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market notes: Too Volatile, Too Slow…Two Tired Criticisms

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5/3/24 - Marcel Kasumovich, Deputy CIO, Coinbase Asset Management

1. The truth isn't out there – at least not for investors. There are facts. There are anecdotes. And there is behavior. Investors are tasked to juggle these in portfolio construction. The best investment ideas often start with a hypothesis about the distant future that is outside of consensus opinion, as is the case for crypto today. It is met with friction. Yet, any contrarian idea must be validated by the crowd to be successful, leading to phases of exuberance. It is the art of active investing.

2. Exuberance isn't the problem – leverage is. When things go smoothly, expectations are extrapolated as though smooth is a feature. Smooth cycles dampen volatility and tempt investors to chase higher returns by taking more risk, adding leverage to returns. It imposes systematic risk. These moments are remembered by fractures, like the Fall of 2008. But the buildup is slow. After all, the demise of US subprime mortgages started 2007 as "contained."

3. Hindsight revealed policy errors. Regulations that allowed for higher-risk mortgages to be transformed into lower-risk investments masked poor underwriting and dampened volatility. All was well, until it clearly wasn't. This is where crypto's slow entry into the regulatory mainstream can be a superpower, demanding investors evaluate and internalize risks from protocol security to market volatility. Not surprisingly, the first institutional steps into crypto technologies are cautious.

4. Institutional engagement is rising sharply, and adoption will follow as investors internalize the volatility attributes of crypto assets. It's not about average correlations. The moments that matter are episodes where volatility spikes. Figure 1 illustrates five of the largest volatility events in the past four years – four to the downside and one upside. Volatility on the Coinbase Core Index jumped to 107% on average in those periods. These are the periods investors must prepare for.

5. Think of the most recent bout of downside volatility. It's large even by historical context. The Bitcoin drawdown is ~20% from its peak in March, coinciding with front-loaded ETF inflows and stagnation since. Reflect on the features of the drawdown. The flat Bitcoin forward curve indicates an absence of leverage. Bitcoin's decline has also accompanied a fall in volatility expectations, signaling an orderly move. And option markets show stronger demand for downside protection.

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6. So, despite the large drawdown, there is no "shock." It is a healthy correction. And the richness of past experiences will afford investors the ability to analyze these episodes as they would for any other commodity market. It also argues for actively managed portfolios. Even "passive" exposure will require material rebalancing given the substantial volatility of crypto assets relative to traditional portfolios. Incorporating tools that are more active in portfolio allocations is only a small step.

7. Which asset is most important in an actively managed portfolio? The one that exhibits no correlation to broader crypto assets yet keeps the same settlement features to allow for continuous time risk management – stablecoin. Through all of these phases of volatility, US dollar stablecoin has proven resilient both in terms of performance and investor confidence. And there is yet another legislative push to bring stablecoin into the US regulatory mainstream.

8. The 2023 "banking crisis" is especially interesting. Detractors point to that period as illustrative of the risks of stablecoin. Yet, this instability was caused by the banking system, not by the design of stablecoins. Like the 2008 crisis, the initial early strains were not resolved in 2006 and nor are the 2023 strains cured now with yet another US bank failure last week. The emergence of tokenized Treasury bills mitigates risk from banks, by providing 24/7 liquidity with no threat of default.

9. The durability of stablecoin is also called into question by the absence of interest payments. Surely, no rational investor would forgo a 5% return. But this depends on liquidity convenience and the expected holding period. A low-interest cash buffer is entirely ordinary in the private sector. For instance, US bank deposits are $17.5 trillion, 87% of which earn virtually no yield and are funding longer-duration credit. Stablecoin duration mismatch, by contrast, is measured in days not years.

10. Institutional engagement in crypto technologies is clearly on the rise. Tokenized Treasury bills now exceed $1 billion. JP Morgan is expanding its use of blockchain technology to issuance of municipal bonds. PayPal has seen a sharp rise in stablecoin for payments. As the features of blockchain technologies become normalized, so too will institutional adoption and its use of active strategies to deliver the unique volatility that are the best fit for portfolios.

11. "It's early", Shaun Martinak explained in a terrific interview about tokenization through the lens of the Project Diamond platform.

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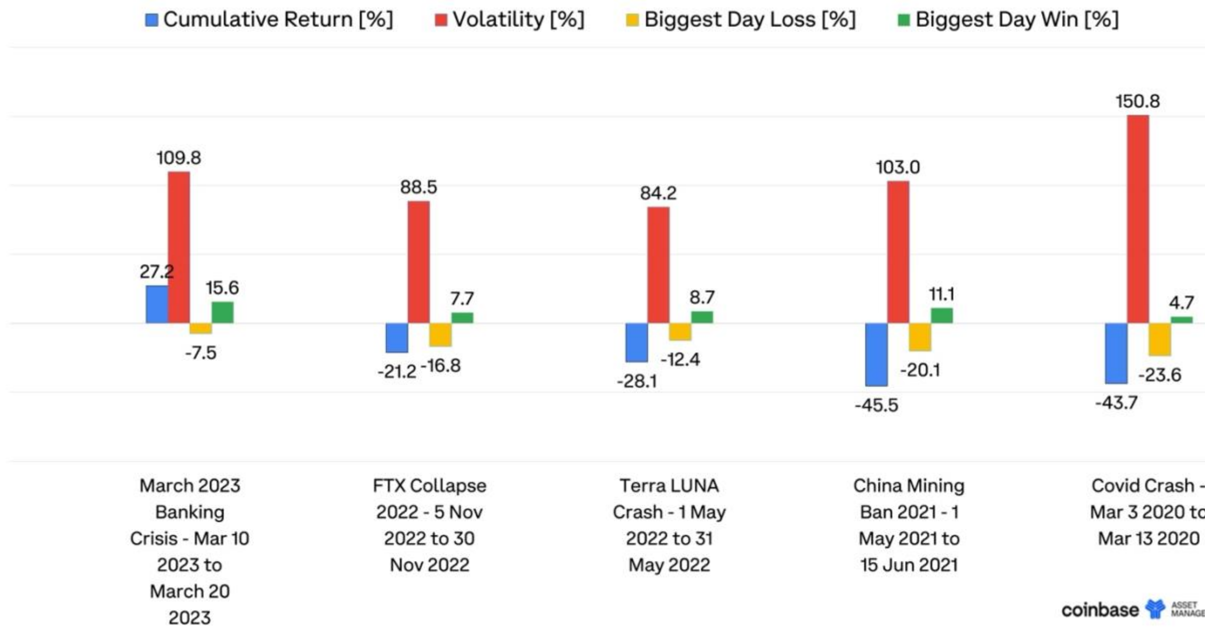
Figure 1: Where's My Vol? Five Large Events



Source: MarketVector Indexes. CBAM Digital Pulse.

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