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Wealth managers remain cautious on crypto

By Sam Downes

Despite a lack of retail products, many high net worth individuals have invested in digital assets, including cryptocurrency. Image: Getty Images

Despite ‘unstoppable’ demand for cryptocurrency, asset and wealth managers are still waiting and watching from the sidelines.

Following a false alarm and fevered speculation, bitcoin was given the seal of approval by the U.S. Securities and Exchange Commission (SEC) for inclusion in spot exchange traded funds (ETFs) in January 2024.

The green light, which led to launch of 11 ETFs, all with direct exposure to bitcoin, immediately sent its value to a record high of $73,000.

A surge in the value of the world’s largest cryptocurrency by market valuation was also enabled by the Financial Conduct Authority’s go-head to cryptocurrency-backed securities – exchanged traded notes (cETNs) in both bitcoin and Ethereum. The latter is the world’s second largest cryptocurrency and during March 2024 hit a two-year record high of more than $4,000.

Regulatory acceptance was evidence of how far bitcoin has been embraced since 2022, when PayPal started accepting it. Bitcoin is now regulated for some cryptocurrency activities. Despite a lack of retail products, by the end of 2022 CapGemini found 71 per cent of high net worth individuals had invested in some form of digital asset, including cryptocurrency.

Scandal and collapse

The SEC’s announcements followed a series of crypto-related scandals: the collapse of fraudulent firm FTX, the money laundering fine related to crypto exchange Binance and a raft of class action lawsuits related to celebrity endorsements.

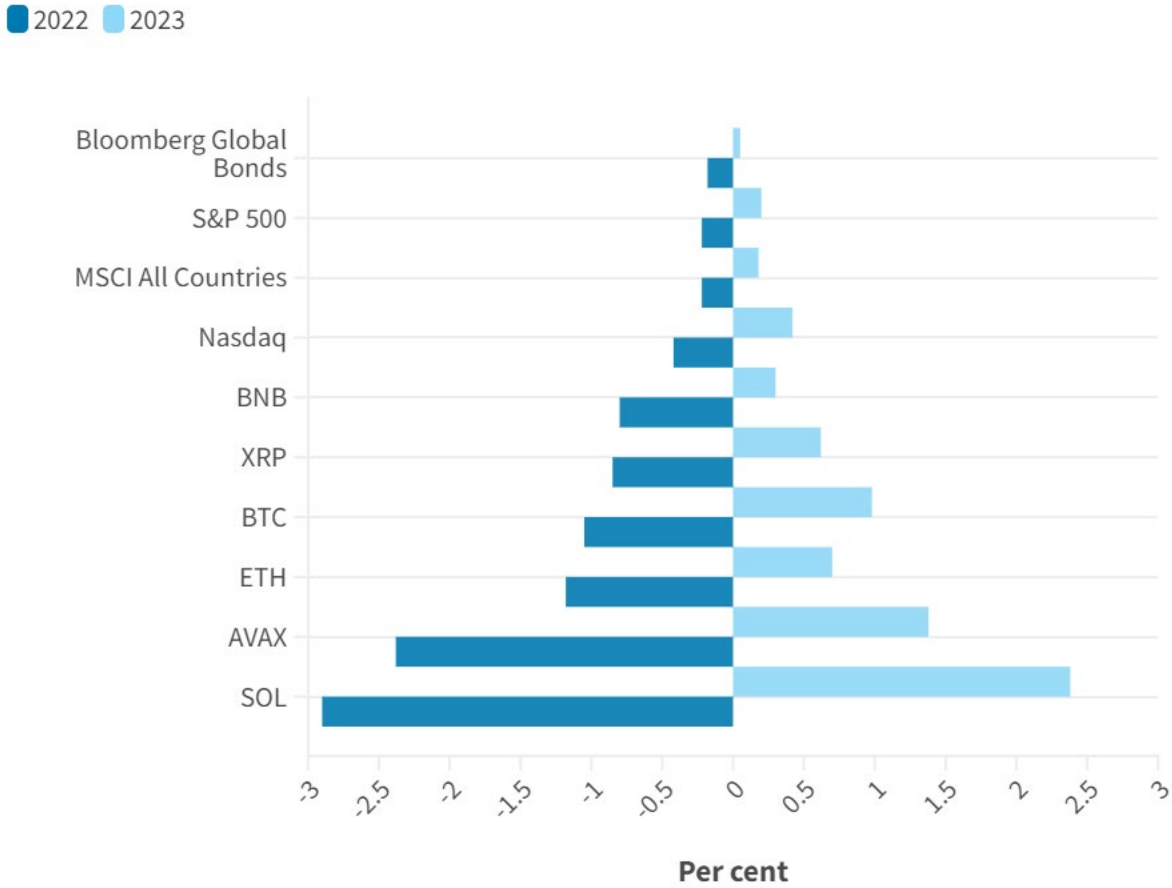
FTX’s bankruptcy was a high profile one. The Bahamas-based company was founded in 2019 and became the world’s largest cryptocurrency exchange. But in 2022, its founder and chief executive Sam Bankman-Fried was arrested and charged with stealing $10bn from investors. Mr Bankman-Fried, due to be sentenced later in March, was dubbed ‘the King of Crypto’ after FTX bought out smaller cryptocurrencies.

