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The case for caution with cryptocurrencies

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The tremendous surge in the price of cryptocurrencies has attracted the attention of many investors, who may be considering the digital currency as a potential substitute for traditional asset classes in diversified portfolios. But Roger Aliaga-Díaz, chief economist for the Americas and head of portfolio construction at Vanguard, cautioned against speculating in cryptocurrencies, which are largely unregulated and accompanied by considerable risks.

"Cryptocurrency prices depend mostly on speculation about their adoption and use," Aliaga-Díaz said. "And that speculation creates volatility that, ironically, undermines their potential use as either a currency or asset class in an investment strategy."

What is a cryptocurrency?

A cryptocurrency is a digital or virtual means of exchange. There are more than 6,700 cryptocurrencies today; among the better known are Bitcoin, Dogecoin, Ethereum, XRP, Tether, and Litecoin.

Unlike traditional currencies, virtual currencies currently operate without central authorities or banks, and they are not backed by any government. Cryptocurrencies are stored in "digital wallets" on a holder's computer or phone, or in the cloud. The wallet serves as a virtual bank account that enables holders to pay for goods and services or simply store the currency in hopes of an increase in value.

Cryptocurrencies defy neat categorization. They are not a traditional currency,

commodity, or asset class, though they share characteristics of each.

There are several reasons why cryptocurrencies are not a traditional currency. Although some merchants have begun to allow cryptocurrency payments, they are generally not accepted as a medium of payment. Cryptocurrencies also are not used as a unit of account because prices, trade invoicing, and contracts are not quoted in digital currency units. Finally, cryptocurrencies' ability to serve as a store of value—a safe instrument to preserve the value of people's financial wealth—is severely limited by their notorious volatility.

"The fact that cryptocurrencies are not issued by a central bank is actually the very reason why they can't achieve the quality of other well-accepted currencies," Aliaga-Díaz explained. "The role of a central bank is precisely to preserve the value of the currency by keeping inflation under control. That's why prices are more predictable under Federal Reserve management of the U.S. dollar money supply."

Cryptocurrencies share some characteristics of commodities. For example, they can be bought and sold in cash markets or via derivatives. But Aliaga-Díaz said they are not commodities because they are not physical raw materials.

No substitute for stock and bonds

Some wonder whether cryptocurrencies can be used in strategic portfolios as substitutes for stocks and bonds. "But unlike traditional asset classes, cryptocurrencies lack intrinsic economic value and generate no cash flows, such as interest payments or dividends, which can explain their prices," Aliaga-Díaz said.

Aliaga-Díaz pointed out that as with currencies and spot commodities, such as gold, there is no risk premium expected with cryptocurrencies as compensation for bearing the risk of their price movements. "Because cryptos represent uncompensated risk to the portfolio, they are not a good substitute for stocks and bonds in a long-term portfolio," he said.

Some investors may be willing to bet on sustained crypto price increases based on the belief that crypto demand will always outpace its supply. And though there might be some valid reasons around projected demand and usage to make a compelling case for a persistent supply shortage that can sustain increasing prices, Aliaga-Díaz noted, the supply of cryptos has exploded over time, and there is no reason to believe that supply can't keep up with demand.

"The biggest risk for all investors would be to assume that demand growth will continue just because their prices have recently gone up," he said. "That's speculation, not investment."

Other risks to keep in mind

Despite all the recent attention devoted to cryptocurrencies, Aliaga-Díaz cautioned that there are a number of additional risks associated with digital currencies, including:

- **Liquidity risk.** Cryptocurrencies are unregulated, and no party is required to accept payments in virtual currency. As a result, certain market conditions might make it difficult or impossible to sell quickly at a reasonable price.
- **Pricing risk.** Cryptocurrencies trade in decentralized markets. In addition, cryptocurrency exchanges and platforms do not feature the regulations, controls, and investor protections available in traditional stock, options, and futures markets. For these reasons, there is no unifying single pricing mechanism that reflects digital currency values.
- **Regulatory risk.** Cryptocurrencies essentially compete with currencies issued by governments. At some point, governments may seek to regulate or restrict cryptocurrencies, or issue a digital version of their own currencies. Such developments could adversely affect cryptocurrency prices.

"There is no enduring economic or investment rationale to expect cryptocurrencies to generate positive real returns," Aliaga-Díaz said. "For investors, adding exposure to cryptocurrencies would mean reducing allocations to traditional asset classes, such as stocks, bonds, and cash, which Vanguard views as the building blocks of a prudent, well-balanced investment program."

Notes:

- All investing is subject to risk, including the possible loss of the money you invest.