"And we love to make money for the people who trusted us early on, when we were young and poor."[1]

- Charles T. Munger quoted in Forbes January 22, 1996

January 16, 2018

Dear Friends and Clients,

I am delighted to share with you the first Pellerin Company client letter!

This letter is my reflection on important market events from the past year with the goal of providing observations, insights and analysis for educational purposes.

Through this exercise I hope to be a filter for the white-noise known as "financial media." I will endure those shenanigans so you don't have to. Trust me, you don't *want* to.

But first, let me take a moment to express my gratitude to all who have entrusted me with their hard earned dollars.

Thank you from the bottom of my heart. It is my pleasure and privilege to serve you, and I will not take this lightly.

Now, let's take a deep dive into the most talked about event of 2017: the meteoric rise of Bitcoin.

Crypto-Hypnosis[2]

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[1] Kaufman, Peter D. Poor Charlie's Almanack: the Wit and Wisdom of Charles T. Munger. Donning Co. Pub., 2011.

[2] The comments in this section are focused on Bitcoin and other fiat cryptocurrencies, and may not be applicable to all cryptocurrencies.

2017 was officially the year of Bitcoin and cryptocurrencies.

After opening the year trading slightly over $1000 per “coin,” Bitcoin began to soar in April, with prices reaching over $19,500 by December. There is no telling where the price will be by the time you are reading this.

People noticed.

Think about this: the stock market made a new record high almost every other day last year but hardly anyone seemed to care in contrast to Bitcoin.

I personally had numerous conversations with people all year on the subject, including unsolicited conversations with people I had never met before. By now you may have even wondered what I think about it or if you should buy some (if you haven’t done so already).

Bitcoin was introduced to me as an economics student around 2010 or 2011 - not by my professors but a smart classmate - and watching Bitcoin since then has been fascinating anyway you look at at.

I never imagined a $1000 investment in Bitcoin back then would be worth somewhere between $600,000 to $237,000,000 at the highs of 2017![3]

Alas, Bitcoin was merely a minor curiosity for me at that time and figuring out how to buy some was harder in those days. So unfortunately for me, I did not buy any Bitcoin then and I have not bought any since, but I have been paying attention.

Now that EVERYONE is talking about Bitcoin and cryptocurrencies, the time is right to share my thoughts and observations with the world.

To be clear, I do not own any cryptocurrencies and I do not intend to buy any, but I am neither “for” nor “against” them. I have tremendous respect for many people on both sides of this debate. <u>And, I am not writing this to make any recommendation to buy or sell.</u>

However, you can color me skeptical.

I cannot see the future and I will not make any predictions, but I do believe we are witnessing a bubble.

<u>What is a Bitcoin?</u>

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[3] Based on the price range of Bitcoin between $0.08 and $31 in 2011.

Bitcoin and cryptocurrency are not intuitive concepts for most people, myself included.

I have received many abstract answers to the question, “what is a Bitcoin?” It is often described in terms like *digital money, digital gold, a decentralized ledger, data, a digital asset,* or *a digital natural resource.*

These descriptions are too ambiguous and open to interpretation. Calling Bitcoin a “digital asset*”* is like saying it is a “digital technology,” it doesn’t really explain any objective facts about Bitcoin.

For comparison, if you asked me, “what is gold?” and I said, “gold is a physical asset,” how much does that tell you about gold? Many things fit the description, “physical asset.”

A more objective description of gold would be something like,“gold is a chemical element with 79 protons and an atomic mass of 196.967 AMUs.” There is no confusing *that* for something else*.*

Gold can be interpreted as an asset or as money, or we can describe its’ properties and functions, but at the end of the day, when you buy a piece of gold, technically, what you own is a just piece of metal.

So what exactly do you own, when you buy a Bitcoin?

Getting an answer to that question is like trying to nail Jello to a wall because Bitcoin represents nothing physical or tangible. What you own when you buy Bitcoin only “exists” in *virtual reality*.