A series of class action lawsuits by investors followed, including one against US celebrities including comedian and actor Larry David and NFL star Tom Brady, said to have “endorsed” the crypto exchange. FTX’s failure was followed by more lurid headlines, included the salutary tale of reality star Kim Kardashian agreeing to pay $1.3m to settle charges with the SEC for promoting EthereumMax to her 331m Instagram followers, without disclosing she had been paid to do this.

On the heels of FTX came the Binance scandal, involving a $4.3bn fine handed down by the US government to the world’s largest currency exchange for money laundering. The ruling required Binance to agree to intensive regulatory monitoring and the exchange’s chief executive Changpeng Zhao was made to step down and pay a $50m fine.

While FTX's collapse pushed bitcoin to a six-year low of $16,000, this merely served as an example of the currency's resilience rather than its volatility, as 16 months later it was trading at a record high.

Performance of selected crypto and traditional assets in 2022 and 2023
Log returns, in %



Source: Bloomberg, UBS, as of December 2023

While the FTX case may have temporarily reduced the pool of potential retail investors in crypto, the increased scrutiny should prove more positive, say commentators. "Long-term, this should allow for the crypto market to emerge stronger and allow it to rebuild its reputation," says Sam Taylor, head of corporate intelligence (Americas) at cyber security consultancy S-RM.

Investors should be reassured of significant progress made in the winding down of FTX during the last 18 months.

"A very large proportion of customer assets have been successfully recovered, with recent reports suggesting that customers may be repaid in full," says Dan Wyatt, a partner and litigator at international law firm Reynolds Porter Chamberlain.

"There have also already been successful prosecutions brought. All of this has happened in an extraordinarily short space of time."

The recovery of assets, he says, has been in stark contrast to the efforts to unpick other high-profile frauds, such as that perpetrated by Bernie Madoff, and return funds to victims. “That process remains ongoing more than a decade later and victims are unlikely ever to be compensated in full.”

Wealth management gap

Previous crypto market doldrums could be left behind us, according to some experts such as Katharine Wooller, a non-executive director of software firm AssetPass, arguing that an “ever-looming voluminous gap in the wealth management market” was appearing.

She believes many high net worth investors are already buying into crypto using platforms, away from their wealth managers or private banks.

“The buying audience for these assets, cryptocurrency and digital assets such as NFTs [non-fungible tokens], has expanded beyond the generation that it originally appealed to, the crypto punks, renegades, and pirates – the digital natives who came into investable wealth in the nascent age of crypto, who have no recollection of life before the internet.”

