Bitcoin: highest risk, highest return

The past year has seen a flood of venture-capital investments into bitcoin-related companies.

At the same time, the price of bitcoin has swung wildly and bitcoin investors have been left with little recourse in cases of fraud and theft, most notably with the collapse of the bitcoin exchange Mt. Gox. So just how risky is bitcoin and who should invest in it?

“ It is pretty much the highest-risk, highest-return investment that you can possibly make,” said Barry Silbert, founder and CEO of SecondMarket and founder of Bitcoin Investment Trust, during a MarketWatch Investing Insights event titled “ Bitcoin: boom and bust,” held recently in New York.

That’s because bitcoin’s outcome is going to be binary, Silbert said. “ It is either going to become this global currency, this global store of value, this global remittance platform, this global payment system, this global money transfer network, or it’s not,” he said.

Bitcoin is a virtual currency and its proponents say that bitcoin’s infrastructure has the potential to change the way people send money around the world. The virtual currency is created through a process called mining that pits computers against each other in a race to solve cryptographic problems. The winner, or group of winners, is awarded a block of bitcoins.

Bitcoin’s functions as a payment system and virtual currency are intertwined, said Mark T. Williams, a banking and risk management expert and a professor at the Boston University School of Management. “ Bitcoin the currency, it’s the equivalent of a locomotive. And it sits on a track, which is that payment system,” he said.

But it’s important to remember that holding bitcoins directly isn’t the same as investing like a venture capitalist in a bitcoin startup, perhaps one that is focused on payments.

“ Bitcoin itself, it’s not a company. You’re not buying an entity itself. You’re not buying a board. You’re not buying a business strategy. You’re not buying a balance sheet. What you’re buying is a potential,” Williams said.

And that means that buying bitcoins leaves an investor vulnerable to the chance that bitcoin’s value could crash to zero. Like any asset, investors should only risk what they can afford to lose, said panelist Todd Harrison, founder and chief executive of Minyanville Media.

Earlier this year, venture capitalist Marc Andreessen wrote in the New York Times that while he only owns a negligible amount of the virtual currency, his firm Andreessen Horowitz has invested significantly in bitcoin-related startups. Fortress Investment Group LLC bought $20 million worth of bitcoins in 2013 and posted an unrealized loss of $3. 7 million on those holdings as of year-end.

The price of bitcoin in January 2013 was around $13. A year later, that price was in the $700s, according to CoinDesk’s bitcoin price index, which tracks prices on different exchanges.

How does the virtual currency stack up against other assets? Bitcoin is seven times as risky as gold, eight times as risky as the S&P 500 SPX +0. 38% and 15 times more risky than traditional currencies, said Williams.

There’s a chance that bitcoin, the first virtual currency to take root in the investing community, could be displaced by a later entrant, Harrison said. That would be similar to how Friendster was rendered obsolete by Facebook and “ the second-mover advantage proves to be more beneficial than the first-mover advantage,” he said.

But Silbert said during the panel discussion that he has been encouraged by developments on the regulatory front in the U. S. and interest from Wall Street. “ I’ve never been more comfortable from a risk perspective and I’ve never been more ... excited about the upside,” he said.