Curmudgeon on Cryptocurrency

'Just because a technology is useful, has a lot of applications, and is widely accepted doesn't automatically mean that you can use it to create a genuine currency'

VK Vitaliy Katsenelson Follow
Jun 24, 2021

Summary

- The third installment of a five-part letter.

This is part 3 of the summer letter I wrote to IMA clients; it was also published in Barron's.

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In mid-April I picked my 15-year-old daughter Hannah and her friend Sarah up from school and took them to Barnes & Noble (BKS, Financial). Sarah found out that I "do stocks" for a living and immediately asked me about crypto. She wondered what cryptocurrency she should buy and if she should open a Robinhood account.

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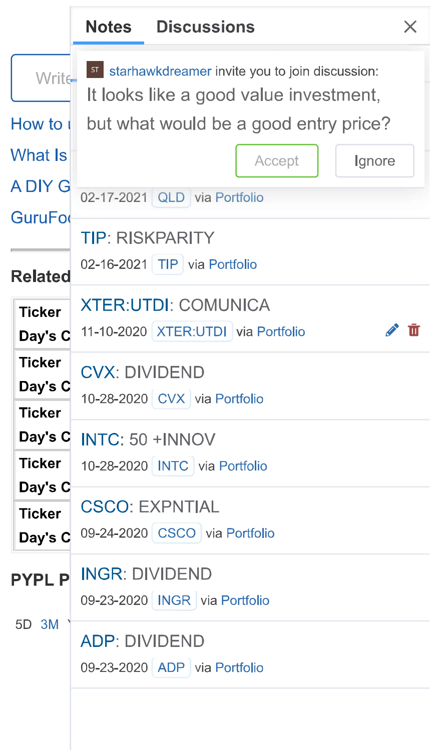
I'll tell you about the advice I gave her in a bit. But a few days later I got three calls in one day from my wife's side of the family – from my sister-in-law (a pharmacist) and my wife's cousins (both are barbers). They were all asking me about crypto. I told them, you don't ask my advice on which number to put your chips on when you play roulette in Vegas; cryptocurrencies fall into the same category.



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No matter what asset class you are discussing, it feels a bit "toppy" when people far removed from investing start asking you for advice about it, all at once.

I feel like an old curmudgeon writing this. I know "I don't get it." Crypto lovers look at me as if I am defending silent movies and treating "talkies" as unwelcome, short-term imposters. Curmudgeon I am.

When we discuss crypto, we need to separate blockchain technology from the so-called currencies. Though I have yet to see a mainstream application of blockchain, I get a feeling they are coming. However, just because a technology is useful, has a lot of applications, and is widely accepted doesn't automatically mean that you can use it to create a genuine currency.

Here is an example. Venmo, which is owned by PayPal (PYPL, Financial), is a very useful technology that many Americans use weekly or even daily. The benefits of widespread usage of Venmo, however, accrue to PayPal's shareholders and don't lead to appreciation of the U.S. dollar or whatever other currency it transacts in.

When we talk about cryptocurrencies we have to make clear which one. Many consider Bitcoin their god and savior. However, there are thousands of these "currencies" out there, with dozens created every week.

Until recently Bitcoin looked like a clear winner; even Elon Musk was touting it, and Tesla (TSLA, Financial) bought $1.5 billion worth of it. Then Musk also shared with us his love of Dogecoin – a joke of a currency (literally, it was created to mock cryptocurrencies), and Dogecoin exploded in price. A few weeks later Musk realized that Bitcoin is "Beanie babies powered by coal." Because of Bitcoin's decentralized nature, solving useless math problems to mine more bitcoins consumes more electricity than Argentina. Musk announced that until Bitcoin starts consuming less energy, Tesla will not be accepting it as a payment for cars. If you are an ESG-oriented pension and don't want to own Exxon (XOM, Financial) ("evil Big Oil"), I want to see how you justify owning Bitcoin.

Arguably, Bitcoin is worse for the environment than internal combustion engine cars if you adjust for CO_2 production in relation to societal utility (at least cars get you places). For the energy cost of processing one bitcoin, Visa (V, Financial) can process 810,000 transactions, about 370 times faster.

I've spilled a lot of ink explaining that one of the biggest assets the U.S. government has in its arsenal is the U.S. dollar being the world's reserve currency. Control over our own currency gives politicians the ability to make promises and not keep them, by constantly running budget deficits and printing and borrowing money to pay for these promises. We are able to run trillion-dollar deficits because the U.S. government has a dollar-printing press. The U.S. government will not give it up without a fight. We've started wars over less.