Understanding Bitcoin, an excellent essay by economist Robert Murphy and co-author Silas Barta, is one of the best sources available for… well, understanding Bitcoin.[4] The following is how Murphy and Barta describe Bitcoin:

“‘Bitcoin’ encompasses two related but distinct concepts. First, individual bitcoins (lowercase-b) are units of **(fiat)[5]** digital currency. Second, the Bitcoin (uppercase-B) protocol governs the decentralized network through which thousands of computers across the globe maintain a ‘public ledger’ - known as the *blockchain* - that keeps a fully transparent record of every authenticated transfer of bitcoins from the

[4] Barta, Silas and Murphy, Robert. (2017, December). Understanding Bitcoin: Version 1.11. Retrieved from http://understandingbitcoin.us/wp-content/uploads/2017/12/2017.11-Understanding-Bitcoin-v1.11.pdf
[5] Murphy and Barta include the following footnote here: “Some Bitcoin enthusiasts may object to our classification of it as a ‘fiat’ currency, because the Bitcoin network is completely voluntary and doesn’t rely on State-enforced legal tender laws or other methods of suppressing competition. However, in monetary economics the term ‘fiat’ has a very precise meaning, under which bitcoins would qualify. (See Ludwig von Mises’ *The Theory of Money and Credit* for scholarly treatment.) In particular, it is simply not true that the State can merely declare ‘through fiat’ that something is money. In our judgment, it is more important for the beginner to understand that there is no other commodity or asset ‘backing up’ bitcoins - and in this sense it is a fiat currency - rather than avoiding the possibly negative connotations from our use of a term that is usually reserved for low-quality money issued by modern states.”

moment the system became operational in early 2009. **In short, Bitcoin encompasses both (1) an unbacked, digital currency and (2) a decentralized, online payment system (bold added).**"

To further explain the mechanics, Murphy and Barta use an analogy of a community where integers are used as money:

"In this setting, Bill wants to buy a car from Sally, and the price sticker on the car reads, 'two numbers.' Bill happens to be in possession of the numbers **18** and **112**. So Bill gives the two numbers to Sally, and Sally gives Bill the car. The community recognizes two facts: the title to the car has been transferred from Sally to Bill, and Sally is now the owner of the numbers **18** and **112**."

Likewise, coindesk.com explains, "conventional currency has been based on gold and silver… But Bitcoin isn't based on gold; it's based on mathematics."[6]

So, what are the most objective facts? What are the protons and AMUs of Bitcoin? I think the best answer is, "math."

What you own when you buy a Bitcoin is the concept of algorithmically regulated digits or units existing in a virtual reality.

Bitcoin is unintuitive because we don't normally think of things like concepts and mathematics as things that can be owned.[7] You can own a dozen eggs but cannot own the concept, "dozen."

You *can* own a Bitcoin but what you own is not something like "digital gold," it is just plain digits. It's *digital nothing*.

The Marketing of Bitcoin

What people *think* they understand about Bitcoin seems largely influenced by persuasive marketing.

For example, Bitcoin and cryptocurrencies are referred to as "coins" and even depicted as gold coins with a "B" embossed on them. But no actual coins are involved in owning a Bitcoin.

The choice to call these things coins associates Bitcoin with hard money and gold in people's minds. But it was a *choice* to call them coins and not something like bills, notes, shares, or wampum.

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[6] (2015, March 20). What Is Bitcoin. Retrieved from https://www.coindesk.com/information/what-is-bitcoin/

[7] Intellectual property is a debatable counterfactual to this claim, which for the sake of brevity I will not elaborate on in this letter. For more on how intellectual property relates to property rights, see the work of Stephan Kinsella.

None of the characteristics of cryptocurrencies more validates the term “coin” versus the term “bill.” Now imagine if a unit of Bitcoin was called a bill - the fundamentals of Bitcoin would not change but people would perceive it differently.

Also, the term “mining” is used to describe the process for creating a Bitcoin. I have actually been inside of an operating mine and *trust me*, no coins, crypto or otherwise, were being produced down there.

Mines do not extract *coins* from the earth, they extract *ore*. Ore becomes ingot, which is then refined into bullion. Coins are then made from bullion and *scrap*[8], and the process is known as *minting*, not mining.

But again, the choice to call the creation of a Bitcoin “mining” associates Bitcoin with gold. Is there any fundamental reason why this process should not have been labeled something like minting or printing instead? No.

And lastly, when new cryptocurrencies are made available for sale, the event is called an “ICO” (Initial Coin Offering). Of course, this sounds very similar to an IPO (Initial Public Offering) for a stock.

Calling the launch of a new “coin” an ICO does at least two things. It associates owning cryptocurrencies to owning stocks. And, it associates participation in an ICO with the excitement of participating in an IPO.

