TEXAS CAPITAL BANK®
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Bitcoin: Learn by Watching

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In the feature below, we bring you information about a prevalent topic in the financial world today: ***Bitcoin****. Read more to find out about its purpose and its rise in popularity, and determine whether it fits your financial strategy—or not.*

Bitcoin has been an ever-present topic in financial news media over the past several months, thanks to a meteoric rise in value this year and recent volatility. Despite the amount of attention paid to the cryptocurrency, many market watchers still do not have a full picture of what exactly Bitcoin is. In this article, we hope to shed some light these topics, among others:

1. What is Bitcoin?
2. How can Bitcoin be used?
3. Is Bitcoin a real currency?
4. Does Bitcoin belong in an investment portfolio?

Bitcoin 101

Bitcoin was conceived as a person-to-person transaction network that did not use banks or regulatory authorities. When it debuted in 2010, its creator envisioned Bitcoin to be used for "small casual transactions," such as buying pizza or for purchasing small items over the internet. Bitcoins can be bought or sold on internet-based exchanges. The exchanges are accessible online via smartphone or other internet applications. These exchanges are privately owned groups of server computers. Bitcoins and other cryptocurrencies are held in unregulated server-based accounts called "wallets" and secured by an encryption key. Bitcoins are created by "mining" — having stacks of server computers crunch through very math-intensive algorithms. The maximum number of Bitcoins that can be created is 21 million. At present, 16.4 million have been mined. Of the 16.4 million an estimated 4 million have been lost, are in limbo, or have been destroyed. Generally, they are lost because the owner lost his or her encryption key, by computer crash, or through fraud. (Source: *Fortune.com*)

Rise in Popularity

The current Bitcoin "mania" revolves around the skyrocketing exchange price, but the initial allure of the technology was threefold: freedom from regulatory constraints of the banking system, a tracking system for every transaction (the Blockchain), and anonymity. Being outside the banking system and the watchful eye of regulators is attractive to certain segments of the population. Regulators around the globe are waking up: recently the IRS obtained a court order demanding that Coinbase, the largest Bitcoin exchange, turn over names, addresses and birthdays of 14,355 of its most active customers. The IRS certainly is interested in knowing how these folks plan on reporting their future capital gains. (Source: *Business Insider*)

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What is Blockchain?

The Blockchain concept is relatively simple but very powerful: create an electronic record or agreement that carries a detailed list of every transaction that the individual Bitcoin has been used for since it was created. Imagine if the dollar bill in your wallet came with a list of its complete transaction history. Additionally, the list is public; everyone else can see all of those transactions, but not the individuals conducting them. This technology hopes to ensure that Bitcoin cannot be hacked or counterfeited. The Blockchain technology is ubiquitous in cryptocurrencies, and it is not only used in Bitcoins. This methodology, and the technology behind it, has a future in financial transactions, such as interest rate swap agreements, tracking real estate, and many other applications.

Outlook for Bitcoin

The potential that Bitcoin could someday be widely accepted by governments or larger merchants has driven some of the boom this year. The Chicago Board of Exchange just began offering an exchange-traded contract on the future value of Bitcoin, and other exchanges will be rolling out similar offerings in the new year. The excitement for cryptocurrencies is not limited to only Bitcoin. A popular tracking website, Coinmarketcap.com, lists 1,345 different cryptocurrencies and tokens, traded across 7,324 exchanges. As with any new mania, most of these cryptocurrencies could fade quietly from a lack of support. Wall Street and professional investors are actively researching which ones to back.

Should Bitcoin Be Considered a Currency?

Just because Bitcoin is valued in dollars, it does not necessarily mean that it is a currency. We use the following generally-accepted tests of a currency:

Medium of Exchange — about 100,000 merchants around the world will currently accept Bitcoin, and the vast majority of them immediately get in line to convert it to their currency. Getting in line is key; an average day sees a backlog of around 70,000 Bitcoin trades waiting to process through exchanges. The fees required to execute a transaction are quite high relative to the amount of the transaction, exactly the opposite reason the creator proposed the Blockchain cryptocurrency in 2009 — to lower transaction fees. Bitcoin has another large drawback: a hard-coded limit in the main program limits the network to processing 12 transactions per second. Most payment systems, Visa, for example, averages 2,000 transactions per second (Source: Bank Investment Consultant). The wild swings in Bitcoin value make it nearly unusable for daily transactions (the price of a pizza would inflate and deflate by the hour). Bitcoin fails this currency test.

Unit of Account — for a potential currency to be considered a "Unit of Account" all items must be valued in that currency: the price of food, cars, clothing, and so forth. Nothing is priced in Bitcoin yet, so it also fails this test currently.

Store of Value — Bitcoin comes closest on this one, but questions still remain. The early adopters who are holding onto their Bitcoins hope that it becomes a cryptocurrency standard someday, or is convertible into something that takes its place. The "value" driving Bitcoin higher is speculation (hope) that some version of a Blockchain cryptocurrency will be recognized by governments or businesses and will gain widespread use. Popular uses of Bitcoin include conducting illicit transactions and for pure speculation, so widespread acceptance of Bitcoin in its present form seems unlikely.

In sum, Bitcoin may have a largely agreed upon value like a collectible, but in our opinion, it is not yet useful as a currency.

Should Bitcoin Be Considered an Investment?

Finally, does Bitcoin fit the necessary criteria to be an investment? Traditionally, an investment must have an underlying cash flow that can be ascertained and discounted (stocks, bonds, real estate, and many more, all fit the bill), or it must be used for transactions that are recognized by a legal authority (like standard currencies). Cryptocurrencies such as Bitcoin seem to have neither of these qualities at the present time.

The "greater-fool theory" states that speculators may buy certain assets based solely on the idea that someone else (the greater fool) will pay them more for those assets. Given the rapid rise in the price of Bitcoin, it appears, to us, that this theory encapsulates the current mania perfectly — the price of Bitcoin keeps getting pushed higher based on speculation, not underlying value.

In Summary

Bitcoin has had multiple 50% drops since its 2009 creation and is likely to have more as its growing pains are worked out. While Bitcoin's rapid rise in dollar terms is certainly exciting, the chart of Bitcoin's rise is much more drastic than the 1999-2000 Dot Com bubble. Shares of Dot Com survivors became affordable and their long term prospects much more enjoyable after they crashed. We believe that our clients may have quality opportunities in the cryptocurrency world after any potential shakeout down the road.

An old market adage states: "To understand a position, you must own it," though in this instance, we would disagree. There is much to be learned from the fast-growing world of cryptocurrencies, but at this point, we view the Bitcoin mania as a speculative bubble.

Please give us a call at 214.210.3092 to discuss further.

ABOUT TEXAS CAPITAL BANK

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