Cryptocurrencies

Should I buy Bitcoin?

14 January 2021, 7:55 pm CET, written by UBS Editorial Team

Many clients are asking whether they should invest in Bitcoin and other cryptocurrencies. Our general guidance is this: While we wouldn’t rule out further price increases, we’re somewhat skeptical of any essential real-world use cases, which makes it hard to estimate a fair value for Bitcoin and other cryptocurrencies. We are also cognizant of the real risk of one losing one’s entire investment. Investors in cryptocurrencies must therefore limit the size of their investments to an amount they can afford to lose. We also suggest thinking about an exit strategy.

Should I buy?

Indeed, prices could continue to climb in the near term given strong price momentum, the potential for further institutional adoption, huge media and social media attention, and the mindset that limited supply will translate into higher prices. But there is nothing stopping future cryptocurrencies—whether launched by a private initiative or by public authorities—from overtaking Bitcoin and other current cryptocurrencies in popularity. The entry barriers to this market are low, as is evident from the more than 4,000 cryptocurrencies currently listed on coinmarketcap.com.

Early success does not guarantee future success. Netscape and Myspace are examples of network applications that enjoyed widespread popularity but eventually disappeared. There is little in our view to stop a cryptocurrency’s price from going to zero when a better designed version is launched or if regulatory changes stifle sentiment.

Last, we note an increase in regulatory attention, following the surge in prices and market capitalization. In the UK, the FCA (Financial Conduct Authority) decided to ban the sale of certain crypto-derivatives to retail consumers, and we wouldn’t be surprised if regulators elsewhere soon follow suit. As cryptocurrencies have become a much bigger asset class in 2020, the impact they can have on financial stability has grown, which makes them more relevant for regulators. Regulatory changes can weigh on prices.

Who is buying?

Anecdotal evidence suggests institutional investors are buying more than in 2017, when Bitcoin exceeded USD 20,000 for the first time. In a December article, the Financial Times described 2020 as the “year Bitcoin went institutional,”
highlighting the growing acceptance of cryptocurrencies by mainstream asset managers. Regulation that permits offering products and custody solutions, as well as the central clearing of cryptocurrencies, have helped instill confidence and pique investor interest in cryptocurrencies.

According to Nasdaq.com, Guggenheim Funds Trust filed an amendment with the US Securities and Exchange Commission to allow one of its funds to gain exposure to Bitcoin by investing up to 10% (roughly equivalent to USD 500mn) of the fund’s net asset value in Bitcoin-related products. The Wall Street Journal reported in December that Massachusetts Mutual Life Insurance Co. had bought USD 100mn of the cryptocurrency. Earlier in 2020, Paul Tudor Jones, a successful hedge fund manager, said that one of his funds may invest “a low single-digit percentage” of its assets in Bitcoin futures.

We also see evidence that retail investors have become more active again. More people are searching for information on cryptocurrencies on the internet. The number of transactions and digital wallets is on the rise, and the topic is trending on social media. Publicly available data from blockchain.com, the world’s leading bitcoin wallet provider, shows 10 million new wallets created in the past three months, as many as were created in the prior year. New users appear to have been attracted by rising prices. It also shows a significant increase in the number of addresses used (roughly equivalent to daily users), likely indicative of an increase in trading activity.

While still underdeveloped, the open interest in the Bitcoin futures market has also increased more than threefold since October. With 95% of coins held by just 2.5% of addresses (note that one user can also have multiple addresses), the potential for price squeezes should be evident.

Cryptocurrencies have also been in the news due to growing mainstream adoption. For instance, some payment service providers have started to offer digital currencies. PayPal’s decision to feature Bitcoin, Ethereum, Bitcoin Cash, and Litecoin will allow account holders in the US to buy, hold and sell these cryptocurrencies. In 2021, the company plans to expand its offerings to Venmo and select international markets. PayPal has been granted a conditional BitLicense by the New York State Department of Financial Services. It is worth noting that all these transactions will be settled in fiat currency.

This means that cryptocurrencies will simply become another funding source inside your PayPal wallet. While this may increase the utility of cryptocurrencies, it doesn’t address concerns around volatility, costs, and the speed of transactions. It also doesn’t necessarily increase demand for the coins offered on the platform on a sustained basis.

**But can’t Bitcoin and other cryptocurrencies help to diversify portfolios?**

This is an important question, because diversification has become a key argument for investors to add cryptocurrencies to their portfolios.

While empirical evidence is mixed, Bitcoin has had an overall low correlation to a wide range of other asset classes (Fig. 3), including bonds, stocks, the Swiss franc (here shown versus the US dollar), and gold. Interestingly, correlations spiked substantially in 2020 with the outbreak of the pandemic, but have normalized since.

This low correlation, if maintained, can indeed help to diversify a financial portfolio. However, a low correlation to other asset classes is not a sufficient reason alone to add Bitcoin to a portfolio. Investors also need to look at risk-adjusted returns to determine whether they are sufficiently compensated for taking a risk.

The historical evidence on this is mixed: Had you held Bitcoin during a period of sharply rising prices, the overall risk-reward of the portfolio would indeed have increased. But during periods of less extreme increases—and of course stagnating or declining prices—this hasn’t been the case.

So, the question of whether to add Bitcoin or other cryptocurrencies to a portfolio can only be answered, in our view, if we have overcome the challenge of deriving a credible estimate for its future fair value (as discussed in Question 4). At this point, we find it hard to have high conviction in such a number.

This is an abridged version of the full Chief Investment Office report, The Rise of Bitcoin, published 14 January, 2021. Please see the full report for more details, including analysis on why people are buying Bitcoin, what could cause people to sell, if cryptocurrencies are bubbles and the difference between cryptocurrencies and central bank digital currencies.

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