

# WHAT IS BITCOIN?

## Bitcoin Introduction

Bitcoin was launched in 2009 as a digital currency that enabled users to transfer value through the internet without the need for a central intermediary. Since its creation, bitcoin has gone from an experimental technology valued below \$0.01 to an asset that was valued above \$67,000 by November of 2021.<sup>[1]</sup> Bitcoin started as an idea led by Satoshi Nakamoto and a few pseudonymous members of a cryptography forum and is now a monetary asset with millions of users across the globe. Bitcoin has emerged as a store of value, but why, and how?

In hindsight, many factors contributed to bitcoin's growing adoption. Historically, monetary systems have evolved from barter economies to monetary metals, to the gold standard, and now fiat currencies. Each jump to a new monetary system was fueled by technological advancements, but had reasons for change, thus evolving into new and improved units of account. While the current government-based system is set in stone, a new alternative way of storing value has been created: a hard-coded monetary system such as bitcoin.

These completely new monetary assets do not come around often, which is why an understanding of bitcoin, its attractive qualities, and how it's achieved its early success is ever important.

So, what qualities does bitcoin have that makes it a form of money and store of value? What bigger secular trends support bitcoin over time and what key macro events have sped up this process? Going forward, what's next for bitcoin?

## Qualities of Money

Useful stores of value and mediums of exchange have the following characteristics: durability, portability, divisibility, uniformity, scarcity, and acceptability. Bitcoin has experienced early success as it scores highly across these categories:

- + **Durability:** Stores of value must not depreciate, degrade, or erode in the future, which is why gold is a better store of value than apples. A bitcoin itself will last forever as it does not break down or ruin with age.
- + **Portability:** Valuable monetary assets can be taken across geographies, and bitcoin can be brought and sent across the globe with ease. There is no cost of carry, transportation, or storage with bitcoin, whereas almost all other assets come with associated ongoing costs.
- + **Divisibility:** Divisibility makes money accessible, and each bitcoin can be broken into 100 million satoshis. This makes bitcoin inclusive, which allows for widespread adoption.
- + **Uniformity:** Uniformity provides standard units of account, creating interchangeability. One US dollar is worth the same as another US dollar, and similarly, one bitcoin can be exchanged for another bitcoin with equal value.
- + **Scarcity:** Sound money is hard to manufacture, which is why gold was a better store of value than seashells. While technology improves production efficiency in commodities and fiat supply is issued subjectively, bitcoin is hard-coded for disinflationary supply and a maximum of 21 million coins.
- + **Acceptability:** Trustworthiness in future value is key to an asset's ability to store wealth, as a lack of confidence leads to the flow of money elsewhere. Bitcoin has become more accepted each year as awareness and education increase, with now over 220 million users of digital assets.<sup>[2]</sup>

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## Bitcoin's Specific Qualities

While bitcoin exhibits many of the traditional characteristics of sound money, bitcoin also has unique qualities that make it unlike any other monetary asset. These qualities have driven both adoption and investment as they serve as a complement to existing stores of value:

- + **Digital:** Bitcoin stores value and transactions with the internet, which provides an instant and efficient means of ownership and exchange. One can access their wallet anywhere with an internet connection and private keys, where they can then send or transact as they please. Bitcoin is easy to store, transport, and travel, which contrasts to commodities such as gold that have large storage costs and low portability. Despite being digital, bitcoins cannot be copied or replicated.
- + **Transparent:** The Bitcoin network is a public ledger that is easily audited, as transactions are fully traceable and stored on the network. All transactions are available and known, which improves bitcoin's security.
- + **Decentralized:** No government, organization, or single entity can control or influence bitcoin. Decisions in governments (monetary and fiscal packages) and organizations (corporate strategy) are centralized, while bitcoin runs through a network of global, individual computers. Bitcoin's longer-term security is strengthened by the near impossibility of a single user to influence the system.
- + **Global:** Bitcoin is readily available to anyone in the world, it is truly a global store of value and medium of exchange.
- + **Hard-Coded Supply:** Bitcoin is the only tradable asset with a known fixed maximum supply. Other commodities have an economic incentive for producers to increase supply upon increases in demand, while bitcoin's supply is hard-coded with a maximum of 21 million bitcoins. Bitcoins are released by mining rewards, and halvings every four years create more scarcity. The final bitcoin will be mined around 2140.
- + **Network Effects:** The value of bitcoin's network grows alongside its user base, as seen in social media. Similarly, bitcoin's users have significant ability to create other new users, which creates a positive feedback loop of both adoption and investment.