Cryptocurrencies are a clear and present danger to the U.S. dollar. There is a very high probability that the U.S. government will outlaw the use of cryptos as currencies. Sounds far-fetched? The U.S. government did this in 1933 with gold. That was less than 100 years ago. India is threatening to ban Bitcoin. South Korea already did.

I am sympathetic to some cryptocurrency investors, especially after seeing what we are doing with our fiat currency. However, for most people they are just speculative vehicles. My wife's relatives pay little attention to the U.S. government's or Fed's balance sheets. They are interested in bitcoin for one reason only – it is going up. Cryptos present these "unique" opportunities for people to pour their life savings into bits and bytes on servers far far away with a hope that they'll magically turn their lives into paradise on the beach.

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When you go to the casino, you are not cashing out your life savings and borrowing from your mother-in-law, unless you are a degenerate gambler. You don't do that because the casino doesn't try to masquerade as a place where you invest. If you have an ounce of common sense, you know you are in a casino, a place where people gamble, the air is pumped in, you hear the unending ring of slot machines, and you can't readily find an exit. A reasonable person will only take as much money to Vegas as he can afford to lose.

Cryptocurrencies are a different beast. You buy them on platforms that resemble your brokage account, where (hopefully) you invest. Also, you're not gambling with casino chips, you are buying "currencies." Suddenly, crypto is competing not with your Vegas purse but with your 401(k). This domain confusion is dangerous. My advice on crypto has been consistent: Gamble with as much money as you can afford to lose. But remember, even when you are winning – actually, especially when you are winning – you are not investing, you are gambling, and thus approach it as a trip to Las Vegas, not a visit to your 401(k).

Now to the advice I gave to Sarah (my daughter's 15-year-old friend). I told her, first of all, don't open an account on Robinhood. This platform has merged the worst that social media and the casino have to offer into one interface. You are too young to gamble. If you'd like to invest, then you have to accept that it's not a get-rich-fast but rather a get-rich-slow activity. Once Sarah heard "get rich slow," I think she lost interest in whatever advice I had to offer. Luckily we arrived at Barnes & Noble, so she did not have to go on listening to this curmudgeon.

I'll leave this discussion with a quote by one of my favorite thinkers, Nassim Taleb: "[Investing/speculating in cryptocurrencies is] the idea that a collection of people would get rich at the expense of society for the sole privilege that the world is adopting their currency and not another."

Vitaliy Katsenelson

I am the CEO at IMA, which is anything but your average investment firm. (Why? Get our company brochure here, or simply visit our website).

In a brief moment of senility, Forbes magazine called me "the new Benjamin Graham."

I've written two books on investing, which were published by John Wiley & Sons and have been translated into eight languages. (I'm working on a third - you can read a chapter from it, titled "The 6 Commandments of Value Investing" here).

And if you prefer listening, audio versions of my articles are published weekly at investor.fm.

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Disclosures

I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours.

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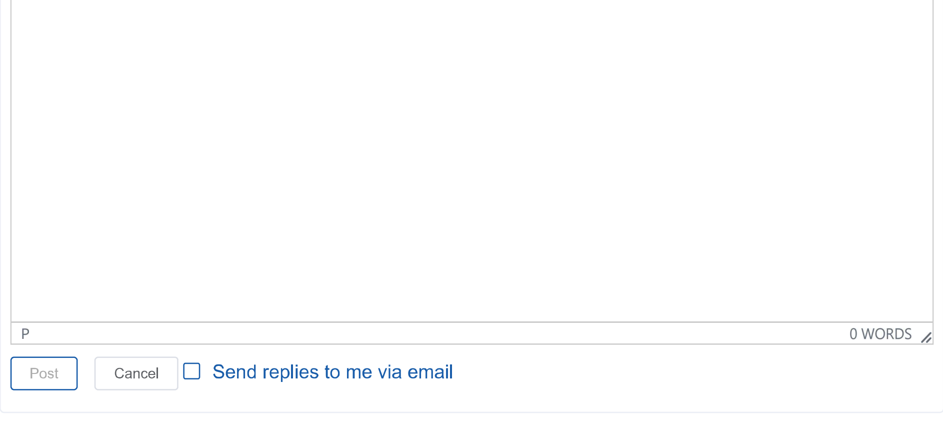
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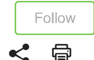
Jun 17, 2021



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Summary

- The second installment of a five-part letter.

