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DON'T SEE IT, BELIEVE IT: THE PHENOMENON OF COLLECTIVE BELIEF

Finding an unlikely parallel between Icelandic elves and cryptocurrencies, Investment Analyst Donald Gawel argues the power of collective belief in financial markets and provides insight into how Burgundy balances a long-term approach, open mind, and protective skepticism to unlock future potential.

As I am sure is the case for many, the COVID-19 lockdowns inspired me to daydream about my future travels, which prompted me to take a deeper dive into Iceland – one of my top return-to-travel destinations. While researching my potential trip, I discovered the island's rugged landscape, its reputation for kind citizens, and its rich cultural history and folklore. Iceland's mythology is particularly interesting. After some initial exploration, I discovered something surprising about the people who live here. Apparently, Icelanders believe in elves.

The nation's folklore dates back around 1000 A.D, when the first Icelandic records of elves appeared in Viking-era poems.[i] The mythology includes a belief among locals in Huldufólk or "hidden peoples." These supernatural beings live out in nature and have historical ties with the culture and landscape. Tourists attend guided tours to visit regions supposedly inhabited by these creatures (while the beautiful landscape is a major draw of these trips, mythical sightings would be an upside). Icelanders even believe in different types of Huldufólk. Ranging from trolls, to fairies, to elves, the belief in each type varies (elves are the most prominent and accepted). Authorities in Iceland take special care to protect these mystical creatures. Rather than disturb suspected elf habitats, some building projects in Iceland have been adapted, and major roads have been diverted to protect them.[ii]

If you dig into this cultural phenomenon a bit further, you discover that Icelanders are split into three main types of "believers." There are those that believe, those that do not believe, and those that do not believe, but also do not "not believe." Most Icelanders fall into this third category, which I will call "the undecided." While those in the undecided camp are not outright believers in Huldufólk, they also cannot deny their existence. It is part of the culture, and many Icelanders say that someone they know has had an encounter, and these witnesses perpetuate these beliefs. Headmaster of Reykjavik's The Elf School, Magnus Skarphéðinsson, explains that these witnesses could be someone's "grandma or grandpa or parents or mother and father, aunt or uncle, niece or neighbor..." He notes that when Icelanders tell you about their elf experience, "they are very sincere." In their eyes, there is just as little evidence proving that Huldufólk do not exist as there is evidence proving they do exist. With zero way to definitively prove either side of the argument, they take an agnostic approach, choosing not to outright deny the existence of Huldufólk, just in case.

COLLECTIVE BELIEF

Of course, collective belief is not isolated to Icelanders and their world of hidden peoples. The concept is ubiquitous in financial markets as well. The trust we share in markets, fiat currency, and the financial system keeps things, by and large, running smoothly (with the occasional disastrous folly). Without this collective belief that the financial system actually works, it ceases to function – at least until confidence is restored. Since there needs to be some level of confidence in market mechanisms for a market to function, the collective belief among participants shapes the market. Returning to Iceland, if enough people believe in or do not outright deny the existence of Huldufólk, it makes them real.

COLLECTIVE BELIEF IN THE CRYPTO MARKET

If we are looking for a Huldufólk counterpart in the financial markets, we may have one in the dramatic expanse and rise in popularity of cryptocurrency. The crypto market shares a lot of similarities with the concept of Huldufólk. Here too we find ourselves with "hidden" intangibles, behind which we have the believers, the non-believers, and – the ones I would wager are the majority – the undecided.

A cryptocurrency is a digital asset originally designed to be used as a currency decoupled from any type of governing body, making it a new currency for the people by the people. One of the key differences with a cryptocurrency versus that of the digital Canadian or U.S. dollars in your bank account revolves around decentralization. Since these cryptocurrencies are decentralized, no government organization can regulate, control, devalue, or theoretically track the use of the currency to a specific individual (as is the case with dollars). The value and supporting infrastructure of the digital currency is controlled by the collective group of those who own it. Currently, Bitcoin, Ethereum, Dogecoin, and Tether are among the most popular cryptocurrencies. Interestingly, there is no significant barrier to entry to create a new coin. For example, we could easily have: TeslaCoin, PrimeCoin, BuffettBucks, or GoogleDough. Imagination is the only limit to the creation of a crypto asset. The value to the digital asset, or technology behind the asset, is largely driven by people's belief that it is worth something, or that it is something worth buying.

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THE BELIEVERS

As with Huldufólk, there are a variety of cryptocurrencies one can believe in. Bitcoin is the crypto equivalent to elves for Icelanders, the most believed of the "hidden" entities. For the (currently) small but very vocal minority of crypto followers, Bitcoin is the predominant coin that advocates have chosen to believe in, and, at the time of writing, the most valuable coin as measured by market capitalization. Many prominent financial institutions and world-renowned investors own Bitcoin or express an interest in Bitcoin, which begets further adoption from those within the financial community.