## Weaknesses

- + **Payment System:** While peer-to-peer capability is an important function for a store of value, most retailers are yet to accept bitcoin as exchange for goods or services. Improvements in bitcoin's use as a medium of exchange have come through the Lightning Network, a layer-2 solution. Lightning Network applications have recently made it possible for major retailers to accept bitcoin and receive either the asset itself or their desired fiat currency. While Lightning provides instant settlement times with very little fees, retailers are yet to fully integrate these applications.
- + **Volatility:** Given its young age, bitcoin remains in price discovery mode. This impedes its ability to be used as a short-term store of value as its price against fiat currencies fluctuates constantly. Long-term holding periods improve use-case as a unit of account.
- + **Skepticism:** Despite its performance and early success, many people remain skeptical of bitcoin's viability in the long run. Education and awareness of bitcoin's attractive qualities have garnered acceptance over time, a trend that is to likely continue as bitcoin matures.

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## Secular Trends Behind Bitcoin

Broader secular trends have set the stage for bitcoin's adoption as they serve as a tailwind to today's growing interest and investment. These themes include technology, populism, demographics, and emerging markets.

- + **Technology:** Technology has accelerated innovation and adoption across a variety of industries and fields. Within the consumer, smartphones, the internet, and computer use has hit all-time-highs in both developed and emerging markets, with younger generations acquiring and using the internet and technology at a rapid pace. Given all that bitcoin requires is a network connection, technology and ease of access are significant tailwinds to bitcoin's adoption. Bitcoin is accessible through major smartphone and payment applications and purchasing bitcoin is as easy as ever.
- + **Populism:** To some, bitcoin is seen as a response to centralized decision-making in monetary and fiscal policies around the world. Many citizens in both developed and emerging markets believe such policies have exacerbated income and wealth gaps, and bitcoin is seen as a potential way to offset such inconsistencies. The populist group thinks their concerns are disregarded by elitist groups and often have a general distrust in institutions, and bitcoin's decentralization fits well into this perspective.
- + **Demographics:** Millennials and younger generations have a significant interest in technology, and this group will experience a generational transfer of wealth from the baby boomer generation. With knowledge and experience in investing in digital assets, incremental money will likely flow to bitcoin. Younger generations are said to own more bitcoin than gold, a trend that is likely to continue with the growth of incomes and savings in this demography.
- + **Emerging Markets:** Many emerging and frontier markets experience hyperinflation, most recently seen in Venezuela and Argentina. Other countries have seen significant currency depreciation, such as Turkey. Residents in these countries have begun to adopt bitcoin as a safe-haven against their fiat currency. Further, bitcoin is used to send remittance payments over borders with little transaction fees. El Salvador was the first country to classify bitcoin as legal tender, a trend that could continue with growing global education and awareness.

## Macro Events Drive Adoption

Certain macro events since bitcoin's creation have pushed adoption forward, as they created awareness, interest, and excitement around the potential for digital assets. These include:

- + **Global Financial Crisis, 2008:** Satoshi wrote about bitcoin prior to the recession and bailout response of the global financial crisis, but Bitcoin launched in the aftermath of these issues. Early adopters were attracted to bitcoin's ability to transfer value without a financial institution, particularly at a time where financial opacity and counterparty risk were of utmost concern.
- + **Low Interest Rates, 2009 - Present:** Easy money policies and ultra-low interest rates around the world have increased risk appetite among investors as bond yields offer little competition to risk-assets. Concerns around substantially high debt levels as a result of monetary easing also highlights bitcoin's lack of debt and counterparty risk.
- + **Rally to \$20,000, 2017:** True public awareness began during the 2017 rally to \$20,000, as the trading frenzy and rush of returns created a stir around financial and daily media outlets. Many people learned about bitcoin for the first time in this period. While the move brought forth public bears and naysayers, it also created significant awareness of a new monetary asset.
- + **Stimulus and Inflation Expectations, 2020:** Bitcoin's price accelerated higher in November of 2020 as investors believed the outcome of the US election would result in significant spending packages and rising inflation. Interest rates moved higher almost immediately, with bitcoin following the path of inflation-sensitive assets. The response to the Covid-19 pandemic was already the largest fiscal and monetary stimulus package in history, and bitcoin served as a hedge to potential further monetary inflation.
- + **Financial Integration, 2021.** Bitcoin rose from ~\$10,500 in October of 2020 to ~\$67,000 in November of 2021, a rally that turned many of 2018's naysayers into advocates. Since, financial advisors and investment managers have experienced significant client demand<sup>[3]</sup> for bitcoin and digital asset exposure, speeding up the process of financial integration and institutional adoption. Bitcoin can now be considered a macro asset and strategic allocation for long-term portfolios.

