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Digital currency or cryptocurrency?

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The term digital currency and cryptocurrency can become interchangeable in general conversation however they refer to two materially different assets.

Similarities are that digital currencies and cryptocurrency do not have physical attributes and are available only in digital form. Transactions involving both are made using computers or electronic wallets connected to the internet or designated networks. In contrast, physical currencies, such as banknotes are tangible, they have definite physical attributes and characteristics. You can hold them.

Digital currencies have ‘utility’ (uses) similar to physical currencies, if they are issued by central banks. They can be used to purchase goods and pay for services. For example, if you open a bank account with £10,000 in it you might find a bank that will literally keep a vault filled with cash on hand, with your £10,000 stored inside. In this case, all of your money would be held in physical currency. More likely in the modern world you will find that banks hold your cash as an entry in their database. They record your £10,000 and hold it in digital currency. You can spend it as a digital currency (for example, if you use your debit card to pay for things), or you can spend it as physical currency (for example, if you make a withdrawal from a cash machine).

Your money can move back and forth between physical and digital form depending on how you hold it.

The key difference between this and cryptocurrencies is that the value of your digital currency is the same as the value of your physical currency. You can walk into a bank on any day and ask for your money to be provided to you in physical form and its value will not alter.

Cryptocurrencies are different. They transact in a similar way to a digital currency issued by a government, however the value of them is not linked to the physical currency. The value of each unit of cryptocurrency you own is derived by supply and demand at the point of the transaction. It can go up and down and materially alter from day to day.

The reason we felt it relevant to write about this topic this week is that many investors that have not invested in cryptocurrencies such as Bitcoin have used the recent falls in their prices to justify not owning these in investment portfolios. At Tacit, we do not take this view.

We have not owned cryptocurrencies in our strategies as they are a relatively new asset with no history of price discovery. They do not have a yield and therefore until they become a recognised competitor to digital currencies issued by central banks we do not see their ‘utility’. Over time this may alter and at that point we will consider them for investment. At present they are an asset that we can not value and this is a risk we have not taken in our strategies.

The difference between the two ‘currencies’ should not be forgotten, however, and the day this difference disappears, we will include them in our asset analysis no doubt.