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cryptocurrencies

On the cusp of mainstream?

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Cryptocurrencies: On the cusp of mainstream?

The period from 2017 to early 2019 saw what can only be called a "hype train" or mania in the world of cryptocurrencies:

(1) **The rise of the altcoins**. Envy experienced by those who missed the rise of Bitcoin led to a surge of interest in what might be the "next Bitcoin." Ownership of so-called alternative coins, or altcoins, (such as Ether, Monero, Litecoin and others) broadened. Cryptocurrencies became the vehicle of choice for aspiration and getting rich quick. Enthusiasts quit their jobs to day-trade altcoin portfolios, and many remortgaged properties to raise capital for investing in cryptocurrency. Asian countries, particularly South Korea, Singapore and Hong Kong, were hotspots where cryptocurrency awareness and ownership became mainstream and normalized.

(2) **A blizzard of new offerings.** New token offerings occurred with almost hourly frequency. There were 966 offerings in 2017, and an acceleration in 2018 produced an eye-watering 2,284. At any point during 2018, 482 token sales were on offer.[1]

(3) **Indiscriminate purchases.** OneCoin, a scheme without an actual token or blockchain, gathered an estimated US$4 billion. Paid celebrity endorsements acted as somewhat dubious unique selling points for various eagerly subscribed-to cryptocurrencies.

(4) **Institutionalization begins.** The asset manager TOBAM launched the first Bitcoin mutual fund in Europe in 2017, making it easier and more palatable for institutions to access Bitcoin. By Q1 2018, Grayscale, an American firm, had launched investment trusts for Bitcoin and many major altcoins. CBOE and CME both launched Bitcoin futures in 2018. (Though CBOE subsequently discontinued its offering.)

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[1] Pozzi D. "ICO Market 2018 vs 2017: Trends, Capitalization, Localization, Industries, Success Rate," *Cointelegraph*, January 5, 2019, https://cointelegraph.com/news/ico-market-2018-vs-2017-trends-capitalization-localization-industries-success-rate.

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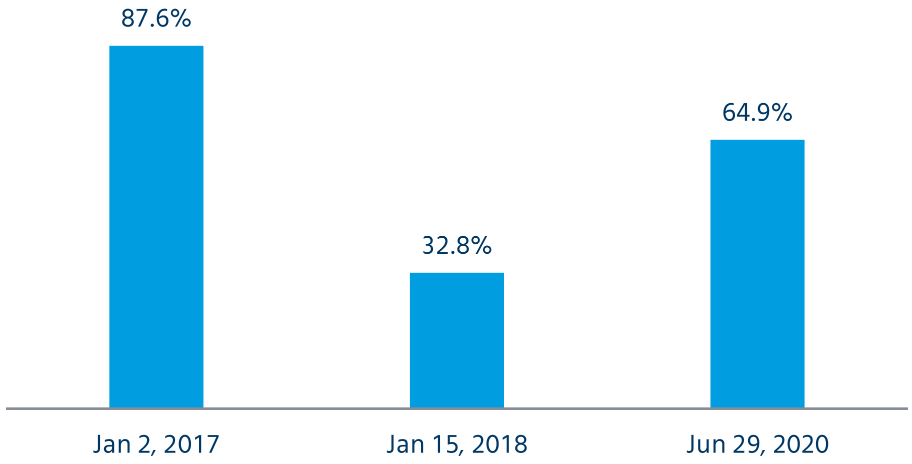
What's changed?

Narrowing and reassertion of Bitcoin

In our 2018 report, ***Cryptocurrencies: Fool's Gold or the Future?***, we highlighted survivorship as one of the main risks with cryptocurrencies.[2] Most had the potential to disappear through obsolescence or because the field was overcrowded and they simply weren't needed. Since then, the blizzard has cleared, and the field of coins taken seriously has narrowed. Furthermore, "Bitcoin dominance," or the percentage of cryptocurrency market capitalization in Bitcoin, has been reasserted. Bitcoin dominance was well above 80% going into 2017 but fell to 33% by January 2018 at the height of altcoin and ICO[3] exuberance. However, by June 1 of this year, Bitcoin dominance had climbed back to 65% as the cryptocurrency field narrowed.

