

CRYPTOCURRENCIES as an investment

Cryptocurrencies are sweeping the world in terms of news headlines, but the question remains in terms of the suitability of the asset class other than pure speculation.

There are two key questions that investors face to determine the suitability of including crypto assets in an investment portfolio:

1. What are the requirements in terms of credit intermediation, regulation and infrastructure as well as cost?
2. More importantly, what should the role be of crypto assets within a portfolio?

These questions are addressed by looking at a couple of specific investment factors, risks and market dynamics.

INVESTMENT CASE

The investment case can simplistically be broken down into relevance and risks on the one side and then return expectations and diversification on the other.

Rates of return are measured by an increase in the asset price and the interest paid or the dividend stream on a specific investment. The only source of return for a crypto asset is to increase in price. Given the nature of the change in price over time, driven by pure supply and demand and perhaps other speculative views, crypto assets do have the ability to behave very differently to traditional asset classes and perhaps provide a hedge against the volatility of global monetary systems and therefore a source of diversification.

Although cryptocurrencies are permitted in most of the world's major economies, there are still a range of risks, in addition to volatile market price movements, that should raise concerns for inclusion in an investment portfolio. These risks include security risks, valuation risk and uncertainty around the regulatory future.

Besides these risks, there needs to be an internationally trusted marketplace for institutional-only cryptocurrency trading.

However, the most interesting development in cryptocurrencies is in the world of investment fund management. Specialist cryptocurrency funds have been created which seek to buy and sell in the same way one might with equities or other securities. The expectation for this market is to grow quickly as people seek non-correlated alternative investments.

There are several possibilities to explore over time as risks subside and more visibility around regulations transpires:

- **Direct investments:** these can be risky, however, especially when investing in larger amounts, given storage and execution risks.
- **Futures:** available if one has the expertise to trade them.

- **Passive crypto funds:** through exchange-traded products, for example. These offer capacity but are a blunt instrument. They have concentration risk (because of the dominance, for the time being, of Bitcoin).
- **Active hedge funds:** exploitation of the inefficiencies presented by the market.
- **Venture capital funds:** these can offer purer forms of Digital Ledger Technology (DLT) exposure, but often have long lockups.

Cryptocurrency as an investment option would greatly increase fiduciary risk and liability. Traditional valuation methods for determining what a stock is worth do not necessarily work when evaluating crypto assets. Crypto volatility requires investors to be patient over the long term and during significant up and down swings, which could result in poor investment outcomes if you were to exit the sector too quickly.

An improved infrastructure is needed to accommodate investments and encourage more widespread acceptance of cryptocurrency. Besides that, potential regulatory and legal hurdles create market hesitation to use cryptocurrency. Until a properly regulated and accountable fund exists, based in a respectable financial territory and with strong custodianship arrangements in place, we must tread with caution.

At Momentum Investments, we relentlessly pursue and interrogate ideas and opportunities to best deliver on our outcome-based investing philosophy. With us, investing is personal, and we seek those investment ideas and opportunities that will allow our portfolios to meet clients' long-term expectations and objectives as prudently and robustly as possible.

While the simple yet profound wisdom of Warren Buffett – "If you don't understand it, don't invest in it" – provides the answer, some investors may still feel compelled. It is important to remember that the crypto space can be highly volatile. Even though cryptocurrencies have been declared as a financial product under the Financial Advisory and Intermediary Services Act of 2002 there is still a lot of uncertainty regarding the regulation of these instruments and therefore makes investing in them a risky proposition. ■



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