There is rapidly increasing interest and fascination with the burgeoning blockchain and cryptocurrency ecosystem, and as investment advisors we are regularly asked about how to best acquire exposure to the space. Here are some responses to the questions we are mostly frequently asked.

1. *What are cryptocurrencies, digital assets, central bank digital currencies (CBDCs)?*

The foundational technology that powers all cryptocurrencies (digital assets) is known as 'blockchain'. A blockchain can simply be thought of as a database—similar to an Excel spreadsheet – that stores all confirmed transactions. What makes blockchains such a powerful technology is that the transaction processing is transparent (anyone can see or scrutinize every transaction), decentralized (processing is not concentrated with a single company or institution) and because of its cryptographic nature, far more private and secure.

While there are hundreds of digital assets or cryptocurrencies that trade on global exchanges, each has its own blockchain and complex criteria for securely confirming transactions. The best known, and largest, cryptocurrencies are Bitcoin (BTC), Ethereum (ETH), XRP (XRP), Tether (USDT), and Cardano (ADA).

Each digital asset trades independently in the same way fiat currencies like the U.S. Dollar, Mexican Peso and Japanese Yen trade separately. However, with cryptocurrencies there is no centralized entity (i.e. government or central bank) controlling the blockchain, the supply of the currency, or its price. For example, a fixed amount of Bitcoin (21 million) were initially established and unlike fiat currency, no more can ever be "printed" or created. The transactions on the Bitcoin blockchain are confirmed by validators or "miners" that are not centrally located in a single data center, but rather are disbursed globally. Anyone with the proper hardware (called "rigs") and an internet connection can connect to the Bitcoin network and earn Bitcoin for processing and validating transactions. This decentralized structure prevents any person or entity from exerting dominant control, establishes processing diversity and redundancy, and creates additional layers of security.

As cryptocurrencies continue to gain popularity, most financial institutions have begun to explore how they might use them, even central banks. In China, the government established a Central Bank Digital Currency (CBDC) that is the digital version of the renminbi. However, unlike the true cryptocurrencies, this digital renminbi does not trade independently of the renminbi, nor is it priced differently, but rather it's being implemented to electronically facilitate money transfers. The idea of a "digital dollar" in the U.S. won't change the value of the US Dollar – it will be priced or linked to the USD.

2. *Are cryptocurrencies speculative or do they provide inflation protection? Is Bitcoin "digital gold"?*

One of the major concerns of investors today revolves around the massive central bank debt accumulation that has occurred globally since the Great Financial Crisis. The fear is that economic growth will not be sufficient to pay down the debt (especially as interest rates return to more normal levels) and governments around the world will have no choice but to print money to meet their obligations. This will lead to increased money supply in the system, higher inflation and ultimately weaken the currency. This is not a new process and is something that has played out over time in countries around the world – from Germany to Zimbabwe.

The historical attraction of gold as an inflation hedge, is that the supply is limited (World Gold Council estimates 197,576 tons exist above ground), and due to the cost and difficult of extraction, the supply has remained stable (2,500-3,000 tons mined per year). In addition to a stable supply, no single government controls the supply of gold and thus it cannot be debased like a currency, leading to its function as an inflation hedge and "store of value".

While some investors argue gold is nothing more than an attractively colored rock, it does have a long history of price stability—despite a 500% increase over the last 17 years – and of retaining value during crisis and has secured its status as a "safe haven" asset.

Because Bitcoin shares the stable supply and lack of centralized control characteristics, some investors consider it a comparable "store of value" to gold. However, while Bitcoin may eventually retain a "safe haven" status similar to gold, the Bitcoin network has only been in existence since 2009 and during that time it has experienced INCREDIBLE price volatility – including several bubble and bust cycles – despite the bull market in equities during the entire period. The lack of history and ability to examine the asset's behavior during times of real crisis leads us to conclude it can only be considered a speculative asset in client accounts. And like most speculative assets, determining the correct "value" (price) is very difficult and like a piece of art or expensive bottle of wine, the value is only what someone is willing to pay for it.