The surge in demand had come from slightly older, significantly wealthier retail investors who were using crypto exchanges to buy blue chip coins.

Not deterred by scandals such as FTX and Binance, these investors wanted exposure to leading cryptocurrencies including bitcoin, Ethereum, cardano and ripple.

“Blue-chip coins are sourced from a reputable exchange with strong regulatory oversight, for those who are not comfortable purchasing digital assets directly themselves,” says Ms Wooller.

These older, but newer crypto investors are “craving” wealth management products and platforms they understand, she adds. “This [the blue chip coin exchange investing] is eminently sensible, it provides levels of diversification, regulatory protection, and frankly emotional support that they cannot get in a Web 3 environment.”

The traditional firms, she warns, need to move with the times in order to keep clients. “Wealth management firms need to adapt to this changing consumer need to provide great service to their customers, and more importantly, market-beating returns,” she says, adding that the interest shown in ETFs was likely to increase the pressure on fund managers to launch more retail-friendly versions of the product.

Rise of the crypto passives

The 11 spot ETFs launched in January continue to attract huge inflows. BlackRock’s iShares Bitcoin Trust (IBIT) now has total assets nudging $10bn while the Grayscale bitcoin ETF, which converted from a bitcoin trust, is the largest of the funds with at least $26bn of assets under management.

The raft of ETF launches- which also included Firedlity Wise Origin Bitcoin fund - has helped to de-risk bitcoin investing, believes Yevgeni Agerd, founder and chief executive of wealth management platform Welrex.

“Prior to ETFs there were issues with storing the coins, dealing with wallets and carrying credit risk of the exchanges like FTX,” he says.

Investment houses have taken the issue of credit risk and liquidity out of the equation by packaging the investment as a safe ETF in what was “a major step forward for crypto to solidify as an asset class”, says Mr Agerd.

“We are seeing some newly emerged bitcoin ETFs trying to lure investors with additional incentives, for example the ETF Van Eck has announced has no management fees for 12 months.”
Even so many family offices were still likely to see bitcoin investing as highly risky. Mr Agerd adds: “Since 2012 we have witnessed 48.5 per cent, 39 per cent, 30.2 per cent, 24.4 per cent and 18.5 per cent among others daily moves down in the price of bitcoin.Therefore risk-sensitive investors try to limit the exposure to a maximum of five per cent of overall portfolio allocation."

Halving it all

Bitcoin’s value is predicted to continue its rise at least for the next few months, which could be a good run for the currency. This is largely due to ‘the halving’, an event which takes place every four years and is scheduled for April 2024, to increase its value.

‘The halving’, which means the mining reward for bitcoin is split in half, increases both its scarcity and appeal. But such events also produce vagaries that worry traditional asset managers.

JP Morgan’s CEO Jamie Dimon has been particularly vocal over many years about the risks associated with crypto and served as a bellwether for investor sentiment.
“Ultimately, he doesn’t view crypto as viable and maintains a healthy scepticism of the product, but he has recently stated that JP Morgan will be a counterparty in these transactions, as long as there is demand,” states Mr Taylor of the S-RM consultancy.

Mark Haefele, chief investment officer at UBS Global Wealth Management, has informed investors that he is watching “client needs, regulatory, and market developments carefully”.
UBS is also monitoring development of infrastructure that can be used to launch more central bank digital currencies, or CBDCs, and what it called “new payment solutions”.

Digital asset showdown

The main appeal of bitcoin, and cryptocurrency, is as an alternative asset. Its decentralised nature, which allows it to be used as a hedge against inflation and interest rates, also means it is not meant to be driven by retail forces.

The digital asset ecosystem has evolved significantly since the publication of the seminal Satoshi Nakamoto whitepaper, which foresaw an electronic payments system based on cryptographic proof, rather than a trusted third party.

Regulatory decisions will still play a role in legitimising the asset class, but investors will need to understand what they are buying into.

