coinbase ASSET MANAGEMENT

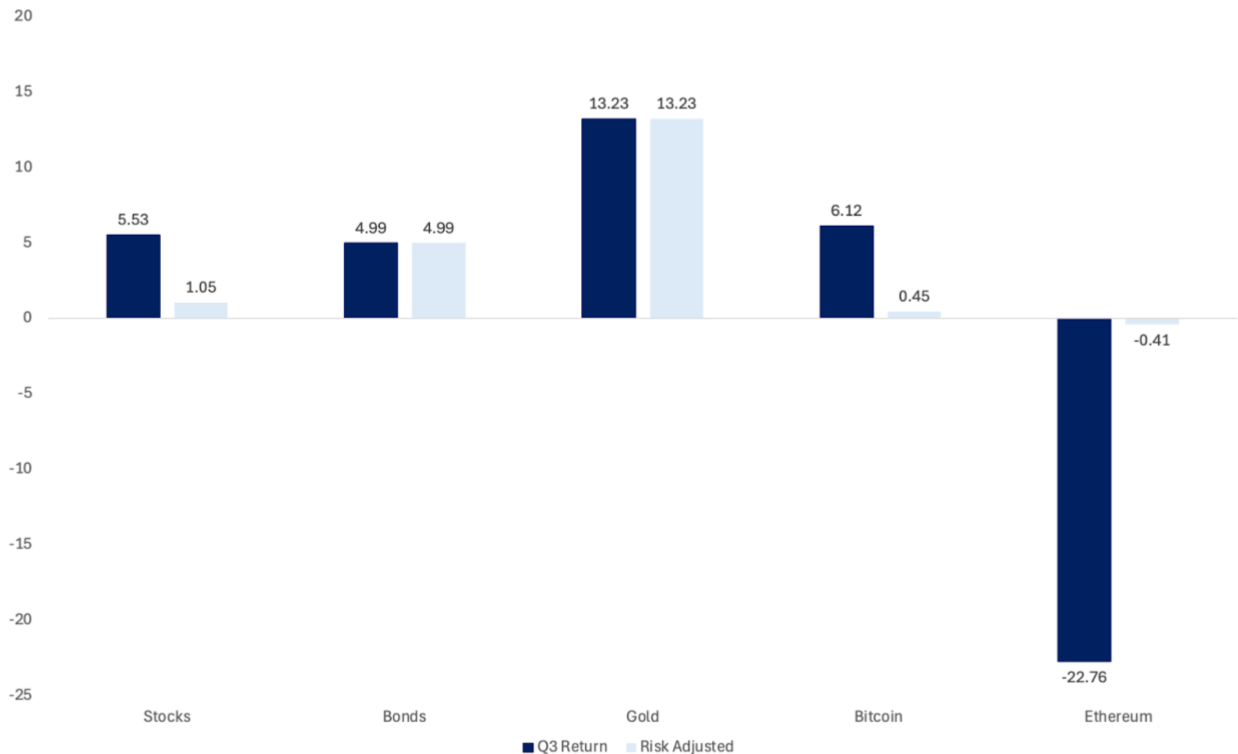
market notes - (un)Balanced Portfolios– (un)Comfortable Realities

The balanced portfolio is chasing a mirage. The seemingly strong Q3 performance is a case in point—balanced portfolios underperformed “do-nothing” hard assets, including Bitcoin.

04 October 2024
Marcel Kasumovich
Coinbase Asset Management

The balanced portfolio is chasing a mirage. The seemingly strong Q3 performance is a case in point—balanced portfolios underperformed "do-nothing" hard assets, including Bitcoin.