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This is the second part of my summer letter to IMA clients. You can read the first part here.

Thoughtfully and humbly.

We need to recognize that inflation in the long-term is a probability but not a certainty. Macroeconomics is a voodoo science; it appropriately belongs in the liberal arts department. The economy is an incredibly complex and unpredictable system.

Here is an example: Japan is the most indebted developed nation in the world (its debt-to-GDP exceeds 260%, while ours is 130% or so). Its population is shrinking, and thus its level of indebtedness per capita is going up at a much faster rate than the absolute level of debt. Anyone, including yours truly, would have thought that this forest full of dry wood was one lightning strike away from a disastrous conflagration. And yet Japanese interest rates are lower than ours and the country has been mired in a deflationary environment for decades.

Admittedly, Japan has a lot of unique economic and cultural issues: Companies are primarily run for the benefit of employees, not shareholders (unproductive employees are never let go); there are a lot of zombie companies that should have been allowed to fail decades ago; and the Japanese asset bubble burst in 1991, when debt-to-GDP was only 60%. The point still stands: Long-term forecasting of inflation and deflation is an incredibly difficult and humbling exercise.

As investors we have to think not in binary terms but in probabilities. The acceleration of our debt issuance and our government's seeming indifference to it and to ballooning budget deficits raise the probability and the likely severity of inflation. At the same time, we have to accept the possibility that the economic gods are playing cruel games with us gullible humans and have deflation in store for us instead.

Inflation and higher interest rates are joined at the hip. The expectation of higher inflation will raise interest rates, as bond investors will demand a higher return. This in turn will result in larger budget deficits and more money printing and thus more borrowing and even higher interest rates.

Here is how we are positioning our portfolio for the risk – the possibility, not the certainty – of long-term inflation:

Valuation matters more than ever. Higher interest rates are an inconvenience to short-duration assets whose cash flows are near the present and devastating to long-duration assets. Here is a very simple example: When interest rates rise 1%, a bond with a maturity of three years will decline about 2.5%, while one with a maturity of 30 years will decline 25% or so.

The same applies to companies whose cash flows lie far in the future and who are thus very sensitive to increases in the discount rate (interest rates and inflation). Until recently they have disproportionally benefited from low interest rates. They are the ones that you will most likely find trading in the bubble territory today. But their high valuations (high price-to-earnings ratio) will revert downward. Value stocks will be back in vogue again. We have started seeing the rotation from growth to value recently.

Inflation will benefit some companies, be indifferent to others, and hurt the rest. To understand what separates winners from losers, we need to understand the physics of how inflation flows through a company's income statement and balance sheet.

Let's start with revenue. Higher prices across the economy are a main feature of inflation. We want to own companies that have pricing power. **Pricing power** is the

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ability to raise prices without suffering a decline in revenue that comes from customers' inability to afford higher prices or from the loss of customers to competitors.

Companies that have strong brands, monopolies, or products that represent a very small portion of customer budgets usually have pricing power.

If Apple (AAPL, Financial) raises prices on the iPhone, you'll curse Steve Jobs and pay the higher price. (A friend of mine curses him every time the iPhone frustrates him. I keep reminding him that Steve is no longer with us. Doesn't help.) Of course, if Apple raises iPhone prices too much and its products become unaffordable, consumers may just start buying iThings less often.

Tobacco companies have pricing power. I lived through a hyperinflation in Russia in the late 1980s and early 1990s, I was a smoker then. One day cigarette prices doubled. I experienced a price shock. I cursed at tobacco companies; cigarettes did not get any cheaper. A day later I was paying double again for my cigarettes. Smokers are very loyal to their brands, and cigarettes are an addictive product. We own plenty of these stocks, too. The same applies to beer and especially hard liquor. (If you think tobacco stocks are socially irresponsible investing choices, you are … just read my thoughts on this topic here).

What the pandemic showed us is that humans are adaptable creatures – you throw adversity at us, we'll indulge in angry outbursts but we'll adapt. The rate of change of inflation matters even more than absolute rate of inflation. If inflation remains predictable, even at a higher level, then businesses will plan for and price it into their products. If the rate of growth is highly variable, then there is going to be a war of pricing powers for shrinking purchasing ability of the end customer. We want to own companies that are on the winning side of that war.

