Bitcoin: The rise of a new currency?

Bitcoin was the talk of the town in the last few months of 2017, rising from relative obscurity to headline news as it rocketed in value. But can it overcome hurdles to cross over from a speculative asset to a mainstream currency?

Like euros, dollars or sterling, Bitcoin can be used to buy things electronically, but there the similarities end. Bitcoin is a cryptocurrency: a digital form of currency based on cryptography and held electronically. It is the first, most popular and most widely traded cryptocurrency, but there are many others – such as Ethereum, Litecoin and Ripple. Cryptocurrencies are not issued by a central bank or any other authority, nor are they printed.

Instead, Bitcoin is created using computers to solve mathematical problems in a process called mining. The more Bitcoin is mined, the harder the mathematics becomes and so the more computer power is required to mine a Bitcoin. There is a limit to this process, with the total amount that can be mined capped at 21 million Bitcoin.

Transactions in traditional currencies need to be authorised by a bank or a central authority such as a government. Bitcoin, on the other hand, is a peer-to-peer electronic payment system designed to allow the execution of online transactions without an intermediary. A block of Bitcoin transactions is checked and processed by the network of participating computers, which can be anywhere in the world. That transaction is then forever stored in the technology that backs Bitcoin, known as blockchain.

Early Bitcoin supporters touted the fact transactions are fast and cheap. As the Bitcoin network has become more congested, however, this has ceased to be the case: by early December, the average Bitcoin transaction cost had soared to around $20 and the average confirmation time was 30 minutes, with transactions jostling for space in too-small blocks.

This trajectory is likely to continue, rendering Bitcoin expensive and impractical as a currency for day-to-day transactions. As its qualities as a simple payment method decrease, Bitcoin's value becomes yet more difficult to assess. The valuation case is further complicated by the fact Bitcoin bears no interest, unlike most other traditional investments.

Moreover, Bitcoin is not a secure means of payment. Although it is practically – though not technically – impossible to hack the Bitcoin network itself, Bitcoin exchanges have been hacked before. Nor is it an officially accepted means of payment by any major government or institution, with most central banks considering subjecting it to regulation given its use in the shadows of the economy (for example, tax avoidance and criminal activity, sometimes by those who want to avoid capital controls in countries such as China and Venezuela).

Bitcoin nonetheless attracted many speculative investors in 2017, but its value was highly volatile. It started 2017 valued under $1,000 per Bitcoin; by the beginning of December, it was at nearly $10,000. Then began the real frenzy: prices briefly topped $19,500 mid-month, before dropping to around $14,300 by year end.

Along with the risk of volatility, investors could face operational and security failures, market manipulation and liability gaps. What is more, different exchanges advertise significantly different prices for Bitcoin, highlighting how difficult it is to establish a universal value.

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Owning Bitcoin is not the only investment option: Bitcoin futures contracts launched in December, providing a way to gain exposure via derivatives. This opened the market up to investors unable to hold unregulated Bitcoin directly. It also enables investors to go short Bitcoin, allowing those who think Bitcoin prices are too high, or even in a bubble, to make money if the value goes down.

Bitcoin was the first cryptocurrency to use blockchain technology, but its weaknesses make it an unviable replacement for our current centralised payment system. It is more likely that central banks will create their own cryptocurrency, at which point Bitcoin will become significantly less valuable. Only last week, the Bank of England has confirmed that it has set up a research unit to investigate the introduction of a cryptocurrency linked to sterling.

In our view, owning Bitcoin is a zero-sum game – more akin to gambling than to investing. The Mixed Investment Funds are not invested in Bitcoin or any other cryptocurrencies, nor do we have any intention to add it to the funds' holdings.

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