PAS Insights
May 2022

Cryptocurrencies had a challenging start to May. Terra Luna, a stable coin that had been among the largest market cap currencies, collapsed in May. The currency was pegged to the USD, but rapidly lost the peg to fall to less than $0.001 by 13 May. The collapse has spread through other cryptocurrencies. Bitcoin has shed around 60% of its value from the peak reached in November 2021. Ethereum has similarly seen its price fall around 60%.

In November 2021, we received a flurry of interest from investors asking whether we would approve cryptocurrencies, and whether they should be included in portfolios. At the time, we wrote a Perspectives note that we shared with our clients.

The conclusion of the note is particularly important, given the recent volatility. We said cryptocurrencies are not an “asset” in the sense that we use the word. There are no cash flows that can be discounted back to arrive at a fair value capital. It is volatile, and that presents challenges within a diversified portfolio.

We warned that cryptocurrencies are probably not inflation hedges or downside risk hedges, and instead are very volatile. We thought it was difficult to make a case for including cryptocurrencies in portfolios using our existing portfolios construction framework. Our view was that any allocation should be appropriate risk weighted – and given the very high risk, that weight was likely to be very small.

For this month’s insights, we have reproduced that Perspectives.

November 2021 – PAS Perspectives on Cryptocurrency

Cryptocurrencies are a relatively new technology, but have gained a lot of attention given the eye-popping growth and returns across a range of different currencies.

The market for digital currencies has grown exponentially. But despite the rapid growth, the size of the market remains smaller than global equities, for example, or global fixed interest.

Cryptocurrencies have delivered outsized returns in the decade to 2021. This has been accompanied by outsized volatility. The eyewatering returns has contributed to the growth, and interest, in these currencies.

Cryptocurrencies present challenges for asset allocators. The higher risk needs to be appropriately positioned if it is used in a diversified portfolio, to prevent the currency swamping the risk adjusted return profile of the portfolio.

While we have not allocated to cryptocurrencies within our client portfolios, we do think it is important to understand the crypto landscape. This note provides a starting point for that understanding, and some suggested further reading.

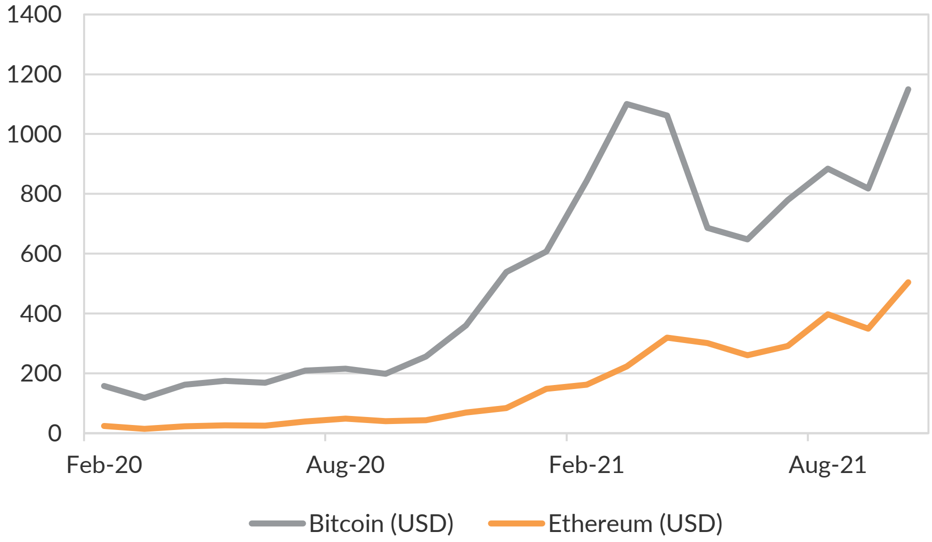
What is cryptocurrency?

Cryptocurrency refers to typically decentralised digital money. Bitcoin, launched in 2008, was the first cryptocurrency and remains the largest and best known. In the years since Bitcoin was launched, other cryptocurrencies have grown as digital alternatives to money issued by governments.

How big is the crypto market?

