Tarheel Advisors Newsletter

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Bitcoin, the Next Virtual Reality?

A fundamental aspect of any sovereign economy is the right to mint and value a currency. In the United States, the Constitution lays this out clearly. Section 8 permits Congress the right to coin money, and Section 10 denies the states or anyone else that right. Creating a physical alternative to the U.S. dollar isn't just difficult, it's outright illegal.

Then came Bitcoin. What makes Bitcoin so unique (and legal) is that it is a digital currency and thus, never minted. While its popularity has grown substantially in the past two years, the currency has been floating around since 2009 when it allegedly was created by clandestine developer Satoshi Nakamoto. Since that time, the currency has gone from being little more than a theory to being worth as high as $1,200 per Bitcoin. It currently trades around $600.

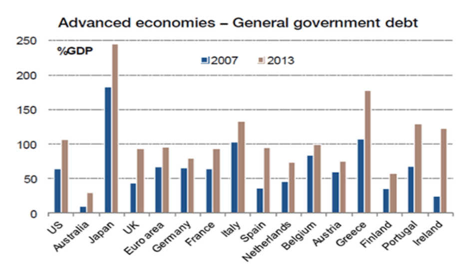
Bitcoins are created through a process called "mining", and they only exist in a computer file known as the blockchain which is akin to a complex puzzle. After a computer works on the blockchain for a certain amount of time, a piece of the puzzle is solved releasing 25 Bitcoins (rate halves in mid-2016) to the solver.

Seems easy, right? Buy a bunch of computers and get to mining! While this was the case in the early existence of Bitcoin, it isn't quite that simple any longer. Part of the genius of Bitcoin is how elegant it is as a functioning monetary base. As more Bitcoins come into existence, the blockchain puzzle becomes progressively more difficult. By design the monetary base of Bitcoin was built to grow by 3% annually. This number was not chosen by accident. A 3% inflation rate is considered a healthy target for developed economies, and is near the figure targeted by central banks around the world.

As the popularity for Bitcoin has exploded in the past two years, the mining of them has grown exponentially more difficult and expensive. Whereas in 2009 it was possible to utilize a standard home PC for mining purposes, today it takes highly specialized kits to mine profitably. One has to remember, computers cost money and run on electricity. So, if you are running a non-specialized PC, it may cost $100 in electricity to mine $25 worth of Bitcoin. While some hobbyists still do such operations (I tried it myself), it is obviously far from a sound business.

If it is not profitable for the average person to mine Bitcoins any longer, then why has it exploded in popularity? The answer is two-fold in my mind. First of all, and most importantly, central banks around the world have done very little to build confidence in paper currencies since the financial crisis in 2007. Furthermore, countries around the globe have taken on dramatic amounts of debt over the past 7 years, resulting in an increase in the debt to GDP ratios of every developed market, and most of them have even doubled.

Open exchange rates have made fiat (paper) currencies viable since the removal of the gold standard in 1971. If one country practiced irresponsible monetary policies, the exchange rates punished them and devalued their currency. But what happens when everyone acts irresponsibly? Bitcoin is what happens.



The second reason Bitcoin has become so popular is that it has caught the attention of the investing community. The virtual currency has turned into a haven for speculators as the exchange rate has had extreme volatility resulting in it doubling at times in the span of just a few weeks.

By design there is a finite amount of Bitcoins that will ever be mined (20,999,839.77 to be exact). With a constrained supply, hedge funds have looked to corner the market on Bitcoin and have accumulated substantial holdings in the currency.

This environment is what has made Bitcoin a viable currency. It is in its infancy and still has a lot that can go wrong. Two of its most recent hiccups were Mt. Gox (a large exchange and bank for Bitcoin) going bust, and a March 2014 IRS ruling deciding that Bitcoin and other virtual currencies will be treated as property for IRS purposes, not currency. While it is impossible to say whether Bitcoin is going to last, the idea behind it seems to be a lasting one. In fact, several major national businesses such as Dish Network, Overstock.com, and Zynga accept Bitcoin as a valid payment for goods. Don't be surprised if the theory behind Bitcoin eventually ends up being the groundwork for a larger international digital currency.

-Ryan Glover, CFP®

2014 Market Update

S&P 500	**+7.14%**
DOW	**+2.68%**
NASDAQ	**+5.54%**
MSCI World	**+5.40%**
BONDS	**+3.93%**
GOLD	**+10.27%**

Mortgage Rates

15-Year	**3.25%**
30-Year	**4.25%**
5/1 ARM	**3.50%**

Did You Know?

