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Bitcoin Basics

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What are Bitcoins?

Bitcoins were developed in 2009 as a virtual, digital currency by one person or group with the pseudonym Satoshi Nakamoto. Bitcoins are not physically tangible and are thus also difficult to grasp mentally for many.

Although Bitcoins were originally conceived as currency, more and more investors (or speculators) regard Bitcoins as an own asset class – a kind of “gold 2.0”. This is the case because, much like gold, Bitcoins are also scarce. Once all Bitcoins have been mined, a maximum of 21 million will exist.

Only the vast minority of owners use Bitcoins as a form of payment; most use them as a store of value despite their high volatility. In December 2017, the first futures contracts denominated in Bitcoins were introduced. As a result, Bitcoins have now undisputedly achieved the status of an own asset class.

What is special about the blockchain technology?

The blockchain technology is a database that does not belong to anybody, i.e. it is regarded as decentralised. Nobody (that includes governments, companies, and persons) can manipulate the data this database contains. A network of computers administers the blocks of data chains (blockchains). Blocks are generated on a continuous basis – in case of Bitcoins, about every ten minutes. In these blocks, all transactions of all kinds are stored.

The generation of blocks is similar to a competition in the network. Whoever validates transactions first and solves a mathematical problem, receives the transaction costs included therein plus new coins. Once a network participant has found a solution, other participants check it and attach it to the chain. The blockchain technology is regarded as extremely forgery-proof and flexible. Due to its special characteristics, predictions for this technology are very optimistic, regardless of whether Bitcoins will prevail or not.

The price of Bitcoins exploded last year. Is this performance a bubble?

The performance of Bitcoins is indeed breath-taking. The first opening price of Bitcoins in 2010 was 6 cents (USD 0.06). Since then, the price has on average increased by a factor of 10 every year! Of course, this lures many speculators to the table. In 2017, the performance was even above the historical average.

The term “bubble” has been in use for a while now. Whether or not an asset has created a bubble is something you only know once it has burst, but unfortunately not before that. But after such a strong performance like the one we have seen over the past months, a correction is very likely. But even if the price were to fall by 50%, the long-term trend would still be intact.

What are the risks?

Bitcoins do not represent any value per se. The value depends on whether and how many people recognise Bitcoins as an asset class, and whether they will ever be used as means of payment. Currently, less than 1% of the world population use Bitcoins.

There are numerous risks:

- Bitcoins are volatile. Their potential fluctuation exceeds that of equities by a factor of 10.
- The interest in Bitcoins can disappear overnight.
- Another cryptocurrency may take the spot of Bitcoins.
- Regulatory risks: Bitcoins can be banned locally (i.e. in certain countries). However, a global ban is unlikely.
- The mining of Bitcoins may become unattractive (i.e. offer little return), as a result of which the network might disintegrate.
- Bitcoin trading platforms have repeatedly been the target of hacker attacks.
- Many more

How can one invest in Bitcoins?

Bitcoins can be bought in various ways. The direct way requires an electronic wallet. After that, you can buy Bitcoins on a stock exchange or from a Bitcoin vending machine.

You can also invest in certificates or in an ETF. Futures contracts have been available for institutional investors since 17 December 2017 from the Chicago Mercantile Exchange.

Does Erste AM also invest in Bitcoins?

Erste AM is interested in the topic and keeps monitoring the development closely. At this point, Erste AM does not yet invest in Bitcoins.

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