



Curious About Cryptocurrencies? Investors Need to Make Sure They Separate "Investing" from "Speculation"

By Don McArthur, CFA®

Bitcoin and other cryptocurrencies have received plenty of media coverage lately, and it is natural for investors to wonder about them. Even celebrities have become associated with Bitcoin publicity through social media. Interest has piqued to a point where there are even Exchange Traded Funds (ETFs) that invest in Bitcoin,



Commerce Brokerage Services, Inc.

A Subsidiary of Commerce Bank

giving investors the means to invest in the Futures market. After having performed in-depth research on Bitcoin and other cryptocurrencies, our position at Commerce Trust Company is that they should not currently play a role in client portfolios. As part of that research, Commerce Senior Vice President and Investment Analyst Don McArthur, CFA, put together a primer on the topic of cryptocurrencies in general. In the following commentary, he explains why Bitcoin at this stage is more about speculating than investing in something with intrinsic value. He also touches on how Blockchain networking technology not only supports cryptocurrencies, but many other industrial applications as well. We thought you would enjoy this commentary as McArthur shares his thoughts in a mind-opening Q&A.

Q. What is Bitcoin and how did it start?

A. Bitcoin is one of hundreds of digital currencies, or cryptocurrency, based on Blockchain technology. As an early mover, Bitcoin is by far the largest digital currency. Bitcoin was launched in 2009 by a mysterious person



Commerce Brokerage Services, Inc.
A Subsidiary of Commerce Bank

(or persons) known only by the pseudonym Satoshi Nakamoto. Unlike traditional currencies, which are issued by central banks, Bitcoin has no central monetary authority. No one controls it. Much of the original use was for illegal activities (e.g., buying drugs or blackmail) or as a way to avoid capital controls in certain countries.

Q. What is Blockchain?

A. Blockchain is a shared, distributed ledger that facilitates the process of recording transactions and tracking assets in a business network. An asset can be tangible, like a house, car, or land, or intangible, like intellectual property. We believe Blockchain will change many industries in the future as it evolves.

Q. How does Blockchain work?

A. Throughout history, a central ledger has been used to create a system of record. For instance, a county records who owns property or an exchange records who buys and sells securities or other financial contracts. Blockchain relies on a community to keep the record. Members of the community see a transaction, then essentially vote



Commerce Brokerage Services, Inc.

A Subsidiary of Commerce Bank

to approve it. Information on the transaction becomes a record on a "block." Blocks are permanent until a later transaction is approved, thus altering the record. New blocks are added to the previous block creating a "chain" of blocks or...Blockchain.

Q. What is driving the supply and demand for Bitcoin?

A. Most of the recent performance in Bitcoin appears to be driven by speculation. There is a scarcity value in that there will only be 21 million Bitcoins created (the industry term is mining). Currently, around 17 million exist. A new Bitcoin is created to "pay" members for solving a complex mathematical equation and to verify transactions. More computing power/electricity is needed to create each additional Bitcoin, thus helping to justify a price paid. Analysts believe over 75% of new Bitcoins are mined by six firms (mainly based in Southeast Asia). Many of these firms keep their inventory, thus limiting supply on the market.

On the demand side, speculation that someone will



Commerce Brokerage Services, Inc.

A Subsidiary of Commerce Bank



pay more in the future for a Bitcoin than the price at which one can buy it now drives a purchase decision. Many people like that no one entity controls it and transactions can occur without an intermediary. This lack of oversight likely explains why Bitcoin has been tied to illegal activity and as a way to avoid capital control (e.g., get money out of a certain country).

Q. Why is there more than one digital currency?

A. With the popularity of Bitcoin, over 100 other digital currencies have been created. I think the simple answer is that if people find out you can create your own currency, it seems like an easy way to get rich. Some of the other leading digital currencies improve upon



Commerce Brokerage Services, Inc.
A Subsidiary of Commerce Bank

Blockchain technology (Ethereum improves upon the speed of a transaction and strives to create a platform and Ripple utilizes a shared network whereby one knows the other members approving transactions). Many of the other hundreds of digital currencies rise out of ICOs (Initial Coin Offerings) that are touted on social media for a cut of the profit by celebrities (Paris Hilton, Floyd Mayweather). It seems a core question is: what is the value of a digital currency without significant backing or significant barriers to entry?