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## Going Forward

Bitcoin is now at a crucial stage as it transitions from a speculative idea to its true use case as a store of value. As this chapter of financial integration and institutional adoption takes hold, the following themes should likely influence bitcoin's success:

- + **Early Innings:** With over 220 million users of bitcoin and digital assets by the end of 2021, adoption is growing faster than the internet did in its earliest stages. As we've seen in the past, technology often exhibits s-curve growth with slow early beginnings, an acceleration phase, and stabilization over time. We believe bitcoin is slowly entering the acceleration phase with today's financial integration and institutional adoption gaining steam.
- + **Halving Cycles Drive Scarcity:** Bitcoin has 64 hard-coded halvings until the final bitcoin is mined. At bitcoin's young age, there have only been three halvings so far. The next halving should occur around May of 2024. Bitcoin's supply will reach 21 million by 2140.
- + **Disruption Potential:** At the time of writing, bitcoin's market cap is below \$1 trillion, compared to gold at ~\$11 trillion, the U.S. equity market at ~\$50 trillion, the global bond market at ~\$120 trillion, and global wealth at ~\$400 trillion.<sup>[5]</sup> The potential to take market share from any of these assets is an opportunity for bitcoin investors.
- + **Lengthening Cycles:** Currently, bitcoin is in price discovery mode, which is expected at the beginning stages of widespread adoption. As bitcoin grows older over the next decade and longer, this "emerging" store of value asset will likely become just a "store of value." Here, we expect bitcoin to trade with less volatility with lengthening cycles and diminishing returns as the asset and user base matures. Bitcoin's annualized volatility has trended downward since 2018, with the highest recorded 90-day annualized volatility of 129% in 2018, 81% in 2021, and thus far, 58% in 2022.<sup>[5]</sup>

## Conclusion

Bitcoin is a new monetary asset that has gained rapid adoption and early success. While still an emerging store of value, bitcoin exhibits all qualities of sound money: durability, portability, divisibility, uniformity, scarcity, and acceptability. Unique qualities such as decentralization and hard-coded scarcity are strong complements and alternatives to today's monetary assets and stores of value, and investors are finding bitcoin as a replacement for cash, gold, alternatives, and even equity and fixed-income investments.

What started as an idea is now a response to the current path of global fiscal and monetary policy. Bitcoin presents a significant opportunity for investors willing to take some level of risk, as adoption remains in the very early innings of bitcoin's potential.

[1] Source: Bloomberg, Eaglebrook Advisors

[2] Source: Crypto.com, Eaglebrook Advisors

[3] Source: 82% of financial advisors surveyed have received client interest in digital assets, as reported in a March 2022 whitepaper from Cerulli

[4] Source: Bloomberg, SIFMA, Oxford Gold Group, Credit Suisse, Eaglebrook Advisors

[5] Source: Bloomberg, Eaglebrook Advisors

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**Volatility Risk:** Digital currency is a speculative and volatile investment asset. Investors should be prepared for volatile market swings and prolonged bear markets. Digital currency can have higher volatility than other traditional investments such as stocks and bonds and market movements can be difficult to predict.

**Economic Risk:** The economic risk associated with digital currency is in the lack of widespread or continuing digital currency adoption. The market and investors could decide that digital currency should not be valued at the current market capitalization due to a variety of factors.

**Regulatory Risk:** Digital currency could be banned or highly regulated by governments that would deter investors from buying or holding digital currency.

**Technical Risk:** Digital currency is a dynamic network with a codebase that is updated to add new security and functionality features. The updated code that is merged by the core developers could potentially have an error that threatens the security or functionality of the digital currency network.

**Cybersecurity Risk:** Digital currency exchanges and wallets have been hacked and digital currency has been stolen in the past. This is a potential risk that clients must be comfortable with when investing and holding digital currency. Theft is less likely when holding digital currency at a qualified custodian in offline systems (cold storage) with institutional security and controls.

**Digital Asset Service Providers:** Several companies and financial institutions provide services related to the buying, selling, payment processing and storing of virtual currency (i.e., banks, accountants, exchanges, digital wallet providers, and payment processors). However, there is no assurance that the virtual currency market, or the service providers necessary to accommodate it, will continue to support Digital Assets, continue in existence or grow. Further, there is no assurance that the availability of and access to virtual currency service providers will not be negatively affected by government regulation or supply and demand of Digital Assets. Accordingly, companies or financial institutions that currently support virtual currency may not do so in the future.

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**Government Oversight of Digital Assets:** The regulatory schemes - both foreign and domestic - possibly affecting Digital Assets or a Digital Asset network may not be fully developed and subject to change. It is possible that any jurisdiction may, in the near or distant future, adopt laws, regulations, policies or rules directly or indirectly affecting a Digital Asset network, generally, or restricting the right to acquire, own, hold, sell, convert, trade, or use Digital Assets, or to exchange Digital Assets for either fiat currency or other virtual currency. It is also possible that government authorities may take direct or indirect investigative or prosecutorial action related to, among other things, the use, ownership, or transfer of Digital Assets, resulting in a change to its value or to the development of a Digital Asset.

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