The ups and downs of investing in cryptos

Cryptocurrencies are attracting North American institutional investor capital. But is it time for UK pension funds to make an allocation to this speculative asset class?

Summary
- The usual investor concerns around cryptos are consistently high volatility and potential bubbles.
- However, large investment managers and North American pension funds have started making allocations to cryptos recently.
- Beyond capital appreciation, cryptos can provide diversification and inflation hedging.
- However, UK trustees face regulatory hurdles that make it challenging to invest in cryptos.

Since the emergence of the world's first decentralised cryptocurrency 15 years ago, digital assets have attracted devoted advocates and many of them have rocketed in value in recent years.

Cryptocurrencies are a form of digital currency that use cryptography to secure transactions. There is no oversight by a centralised or regulated authority – instead, they use a decentralised system to record transactions and issue new units.

The first crypto to really catch on, Bitcoin, which uses public key cryptography to record, sign and send transactions over a blockchain, surged from almost $7,000 in 2020 to above $47,000 as of 29 March 2022. Its success has spawned many imitators; there are now more than 18,000 cryptos in existence.

Institutional interest

Retail investors and hedge funds have poured money into Bitcoin and other leading cryptos such as Ethereum, but the asset class had struggled to attract similarly large amounts of capital from institutional investors.

This is now changing. Several global investment managers have announced they are investing in cryptos, while large North American pension funds are also making allocations.

Nickel Asset Management founding partner and CEO, Anatoly Crachilov, whose company runs several strategies targeting digital assets, says his firm is having "a range of conversations with large wealth managers, university endowments and pension funds, which were not on the table three years ago".

Over the past 18 months, crypto has attracted the attention of large asset managers, and more recently pension funds in North America and Canada. In 2021, the Houston Firefighters' Relief and Retirement Fund became the first US pension fund to invest in cryptocurrencies, allocating $25 million to Bitcoin (0.5 per cent of its $5.3 billion portfolio).

The US is generally ahead of the adoption curve, with many institutions making or considering allocations, while European pension funds are lagging, Crachilov adds. So, should pension funds on this side of the pond also consider investing in cryptos?

Managing volatility

Institutional investors may be put off allocating to cryptos by their consistently high volatility and concern over bubbles forming.

However, WisdomTree head of digital assets for Europe, Jason Guthrie, says it is no longer in dispute whether cryptos is a real asset class and high volatility does not mean it lacks the potential to be a major market disruptor.

He says: "This is a real technology trend and it's here to stay. Having no exposure to it now really feels like a systematic bet against it. It is like saying you didn't want exposure to the internet in the 90s.

"We had a big market correction in the 90s around internet stocks. But the emergent business models from the companies that survived and thrived are worth multiples of what the sector was worth at its top in the 90s. And if you take a long-term view of things, which most institutional investors should be doing, the price right now and short- to medium-term volatility shouldn't be something to fear if you think about it on a risk-adjusted basis."

Crachilov predicts that cryptos will structurally appreciate over the long term. "Every subsequent year, Bitcoin's lowest point has been higher than the previous year. There is some volatility and uncertainty, but our longer-term view is this market will appreciate as cryptos become more widely adopted," he says.

He adds that volatility is likely to become more subdued over time, as wider adoption will facilitate better price discovery.

"Investors should not shy away from volatility – a small allocation makes sense because the rest of the portfolio would absorb this volatility," he adds, while pointing out that it is also possible to exploit high volatility to generate alpha.

Fundamental value

However, most UK pension consultancies are broadly against investing in cryptos.

For example, XPS Pensions chief investment officer, Simeon Willis, says his consultancy strongly suggests pension funds do not invest in them.

"People say that traditional institutional investors aren't investing because they don't understand it and they need to get with the times. But a lot of things that pension schemes do are for a very good reason – which is you can't take speculative risks with pension scheme members' retirement savings.

"Cryptocurrency is a classic example of people being drawn into something by the hope of a speculative gain. But, as a pension scheme investor, you've got to ask yourself: is there fundamental value in the investment, and what's the fundamental case for its value to increase?"

Willis does not think there is a particularly strong case for having a large amount of exposure to currencies in general and that the case for cryptocurrencies is even weaker.

He adds: "Even if these cryptos serve a useful purpose, that doesn't make them a good investment. We wouldn't tend to consider currencies in the main as an investment opportunity. Pension funds tend to use currencies to invest in assets."

Uncorrelated returns

However, cryptos provide another benefit beyond capital appreciation: Diversification. Bitcoin, for example, has been relatively uncorrelated with mainstream asset classes (although there is a partial correlation to tech shares).

"In multi-asset portfolios, the intention is to have diversified exposure. During a given period, some investments will go up and some will go down. It's very hard to justify a multi-asset portfolio that has no fixed income or commodities, for example," says Guthrie.

Having examined the effects of an allocation to Bitcoin on diversified portfolios, Nickel found that between 31 December 2012 and 31 December 2021, a standard portfolio of 60 per cent equities and 40 per cent bonds would have delivered a cumulative total return of 160 per cent with a standard deviation (a measure of volatility) of 9.8 per cent.

Reallocating just 1 per cent of equities to Bitcoin within the portfolio would have increased the return by 29 per cent to 189 per cent – without having a negative impact on the portfolio's standard deviation (9.8 per cent). It also found that by allocating 3 per cent to Bitcoin, the portfolio's cumulative total return would have been 255 per cent – an increase of 95 per cent.

Cryptocurrencies also have the potential to protect against inflation. Crachilov says it is certainly the case with Bitcoin, due to its scarcity and the fixed maximum number of coins that could ever be in circulation.

"There is a limited number of Bitcoins, which creates a scarcity element. This means we can draw a parallel with gold. The number of coins in circulation is clearly prescribed and 90 per cent already have already been released into circulation. The remaining 10 per cent will be issued over the next 119 years."

This is in stark contrast with the traditional fiat money system, "where the number of dollars in circulation is defined by one agency and no one has visibility into how many dollars are going to be thrown into circulation".

Regulatory issues

UK pension funds face regulatory hurdles that make it particularly challenging to invest in cryptos.

Osborne Clark UK associate director, James Saddler, notes that there are regulatory issues that are likely to prevent trustees from making allocations.

"Pension trustees must go through a decision-making process before making an investment decision. The first part of the decision is whether they are authorised to make this kind of investment.

"Do they have requisite power in their scheme governance documentation, and are there any statutory restrictions? There are quite a few statutory restrictions that would prevent pension schemes and pension trustees from investing in the first place, because of their 'regulated market' restriction."

UK trustees must ensure that their portfolios consist predominantly of investments that are traded on regulated markets.

Cryptocurrencies are not regulated by the Financial Conduct Authority. This means trustees could only currently allocate a relatively modest amount of their overall portfolio to direct investment in cryptos.

"If cryptocurrencies are not explicitly listed in the scheme's rules as an acceptable form of investment, trustees… *[may need to]* amend the rules to make the position clear. This would likely involve getting the agreement of the employer," says Saddler.

Another risk is that the pension fund could lose the private key, the passwords needed to access the account. If it did so, the cryptos could be lost forever. That said, institutional custody arrangements have started to appear that eliminates this risk. Another way forward is for schemes to invest in cryptocurrencies through exchange traded funds, which are listed on regulated markets.

Given this new asset class presents opportunities for pension funds in terms of capital appreciation, diversification and protection against rising inflation, it is unsurprising there is institutional interest. However, it is important to remain cautious, given the significant risks involved.

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