Figure 1: Q3 Market Moves (%) – Golden Quarter



Source: Bloomberg LP. CBAM Calculations. Q3 performance is measured from June 28, 2024, to September 30, 2024. Stocks are represented by the S&P 500 Index, and bond performance is measured by US Total Return Government Bonds. Returns cited in the text are sourced from CoinMarketCap.com, except for Bitcoin and Ethereum, which are included with traditional assets to align data timestamps for computing consistent returns and correlations against those assets. Risk-adjusted return is an experimental measure. The return is scaled by the maximum drawdown during the quarter. Any drawdown of less than 1% equates to a risk-scalar of one. That is, if an asset's price never falls below its June 28, 2024 value during the quarter or has a drawdown of less than 1%, the risk-adjusted return is the same as the total return. The larger the drawdown, the smaller the risk-adjusted return or loss. For instance, ETH was down 23% in the quarter, with a maximum drawdown of 56% from the end of June. The Q3 performance of –23% is scaled by the 56% drawdown, implying a sharp rise from the intra-quarter lows. In contrast, Bitcoin's performance is scaled down to roughly 0.5 as its maximum drawdown was around twice the Q3 return, implying a more volatile trend than Gold in the quarter.

Private and Confidential: Any unauthorized use, distribution, modification, forwarding, copying or disclosure is strictly pro hibited

market notes: (un)Balanced Portfolios–(un)Comfortable Realities
10/4/24 – Marcel Kasumovich, Deputy CIO, Coinbase Asset Management

1. Balance. It's the goal many strive for in financial decisions-a portfolio designed to weather volatility so you can "set it and forget it." The textbook rule is simple: there's one optimal portfolio that maximizes returns for the least risk. That's a statistical truth. But it's also a practical lie. Reality paints a different picture. New assets and innovations, like crypto, force investors to embrace being unbalanced-to get comfortable with risk.

2. Take market performance in the third quarter as an example. For a traditional "balanced" stock-bond portfolio, it was a dream, with US equities and bonds each returning 5% (Figure 1). The looming risk of recession was offset by pre-emptive rate cuts, causing almost everything to rally-stocks, bonds, commodities, and crypto. But peel back the layers at the surface and the illusion of stability falls apart.

3. The truth? These traditional portfolios were far from balanced. Inflation expectations are the main disruptor. Gold, often viewed as a "do-nothing" asset, surged 13% in Q3. Historically, gold's industrial use has been sidelined by its status as an investment safe haven. In a world gripped by inflationary fears, gold's rise highlights the imbalance in "balanced" portfolios-they performed poorly when judged against hard assets.

4. Crypto's Q3 performance echoes this narrative. Bitcoin rose 6% in Q3, with its share of the crypto market hitting a new cycle high of 58%. Like gold, Bitcoin is increasingly viewed as a store of value, with longer-term holders also reaching cycle highs of 71%. However, Bitcoin's Q3 48% correlation with equity returns, compared to just 22% for gold, shows it behaved as a risk asset, reflecting its age more than character.

5. Yet Q3 wasn't without surprises. The Bitcoin protocol became more secure, as mining difficulty hit a new high despite record-low profitability. Bitcoin mining companies remained largely unchanged in the quarter, thanks to Bitcoin's growing role as a flexible, energy-intensive data center solution. The synergy between Bitcoin mining and AI power needs is driving this change, with nuclear stepping in as a potential "green" solution.

6. Not all crypto performed well in Q3, though. Dispersion was a big theme, even for the major assets. Ethereum fell 23%, despite receiving US ETF approval, as cheaper layer twos and scaling solutions challenged its profitability. Unlike traditional tech, Ethereum won't be able to charge the high "take-rates" that firms like Apple demand. Instead, its growth will depend on building more efficient, productive solutions to drive adoption.

7. Naturally, the market also sent a strong message about Ethereum's value. Short-term traders dominated performance. Longer-term investors stayed resilient, reaching new all-time highs. The amount of Ethereum staked to secure the network also hit a new

Private and Confidential: Any unauthorized use, distribution, modification, forwarding, copying or disclosure is strictly pro hibited

high. And traditional companies, like Sony, continued to build on Ethereum's blockchain. The Q3 downturn was more speculative noise than strategic signal.

8. At the same time, onchain asset migration continued to grow, reaching a total value of nearly $100 billion in tokenized assets (excluding stablecoins). These assets, concentrated in government securities, are part of a larger onchain Cambrian explosion, with more than 65 million users since inception. Ethereum continues to lead the way, holding 75% of the market share in smart contracts tied to tokenization.