Over 1400 coins have ICO’d since Bitcoin and the list is growing. Several coins have launched with organized public-relations campaigns featuring celebrities like Paris Hilton and Floyd “Money” Mayweather. And making matters ridiculous, just look at some of the names of these coins:

- ***Titcoin*:** Designed to be used for adult entertainment with a market cap (at the time of this writing) of $1,412,927
- ***Potcoin*:** For the marijuana industry. Market cap of $50,145,767.
  and,
- ***Useless Ethereum Token*:** According to this coin’s website Useless Ethereum Token, “offers investors no value,” and the site recommends, “seriously, don’t buy these tokens.” And yet, *some people are still buying them!* Useless Ethereum Token currently has a market cap of $191,565.

Most people think about Bitcoin and cryptocurrencies as something similar to actual coins, gold, or stocks because of the influence of “crypto-terminology.”

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[8] This includes things like old jewellery and excess materials, or *sisal*, from coin production.

But those are merely analogies to describe what Bitcoin and cryptocurrencies *might* be similar to. Bitcoin and cryptocurrencies are literally none of those things.

Is it Money?

In theory, anything can be money and throughout history many things have been.

Milton Friedman once described it like this:

“There’s hardly anything that hasn’t been used for money. Rock salt in Ethiopia. Brass rings in West Africa. Cowrie shells in Uganda. Even a toy cannon. Anything can be used as money! Alligator money in Malaysia[9]. Absurd isn’t it!”[10]

But most commonly, money has been either gold and silver, or fiat issued by governments.

So of course, Bitcoin could be money too and in some ways it is better suited to be money than anything that has come before it.

For something to be money, it must satisfy at least 4 criteria.[11] Money must be:

1) A unit of account
2) Easily divisible
3) A store of value
   and,
4) Widely accepted

Other characteristics of sound money include being valued for alternative uses and difficult to replicate, or substitute.

Bitcoin is certainly a unit of account and it is infinitely divisible. By design Bitcoin is increasingly difficult to produce and the total number of Bitcoins that can ever exist is capped at 21,000,000.

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[9] Malaysian Alligator money, depicted above was used from the 15th through the 18th centuries. Photo Retrieved from https://en.wikipedia.org/wiki/Tin_Animal_Money

[10](2011, June 6). Milton Friedman: Defines Money. Retrieved from https://www.youtube.com/watch?v=OLLokkCr3qc

[11] To avoid going too deep into the weeds, I have omitted other common descriptors like fungibility and a medium of exchange.

Plus, Bitcoin is encrypted and has the advantage of not being subject to the whims of governments, or central bankers.

I understand why those features make Bitcoin seem like an excellent choice to be money. However, Bitcoin fails to meet the other criteria.

Bitcoin does not appear to have many alternate uses but it does have numerous substitutes.

Bitcoin is not a store of value because it is too volatile. True, it has been mostly volatile to the upside but a store of value is something that *maintains* purchasing power over time.

When something is typically increasing in value over time, people won't want to use it as money because they should prefer to hold on to it. Who wants to be like the poor guy who bought two pizzas for 10,000 Bitcoin back in 2010?[12]

And despite what some Bitcoin enthusiasts will say, Bitcoin is not widely accepted as money (at least not yet). You can't use Bitcoin to pay your taxes, mortgage, tuition, energy bill, or fill your gas tank. You cannot take out a loan in Bitcoin or spend it at the grocery store.

You may use a service like BitPay to buy something "with Bitcoin" but when you do, you are actually selling your Bitcoin first and then using the dollars from that sale to make a purchase. In which case, the vendor is not actually accepting the Bitcoin and the process is slower and more costly, contrary to the original intent of Bitcoin.

In truth, the majority of the cases where Bitcoin is directly accepted as payment have likely occurred on the black market. But most people are not spending their Bitcoins at all, they are holding them so they can cash out when the price goes up.

(If you are not interested in free market economics, feel free to skip this section)

As I mentioned before, many people like Bitcoin because it comes from the private sector and is not subject to the whims of central bankers, and politicians. Believe me, I fully appreciate why that would be the case.

However, I think the "free market" case for Bitcoin needs to be considered in context with the incentive structure that fostered Bitcoin.

[12] Mack, Eric. (2013, Dec 23). The Bitcoin Pizza Purchase That's Worth $7 Million Today. Retrieved from https://www.forbes.com/sites/ericmack/2013/12/23/the-bitcoin-pizza-purchase-thats-worth-7-million-today/#75e809ba2509

Bitcoin was designed as an alternative to government issued fiat. The idea for it came from the fact that *there is no free market for money*. Money designed for that purpose and under those circumstances is probably different from sound money in a free market.