“Traditional valuation methodologies, such as discounted cash flows or price/earnings multiples and which are very familiar to investment professionals, simply do not work when valuing digital assets,” argues Mark Cleary, director at wealth solutions provider Zedra.

“So, the type of client choosing to invest will be one who spends a significant amount of time undertaking detailed due diligence, understanding the risks and also understanding the use cases of any particular asset. For any specific digital asset, this remains very much a *caveat emptor* market and one of extreme care.”

There is even an argument that greater acceptance can actually pause a threat to crypto assets.

“I’d note that if and when G20 governments introduce their own digital currency, there could be another major shock to mainstream cryptocurrency," believes Mr Taylor from S-RM.

Crypto: avoid or marry?

But not all wealth managers are avoiding taking action. Indeed, some are enabling investors to benefit from exposure to cryptocurrency in innovative ways that do not scare them off.
Donald McFarlan, portfolio management associate director at multi-family office Capital Generation Partners, says its asset allocation team has made the call that cryptocurrencies including bitcoin and Ethereum are “investable assets.”

While it does not choose to invest in them, they were added as "tools in our toolbox should we want to use them".

Where there has been client interest, CapGen has invested in blockchain enabled businesses via a venture fund of funds. Their use of blockchain technology is not simply about cryptocurrencies, however. Instead, the businesses the funds are investing in are – rather than creating currencies – benefitting from the technology that has evolved from the currencies.

“This means we don’t have to take one single bet on the technology which is still nascent,” says Mr McFarlan. “We can instead own a lot of market beta in the blockchain technology.”
One example he offers is around how tokenisation and securitisation can be used to improve the purchasing and selling of a house. “So rather than going to the Land Registry, the company we invest in uses the technology to recreate everything the Land Registry holds on the blockchain.”

Crypto or bust

Overall, the community still remains split on the efficacy of crypto in portfolios of wealthy clients. Javier Rodriguez-Alarcon, chief commercial officer at digital asset services platform XBTO says: “Embracing innovation and diversification within the cryptocurrency space holds the promise of fostering more resilient and inclusive financial markets, that adeptly cater to the needs of investors in the digital age.”

Anders Kvamme Jensen, the founder of AKJ, a token-driven cryptocurrency provider for hedge funds, banks and brokerages, is equally ebullient, saying cryptocurrency shows a resilience that remains appealing to investors.

“The fact that the market recovered quickly after a period of overselling and fear uncertainty and doubt shows there is appetite for a hedge against inflation and de-dollarisation,” says Mr Kvamme Jensen.

“There is also a belief in the viability of shared financial infrastructure that is optimised for automation and open innovation. It’s a force that will not stop."

Others are more wary, believing investors might want to hold off before tighter regulation is introduced. “In the short term, tighter regulation may put up greater barriers to entry,” believes S-RM’s Mr Taylor. “In the long run, it creates a safer marketplace and encourages fund managers as well as retail investors to enter with the confidence that there are safeguards and protections.”

While new regulations can hurt near-term market liquidity, they can also create “an environment where everyone can take greater comfort in knowing that regulators are taking the issue seriously and law enforcement is focused on removing bad actors”, says Mr Taylor.
“Over time, unless crypto completely blows up, it is more likely to become a financial product like any other.”

Lombard Odier, one of the most prominent and digitally innovative private banks, strikes a note of even greater caution. “Investors must realise that even small allocations to crypto, say 2 per cent, of an otherwise balanced portfolio, drive large shares of the overall portfolio volatility, around 25 per cent,” says Nannette Hechler-Fayd’herbe, chief investment officer for Emea at Bank Lombard Odier.

“Raising allocations to 5 or 10 per cent would eventually triple overall portfolio volatility and change the nature of the portfolio. We do not include it into our asset allocations for that reason, and think great caution is required when investors introduce bitcoin or other crypto assets into portfolios, as well as a long investment horizon.”