asset classes, making them difficult to value.
- **Volatility and regulation**: While high returns are a possibility in the future, crypto assets experience elevated volatility and carry substantial regulatory risk.
- **Investment strategy**: The budding asset class can offer opportunity for a small high-risk slice of one's overall portfolio, but players need proceed with plenty of caution.

"I think it is rat poison!" Not mincing any words on May 6, 2013, when asked what he thought about Bitcoin on *Fox Business News*, Charlie Munger proclaimed that he regarded the cryptocurrency as "deeply flaky."

The price of Bitcoin was then $109.

Nearly a decade later, the late Berkshire Hathaway Vice-Chair, doubled down on his disdain, stating, "Of course I hate the Bitcoin success. I don't welcome a currency that's so useful to kidnappers and extortionists and so forth, nor do I like just shuffling out a few extra billions of billions of dollars to somebody who just invented a new financial product out of thin air."

By then, Bitcoin had risen to $57,000

Obviously, great fortunes were made by early adopters. And with Bitcoin having traded above $70,000 recently, while advocates trumpet a potential six- or even seven-figure price tag down the road, plenty of folks young and old have come to believe in the investment prospects of digital currencies.

INTRINSIC VALUE

We have been asked on numerous occasions for our take on crypto and each time our response has echoed what Mr. Munger more calmly stated a few years back, "It's really kind of an artificial substitute for gold. And since I never buy any gold, I never buy any Bitcoin."

In short, Bitcoin and other cryptocurrencies, as is true of gold, produce no income, making these assets impossible to value from our way of thinking. At the end of the day, they are worth what someone will pay for them, with gold at least providing some utility via its usage in jewelry, electronics, and dentistry, not to mention its 2,000-year history as a store of value.

But that hardly means that cryptocurrencies have no value...as long as there are others who think they have value!

To be sure, digital asset fans will argue that Bitcoin and other cryptocurrencies are storehouses of value in a world filled with disconcerting headlines and constant geopolitical drama. There is also something to be said for decentralized finance, though we are a long way from digital wallets being used around the world to pay for a loaf of bread or gallon of milk.

Our asset class of choice, equities, on the other hand, offer an ownership stake in corporations that generate sales and earnings, which allow businesses to return capital to shareholders via dividends and stock repurchases, while continuing to invest cash into growing their enterprises. True, stock prices have always been volatile, going through more than few booms and busts, but they generally have tracked economic growth and corporate profits higher over the long term.

And other asset classes like bonds come with interest payments and a claim on the repayment of principal, while real estate usually provides rent/lease payments, utility in business and/or a roof over one's head. We can value these instruments as they have income streams.

We have no way of knowing if Bitcoin is worth seventy thousand dollars or seventy cents!

Of course, we also have no way of validating that the Michael Jordan *Logoman* trading card was worth the $2.928 million at which it just sold, or that the Princess Beanie Baby listed for sale on *Poshmark* for $500,000 is a bargain.

Obviously, there are many assets that do not generate any income and we can turn to the art world for even more astronomical price tags, with Leonard da Vinci's *Salvator Mundi* fetching a record $450.3 million at auction in 2017. No doubt, many will argue that works by the great masters are worth every penny as Michelangelo said, "The true work of art is but a shadow of the divine perfection." However, such was not always the case as it is said that Gauguin, Rembrandt, Vermeer, van Gogh and Monet all died poor.

At the end of the day, we will stay in our lane, leaving digital currency investments to others as we continue to think Paul Samuelson had it right, "Investing should be like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas."

HEADING TO SIN CITY

We respect that many can't resist the temptation to get involved in the cryptocurrency game for a small portion, hopefully, of an overall investment allocation that can tolerate wild price gyrations and substantial risk of loss of principal. So, we offer a list of high-level considerations that we believe apply across the asset class.