9. Still, crypto dispersion in Q3 performance is everywhere. Take the Optimism Token. It's a scaling solution for Ethereum transactions ranked second in market share. Yet despite bright prospects for onchain activity, the OP Token is down more than 50% for the year, even with ~10% gain in Q3. It's a reminder that active investing opportunities lie beyond the narrative-performance is what counts, and the devil is in the details.

10. Dispersion was also evident in competitors to the existing onchain ecosystem. Sui, a competing smart contract platform, was one of the strongest performers in Q3. But with only 27% of its tokens circulating, there's significant supply to absorb, dampening the appetite of long-term investors. It's a common tension in crypto assets-between short-term speculation and longer-term value.

11. Crypto markets demand a nuanced understanding, where failure is not just possible-it's expected. After all, the collapse of past ventures like MojoNation led to the birth of Bitcoin. Crypto investors must ruthlessly evaluate new ideas to get to the next one. And "new" ideas need to be recognized for what they are. Adding leverage to double crypto yields isn't innovation-it's just an old-fashioned risk transfer.

12. As with growth, the best investors are comfortable being uncomfortable in their portfolios. Just as growth requires venturing into the unknown, portfolios must adjust to the reality of imbalance over the illusion of balance. Crypto thrives on discomfort. It's here to stay, and investors have two options: proactively determine how it fits into portfolios, or let the market decide for them-potentially at much higher valuations.

Private and Confidential: Any unauthorized use, distribution, modification, forwarding, copying or disclosure is strictly pro hibited

Disclaimer

This communication, including any attachments, is intended only for the use of the addressee and may contain information that is confidential or otherwise protected from disclosure. Any unauthorized use, distribution, modification, forwarding, copying or disclosure is strictly prohibited. If you have received this communication in error, please delete this message, including any attachments, and notify the sender immediately. The information and any disclosures provided herein do not constitute a solicitation or offer to purchase any security or other financial product or investment and is not intended as investment, tax, or legal advice. Unless otherwise noted, all information is estimated, unaudited and may be subject to revision without notice. Past results are not indicative of future results.

This communication may contain statements of opinion, including but not limited to, the author's analysis and views with respect to: digital assets, projected inflation, macroeconomic policy, and the market in general. Statements of opinion herein have been formulated using the author's experience, research, and/or analysis, however, such statements also contain elements of subjectivity and are often subjective in nature. In addition, when conducting the analyses on which it bases statements of opinion, the author(s) will incorporate assumptions, which in some cases may be shown to be inaccurate in the future, including in certain material respects. Nothing in this presentation represents a guarantee of any future outcome. The author(s) are under no obligation to update this document, notify any recipients, or re-publish the content contained herein in the event that any factual assertions, assumptions, forward-looking statements, or opinions are subsequently shown to be inaccurate.

Certain information contained in this Communication constitutes "forward-looking statements," which can be identified by the use of forward-looking terminology such as "may", "will", "should", "expect", "anticipate", "target", "project", "estimate", "intend", "continue" or "believe" or the negatives thereof or other variations thereon or comparable terminology. Forward-looking statements made in this communication are based on current expectations, speak only as of the date of this communication, as the case may be, and are susceptible to a number of risks, uncertainties and other factors. Assumptions relating to the foregoing involve judgments with respect to, among other things, projected inflation, the regulation of digital assets and macroeconomic policy, all of which are difficult or impossible to predict accurately and many of which are beyond our control. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation to future results or that the objectives and plans expressed or implied by such forward-looking statements will be achieved.

Certain information contained herein may have been obtained from third party sources and such information has not been independently verified by the author(s). References herein to third parties are for illustrative purposes and are not an endorsement or recommendation for products or services. No representation, warranty, or undertaking, expressed or implied, is given to the accuracy or completeness of such information. While such sources are believed to be reliable, the author(s) do not assume any responsibility for the accuracy or completeness of such information.

The information and any disclosures provided herein do not constitute a solicitation or offer to purchase any security or other financial product or investment and is not intended as investment, tax, or legal advice. Unless otherwise noted, all information is estimated, unaudited and may be subject to revision without notice. Past results are not indicative of future results.