For example, consider what we observe in prisons where cigarettes are commonly used as a type of currency. These cigarettes are not created, issued, or regulated (as money) by governments, and so in a sense we might say cigarettes in prison are a type of “free market” money supply.[13]

But if we tear down the walls of the prison and set the prisoners free, would they continue using cigarettes as money? Probably not. In fact, tobacco leaves were used as money at times in colonial America but people preferred gold.

Central bankers have placed their citizens in a type of monetary prison and Bitcoin is a reaction to this situation. That is why Bitcoin has the most value in places like Venezuela and Zimbabwe. But would it still be valuable or viable under actual free market incentives?

Keep in mind, the free market is not a profit based system, it is a profit *and loss* system, and Bitcoin could still be a loser.

While Bitcoin offers some *quantitative* advantages, it lacks the *qualitative* characteristics of sound money. It is fiat, too volatile, has too many substitutes, and as of yet it is not widely accepted.

So for now we must conclude that Bitcoin could be money, like anything else, but it is not money at the moment. And, expecting it to become the money of the future may just be wishful thinking.

Note: many Bitcoin advocates even agree that Bitcoin is not money. Now they argue Bitcoin is something like “digital gold” and *Bitcoin Cash* or some other cryptocurrency will be used as money instead.[14]

Why I think it is a bubble

Bitcoin has all the signs of a bubble and again, even many Bitcoin proponents would agree.

[13] For the record, I do not think “free market” is the correct way to characterize either Bitcoin or cigarettes used as money in prison, they are more like a black market or grey market phenomenon.
[14] Schmid, Valentin. (2017, October 31). Bitcoin As Digital Gold. Retrieved from https://www.theepochtimes.com/bitcoin-as-digital-gold-2_2341417.html

Billionaire investor Mike Novogratz is described as, “the king of Bitcoin” and is currently planning to launch a $500 million Bitcoin fund. In an interview with Bloomberg, Novogratz described Bitcoin as, “the largest bubble of our lifetimes.”[15]

According to *Austrian Business Cycle Theory*, bubbles may arise when central bankers mistakenly set interest rates too low, sending the wrong signals to investors and businesses.

Such artificially low interest rates incentivize more borrowing and spending than can be sustained by actual resource availability and the structure of production.

That condition is almost guaranteed to have been satisfied by the ultra low interest rates set by the Federal Reserve under Ben Bernanke and Janet Yellen, and even going back to Alan Greenspan.

So, we should expect to potentially see many bubbles at this time and Bitcoin could be one of them for reasons I will now explore.

The appeal to novelty

Bitcoin and cryptocurrencies have an appeal to novelty. What will happen if the neophytes and technocrats become enamored with the next new thing and the novelty wears off?

Unsustainable growth

Look at the following list from zerohedge.com detailing how long Bitcoin took to reach each $1000 milestone:[16]

- $0000 - $1000: 1789 days
- $1000- $2000: 1271 days
- $2000- $3000: 23 days
- $3000- $4000: 62 days
- $4000- $5000: 61 days
- $5000- $6000: 8 days
- $6000- $7000: 13 days
- $7000- $8000: 14 days

[15] Schatzker, Erik. (2017, September 26). A Crypto Fund King Says Bitcoin Will Be The Biggest Bubble Ever. Retrieved from https://www.bloomberg.com/news/articles/2017-09-26/mike-novogratz-is-set-for-comeback-with-crytocurrency-hedge-fund
[16] (2017, December 22). Bitcoin Plummets Below $14,000; Peter Schiff Says ‘Mark It Zero.’ Retrieved from http://www.zerohedge.com/news/2017-12-21/crypto-carnage-continues-bitcoin-down-5000-record-highs-schiff-says-mark-it-zero

- $8000- $9000: 9 days
- $9000-$10000: 2 days
- $10000-$11000: 1 day
- $11000-$12000: 6 days
- $12000-$13000: 17 hours
- $13000-$14000: 4 hours
- $14000-$15000: 10 hours
- $15000-$16000: 5 hours
- $16000-$17000: 2 hours
- $17000-$18000: 10 minutes
- $18000-$19000: 3 minutes

Nothing grows forever and can anything, from here to Heaven or Hell, grow any faster than this?

Herding behavior

Herding behavior in finance occurs when investors mimic the actions of others.

This would have described my behavior if I had bought Bitcoin in 2011 because a smart classmate had done so first. And I think this aptly describes what we see with Bitcoin right now.

Frankly, too many "normal people" are involved.[17]

Too many people are buying without truly understanding what they are buying because they know someone else who did it or they read about Bitcoin on the front page of some news site or paper.

The herd is not doing diligence. They are merely conforming to social pressure.