Figure 1: Major Cryptocurrency Annual Returns

Index-Level Sector Exposures							
Year	Bitcoin	Ethereum	Binance Coin	XRP	Cardano	SOLANA	DOGECOIN
2011	1317%						
2012	218%						
2013	5428%						
2014	-58%						
2015	36%						-50%
2016	120%						100%
2017	1375%						4550%
2018	-74%				-95%		-75%
2019	95%	-1%	131%	-45%	-12%		26%
2020	305%	476%	162%	18%	401%		62%
2021	60%	399%	1275%	268%	624%		3526%
2022	-64%	-67%	-52%	-59%	-81%	-94%	-59%
2023	157%	90%	27%	81%	139%	916%	27%

As of 12.31.2023. SOURCE: Kovitz using data from Bloomberg Finance L.P.

1. **Volatility:** Cryptocurrency investments can have extreme price fluctuations. While few complain of price fluctuations when prices are rising, the table shows heavy losses up to 95% in some years (and up to 94% in 2022 amid broad crypto struggles) and investors should be able to withstand such gyrations.

2. **Market Dynamics:** Crypto investments trade at all hours, meaning that conventional trading strategies may not apply. With price changes happening 24/7, it is important to have a steady hand.

3. **Liquidity & Transaction Costs**: Some cryptocurrencies have lower liquidity than publicly traded stocks or bonds, which can lead to larger price swings when transacting. In addition, network, spread and wallet fees are usually charged, adding up to 2% or more.

4. **Regulation and Legal Status**: Regulators and lawmakers tend to move slowly, meaning tax, holding rules and the general treatment of cryptocurrency wallets is not set in stone. This brings additional risks, as regulators and governments sort out the path forward.

5. **Technology:** The blockchain, or foundation on which cryptocurrencies have been built, is a budding technology. Applications for blockchain reach far and wide, while a firm understanding of the basics is imperative for investors with crypto exposure.

6. **Security:** A fundamental distrust of centralized currencies and central banks was a primary point of popularity among early cryptocurrency investors. Long passwords, keys and other safeguards are essential to investing success, especially as there's limited recourse in case items end up in the wrong hands.

7. **Investing and Diversification:** Cryptocurrencies are relatively new to the investment world but have quickly found a home among the other major asset classes. Propelled by worldwide popularity, cryptocurrency investments can be made directly, through ETFs and in select retirement accounts. Over the years, we have stressed the importance of broad diversification and crypto investors would be wise to apply similar principles in their investment portfolios. Even over the same time periods, returns vary widely. In 2021, for example, Bitcoin gained 60%, while Dogecoin gained 3,526%.

8. **Risks and Reward Considerations:** Cryptocurrency investments are inherently risky. Over the last decade or so, investors have been sufficiently compensated for risk-taking activities in the form of enormous returns. Whether that will continue in the future is anyone's guess, and we would not ignore Warren Buffett's famous admonition, "A pin lies in wait for every bubble and when the two eventually meet, a new wave of investors learns some very old lessons."

PROCEED WITH A FOCUS ON THE LONG TERM

While we will always remain focused on our broadly diversified portfolios of what we believe to be undervalued stocks, we can appreciate the allure of digital currencies. The budding asset class can offer opportunity for a small, high-risk slice of one's overall portfolio, but players should proceed with plenty of caution.

Indeed, *Money.com* reported last year that 1,900 crypto projects listed on the site of crypto aggregator *CoinGecko* in 2022 had already failed, while former crypto titans Sam Bankman-Fried and CZ Zhao are in prison.

And we can't forget the tale of woe of Stefan Thomas, who supposedly lost the password for an encrypted USB drive holding 7,002 Bitcoins, which as of this writing would be worth nearly $500 million!

For additional information about subscribing to the *The Prudent Speculator* newsletter, please call Phil Edwards at 800.258.7786 or email pedwards@kovitz.com.

