Cryptocurrency mania: what's your edge?

Crypto is an increasingly dominant topic of conversation among investors, but is it a genuine asset class or the latest in a long list of financial manias, asks Dan Kemp?

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Cryptocurrency is an increasingly dominant topic of conversation around the BBQ (or these days, on social media) as investors try to understand whether they are a genuine asset class or simply the latest in a long list of financial manias.

As long-term, valuation-driven investors who take the stewardship of our investors' capital seriously, it is tempting to ignore the convulsions occurring in one corner of the capital markets and focus our attention and resources on assets with more predictable outcomes. However, experience has taught us that excess in one part of the capital markets can metastasise, impacting all investors and therefore cannot be ignored.

When tackling these situations, it is often useful to look at similar episodes in history in an attempt to learn lessons that will benefit our decisions in the present. It is therefore with perfect timing that William Bernstein has published his new book on "The Delusions of Crowds". As a psychologist and investor, Bernstein is interested in the way we make investment decisions and this book does a wonderful job of recounting the more serious religious and financial manias over the past 500 years.

Characteristics of market mania

Against this backdrop, the current enthusiasm for cryptocurrencies and related technology companies appears rather tame. Yet it bears many of the hallmarks of these historical episodes:

- the advent of a new technology
- the support of low interest rates
- a rapid increase in supply (according to CoinMarketCap, the total value of cryptocurrency reached a recent peak of more than $2.2 trillion, up from $243 billion a year ago)
- a disregard for traditional asset valuation principle; and
- a separation of society into those who "get it" (recall the "laser-eyes" social media profiles) and those that don't, with the latter resulting in the creation of echo chambers and self-reinforcing loops of belief.

Given these similarities, historic manias can therefore provide several important lessons for investors in the current environment that are equally relevant to those on the "inside" or "outside".

First, manias can persist and grow for longer than seems reasonable as they are fuelled by stories of those that have made huge sums of money. Such stories tend to draw more people in until the mania collapses under its own weight, resulting in a redistribution of wealth between those that sold early and those that bought late.

Second, the apparent availability of wealth acts as a strong incentive to poor moral behaviour and so we should be more than usually vigilant to the potential for fraud which is typically only discovered after the event.

Third, the existence of a mania does not preclude the possibility of significant financial gains for some long-term investors and benefits to society as a whole. While the railway mania of the 18th century ruined many investors, for example, the resulting infrastructure development fuelled long term economic growth in the UK. Similarly, the dotcom bust ruined investors but promoted the technology that has allowed many of us to continue to be both productive and in touch with our families while at home over the past year.

Fourth, there may be hidden transmission mechanisms between the epicentre of the mania and the broader financial system exposing previously unknown vulnerabilities in the latter. A good example of this is the impact on UK savers, especially the retired, following the bursting of the US property boom of the last decade.

Finally, beware of escalating commitment. This phenomenon was identified by Professor Barry Staw and describes a situation where enthusiasts become increasingly committed to a belief following setbacks, resulting in increasing investment (of either monetary of emotional capital) and subsequently greater loss as the eventual outcome becomes inescapable. This escalation is characteristic of a deterministic view of the future. In reality, the future is uncertain and therefore as investors, we should be careful about adhering to a single opinion too strongly.

We remain cautious

Perhaps the most notable observation is the changing motive of cryptocurrency traders. What started as a pool of "early adopters" has morphed into a growing group of "quick profit traders". This motive is innately understandable yet fraught with danger.

Knowing who is on the other side of a trade is a key consideration we would emphasise. For every buyer, there is a seller (unless you're in the business of mining coins), so you really need to think about what your edge might be over that person or entity. Bill Miller famously set a framework for thinking about your investment edge, which he gracefully captured in three buckets.

- **Informational edge:** do you truly have greater access to insights or data than the pool of investors?
- **Analytical edge:** can you do more with that information than the pool of investors?
- **Behavioural edge:** do you have a better temperament or ability to understand others' behaviour than the pool of investors?

In reality, the future is uncertain and therefore as investors, we should be careful about adhering to a single opinion too strongly, including our own. Always think back to your edge as an investor. If you don't have one, you should tread very carefully. That's not to say an edge isn't attainable in the exhilarating world of cryptocurrencies - and some investors will be able to capitalise on their edge.

To close on this increasingly important topic, the one thing we do know about manias is that we must be incredibly focused on the robustness of the portfolios we manage. This is holistic by necessity, looking for potential knock-on effects to other assets or inherent vulnerabilities in the financial system.

Ultimately, cryptocurrencies are complex and extremely difficult to value, but such deep work is exactly what is required to make a sound investment. We would argue that now is a great time to focus on portfolio robustness as part of this analysis, which is really two sides of the same (Bit)coin.

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