But fortunes are not usually made by the herd or from investing in front page news. Fortunes are made by individuals who identify opportunities that will become front page news in the future.

Cognitive dissonance & confirmation bias

In behavioral science, cognitive dissonance can occur when someone encounters evidence that conflicts with prior beliefs. Rather than question or change the prior belief, someone experiencing cognitive dissonance will distort reality or hallucinate a new reality to conform to the prior belief.

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[17] I offer my apologies to anyone who takes offense at this but I don't know how to say this without sounding at least vaguely offensive.

Confirmation bias is a similar concept. This is when a person emphasizes new information that supports a prior belief but ignores contrary information. Sometimes confirmation bias can cause someone to interpret any new information as supportive of ones preconceived notions.

Cognitive dissonance and confirmation bias often go hand in hand, and are usually present in the psychology of a bubble.

Consider the following 2 observations:

Observation 1:

Early proponents of Bitcoin said it was money and it was cheaper and faster to use. The evidence so far has been to the contrary but rather than question the value of Bitcoin, proponents have simply changed the argument to conform to their prior belief. Now Bitcoin is not money, it is something like “digital gold” and therefore is still valuable.

Observation 2:

Early proponents of Bitcoin also said one of the benefits was a lack of a derivatives market where it can be manipulated. But when Bitcoin futures were introduced last year, the same people embraced it as a positive new development.

Cognitive dissonance may have been triggered in either of these examples and confirmation bias may be present in the second one.

Confirmation bias may also be present if people are emphasizing Bitcoin’s up moves more than the down moves.

Speculation and day trading

In general, investors buy an asset because they think it will go up in the future. However, investors may also buy an asset for other reasons such as safety, diversification, value or income.

These other reasons are not often mentioned by the Bitcoin crowd, which includes many speculators and short term traders who rely mostly on technical analysis, as compared to value investors who rely on fundamentals.

Value investors tend to buy assets when the price goes down because they want to buy low and sell high. With Bitcoin, people seem to think it will go up in the future *because* it has already gone up in the past. They want to buy high and sell higher.

This indicates that many who own Bitcoin don't really know or care what it is worth, and they would quickly cut and run when things go south.

Speculating and day trading does not make you a bad person, but those mentalities are closer to gambling than they are to investing. As the old adage says, it relies on selling to the "next greater fool." Eventually you run out of greater fools.

Irrational exuberance

Emotions can run high in the Bitcoin community. Expressing skepticism towards Bitcoin is often met with name calling and abuse from Bitcoin supporters.

The high presence of emotions may explain the momentum behind Bitcoin's big move. It would also explain the irrational behavior observed by those who bought "Useless Etherium Token" for example.

Several companies have found a way to exploit this irrationality and boost their stock prices by either turning their focus towards cryptocurrencies, or simply changing their name to include some kind of crypto buzzword.

For example, consider the struggling tea and lemonade company, formerly known as "Long Island Iced Tea," whose stock increased 500% after the company changed their name to "Long Blockchain."[18]

Remember this: emotions and momentum can move an asset price in *either* direction. People who buy on excitement and optimism when prices are rising, may quickly sell out of fear if prices begin to fall.

Suddenly, everyone's an expert

Many proponents of Bitcoin are highly intelligent and credible people. Many of them were way ahead of the curve and most likely do know what they are talking about. The comments in this section are not directed towards those people.

On the other hand, I can't help but notice the emergence of people who are suddenly experts on investing in cryptocurrencies. When I search for "bitcoin" on LinkedIn, it produces over 48,000 profiles of people with titles such as:

- "Digital Currency Specialist"

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[18] (2017, December 21). Long Island Iced Tea Soars 500% After Changing It's Name To Long Blockchain. Retrieved from http://www.zerohedge.com/news/2017-12-21/long-island-iced-tea-soars-500-after-changing-its-name-long-blockchain

- "Bitcoin Economist"
- "Bitcoin Ambassador"
- "Bitcoin and Blockchain Consultant"
  and even,
- "Bitcoin Evangelist"

I honestly wonder how many of these people even knew what Bitcoin was before last year and I could not be more skeptical about their expertise.

This sudden emergence of dubious expertise is indicative of what happens during a bubble as participants are fooled into believing their skills exceed their actual abilities.

Let's compare the cases of two real investors: investor **α** and investor **β**.

Fortune Magazine interviewed investor **α** in 1999 during the height of the Dot.com Bubble[19]. The article credits investor **α** for her impressive performance citing she made over "$130,000 on eBay stock in just one month," she was up 89% on her investment in AOL, and she helped a friend turn $1,000,000 into $1,800,000, "after five months of intense trading."

