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This is Crazy: Tulips, Dot-coms and Bitcoin

INSIDE STORY

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This is Crazy:
Tulips, Dot-coms and Bitcoin

The mania peaked in 1637 – twelve acres of land traded for one tulip

My wife loves flowers. Her Mom and Dad both liked digging in the dirt, as they say, and they grew lots of things. This was a little different for me when we first got together; my Mom baked, and she was (still is – though she does it much less now) fantastic at it. My father dug in the dirt, but only with his wedges…golf wedges that is, not any type of garden tool.

My mother-in-law particularly liked orchids. The care it takes to keep them happy, so that they will bloom, is amazing. She had a gift for it and she passed that onto my wife. Unfortunately, my mother-in-law is no longer with us, but some of her orchids still are, and my wife would not trade them for all the tea in China.

While I did not grow up in a home that had lots of flowers I do understand their value. Like all self-respecting security analysts, I am familiar with what many people think is the world's first investment bubble. It probably is not, but we don't know a whole lot about the investing world prior to seventeenth century Europe. This was the Dutch Golden Age; the Netherlands were the center of the civilized world, leading the way in trade, science, art, and of course military might. In 1602, the Amsterdam Stock Exchange was established by the Dutch East India Company. Investing in stocks was born.

The problem with markets and the speculators that are attracted to them is that they are never satisfied with simply investing in companies. They always want something more exciting, and it doesn't take long for them to find something, anything. In the 1630s they found tulips. The then-rare and exotic flower was all the rage. As their popularity grew speculators started to want in on the action, and the already-rising prices headed for the sky.

The mania peaked in February 1637. One tulip type known as the "Viceroy" sold for 3,000 to 4,200 guilders depending on size. For perspective, the annual income of a skilled craftsman was about 300 guilders. In his classic 1841 book, Extraordinary Popular Delusions and the Madness of Crowds, Charles Mackey records one transaction where twelve acres of land were traded for one tulip. Then, as suddenly as it had started, on February 3, 1637, the prices of tulips began to fall. On February 5 they dropped like a rock, and by May of that year their prices had dropped 99.999 percent.

This episode in history has been discussed by economists ever since. Of course, like anything that happened so long ago, there are varying explanations and debates about how accurate the facts really are, but there is no doubt that the prices of tulips rose sharply and then collapsed in February 1637. Lesson learned, right?

Of course not. There have been other bubbles in history, but why don't we just fast forward to our lifetime, or at least mine. I remember vividly sitting with my boss in his boss's office sometime in 1999. "The market is wrong, it is just plain wrong." That was the statement from the elder statesman. My boss respectfully but firmly said, "The market is never wrong." I remember being torn. I was too young to disagree with my immediate supervisor, but the wisdom of the more seasoned veteran seemed more correct than not. Six months later I was in my former boss's job and my lesson was learned. The market may not be wrong often, but it certainly can be wrong, and when it is, it is usually by a large margin.

That brings us to bitcoin. So how many presents under your Christmas tree were purchased with the digital currency or so-called cryptocurrency? Really? Same here, my answer is also zero. That may be because it isn't actually a currency, at least not one that can be used to do stuff like buy something. So, what is it?

The truth is, I'm not really sure. That is not what worries me about the cryptocurrency, however. There have been many good investments that I did not understand the first time they were explained to me. I didn't understand Google's business model when they first went public. It did not take me long to figure it out. We now own shares in Alphabet, Google's parent company. I didn't fully appreciate the wonder that was the iPhone in 2007, but we made a good deal of money on Apple's stock, which we no longer own.

There are many things I don't understand, but in my world I have the good fortune of being connected to lots of smart people who can help explain complicated investments to me. This is what worries me about bitcoin and the rest of the crypto stuff: Not only do I not understand it, but no one who I have ever talked to or read does either. Let me explain.

Here is how the usual bitcoin conversation goes:

Me: What is it?

Expert: It isn't the currency, you can't think of it that way. It is this technology called block chain.

Me: What is block chain?

Expert: It is like a giant ledger where you can record trades. It can allow you to transact wherever you want in the world.

Me: But I can do that now.

Expert: But this cuts out the middleman.

Me: The middleman is there to verify the transaction.

Expert: The ledger does that.

Me: So we just say we did something and everyone believes us?

Expert: Well no, there are these "miners" who must unlock the ledger for you. It takes a ton of computation and enough energy to light a small town.

Me: So, there is a middleman?

Expert: You just don't get it, it's complicated but trust me, everything will be block chain within five years.

Me: Why?

That is how it goes. Sometimes the "expert" will be ruder than others. Some have actually called me, heaven forbid, old. When I was young, "old" often went with "wise," but I don't think millennials know that. There is a man who understood far more than me about the science of our physical world. His name was Albert Einstein, and he famously said, "If you can't explain it to a six-year-old, you don't understand it yourself." I have yet to meet the person who can explain bitcoin to a six-year-old.