3. *How do you think about regulatory uncertainty in the industry?*

One of the most difficult obstacles to analyzing cryptocurrencies and digital assets is the lack of regulatory clarity, especially in the U.S. While many foreign countries (including most developed Asian countries) have given cryptocurrencies the regulatory blessing required to foster development and innovation in the space, the U.S. has yet to provide full clarity. For example, it is currently unclear whether all cryptocurrencies are classified as currencies, commodities, or securities – which creates an issue over which government agency has regulatory oversight.

In 2014, the Commodity Futures Trading Commission (CFTC) stated that virtual currencies are encompassed under the definition of a "commodity" in the Commodity Exchange Act (CEA) and thus subject to its jurisdiction. Since that time, the CFTC has attempted to avoid impeding innovation and encouraged other regulators to take a "do no harm" approach to the burgeoning industry. By 2018, the SEC had declared that Bitcoin and Ethereum were not securities, but rather commodities, but refused to opine on any of the other hundreds of cryptocurrencies—many actively trading globally for years.

Recently the SEC's filed a lawsuit against Ripple and its executives for claims they sold an unregistered security, their own digital asset called XRP, without a formal SEC registration. So, while Bitcoin and Ethereum were deemed NOT to be securities, apparently the SEC believes XRP is one. — despite the fact it was the 3rd largest crypto asset at the time and had been actively traded for many years. After the SEC suit was announced, XRP trading was immediately halted on all U.S. exchanges (but it remained available to be traded outside the U.S. where XRP had already been declared a commodity by regulators).

Unwilling to leave it all to the regulators to sort out, in a recent Congressional bill called the Cryptocurrency Act of 2020, it was proposed that there be three new categories of digital assets: "crypto-commodity", "crypto-currency" and "crypto-security" – with jurisdiction assigned to the CFTC, FinCen, and the SEC respectively. If this sounds as clear as mud…. it's because it is.

Fortunately, Gary Gensler was recently confirmed as the SEC Chairman and he is likely to make some of the hard cryptocurrency regulatory decisions required to provide more clarity for investors. Gensler is an expert in the space (he was teaching blockchain and cryptocurrency at MIT) so hopefully he brings logical and rational decision making to the ecosystem. It is this regulatory clarity that we feel is necessary before we are truly comfortable advising clients to participate.

4. *If there is no regulatory certainty, how can exchanges like Coinbase make a market in these cryptocurrencies?*

Without the regulatory clarity on many of the cryptocurrencies, trading exchanges like Coinbase or Kraken have been forced to proceed cautiously with any cryptocurrency beyond Bitcoin or Ethereum. XRP was traded on both exchanges, but trading was halted almost immediately after the SEC announced the lawsuit. Anyone holding XRP at the time trading was disrupted was immediately put in a difficult situation.

Additionally, since the IRS has not yet figured out exactly how to monitor and tax all the cryptocurrency capital gains, a trading platform like Coinbase is not yet required to disclose transaction detail to the IRS for tax purposes (the way a regulated equity broker is required). Only in the last week did the IRS issue a "John Doe" summons to Kraken seeking the identities of U.S. taxpayers who conducted at least $20,000 in transactions from 2016 to 2020. The government may be slow to institute cryptocurrency regulations, but they rarely miss an opportunity to collect taxes.

WHAT DOES FISCHER STRALEM RECOMMEND IN CRYPTOCURRENCIES

In the opinion of Fischer Stralem Advisors, there is more industry regulation, maturation and stabilization that needs to occur before this speculative asset class becomes truly investable. This process will be positive for investors in the long run, but likely makes for more volatility in the near term

The good news is that several large asset managers have applied to the SEC for permission to launch cryptocurrency ETFs, and the current consensus is that the SEC will make some decisions later this year. It is unknown whether these ETFs will hold a single cryptocurrency or a basket, but additional investment options will be good for investors and likely lead to more mass adoption. These ETFs probably represent the best solution for individual investors, and they may soon be available. Canada and Europe have recently launched several crypto ETF products and there is no reason to think the U.S. won't approve them as well.

The bottom line is that we view cryptocurrencies as a burgeoning asset class that remains highly speculative and risky given the lack of regulatory certainty and the immaturity of the underlying assets. Our strong preference is to wait for there to be a reasonably priced and secure ETF option that clients can easily buy and sell and we will continue to monitor industry developments and plan to keep our clients informed.

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