* Please welcome Patrick Riess, our Summer Intern!

* Patrick is a student-athlete at the University of North Carolina at Chapel Hill, where he competes on the swim team. He is from New Orleans, Louisiana, and is looking to gain some valuable real world financial experience while completing his studies and training. Please welcome him and support him as he gives up his summer time to help us and our clients.

GoPro or Go Home?

One of the most notable acronyms in the financial world is IPO. On the surface, an Initial Public Offering (IPO) is a pretty common transaction where a private company sells stock shares to the general public. There were 222 IPOs in 2013, and 148 IPOs thus far in 2014. These offerings have raised billions of dollars for their respective corporate coffers. Along the way, they have lined investment bankers' pockets with hefty underwriting fees. In total, the IPO index has outperformed the major averages for the last two years and has provided a healthy average first day pop of 17%. This may seem a bit frothy for most seasoned long-term investors, but it pales in comparison to the 50% average pop in the 1999-2000 time span. So, where are we in the IPO cycle, what can we expect for the remainder of the year, and what more should we know about the nuts and bolts of the process?

Let's start with the basics. IPOs are used by the companies for various purposes, which most commonly include raising funds for liquidity, expanding their business, paying down debt, or even cashing out large ownership stakes. Regardless of the purpose, a company will need help with the legalese, marketing, and the pricing and placing of the shares —that's where the investment bankers come into play. Usually a group of banks headed by a lead underwriter or two will put together a syndicate of underwriters to pool the funds and risk for the deal. The syndicate will help the company draft a registration statement to file with the Securities Exchange Commission (SEC) that includes relevant info such as financial statements, management background, proposed use of proceeds, etc. This document will be investigated by the SEC for accuracy and then they will work with the company to set a date for the offering to take place. The next step for the company going public is to drum up interest in its shares. This process is known as a "road show", and typically takes place no sooner than 21 days following the filing of the registration statement. As the IPO date draws close, the underwriter and company will decide on a price at which to offer the shares depending on the success of the road show and the investor demand.

For example, a recent IPO by the wearable action camera company, GoPro, was led by lead underwriters JP Morgan and Citigroup. Prior to the offering, the underwriters indicated a likely pricing range of between $21-$24. Due to high demand by investors for an ownership stake in this buzz-worthy technology, the shares priced at the high-end of the range at $24. At that price, GoPro issued 17.8 million shares and raised $427 million. The next morning, the shares were officially listed on the Nasdaq and opened at $28.65 when the general public gained access. A bit if a feeding frenzy ensued with the shares closing at $31.34, resulting in a 30%+ first day pop. In this case, the momentum has continued and the stock has moved even higher, but this increase is largely speculative since no new information has been disseminated by the company or any of the big Wall Street research houses. This lack of information is due to what's known as a "quiet period" following the start of trading that legally discourages management or the underwriters from hyping the stock for at least 25 days. A lot of times, the underwriters are still involved in the stocks they took public for up to 30 days as they can buy shares of the IPO to boost its price or stabilize the market for the shares, so "hyping" the shares would certainly be a conflict of interest. Given this gap of true information and a manipulated supply / demand dynamic for the first month, investors would be wise to avoid making a long-term decision on the company's future prospects based on a first day pop, or even a price trend in the first few weeks. In fact, for non-institutional investors, unless you were able to get shares prior to the offering, most IPOs have flat-lined after the opening day of trading and all of the average gains have come due to the first day pop.

As an individual investor, it's nearly impossible to get any kind of an IPO allocation. Most pre-IPO shares are promised to institutional investors unless you happen to have a very large account with the banks doing the underwriting. Only then would you be offered shares, if your broker submitted a Conditional Offer To Purchase (COTP), which is typically due the day before the pricing. Another factor to consider is the desired holding period of the newly minted shares. As I mentioned earlier, investment banks typically are dabbling in the stock for 30 days after the offering. Thus, they sincerely frown upon anyone who was given an allocation selling those shares for the first 31 days. The shares are yours once allocated, and you can sell day one if you want to lock in any profits, but consider your actions carefully as your premature transaction can get you blacklisted from any future IPOs in which you may want to participate. For this reason, it is important that you only seek to invest in IPOs that you are comfortable holding for at least 3-6 months. If you don't like the long-term prospects of the stock, then don't buy just hoping for a first day pop. A lot of the time it won't materialize and frankly, there are not that many of the 148 IPOs thus far this year that are worthy of a coveted spot in your portfolio.

-Walter Hinson, CFP®

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