This is not unique. There is something about human nature and it starts at a young age. I love the Tom Hanks movie, "Big." If you don't remember, this is a movie where a young boy made a wish to be big and he woke up as a 30-year-old man. While trying to find a way to turn himself back, he had to get a job. In his first meeting, a superior was introducing a new product that made no sense, and the 30-year-old boy rose his hand and said, "I don't get it." It turns out none of the adults got it either, but they were not brave enough to admit it.

I use this all the time. I call it having a Tom Hanks moment. Every analyst who has ever worked here and had to present an investment idea absolutely hates it when I have a Tom Hanks moment.

The problem with the movie is that it implies that when we were young we were more honest with ourselves, and as we grew older we lost that ability. My son is 10. He is two years younger than Tom Hanks' character in that movie. At

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REVIEW *of* ECONOMY

The 3rd quarter 2017 GDP growth came in at 3.2 percent, marking the second quarter in a row of 3 percent growth. The 4th quarter is expected to be in that neighborhood as well. We may finally be breaking out of the so-called new normal.

The official unemployment rate dropped to 4.1 percent in December. The labor market keeps improving and perhaps more importantly, we are seeing wage growth of 2.5 percent. That is an encouraging sign.

Inflation is at 2.1 percent based on the latest consumer price index report. This should give the Fed all the reason it needs to continue to raise rates in 2018. +

REVIEW *of* MARKET

We are breaking out. For the quarter, the S&P 500 was up 6.64 percent. Growth outpaced value for the fourth quarter in a row. The Russell 1000 Growth index finished up 7.86 percent, while its value counterpart was up 5.33 percent. Small companies lagged but were still up with the Russell 2000 index finishing up 3.34 percent.

Bonds rose slightly during the quarter. The Barclays US Aggregate Bond index ended up 0.39 percent. High yield bonds ended the quarter up 0.38 percent.

International stocks no longer led but still did well. The EAFE index finished up 4.27 percent and the MSCI Emerging Markets index ended the quarter up 7.50 percent. +

MARKET *forecast*

With tax reform, we now expect the bull run to continue. Even if we see a mild correction that will likely be just a pause for a breath and then upward we go. Small companies lagged last year and should benefit the most from tax reform so we think they should do well.

Emerging markets still look attractive and the rally in international stocks should have more legs.

Bonds remain our biggest concern over the long term and will until the yield on the 10-year treasury exceeds 3 percent. High yield remains the best place within the bond universe but even it is getting weary. +

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least four time a week I'll ask him if he knows what something, anything, is. "Yes, of course I do Dad." So, what is it? "Well, aaaa… I can't really explain it." So, every time I try to tell him the same thing: There is no shame it not knowing something, it is only dangerous if you will not admit that you don't know something.

Just for the record, my son is not unique in this. As most of our readers know, I coach youth basketball. I will explain a drill to a group of 10-year-old boys and then ask, "Do you understand?" "Yes, Coach, we understand." Then, two seconds later they are doing exactly what I told them not to do. One of these days I'll learn to just stop asking the question, because I know the real answer. But this is human nature, and that nature often forces us to do crazy things.

We are hard wired to want to go with the crowd. There is safety in numbers. We want to know what others are doing, even when deep down we know that most others do it wrong. We have this desire to compare and contrast. We don't want to miss out. Or, we are the exact opposite: We love being the naysayer, the contrarian, the one who always disagrees with popular opinion, Mr. or Ms. Let Me Tell You Why You're Wrong. Neither of these natural tendencies are helpful when making investment decisions.

The famous investor and Warren Buffett mentor, Benjamin Graham, put it best when he said, "You're neither right nor wrong because other people agree with you. You're right because your facts are right and your reasoning is right – and that is the only thing that makes you right." So here are my facts and reasoning regarding bitcoin.

I don't know why we need it. No one has sufficiently convinced me that the world needs another form of currency. In fact, most of the backers don't even bother attempting to explain this. Many say you buy bitcoin not because of the currency but because you wish to invest in the technology. However, a purchase of bitcoin is not an investment in the technology any more than buying an iPhone is an investment in technology. Buying shares of Apple would be investing in iPhone technology, but no such opportunity exists with bitcoin. These are the facts.

In terms of reasoning, the future is always uncertain, but we can reason possible futures so let's think about that. One possibility is that bitcoin does become the currency of the entire world. So what? That would mean that my house and my investment portfolio would simply be translated to bitcoin. I still don't want to invest in the currency any more than I would in dollars or euros, etc. Another possibility with a greater likelihood of happening is that bitcoin goes away, but we find some use for the underlying technology, block chain. Buying a bitcoin is not an investment in block chain, so that doesn't help. Regulators could also step in and shut it all down. Try buying something with a Confederate dollar.

So, even if all the hype comes true one may not benefit from buying bitcoin today, but there are multiple scenarios where it becomes worthless. The investment conclusion is, we don't fully understand what it is, and even if one thinks he does, there is no useful reason for owning it.

Know what you own and why you own it. This is a cardinal rule in investing. Why would anyone buy bitcoins? Why did they buy tulips? We have seen this story before and it does not end well. At Iron Capital we will stick to prudent investing. If you wish to gamble on some technology still in search of a useful purpose then by all means do so, but know what you are doing. That is gambling and that is not what we do here.

Warm Regards,

Chuck Osborne

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