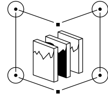

Lecture 04 — How can we use Digital Assets in an investor portfolio?

Transcript

Digital assets have evolved considerably in the fifteen years since the launch of Bitcoin, enduring multiple market cycles. Today, we believe they present viable investment opportunities. But how should investors think about incorporating digital assets as part of a well-balanced, diversified portfolio allocation?

While fraudulent behavior and failed crypto projects have made headlines, it only underlines the importance of understanding the fundamentals before investing. Research and due diligence are key to making informed allocation decisions. By doing so, investors can harness the potential of digital assets while mitigating the associated risks with this disruptive innovation.

We are still at the initial stages of the adoption curve for digital assets. Despite the 2022 market correction, we remain optimistic about the momentum that lies ahead in the coming years. Several factors contributing to this positive outlook are:

The accessibility to digital assets continuing to improve

The utility and use cases for cryptocurrencies expanding, leading to higher liquidity levels

The knowledge and awareness of digital assets becoming more widespread

The maturing of the industry is gradually reducing the historically high volatility that has been associated with digital assets

And finally, correlations of digital assets to other asset classes continue to evolve

Rising institutional participation highlights the growing conviction in the digital asset landscape. Established traditional financial institutions such as Fidelity, Blackrock, Invesco, Deutsche Bank, and others are actively exploring opportunities to promote innovation in the digital economy and build utility around enhanced settlements, custody, asset management, decentralized finance, and tokenization of digital and physical assets.

As introduced in our first lesson, we can classify digital assets into three distinct categories: Cryptocurrencies, such as Bitcoin and Ethereum, Tokenized Money, such as instance Stablecoins, and Tokenized Assets like Tokenized Bonds, Tokenized Funds, or NFTs.

The investability and growth potential for digital assets differ significantly based on their intended purpose and functionality. For this particular video, we will focus on cryptocurrencies, with a primary emphasis on Bitcoin and Ethereum.

We firmly believe cryptocurrencies offer diversification benefits and present a compelling opportunity within the current macroeconomic environment.

Despite their high volatility, Bitcoin and Ethereum have demonstrated exceptional performance on a risk-adjusted basis over recent years. However, it's important to keep in mind that past performance does not guarantee future results.

Over the years we have seen volatility decline.

Taking Bitcoin for example, we can observe that its overall volatility has been gradually declining over time and will likely continue to do so as the cryptocurrency market matures.

It's essential to recognize that Bitcoin and Ethereum started from modest beginnings and have experienced substantial growth, which resulted in high levels of volatility. This is not uncommon for assets in their infancy. As adoption continues, and their market capitalizations continue to grow, it is reasonable to expect that volatility should continue to decrease. This trend is similar to that of small-cap growth companies evolving into large-cap companies in the traditional financial markets.

Let's look at the correlation to other asset classes.

As digital assets like Bitcoin operate in a unique and relatively nascent market, their correlations to other asset classes like stocks, bonds, and commodities have evolved over time. This evolving correlation can significantly impact their potential as diversification tools within an investment portfolio. After historically having little to no correlation to equities, Bitcoin's correlation to equities was extremely elevated during the overall market correction in 2022. Since the end of 2022, Bitcoin's correlation to equities has drifted lower.

The recent regional banking crisis in the US may have aided in the shift in Bitcoin's correlation patterns. Specifically, Bitcoin's correlation to equities has decreased while its correlation to gold, the traditional safe haven asset, increased sharply. This evolving correlation dynamic suggests that cryptocurrencies may offer diversification benefits and highlights the importance of considering cryptocurrencies in an investor's portfolio.

It is worth noting that currently cryptocurrencies tend to exhibit high levels of correlation with each other. For instance, the correlation between Bitcoin and Ethereum, the two largest cryptocurrencies, has ranged between 75% to 95% over the past two years. A lower Bitcoin and Ethereum correlation in the future could have implications for portfolio diversification and risk management.

Besides the value proposition of Bitcoin and Ethereum which we presented in previous lectures, the following drivers make them attractive investment allocation choices:

The changing economic backdrop and institutional adoption

Strong on-chain data and fundamentals

And positive regulatory progress across the world

The current economic backdrop has amplified the value proposition for decentralized platforms that have full transparency, making the case for cryptocurrencies like Bitcoin and Ethereum even more compelling. Global economies are still battling heightened inflation even after significant tightening by global central banks. Bitcoin's transparent and predictable fixed total supply of 21 million stands in contrast to modern fiat currencies issued by central banks that exhibit constantly increasing money supply and balance sheet size. As a result, Bitcoin could be viewed as a hedge against central bank monetary policies and a store of value that can preserve purchasing power over time.

