Crypto and digital assets

Sandra Haurant investigates the role that cryptocurrency could play in pension investments and the reasons why it has been kept at arm's length so far

Summary

- Cryptocurrency is one of those rare 'novel' asset classes, but there are perhaps historical parallels to be drawn with the multiple, but short-lived, private currencies of 19th century America.
- The asset class has seen some stratospheric highs and some drastic lows in its short lifespan.
- Volatility and uncertainty make this an area that pensions are so far keeping at arm's length.
- The future may bring a less stormy landscape, potentially opening opportunities for pensions investors.

Cryptocurrency has been making headlines since it came into existence in 2009. Defined by the *Financial Times* as 'a currency created digitally, usually by private companies', it was originally conceived to allow people 'to make electronic payments without going through any financial institutions'. And, like dot coms at the turn of the millennium, it has captured the public's imagination.

But while crypto is an emergent asset class, there is nothing new about starting a currency. "This is, in essence, a private currency system," says Mercer investment consultant, Matthew Scott. "There was a 30-year period in the 19th century in America, where there were a lot of private currencies. It was called the free banking, or wildcat banking era."

More recently, and closer to home, Bristol launched its own currency, the Bristol Pound, in 2009. It has been retired since 2021 (and since 2020 in its digital form), but during its existence members used it for £6 million worth of transactions, to pay for bus tickets, groceries and council tax.

Building blocks

One of the many things that differentiates cryptocurrency from those old dollar bills, Bristol's foray into its own money, and mainstream currencies like the dollar or sterling, is the technology that underpins it: Blockchain. As the *Financial Times* defines it, blockchain is a 'type of distributed ledger, written on open-source software. It is a growing database of time-stamped transactions that cannot be altered. Each new transaction is verified by a network of computers and added as a 'block' to the chain'.

"A ledger is a book where you record transactions, essentially," says Scott. "And what we've got here is a secure ledger." The idea behind blockchain is that it removes the need for trust. Anyone can access the transaction record, and so, says Scott, "it's quite hard to be a bad actor in that system."

Highs and lows

So why does crypto keep grabbing the headlines? Cambridge Associates global head of digital assets investing, Joe Marenda, says: "Liquid tokens such as Bitcoin and Ether, and liquid token funds, attracted institutional attention beginning with the initial public offering (ICO) 'boom' in 2017."

An ICO is effectively a form of

cryptocurrency crowdfunding. While in an initial public offering, a private company issues shares that can be bought by investors, an ICO involves the issuance of coins or tokens. During the 2017 flurry of ICOs, the value of a bitcoin soared to around $20,000, then fell again the following year to $4,000. The highs and lows didn't end there – Marenda cites the recent Bitcoin bull market that saw the currency rise to a vertiginous $68,000 in 2021; since then, it has once again dropped to around $21,000.

Tulips and tokens

With such dramatic price inflations and deflations come concerns about investment bubbles. And whenever the idea of a bubble is floated, the mention of tulips is never far behind. The 17th century Dutch phenomena, where the prices of tulip bulbs reached such heights that the most prized were traded for thousands of pounds in today's money, remains an illustration of what happens when valuations get out of control. But can the crypto craze be compared to the tulip mania?

Scott says the tulip mania analogy is better suited to another virtual space: Non-fungible tokens (NFTs). "What an NFT often is, at the moment, is basically some sort of ownership of an image. The NFT usually encodes a URL to a website, where you can go and see the picture. And, obviously, anyone can go and see that picture. But only *[the owners]* have the bragging rights."

At the height of tulip mania, he says: "You could be purchasing a tulip bulb for the same price as a mansion on the Grand Canal in Amsterdam. If you look at some of the NFT auctions, they can reach the price of a penthouse in Miami."

Headlines and high-profile falls

Investors buy and sell on cryptocurrency exchanges. So, when cracks began to appear in the walls of one of the major players, FTX, the world watched to see if it could withstand the shock. The structure, it turned out, was not sound. At the time of writing, it's unclear how much investors have lost in its collapse.

Those investors included the Ontario Teachers Pensions Plan (OTPP), which in October 2021 invested $75 million in FTX International and its US entity FTX. US, as well as a follow-on investment of $20 million in FTX.US in January 2022. (This was "less than 0.05 per cent of our total net assets and equated to ownership of 0.4 per cent and 0.5 per cent of FTX International and FTX.US, respectively," OTPP said.)

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Generally, investment in crypto remains 'of interest' but at arm's length for many pension funds. Questions are raised around whether pensions could invest in crypto, if they wanted to, from a legal viewpoint. "You wouldn't necessarily associate *[cryptocurrency and pension funds]* as good bedfellows," says Osborne Clark association director, James Saddler.

"Trustees making any sort of discretionary investing decisions inherently have the power to invest how they want to, subject to their legal duties. But is that power subject to any kind of statutory restrictions?" A lack of regulatory clarity is another potential barrier. "There's a restriction in statute about trustees having to invest predominantly in regulated markets, so they've got to overcome that too."

And then there is the final point: "Are they acting in the best interest of the members in investing in this way? And that's where they need to be taking advice from investment consultants to support them in their decision," says Saddler.

Forward thinking

For now, most pensions continue to view crypto and its peripheral industries as a curiosity. As Cardano deputy CIO, Keith Guthrie, says: "Broadly, we don't think cryptocurrencies have a place in pension investments. The technology is at a very nascent stage. It's very volatile and speculative, and it's unclear who the winners and losers will be. In the past few months, there has also been a substantial loss of confidence in this space after recent events, for example FTX.

"Pension schemes should also be aware of the negative environmental impact of many of the algorithms," says Guthrie. "This is particularly the case for Bitcoin which uses extreme amounts of energy."

"As an investment in a nascent technology, the risk/reward profile is quite broad with a wide range of potential outcomes, partially driven by macroeconomic and market factors, but also driven by manager and position selection and sizing," says Marendo. "Volatility management is critical at this early stage, although as the technology matures and becomes more widely adopted, we expect volatility to decline over the long term."

There may, in future, be scope for introducing crypto in some form. "Blockchain as a technology has some really exciting potential real world," says Guthrie, while Saddler adds: "With DC, the emphasis is more on giving members the flexibility and different options, so they can make their own choices. I can see a future in which DC schemes maybe kind of open up investment opportunities involving cryptocurrency."

But for now, the risks are likely to outweigh the rewards. "We'd say keep a watchful eye on the asset class but leave it to specialists to invest. Eventually the ecosystem will mature and could potentially create some interesting real-life applications, which some asset managers might take advantage of," says Guthrie.

Written by Sandra Haurant