Investor **α** engaged in time consuming investment rituals. "She Studies business publications like Barron's and watches CNBC religiously. She has installed a real-time stock-quote service at home. And, she wakes up at 6:30 every morning to catch the opening of the East Coast stock markets."

Investor **α** told *Fortune* her investment ideas came from life, stating, "we go to Starbucks everyday, so I buy Starbucks stock." And, she refused to hold onto underperforming assets, "I can't stand to see red in my profit-or-loss column. I'm Taurus the bull, so I react to red. If I see red, I sell my stocks quickly."

Now let's consider investor **β** who was featured in a 2017 article from *SBS News* in Australia[20]. Investor **β** is a Bitcoin advocate and she operates a website where people can learn about and invest in Bitcoin.

At the time the article was published, Bitcoin was trading around $8,000 and investor **β** had already tripled her money. So if investor **β** has held on to her Bitcoin since the article was published, then she had around a 600-700% return on her investment at the high point in 2017.

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[19] Lee, Jeanne. (1999, June 21). Barbra Streisand's Latest Role: Stock Picker "IF I SEE RED, I SELL QUICKLY." Retrieved from
http://archive.fortune.com/magazines/fortune/fortune_archive/1999/06/21/261690/index.htm

[20] Upton, Lisa. (2017, November 21). Risky business?: How a pole dancing instructor found success with Bitcoin. Retrieved from
https://www.sbs.com.au/news/risky-business-how-a-pole-dancing-instructor-found-success-with-bitcoin

Investor β is quoted in the article saying:

“It comes with any investing, it’s volatile at times, especially cryptocurrencies… **The good thing is when it goes down, you can buy some more, and you know it’s going to go up at some point**. As long as you’re calm and you don’t let emotions run you when you’re dealing with any sort of cryptocurrency, particularly Bitcoin, then you’re safe.”

If you visit investor β’s website, startingoutwithbitcoin.com, and go to the page titled *Grow Your Bitcoin,* you will be greeted with the following message.[21]

“Congratulations!! You now have your first piece of Bitcoin! Now that you are no longer a Bitcoin virgin. **Check out my secret strategy to grow your Bitcoin by 40%!!!**”

And clicking the link labeled, “Yes! Show me HOW!” will bring up a page asking for your email.

Neither investor α or β are professional investors, and both are (or were) relatively new to the world of selecting investments. I think most value investors would have scoffed at investor α for buying Starbucks stock simply because she drinks Starbucks coffee or for selling a stock just because it went down a little bit. And, we might question investor β’s assumption that if Bitcoin goes down, it will always go back up.

But to the contrary, α and β both seemingly have (or had) the results to back up what they say. Stodgy old value investors be damned, everything is different this time!

Not. So. Fast.

By now you are probably wondering who these mystery investors are.

Investor α was Barbra Streisand and investor β is a professional pole dancing instructor named Dee Heath.

Barbra Streisand’s investment prowess diminished dramatically after the Dot.com Bubble went bust. Time will tell the rest of the story for Dee Heath and the new wave of crypto experts.

The prevalence of predictions

Speaking of the experts, you may have seen someone somewhere make the case for Bitcoin to reach some specific level as in the headlines below:

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[21] Retrieved from http://www.startingoutwithbitcoin.com/bitcoin-landing-page/

"Trader who called bitcoin rally says cryptocurrency will surge above $100,000 in 2018"[22]

- *CNBC*

"Bitcoin Will Reach $400,000, Says Investor Mark Yusko"[23]

- *Thestreet.com*

"James Altucher predicts bitcoin will reach $1 million by 2020"[24]

- *CNBC*

In economics, value is subjective.[25] So, in theory the price of a Bitcoin could go as high as any of those predictions. But in practice, humans are terrible at predictions, especially with such specificity.

Bitcoin could go to $100,000 or higher in 2018. By the same token, we cannot rule out a drop of 90% or more with potentially no recovery either.

No one actually knows what will happen. No one is psychic. But confident predictions of massive returns do make exciting headlines.

I think this prevalence of predictions is a sign of overconfidence bias and underestimation of downside risk.

