KENAN INSTITUTE of Private Enterprise
UNC KENAN-FLAGLER BUSINESS SCHOOL

KENAN **INSIGHTS**

Should your portfolio include cryptocurrency?

April 2021 | kenaninstitute.unc.edu/insights

Last week, the biggest cryptocurrency exchange in the United States, Coinbase, listed on Nasdaq.[1] It was a significant step in growing cryptocurrency's legitimacy among investors as a viable and even desirable asset class. And although crypto still has its critics, it's becoming an increasingly mainstream option for retail and institutional investors alike.

As cryptocurrency continues to mature as an asset, more traditional financial institutions are offering their clients options to invest, particularly in bitcoin. Morgan Stanley recently announced that it was launching three funds that allow some of its clients to own bitcoin.[2] Three days after Morgan Stanley made its announcement, Fidelity also announced it was going to launch its own bitcoin exchange-traded fund.[3]These major milestones for crypto may have helped the technology reach, in the terminology of Fidelity's head of digital assets, Tom Jessop, a "tipping point" in institutional adoption by more traditional financial spheres.[4]

All this recent traction leads to the question: Should you, as an investor, add cryptocurrencies to your portfolio?

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 a traditional portfolio. Cruz is uniquely positioned to speak on infusing seemingly riskier digital assets into a more conventional portfolio, with an extensive background in managing global investments, first through a 25-year tenure with Morgan Stanley, and then through her own boutique investment firm. Recently, she made the leap into the crypto 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 when determining your portfolio composition. Rather, legitimate crypto investments like Bitcoin should be viewed as moonshot opportunities in which your investment could fall to zero or reap a return of 100% or more. Cruz cautions against doing something risky — such as investing all of your child's education savings into cryptocurrency — but says that it's fine to invest 1%-5% (or, if you truly believe in the stagflation macroeconomic environment, up to 10%) of your portfolio in crypto.

Cruz recommends several top cryptocurrencies for investors to consider, with Bitcoin the most notable one. Introduced 12 years ago, Bitcoin is the oldest cryptocurrency, becoming a legitimate asset for investors around 2014. Since then, other cryptocurrency systems — including Bitcoin cash, Litecoin and Ethereum — have made their way onto investors' radar.

When adding digital assets to a portfolio, Cruz suggests starting with a two-step diversification. First, diversify from traditional asset classes. Then determine your risk profile — whether, for example, it's 3% or 10% — and diversify within the digital asset

[1] Wilson, T. & Irrera. (2021, April 14). *Coinbase listing marks latest step in crypto's march to the mainstream*. Reuters. https://www.reuters.com/article/coinbase-ipo/coinbase-listing-marks-latest-step-in-cryptos-march-to-the-mainstream-idUSL4N2M62MI

[2] Son, H. (2021, March 17). *Morgan Stanly becomes the first big U.S. bank to offer its wealthy clients access to bitcoin funds*. CNBC. https://www.cnbc.com/2021/03/17/bitcoin-morgan-stanley-is-the-first-big-us-bank-to-offer-wealthy-clients-access-to-bitcoin-funds.html

[3] Franck, T. (2021, March 24). *Fidelity to launch bitcoin ETF as investment giant builds its digital asset business*. CNBC. https://www.cnbc.com/2021/03/24/fidelity-to-launch-bitcoin-etf-as-investment-giant-builds-its-digital-asset-business-.html

[4] DeCambre, M. (2021, April 10). *'We've reached a tipping point' on bitcoin adoption, Fidelity's Tom Jessop says*. MarketWatch. https://www.marketwatch.com/story/weve-reached-a-tipping-point-on-bitcoin-adoption-fidelitys-tom-jessop-says-11617847910

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, to avoid missing out on future outperformers. She likens investing in only one cryptocurrency to the shortsighted strategy of investing in only one internet stock in the early 2000s. If you did, she said, you likely would have picked Netscape, which was the browser of choice at the time, with a roughly 75% market share. But because Google and Facebook did not yet exist, you would have missed out on a huge investment opportunity if your assets were tied up in Netscape. Today, Google is one the largest internet-related companies, and Netscape is out of business.

Weighing the pros and cons of various crypto assets and currencies

It's critical to consider that each crypto currency is designed differently, and each has its own underlying business model. Cruz 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 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, Bitcoin 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, say, Morgan Stanley is sending a billion dollars to Goldman Sachs or Citigroup. But it's not as viable for high-volume, low-value business transactions. XRP, on the other hand, was designed for nearly instantaneous transactions for smaller amounts at high volumes. XRP's advantage is that it meets a specific market need. But its drawback is that it has a lot of concentrated holdings in Ripple, where 50% of all the coins minted are on the balance sheet. As Cruz points out, each digital asset and cryptocurrency has its own benefits and shortcomings that need to be considered when incorporating crypto into a more traditional portfolio.

The underlying challenges of cryptocurrencies

Two significant challenges make some retail investors nervous about investing in cryptocurrencies: the lack of regulatory oversight and a scarcity of information intermediaries.

Cryptocurrencies have largely been unregulated, but as they continue to pursue legitimacy, new regulatory frameworks will likely need to be put in place. There are a couple of reasons for this added oversight. First, it's widely acknowledged that cryptocurrency can be used to fund unlawful activities (e.g., organized crime, drug trafficking) largely due to a lack of regulation. Cruz notes that the industry, with the help of global regulators, needs to develop rules of engagement that eliminate the bad actors.

Additionally, unlike investment within the traditional asset classes, where credentialed financial advisors and analysts provide insight into the market and make recommendations on buying and selling, the crypto currency space has no formal intermediaries serving as the source of sound investment decisions. In the absence of traditional intermediaries, online discussion platforms such as bitcointalk.org and reddit.com emerge as an alternative source of information on the cryptocurrency market. Active users of these platforms who analyze the crypto markets can give investment advice, but have no formal qualifications or credentials.

A final obstacle to investing in cryptocurrencies is the fact that exchange-traded funds (ETFs) have yet to embrace crypto. This further limits the ease with which individual investors can enter and diversify in the space.

The bottom line? In spite of the challenges, individual investors who approach cryptocurrencies with awareness and a dose of caution should consider adding crypto as a viable part of their diversified investment portfolio.

OUR EXPERTS

Eric Ghysels
Rethinc. Labs

CONTRIBUTING EXPERTS

Zoe Cruz
Ripple

RESEARCH

Liquidity Guided Machine Learning: The Case of the Volatility Risk Premium

Should cryptocurrency Pump and Dump Schemes be Regulated?

More Research at
kenaninstitute.unc.edu/research

RESOURCES

View the entire conversation with Zoe Cruz

More Insights at
kenaninstitute.unc.edu/insights