For more details about our wealth management and asset management services, kindly reach out to:

Jason R. Clark, CFA

Principal, Portfolio Manager

949.424.1013

jclark@kovitz.com

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The description of products, services, and performance results contained herein is not an offering or a solicitation of any kind. Past performance is not an indication of future results. Securities investments are subject to risk and may lose value.

All returns are geometric average unless otherwise stated. The geometric average is calculated using the mean of a set of products that takes into account the effects of compounding.

The Standard & Poor's 500 index (S&P 500) is a broad stock market index based on the market capitalizations of the largest 500 companies listed in the U.S. Small company stocks, via Ibbotson Associates, are the bottom twenty percent of the New York Stock Exchange. Large company stocks, via Ibbotson Associates, are represented by the S&P 500 index. The S&P 500 Growth Index is a market capitalization weighted index. All the stocks in the underlying parent index are allocated into value or growth. Stocks that do not have pure value or pure growth characteristics have their market caps distributed between the value & growth indices. Prior to 12/19/2005 this index represented the S&P 500/Barra Growth Index. The S&P 500 Value Index is a market capitalization weighted index. All the stocks in the underlying parent index are allocated into value or growth. Stocks that do not have pure value or pure growth characteristics have their market caps distributed between the value & growth indices. Prior to 12/19/2005 this index represented the S&P 500/Barra Value Index.

The factor-based (book value-to-price) portfolio data is from Eugene F. Fama and Kenneth R. French. The dataset is broken into four groups: large value, large growth, small value and small growth. The aggregate Value and Growth portfolios are monthly averages of the two returns.

Growth stocks = 50% Fama-French small growth and 50% Fama-French large growth returns rebalanced monthly. Value stocks = 50% Fama-French small value and 50% Fama-French large value returns rebalanced monthly. The portfolios are formed on Book Equity/Market Equity at the end of each June using NYSE breakpoints via Eugene F. Fama and Kenneth R. French. Dividend payers = 30% top of Fama-French dividend payers, 40% of middle Fama-French dividend payers, and 30% bottom of Fama-French dividend payers rebalanced monthly. Non-dividend payers = Fama-French stocks that do not pay a dividend. Long term corporate bonds represented by the Ibbotson Associates SBBI US LT Corp Total Return index. Long term government bonds represented by the Ibbotson Associates SBBI US LT Govt Total Return index. Intermediate term government bonds represented by the Ibbotson Associates SBBI US IT Govt Total Return index. Treasury bills represented by the Ibbotson Associates SBBI US 30 Day TBill Total Return index. Inflation represented by the Ibbotson Associates SBBI US Inflation index.

The Russell 3000 Index is composed of 3000 large U.S. companies, as determined by market capitalization. This portfolio of Securities represents approximately 98% of the investable U.S. equity market. The Russell 3000 Index is comprised of stocks within the Russell 1000 and the Russell 2000 Indices. Russell 3000 Growth Index measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values. Russell 3000 Value Index measures the performance of those Russell 3000 Index companies with lower price-to-book ratios and lower forecasted growth values.

The MSCI ACWI Index is a free-float weighted equity index. It was developed with a base value of 100 as of December 31 1987. It includes both emerging and developed world markets. The Bloomberg Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers. The DJ US Real Estate Index represents REITs & other companies that invest directly or indirectly in real estate through development, management or ownership, including property agencies. The index is a subset of the Dow Jones U.S. Index, which covers 95% of U.S. securities based on float-adjusted market capitalization. The S&P GSCI Total Return Index in USD is widely recognized as the leading measure of general commodity price movements and inflation in the world economy. Index is calculated primarily on a world production weighted basis, comprised of the principal physical commodities futures contracts.

From 1927 to present, we utilized the dividend-weighted portfolio data from Eugene F. Fama and Kenneth R. French. The dataset is broken into five groups: non-dividend paying, top 30% of dividend payers, middle 40% of dividend payers, bottom 30% of dividend payers and all dividend payers (weighted 30% of top dividend payers, 40% of middle dividend payers and 30% of low dividend payers).

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