One way to win, many ways to lose

I want to reiterate, I am neither "for" nor "against" Bitcoin. I actually think blockchain technology is wonderful and it could indeed change our lives in profound ways if companies can find clever ways to use it.[26]

[22] Murphy, Dan. (2017, December 11). Trader who called bitcoin rally says cryptocurrency will surge above $100,000 in 2018. Retrieved from https://www.cnbc.com/2017/12/11/bitcoin-could-exceed-100000-dollars-by-2018-says-trader.html
[23] Akhtar, Tanzeel. (2017, November 12). Bitcoin Will Reach $400,000, Says Investor Mark Yusko. Retrieved from https://www.thestreet.com/story/14387100/1/bitcoin-will-reach-400-000-says-investor-mark-yusko.html
[24] Cheng, Evelyn. (2017, November 29). James Altucher predicts bitcoin will reach $1 million by 2020. Retrieved from https://www.cnbc.com/2017/11/29/james-altucher-predicts-bitcoin-will-reach-1-million-by-2020.html
[25] Based on the marginalist or subjective theory of value advanced by Austrian economists such as Carl Menger, Eugen von Böhm-Bawerk, Murray Rothbard and others.
[26] This change could involve some of the cryptocurrencies currently in existence but that is not for certain.

Blockchain could be used to transfer ownership of real assets. For example, publicly traded companies could register shares through blockchain instead of exchanges. Or, a gold company could sell shares of pooled gold through blockchain instead of a dealer.

But for now these unbacked cryptocurrencies are transferring ownership of nothing. And, the notion of unbacked digital currencies becoming the money of the future makes about as much sense to me as the prospect of a robot digital girlfriend becoming my future wife.

Blockchain may be “internet 2.0” but fiat cryptocurrency looks more like another Dot.com Bubble. Participants in the Dot.com Bubble were correct about how transformational the internet would be but mistaken about how to profit from it.

If you are a trader or a speculator, Bitcoin might be a place where you can make some money. But from an investor perspective, especially those like me who want to buy low and hold for a long time, Bitcoin does not fit the framework.

Bitcoin offers investors like me just one way to win and that way involves an improbable and radical transformation of the global monetary system. But there are many more ways to lose.

One way to win, many ways to lose, is not the game I like to play.

If Bitcoin becomes the money of the future, any other asset I own will be valued in Bitcoin and I will be no worse off. I may miss out on a huge opportunity by sitting on the sidelines but I don’t lose.

In any case, FOMO[27] is not an investment thesis and the days when a $1000 investment in Bitcoin can make you a millionaire are likely gone anyway.

The only advice I have is this: if you do choose to speculate on cryptos, don’t put more in than you can afford to lose. Our future may be filled with people who became Bitcoin billionaires or people who went *Bitcoin broke*.

Either way, this looks like one for the ages.

Other **Market & Economic Observations**

Outside of cryptocurrency, it is hard to believe anything else happened in 2017 but last year was actually full of significant, or at least interesting, developments.

This letter is already quite lengthy so I will present these comments in a bullet point format.

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[27] Fear Of Missing Out

- Jeff Bezos surpassed Bill Gates as the new richest man in the world, with a net worth of $99.6 billion at the time of this writing.

- The United States surpassed $20 trillion in national debt… and nobody seemed to care.

- Richard Thaller received the Alfred Nobel Memorial Prize in economics for his work in the field of behavioral economics.

- The stock market continued to ride the “Trump Bump.” The Dow made over 70 new record highs and we are now close to having the longest bull market in history.

- The Trump administration failed to repeal Obama Care but was able to cut some regulation and pass a tax bill. The optics look good but how it all plays out is still to be determined. All else equal, lower taxes and less regulation should be positive. NOW GO CUT SOME SPENDING!!!!

- Jerome Powell has been selected to replace Janet Yellen as the Federal Reserve chair.

- The Federal Reserve raised interest rates 3 times and plans to raise rates 3 more times in 2018. And, they actually began to wind down their balance sheet!

- Yield curves continued getting flatter and even inverted before the end of the year.

- Unemployment reached new post-recession lows but labor force participation remains near 40 year lows as well.

- The VIX (volatility index) was low and consumer confidence was high for most of the year.

- Gold closed the year above $1300 per ounce and oil closed the year above $60 per barrel. Both were the highest year-end closes since 2012.

- Hurricanes Irma and Harvey broke a lot of windows and fallaciously boosted GDP.[28]

- The formal onset of the “Great Recession” reached its 10th anniversary.