Figure 1. Bitcoin dominance: Bitcoin as a percentage of total cryptocurrency market capitalization



Source: Coinmarketcap, https://coinmarketcap.com/charts/.

The above phenomena of narrowing and Bitcoin dominance are related in that Bitcoin has essentially acted as the reserve currency for altcoin purchases and sales. As altcoins have diminished in importance, balances have flowed back to Bitcoin. This makes it hard to build a diversified cryptocurrency portfolio, as investors remain highly exposed to the idiosyncratic risks of one asset. The risk is even greater for those with a coin market cap benchmark starting point.

[2] We refer the reader to the previous report for primer information on cryptocurrencies.

[3] Initial coin offering.

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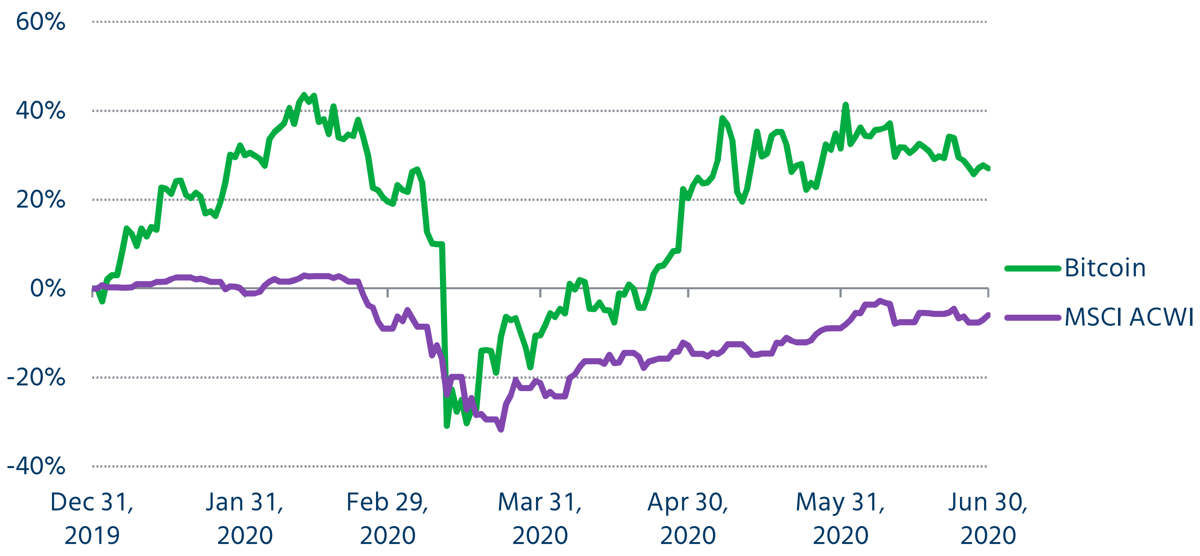
Linkage to broader economy

In Q1 2020, cryptocurrencies suffered the effects of broader economic problems sparked by the COVID-19 pandemic. Investors (institutional and individual) in need of capital sold almost any liquid asset, and cryptocurrencies are relatively liquid. Cryptocurrencies endured a long squeeze, exacerbated by extreme leverage limits in cryptocurrency markets (up to 100 times on some exchanges). As investors sold Bitcoin to cover their margin calls, the price further decreased, leading to a cascade of redemptions.