Q. Are there regulations governing digital currencies?

A. Currently there are not, which seems to be a primary reason why digital currencies are being created.

However, there has been a considerable amount of discussion by many regulatory bodies (in South Korea, United States, and China) regarding regulating activity around digital currencies. One regulatory aspect often discussed is the issue of taxation. Governments could look to digital transaction fees as a means to raise revenue or monitor commerce for unreported activity. In the United States, Bitcoin is treated as a capital asset, and therefore subject to the rules that govern capital gains

and losses. Regulation discussions have been attributed to large declines in the value of digital currencies.

Q. Are digital currencies really currency?

A. Typically, a currency is a store of value and medium of exchange. Bitcoin fails on some levels to meet either of those two definitions for currency. First, with such volatility in the price paid for a digital currency, it is difficult to believe it is a true store of value. Some argue, however, that a digital currency is similar to gold in that in the event of geopolitical instability, it will be looked at as a safe haven because no one country backs or controls it. Second, while there are companies and individuals that advertise they accept Bitcoin as a medium of exchange, it appears to be typically done for primarily promotional reasons as opposed to actual transactional purposes. Analysts believe there are currently only three of the leading 500 eCommerce merchants accepting Bitcoin, which also fails the medium of exchange test. One reason contributing to this lack of acceptance is that Bitcoin structural limits prevent transactions from being processed quickly enough for mass use. Credit card networks, for instance, process in excess of 30,000

transactions a second. Currently, a leading digital currency topped out at seven transactions per second. That's not 7,000 transactions, but only seven transactions.

Q. Is Bitcoin safe?

A. So far, Bitcoin is cumbersome with seemingly high transaction costs embedded in transactions, and there is another angle that concerns me: What do you do with it? One could keep the "key," which is a long sequence of number and letters to access the Bitcoin at a later date. But where do you keep it? On your computer? Write it on a piece of paper? On a flash drive? A popular way to store digital currencies is through a "vault" or service that keeps it for you. However, there have been six publicized hacks/break-ins/thefts of these vaults totaling losses of \$630 million. There is no recourse available for these losses.

Q. Does Commerce support digital currency investors?

A. No, we do not see a safe, efficient way to invest in digital currencies. However, we believe the underlying Blockchain technology will be important in the future.

The 2018 investment commentary is a special report designed to provide investment information on economic markets for Commerce Brokerage clients. It is intended to provide general information only and reflects the opinions of Commerce Trust Company's Investment Policy Committee.

Commerce Trust Company is a division of Commerce Bank. Commerce Brokerage Services, Inc., member FINRA and SIPC, and an SEC registered investment advisor, is a subsidiary of Commerce Bank.

This material is not a recommendation of any particular security, is not based on any particular financial situation or need, and is not intended to replace the advice of a qualified attorney, tax advisor or investment professional. The information in this commentary should not be construed as an individual recommendation of any kind. Strategies discussed here in a general manner may not be appropriate for everyone. Diversification does not guarantee a profit or protect against all risk. Past performance is no guarantee of future results, and the opinions and other information in the investment commentary are as of March 6, 2018.

Commerce does not provide tax advice or legal advice to customers. Consult a tax specialist regarding tax implications related to any product or specific financial situation. Data contained herein from third-party providers is obtained from what are considered reliable sources. However, its accuracy, completeness or reliability cannot be guaranteed. All expressions of opinion are subject to change without notice depending upon worldwide market, economic or political conditions.



Commerce Brokerage Services, Inc.
A Subsidiary of Commerce Bank

commercebank.com/brokerage

1.800.772.7283

NOT FDIC INSURED | MAY LOSE VALUE | NO BANK GUARANTEE



DON MCARTHUR, CFA®

Senior Vice President, Investment Analyst

Don serves as a senior investment analyst with Commerce Trust Company in Kansas City and manages the Fundamental S&P 500 Equity Strategy. Don earned his accounting degree and business administration degree in economics from University of Kansas in 1995. He also earned his master in business administration degree from the University of Missouri-Kansas City in 2000 and holds the Chartered Financial Analyst® designation.



Commerce Brokerage Services, Inc.

A Subsidiary of Commerce Bank

commercebank.com/brokerage

1.800.772.7283

NOT FDIC INSURED | MAY LOSE VALUE | NO BANK GUARANTEE