The cryptocurrency markets is big, and it is growing quickly. Chart 1 shows the market capitalisation for outstanding Bitcoin and Ethereum, two of the largest digital currencies. The value outstanding of Bitcoin, for example, has increased from around USD200billion in early 2020 to USD1.2trillion in October 2021. While the growth has been staggering, it remains relatively small compared with the market capitalisation of the S&P500 (US41.5trillion) or the US Treasury market (USD22.8trillion).

Chart 1: Market capitalisation of Bitcoin and Ethereum has surged since 2020.



What has the risk-return experience been?

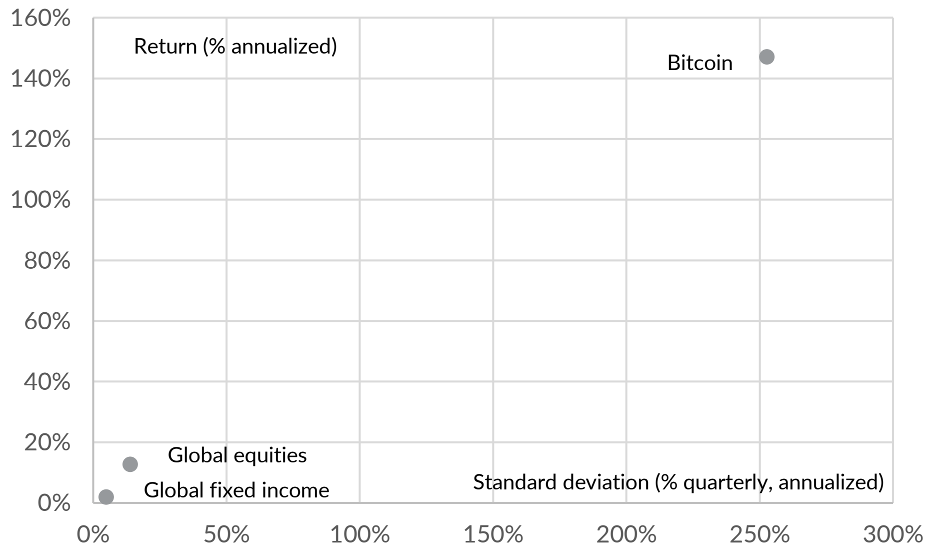
Cryptocurrencies are volatile. The annualised quarterly volatility for Bitcoin over the past decade has been greater than 200%! That compares with around 14% for the MSCI World Index, and around 5% for the Bloomberg Global Aggregate fixed income index.

Returns have also been high for Bitcoin. The annualised compound return over the past decade is in excess of 140%. That compares with around 12% for global equities and 2% for global bonds (see chart 2).

These capital market assumptions are not set in stone. Over time, the risk-return trade off could move to be more like global equities. But it may not. And we only have a short period of historical returns to help with this judgement.

The challenges in building sensible capital market assumptions for cryptocurrencies adds to the challenge for asset allocators who want to include cryptocurrencies in portfolios.

Chart 2: Risk-return outcomes for asset classes, 2011-2021.



How can I use crypto?

Cryptocurrencies are not an "asset" in the sense that we use the word. There are no cash flows that can be discounted back to arrive at a fair value capital. It is a volatile, and that presents challenges within a diversified portfolio.

Cryptocurrencies have been touted as inflation hedges, downside risk hedges, and hedges against a number of other risks. We think it is too soon to be able to take that view with conviction.

It is difficult to make a case for including cryptocurrencies in the portfolios using our existing portfolios construction framework. This does not mean cryptocurrency has no role in any investor's portfolio. But we do think that any allocation should be appropriately risk weighted. And given the historical risk (standard deviation), that allocation may be relatively small.

Where can I learn more?

There are many websites and courses available to delve deeper into cryptocurrencies and blockchain, the associated technology. The following links share three such sites that we have used. Note that we do not endorse the views of any content on those websites, but we have found them useful in building out our own knowledge.

https://www.coinbase.com/learn

https://crypto.com/university?category=crypto101

https://www.gemini.com/cryptopedia/story/crypto-101