Bitcoin began to recover in March, well before broader equity markets, and it has so far fared better than equities in 2020 (see Figure 2). However, investors may have to get used to cryptocurrencies falling in ”risk-off” market crises. Risk-off environments occur when market participant appetites for risk dry up, usually in response to bad economic news although sometimes due to purely technical market events. At this point leveraged long-term positions are unwound, exacerbating initial market falls. This means that low correlations with traditional asset classes that could have justified investing in cryptocurrencies are evaporating quickly as cryptocurrencies respond to wider market occurrences.

Figure 2. Bitcoin and equities in H1 2020, USD returns



Source: Coinmarketcap and Thomson Reuters Datastream. The MSCI ACWI Index is designed to represent performance of large- and mid-cap stocks across developed and emerging markets. It covers approximately 85% of the free float-adjusted market capitalization in each market covered. Here the MSCI ACWI Index is used to represent the universe of listed and liquid equity stocks.

Recent correlation statistics between cryptocurrencies and traditional risk markets are inconclusive. However, a more qualitative perspective suggests that cryptocurrencies have a low correlation during low volatility but respond to both surges and crashes in equity markets. This is relatively intuitive.

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Cryptocurrencies have evolved from a penny-ante game played by computer enthusiasts to a much more mainstream store of value. They are a big deal. As equity markets boom, some investors will trim from their holdings and allocate to Bitcoin and other cryptocurrencies. While early-uptake “HODLers”[4] of cryptocurrency may approach crashes with relative sangfroid, a new breed of investor is likely to panic sell.

Outlook

Below are some important tailwinds and headwinds for cryptocurrencies.

Tailwinds (positive):

(1) **Improvements in accessibility.** Buying cryptocurrency is still a relatively awkward process for many citizens, poorly linked to their day-to-day digital experience. Integrating cryptocurrencies with the apps that have established user bases on mobile phones — Apple Pay, eBay, Amazon and others — would produce new users and drive up prices. One notable project in this space is Libra, Facebook’s cryptocurrency. Originally intending it as a grand project — a blockchain and a token to rival the likes of Bitcoin and Ethereum, Facebook faced stiff political and regulatory opposition. Libra 2.0 is essentially a stablecoin, or coin that tracks fiat currency markets. Libra still seems likely to be an important development in terms of mobile banking. It is also a cautionary tale for other major e-brands looking to create their own utopian cryptocurrencies or host existing decentralized and free-floating cryptocurrencies.

(2) **Increase in number and sophistication of internet users.** In Figure 3, we can see that there has been a relatively relentless increase in the number of cryptocurrency users over time. The number of users and the amount of capital they deploy drive cryptocurrency value; this is known as a “network effect.” More users support greater longevity.[5]

[4] The jocular term “HODLer” denotes a determined, come-what-may, long-term owner of a cryptocurrency

[5] Deutsche Bank forecasts an estimated 200 million wallet users by 2030. Deutsche Bank. “Imagine 2030,” *Konzept*, December 2019.

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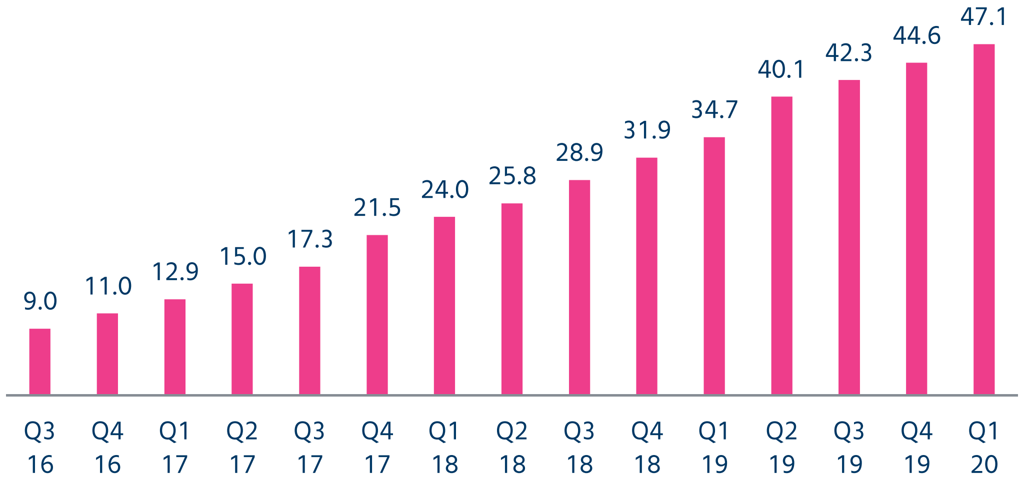
Figure 3. Number of blockchain wallet users (in millions)