The inelasticity of Bitcoin's supply and Ethereum's transparent smart contract technology, present unique value propositions that are increasingly capturing the attention of institutions worldwide. Growing institutional interest is poised to become a key driver for the widespread adoption of this new asset class in an investor's portfolio.

Thanks to the transparent nature of Bitcoin's blockchain, we can gain worthwhile insights into the state of its supply across a range of metrics which can provide valuable information to investors. By analyzing blockchain data, we can observe that of the 19.4 million Bitcoins in circulation, nearly 70% have not moved in at least one year or more. This confirms a strengthening holder base and supporting the notion of strong fundamentals for Bitcoin.

Another metric that helps understand the profitability of Bitcoin's supply is the *spent output profit ratio*, commonly referred to as the SOPR. This ratio is calculated by dividing the realized value of spent coins by the value at which the coins were originally acquired in US Dollars. This ratio informs us as to whether Bitcoin spenders are realizing profits or losses on bitcoins they acquired. When the SOPR is above one, like it is today, it indicates that users are spending coins they acquired for lower prices. In the context of a rising market, this behavior is expected as holders may take profits during bull markets.

Bitcoin's 4th halving, the highly anticipated event that occurs approximately every four years is expected to take place in April 2024. The halving will cut in half from 6.25 to 3.125 BTC the reward that miners receive for mining an incremental block. While the impact of each halving diminishes over time as the block reward approaches zero, the event showcases two of Bitcoin's most fundamental characteristics: it's fixed supply and it's automated monetary policy which are programmed into the network.

Ethereum has emerged as the leading blockchain in programmable finance, and its latest upgrade, called Shanghai, completes its multi-year transition from proof-of-work to proof-of-stake validating. Many consider Bitcoin as a store of value, but Ethereum differs in that it stands to become the “world computer” due to its ability to support decentralized applications for many use cases including decentralized finance, tokenized assets, blockchain gaming, decentralized identity, and more.

We believe the combination of Ethereum’s first-mover advantage and the adoption of Layer 2 scaling solutions to address the network’s scalability concerns will enable Ethereum to compete against newer, highly scalable blockchain competitors allowing it to maintain its lead as the public blockchain with the highest amount of developer innovation and activity.

Recently, we are witnessing progress on the regulatory front, with many countries and jurisdictions working towards comprehensive regulatory frameworks for cryptocurrencies. Sensible and clear regulations provide a sense of legitimacy and security for users and investors. They reduce skepticism, foster confidence, and help drive more institutional adoption. The European Union’s Markets in Crypto-Assets Regulation, known as MiCA, is a concrete example of this regulatory progress.

Please note that investors should always consult their financial advisors to determine appropriate portfolio allocations and whether cryptocurrencies are appropriate for their investment goals.

If you are a conservative investor who typically seeks minimize risk, cryptocurrencies may not be an ideal fit due to their higher volatility and their novelty risk. For these investors, it may be prudent to wait for digital assets to establish a longer track record and allow more time for regulatory uncertainties to be further resolved before considering an allocation.

On the other hand, for investors that prefer growth-seeking portfolios, cryptocurrencies are suitable. In the current market landscape, cryptocurrencies like Bitcoin and Ethereum have the potential to offer additional alpha and enhance overall portfolio returns.

The ideal allocation to cryptocurrencies depends on an investor’s time horizon and risk appetite. As a general rule of thumb, allocations could range anywhere between 1 and 5% of an investor’s portfolio.

For example, we analyzed a hypothetical portfolio made up of 60% stock and 40% bonds. Adding 1- to 5% of Bitcoin over the course of six years led to an increased Sharpe Ratio, indicating improved performance relative to risk.

We anticipate growing interest from both retail and institutional investors for allocating a small portion of their portfolios to well-established cryptocurrencies. With growing adoption and utility, we will likely see more opportunities in other related areas such as DeFi, NFTs, and tokenization in the future.

In Summary:

Investors should carefully consider volatility and novelty risk for all digital assets categories.

We are still in the early stages of the adoption curve.

We believe the more well-established cryptocurrencies like Bitcoin or Ethereum deserve consideration in investor portfolios today.

Arguments for allocation to cryptocurrencies include: the value proposition of blockchain technology, the economic backdrop, transparent on-chain data and fundamentals, and the positive regulatory progress.

Conservative investors should likely avoid digital assets given their volatility, but a small allocation within a growth-seeking portfolio could offer additional diversification and improve risk-adjusted returns.