THE NON-BELIEVERS

The non-believers group makes up another loud minority, those who have made up their mind that digital assets are nonsensical. Indeed, as digital assets grow in popularity (and price), the number of those actively bashing them declines. The arguments the non-believers make are sound and rational. For example, one common risk they have cited has been the recent regulatory crackdown of various governments not wanting to lose control of their own financial systems or that these crypto assets are largely used by criminal organizations to fund nefarious activities. The simplest argument is that these cryptocurrencies are figments of people's imagination and, as a result, should be worth zero. The cited regulatory risk has the real potential to leave investors with stranded digital assets on a thumb drive with little to no value.

THE UNDECIDED

I would argue that this third group of people makes up the vast majority of market by-standers. While they will not claim to necessarily believe in, fully understand, or own crypto assets themselves, they also cannot deny that early investors in these crypto assets have at least had astronomical returns on paper.

As is the case with the Icelanders and elves, the undecided, with zero way to definitively prove either side of the argument, decide not to outright deny that cryptocurrencies have some sort of value, just in case. After all, there is a quoted market price on every major business news outlet, is there not?

FLUIDITY OF BELIEF

Between the two loudest parties (the believers and the non-believers), the non-believers have the disadvantage of fighting the momentum of the new, innovative technology. Convincing crypto zealots that their views could be incorrect is much harder than convincing non-believers that they might be missing something and should at least educate themselves more on the subject, thus bumping them into the undecided camp. Each incremental acceptance (or at the very least, non-denial) by market participants contributes to the cycle, turning those in the non-believer camp into the undecided camp. Recently, Howard Marks, Co-Chairman of Oaktree Capital Management, is the most notable investor to have made this shift between camps. In my opinion, this move represents an intelligent open mindedness over a capitulation.

BELIEF AMONG MARKET PARTICIPANTS

As support behind each coin changes, so do the value rankings – illustrated most notably by Dogecoin. Despite the founder admitting it was started as a joke, the cryptocurrency went shooting up the market capitalization rankings to become one of the top-10 crypto assets. (With current estimates suggesting there are approximately 5,000 cryptocurrencies, this is very much the Wild West of "asset" classes.) If enough people believe Dogecoin will prove to be a profitable "investment," it becomes a self-fulfilling prophecy. Incremental bystanders watch early adopters make significant returns. Hoping for the same success, they join the party, which drives the price incrementally higher. The collective belief among market participants suggests some sort of value should be attributed to these digital assets. And, with the attention they are garnering, it is hard to make the argument that cryptocurrencies carry no value whatsoever. This begs the question: What is the value of a cryptocurrency?

The short answer is "We don't know." While people can and do have strong opinions, there is not one correct answer. The value of a cryptocurrency hinges on the collective belief of what those buying and selling that currency think it should be valued on. There is no (widely agreed upon) fundamental basis to value a crypto asset, hence the volatility, largely because we are making it up as we go. If enough participants in the financial markets believe cryptocurrencies have value, who is to say they do not? Is it a substitute for the U.S. dollar? Is it a form of digital gold? Is it a means to conduct illicit transactions? Can you calculate an implied value to scarcity and the incrementally constrained supply? Should it be valued on the incremental cost to "mine" a new coin? The fact that we do not even have simple heuristics or rules of thumb to value these instruments illustrates the market infancy.

What we do know is that current cryptocurrencies are financially non-productive assets. They do not (currently) generate any sort of predictable income stream or cash flow that can be forecasted, discounted, and valued in the traditional sense – the way we can with companies (even currently unprofitable

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ones). Cryptocurrencies are simply bought for one price and sold for another. Much as they say beauty is in the eye of the beholder, the value of financially non-productive assets is in the eye of the collective group and the incremental buyer or seller. The price you pay equals the value because that is what you determined it should be. You are subordinating your individual beliefs on valuation to the collective belief and opinion of cryptocurrency traders.

It is important to note that gold shares many of these same characteristics. Gold is a financially non-productive asset that we do not think can be fundamentally valued (like Bitcoin). That being said, some investors may find that gold has a place in their portfolio. It can act as a store of value to protect against extreme tail events, such as hyper inflation, and has done so with moderate success in the past. This is largely because those buying gold collectively believe that it is a good store of value. This track record of usefulness in a catastrophe is what differentiates gold from cryptocurrencies. Belief in gold as a disaster hedge has frequently been justified. That can't be said of crypto. However, following this logic, if investors believe that Bitcoin represents a new form of (digital) gold (albeit, without any of the proven historic track record), we cannot tell clients not to own it if they feel it has a place in their overall portfolios. We remain skeptical, but open minded as we believe this is the most prudent course of action an investor can take.

OUR BELIEF

While Huldufólk and cryptocurrencies are both nebulous concepts, they are clearly driven by the collective belief of the (market) participants. With Icelandic elves, collective belief keeps their existence going. With crypto assets, collective belief gives them a market price. We are seeing this price and corresponding value being determined right before our eyes, and the evolution of these instruments should not be understated.