Source: Statista, https://www.statista.com/statistics/647374/worldwide-blockchain-wallet-users/.

Headwinds (negative):

(1) **Security.** In 2019, we saw a substantial increase in cryptocurrency theft, with US$4.5 billion of fraud and theft related to cryptocurrencies, up from US$1.7 billion in 2018.[6] Security risk has been an ever-present threat in the cryptocurrency space and shows no sign of abating.

(2) **Regulation and government policy.** Cryptocurrency prices are highly sensitive to regulatory shifts, such as changes in tax treatments. Asian governments are currently softening their stances on cryptocurrencies. However, policy may not be good news for big-name cryptocurrencies, as governments like those of India and China may prefer to move to their own state-backed cryptocurrencies and outlaw the rest.

(3) **Responsible investment.** The major cryptocurrency, Bitcoin, still operates with a proof-of-work protocol for validating transactions. From a responsible investment point of view, this is not desirable, as it uses a large amount of electricity, and Bitcoin thus has an unfavorable emissions profile. The Ethereum blockchain, by contrast, looks set to move to proof-of-stake, which is far less electricity-intensive.

[6] Cipher Trace Cryptocurrency Intelligence.

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Conclusion

Cryptocurrencies have a track record, albeit a relatively short one, of resilience after large crashes, and it's difficult to imagine a scenario which would cause a sudden end to their use. The entrenched user base lives and breathes cryptocurrency, and users are steady in their convictions. However, despite the reassertion of Bitcoin dominance, it is still far from clear whether we presently have the cryptocurrencies of the future. State or corporate actors could take over at some point. We have seen now that cryptocurrencies are not immune to wider market fallout, as correlations have begun to emerge, and the volatility and future uncertainty remain extreme. This raises questions about how much diversification benefit they actually add to a portfolio on an asset class level. Within the asset class, cryptocurrencies are primarily dominated by Bitcoin and thus highly exposed to idiosyncratic risk.

At this time, we still see risks and general uncertainty in this space outweighing potential benefits and would thus caution investors against investing in Bitcoin and altcoins. Cryptocurrencies do however cater to the contrarian and may be of interest to individual investors, but they should be accompanied by risk warnings of sufficient gravity (cryptocurrencies are an order of magnitude riskier than traditional investments). Cryptocurrencies are largely unregulated investments and should be presented as such. Investors should obtain legal advice regarding investment suitability and should avoid their use in countries where cryptocurrencies are banned.

The same risks and issues apply to institutional investors. But investors who are alert to these risks and have a sufficiently futurist perspective, access to digital expertise and an interest in positively convex investments[7] might make a small allocation in their opportunistic portfolios.

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[7] Often, investors focus on the mean/average expected result — for example, they might invest in an equity portfolio and expect to harvest the equity risk premium. Some investors look instead at the range of possible outcomes for an investment. They focus on investments that have asymmetric return profiles, where there is a small probability of a very strong upside (although a high probability of losing money, or not gaining much). Imagine a "popcorn popper" portfolio where, occasionally, a kernel of corn pops and shoots up. Examples of such investments are single-company opportunities in distressed debt or venture capital, and cryptocurrencies, and these are positively convex investments. A lottery ticket is an example of an investment with extreme positive convexity, whereas an investment grade credit portfolio typically has negative convexity (limited upside, unlimited downside).

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