Let's go to the expenses side of the income statement. Companies whose expenses are impacted the least by rising prices do well, too. Generally, companies with larger fixed costs do better.

But.

It is important to differentiate whether the capital intensity of a business lies in the past or in the future. A business whose high capital intensity is in the past benefits from inflation. Think of a pipeline company, for instance (we own plenty of those). Most of its costs are fixed, and they have been incurred in yesterday's pre-inflation dollars. The cost of maintaining pipelines will go up, but in relation to the total cost of constructing pipelines these costs are small. However, companies that operate pipelines have debt-heavy balance sheets, which can become a source of higher costs. Pipeline companies we own have debt maturities that go out many decades into the future. They'll be paying off these debts with inflated cash flows.

I've seen studies that looked at asset prices over the last few decades and declared "These assets have done the best in past inflations." Most of these studies missed a small but incredibly important detail: The price you pay for the asset matters. If we are entering into an inflationary environment today, it is happening when asset prices are at the highest valuation in over a century. (This was not always the case during the period covered by these studies.)

For instance, one study showed that REITs have done well during past inflations. This may not be the case going forward. Aside from its being a very broad and general statement (not all REITs are created equal), low interest rates brought a lot of capital into this space and inflated valuations. Investors were attracted to current income, which was

better than from bonds, and they paid little attention to the valuations of the underlying assets. Buying REIT ETFs may do more harm than good.

I cannot stress this point enough: Whatever landscape is ahead of us, we are entering into it with very high valuations and an economy addicted to low interest rates.

We have to be very careful about relying on generalized comments about past inflations. We need to be nuanced in our thinking.

We get asked about gold and cash

Gold: We don't have a great love for gold. We have a position through options as a hedge. We discussed it in the past in great depth, so I won't bore you with it here.

Cash: I am basically referring to short-term bonds, which seem like the most comfortable asset to be in today. However, their ability to keep up with inflation has been spotty in the past. It is okay in the short term but likely to be value-destructive in the long term. Our view on cash has not changed: In a portfolio context cash should be a residual on other investment decisions. In our portfolios cash is what is left when we run out of investment ideas.

Investing Outside of the U.S.

The U.S. government was not the only one borrowing and paying people to stay at home. But the U.S. has done it to a much greater degree than others. Most importantly, we are not slowing down our spending (and thus borrowing), which will likely lead to a weaker dollar. If nothing else, a declining dollar makes foreign securities more valuable in U.S. dollars. The probability of a stronger dollar is low.

But there is more.

The next decade will likely belong to ex-U.S. investing. If you invested outside the U.S. over the last decade, your returns were overshadowed by the gigantic outperformance of the U.S. markets. Today the U.S. is the most expensive developed market. Take Europe, for instance; most European stocks are still trading below 2007 highs. U.K. stocks trade at a half of the valuation of U.S. stocks.

Our approach to investing is very simple: We are die-hard value investors looking for high-quality companies that are significantly undervalued and run by great management. We do not change into flamboyant value-indifferent investors when we cross the border. International investing just gives us a greater palette with which to paint our investing canvas.

We've been doing ex-U.S. investing for a long time. Today, about a third of our portfolio is in international stocks. In a few months we are going to roll out a new ex-U.S. portfolio (some stocks from this portfolio will spill into our core value and dividend portfolios, but not all).

If you thought we had a silver bullet and easy answers, we don't. I know what I am about to say is going to fall on deaf ears, especially since we are in an apparently never-ending bull market. But *as steward of our clients' capital, our most important objective is survival (avoiding permanent loss of capital and maintaining purchasing power) in both inflationary and deflationary environments.*

Last decade this did not matter. Risks were only figments of our imagination, as money printing by the Fed, which was trying to fix a lot of sins and became the biggest sin of all – significantly distorting the price of money and thus the economy. But as **Charlie**

Munger (Trades, Portfolio) said, “If you are not confused about the global economy, you don’t understand it.”

A suddenly appearing iceberg is life-threatening to a speedboat (or cruise liner), but it is just an unpleasant inconvenience for an icebreaker. Our goal is to have a portfolio of icebreakers. We are playing a different game – we are not racing against the speedboats. We take comfort in knowing that, while the speedboats may outrace us for some time, they are bound to eventually hit an iceberg and sink. One iceberg that we have an eye on today is inflation (though we are prepared for deflation, too.)

Vitaliy Katsenelson, CFA

Student of Life

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