Retail and institutional investors often follow simple rules, like a 60/40 mix of stocks and bonds. But this common approach to investments is being challenged these days by the combination of near-zero interest rates, uncertainty due to COVID-19 and stocks reaching historically high valuations. Many investors are now looking beyond the traditional array of assets to consider the value-add of alternative asset classes, including digital holdings such as cryptocurrencies.

In a recent Rethinc. webinar, Zoe Cruz, strategic advisor to the CEO of Ripple and former co-president of Morgan Stanley, spoke with Rethinc. Faculty Director Eric Ghysels about the impact of adding cryptocurrencies to traditional portfolios. Cruz is uniquely positioned to speak on introducing such seemingly riskier digital assets into investor portfolios, with her extensive background in managing global investments — first through a 25-year tenure with Morgan Stanley, then through her own boutique investment firm. She also recently made the leap into the cryptocurrency sphere as the strategic advisor for blockchain/fintech company Ripple.

Diversifying your portfolio to include digital assets

According to Cruz, cryptocurrencies should not be correlated with other asset classes (i.e., the usual diversification argument) when deciding your portfolio composition. Rather, legitimate moonshot opportunities like Bitcoin should be viewed as riskier digital assets into investor portfolios, with her extensive background in managing global investments — first through a 25-year tenure with Morgan Stanley, then through her own boutique investment firm. She also recently made the leap into the cryptocurrency sphere as the strategic advisor for blockchain/fintech company Ripple.

Cruz says there are several top cryptocurrencies that investors should consider, with Bitcoin the most notable. In existence for 11 years, Bitcoin is the oldest cryptocurrency, and became a legitimate asset for investors around 2014. Since then, other cryptocurrencies, including Bitcoin Cash, Litecoin and Ethereum, have also made their way onto investors’ radar.

When adding digital assets to your portfolio, Cruz recommends starting with a two-step diversification. First, diversify from traditional asset classes. Then, determine your risk profile — whether it’s 3 percent or 10 percent — and diversify within the digital asset class among the top five to 10 crypto assets and currencies. Cruz stresses the importance of choosing multiple digital assets and not just the current winner, like Bitcoin; otherwise, you’re likely to miss out on future outperformers. A shortsighted strategy of investing in only one cryptocurrency, she says, would be the equivalent of having invested in only one internet stock in the early 2000s. You likely would have picked Netscape, which was the browser of choice, with a roughly 75 percent market share at the time. When Google and Facebook subsequently arrived on the scene, you’d have missed a huge investment opportunity. Google is now one of the largest internet-related companies, and Netscape is no longer in business.

Weighing the pros and cons of various crypto assets and currencies

It’s critical to consider that each cryptocurrency is designed differently, with its own underlying business model. Cruz further explains that some digital assets have clear winning characteristics, while others are less likely to be successful. For example, Bitcoin, often termed “digital gold,” has its own pluses and minuses. Bitcoin’s success has made a lot of people wealthy, and those people are now passionate about the currency and have become ardent advocates for it. However, mining for Bitcoin
uses a lot of energy. With environmental, social and governance (ESG) movements gaining ground, it may not be a sustainable long-term model.

Another example is XRP, the leader in cross-border payments systems. Currently, larger cross-border payments take place through corresponding banks using the SWIFT messaging system. This messaging system works well if, for example, Morgan Stanley is sending $1 billion to Goldman Sachs or Citigroup. But for high-volume, low-value business transactions, this method is more difficult. Therefore, XRP was designed for nearly instantaneous transactions for smaller amounts at high volumes. XRP’s advantage is that it meets a specific market need. But the disadvantage is that it has a lot of concentrated holdings in Ripple, whose balance sheet includes 50 percent of all coins minted. Again, each digital asset and cryptocurrency has its own benefits and drawbacks that should be considered when incorporating such assets into a more traditional portfolio.

The underlying challenges of cryptocurrencies

There are two significant challenges that can make retail investors nervous about investing in cryptocurrencies: the lack of both regulatory oversight and information intermediaries.

Cryptocurrencies have been largely unregulated, but as they continue to pursue legitimacy, there likely will need to be new regulatory frameworks put in place. It’s widely known that cryptocurrency is used to fund devious activities (e.g., organized crime, drug lords) largely due to this lack of regulation. Cruz notes that the industry, with the help of global regulators, needs to develop rules of engagement that absorb the bad actors.

Additionally, unlike investment within the traditional asset classes, where financial advisors and analysts provide insight into the market and make recommendations on buying and selling, in the cryptocurrency space there are no formal intermediaries serving as the source of sound investment decisions. In the absence of traditional information intermediaries, online discussion platforms such as bitcointalk.org and reddit.com emerge as an alternative source of information in the cryptocurrency market. Active users on these platforms who analyze the cryptocurrency markets can give investment advice, but there are no required qualifications or credentials, unlike within traditional asset classes. The idea of the ETF has yet to translate to the cryptocurrency space, further limiting the ease with which an individual can enter and diversify in the space.