- Annual CPI exceeded the Fed’s “target” rate of 2% for the year. According to economist John Williams, CPI calculated based on alternate methodologies from 1990 and 1980, exceeded 5% and 9% respectively.[29]

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[28] In case you missed it, this comment is alluding to Frederic Bastiat and his *Broken Window Fallacy.*
[29] Williams, John. (2017, December 13) COMMENTARY NUMBER 925 November CPI and PPI Inflation, FOMC. Retrieved from http://www.shadowstats.com/article/c925?display=pdf

- The "Buffet Indicator," a ratio of US equities market cap to GDP exceeded 133%, the highest since the Dot.com Bubble.[30] Anything over 80% is said to mean the market is overvalued. Meanwhile the Shiller PE ratio reached 32.46, exceeding 1929 "Black Tuesday" levels, and also the highest since the Dot.com Bubble.[31]

Reading this market is more difficult today than it was 6 months ago. Tax cuts and deregulation are reasons for hope, and a new Fed Chair could be a game changer.

But I think investors should be cautious of a bull trap. Things always look the best from the top. Volatility is low, consumers are confident, interest rates are low, and markets are high.

Flat and inverted yield curves indicate irrational investor preferences, and typically appear before market corrections. This market is priced for perfection and if the Fed continues to raise rates and shrink its balance sheet (as it should in my opinion), it could take some of the air out of the market.

Overvalued/Undervalued

NOTE: these are not "buy/sell" recommendations or forecasts. Overvalued assets can always become more overvalued. Undervalued assets can always become more undervalued.

Overvalued: US Stocks, Bonds, Real Estate, & USD

Undervalued: Gold, Oil, Commodities, Chilean Stocks, & Russian Stocks

(B)E-Trade

For years now the online discount stock brokerage, E-Trade, has used flashy gimmicks in their marketing campaigns including those stupid talking babies as well as those stupid talking celebrities.[32] But last year they totally outdid themselves.

E-Trade's latest campaign juxtaposes normal people with lavish lifestyles that would make Caligula blush. The most offensive of these commercials depicts "the dumbest guy in high school" partying like a rock star on his yacht, which apparently came fully loaded with swimsuit models.

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[30] Mislinski, Jill. (2018, January 3). Market Cap to GDP: An Updated Look at the Buffett Valuation Indicator. Retrieved from https://www.advisorperspectives.com/dshort/updates/2017/12/06/market-cap-to-gdp-an-updated-look-at-the-buffett-valuation-indicator

[31] Retrieved from http://www.multpl.com/shiller-pe/

[32] Most prominently featuring Kevin Spacey.

Fred Schwed must be rolling in his grave![33]

Each commercial ends with the phrase, “don’t get mad, get E-Trade,” implying you too can be an idiot with a boat if you use their platform. But even an idiot can see these commercials are a not so subtle appeal to greed and envy while simultaneously encouraging utterly reckless behavior.

As you probably know, investing jargon includes a small menagerie of *bulls*, *bears*, and *pigs*. And, you may have heard the old adage which goes something like this:

Bulls make money when the market goes up.
Bears make money when the market goes down.
But, greedy *pigs* just get slaughtered.

Newsflash: greed is a terrible quality for an investor to have! E-Trade might as well make an appeal to the “profitability” of impatience and mood swings next.

Investing is serious and difficult. This industry attracts the best and brightest; the most cunning and clever; and only *some* of those people get to buy yachts with their capital gains.

Telling people, “the dumbest guy in high school” can do that too is like saying, “the weakest guy in high school” could get in the ring and knock out Floyd “Money” Mayweather. It is misleading and asinine.

But I suppose as long as E-Trade gets to collect a few more $6.95 transaction fees, then they don’t care how many people might get their clocks cleaned.

E-Trade’s irresponsible message conveys a mindset of viewing the stock market as some kind of get rich quick scheme or casino. But if you treat the market like a casino, then the market will treat you how casinos treat gamblers: take all your money and break your thumbs.

Recommended Reading

As you may know, I am an avid reader. For those who are interested, the 3 best books I read in 2017 were:

The Life Changing Magic of Tidying Up - Marie Kondo

The New Evolution Diet - Art DeVany

[33] Fred Schwed wrote the classic investment book, *Where Are the Customers' Yachts?: or A Good Hard Look at Wall Street.*

Fooled By Randomness - Nassim Taleb

Only one of these books is investment related but I chose to mention them in my letter because each one has in someway improved the way I think. Anyone looking for a good read should check these out.

Nothing More to Add

Thanks for taking the time to read my letter, hopefully, you have enjoyed it and can take something of value from it.

2017 was weird, wild, and kind of wonderful. I am forever thankful to those of you who became my first clients last year and I am honored to continue to working for you in 2018.

To your wealth,

- Henri Pellerin, AAMS®
Portfolio Manager

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