Crypto assets are not self-driven entities with bottom-up fundamentals where we can confidently understand the underlying drivers. Companies, by comparison, can largely control their destiny. They have dedicated management teams that make decisions regarding the direction and strategy of the business, and these decisions have an impact on the intrinsic value. Since we do not think any sound fundamental analysis can be done on cryptocurrencies at this time, determining the value of these assets or which one is the "best" is solidly in the "too hard pile." Asking what a Bitcoin should be worth is the entirely wrong question long-term investors should be asking. (Largely because I am not certain there is an answer at this time.) I believe the right question we should be asking is: How will the technology behind the blockchain potentially shape the world around us?

CRYPTO AS A CURRENCY

One area we are exploring surrounds what could turn these crypto assets into real, usable currencies and the potential implications on the financial system. A frictionless payment system was, after all, the initial idea behind Bitcoin.

Classical economics tell us that a currency must act as a store of value, a medium of exchange, and a unit of account. Applying this "textbook" definition, we see that the real-world implementation of crypto(currencies) as a currency, currently fails to achieve all three of these characteristics. We also run into some interesting paradoxes that may make it difficult for certain crypto assets to become reliable currencies.

Take Bitcoin for example. People tend to buy Bitcoin because they believe it is valuable. Many tend to believe it is such a good store of value that as more people realize this value, the price of a Bitcoin will continue to rise over time. This results in believers holding coins rather than transacting with them (i.e., not using them as a medium of exchange), which effectively eliminates any real use as a day-to-day currency. Additionally, this expectation of increased future value contributes significantly to Bitcoin's price volatility – in this market, a 50% swing over a few months is not uncommon. This price volatility further makes Bitcoin an unreliable unit of account (something used to measure and record our assets or liabilities, or incomes and expenses). You know how much money you make every week, how much you pay in transit fare costs to and from work, and what the outstanding balances on your mortgage or student debt are. With this information, you can budget, plan, save, and invest. In essence, a unit of account is a measurement of value. Currently, we use dollars for this, largely because everyone else uses dollars. There is a significant positive network effect experienced by an incumbent currency. It is easy and simple to understand the value of my dollars and what I can purchase with these dollars; however, if my personal unit of account is measured in Bitcoin and the rest of the world accounts in dollars, on a good day, I can afford a Tesla with one Bitcoin (if they accept Bitcoin as a form of payment on that particular day). On a bad day, I would have to convert my Bitcoin back to dollars and buy a Corolla (Toyota does not accept payment in Bitcoin). So, why would I, as a consumer, ever transact and buy a Corolla if I think that I will get a Tesla (or two!) once everyone else realizes how valuable Bitcoin is and the price rallies? While it is this pricing volatility that currently prevents Bitcoin from being used as a medium of exchange and as a reliable unit of account, this same pricing volatility (experiencing an upward trend) also makes people believe that Bitcoin has great value and encourages incremental purchases. This increases the popularity, but it also further contributes to the dynamic that prevents Bitcoin from acting reliably as a currency – continued price volatility.

Imagine a world where the quorum of market participants agrees to forecast a relatively stable Bitcoin price into the future. Would as many people be interested in buying Bitcoin? If the future expected returns on Bitcoin were flat, how many current Bitcoin holders would be as excited to own it? After all, if a store of value would not appreciate to the same extent Bitcoin has historically, would you not seek to find a different asset with appreciation potential? Could this anticipation of a stable forward price actually lead to increased selling pressures and price volatility (downward) as holders seek to sell their Bitcoins and invest in other return-generating opportunities? It is easy to imagine this type of market behaviour playing out as speculators flock to the next supposedly great coin idea. This potential dynamic makes us believe that Bitcoin is quite a way off from being a widely accepted currency and the mechanism used to enable frictionless payments. Perhaps some other cryptocurrency could fulfill this destiny, but we do not believe it is Bitcoin at this time. Still, we will continue to apply our thinking frameworks to real-world observations to try and identify when this dynamic could change. Should a crypto coin emerge that displays the classical traits of a currency (acting as a store of value, a medium of exchange, and a unit of account), the impact to many highly regarded businesses could be significant.

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WHERE DO WE GO FROM HERE?

At Burgundy, our wariness around this sector has not deterred us from educating ourselves. At a fireside chat earlier this year, Burgundy invited a speaker to help the investment team understand more about these alternative digital assets. Since then, we have continued to expand our knowledge on cryptocurrencies and the underlying technologies that support them, which we believe have the potential to be quite disruptive. We share the Icelandic sentiment of lacking definitive proof either way as well as their preference to remain open to the possibilities. As a learning organization, we are always working to expand our circle of competence. We actively explore the areas gaining increasingly more attention in the technological and financial zeitgeist, and we try to think critically about the long-term potential implications.

Even though we do not know what the future holds for cryptocurrencies or the underlying infrastructure, as investors, it is important for us to continue to observe, understand, and learn from these disruptions. After all, we are witnessing a fascinating social and financial experiment play out right before our eyes. By remaining open to the possibilities and continuing to expand our knowledge, we can act thoughtfully, with a long-term perspective, and in the best interests of our clients. ■

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ENDNOTES

i. https://www.theatlantic.com/international/archive/2013/10/why-so-many-icelanders-still-believe-in-invisible-elves/280783/

ii. BBC Ideas: https://www.youtube.com/watch?v=XzGmwlXirC4

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