CRYPTOCURRENCY

A case for crypto?

The benefits of cryptocurrency have been promoted across the internet by the likes of Kim Kardashian and Elon Musk; but is it all hype, or does the asset class hold a genuine opportunity for institutional investors such as pension schemes? Sophie Smith reports

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Interest in cryptocurrencies has surged in recent years, particularly as social media influencers began to promote investment in the latest trending asset class. But it is not only hopeful individuals who are looking to the asset class as a potential opportunity.

A recent shift in German regulations, which allows Spezialfonds to hold up to 20 per cent of their assets in cryptocurrencies, is expected to "open the gates" for pension funds, with Spezialfonds to able to hold more than USD 400 billion of crypto investments, according to Global Digital Finance.

Nickel Digital Asset Management founding partner and CEO, Anatoly Crachilov, agrees that this will "open access to this market to a very significant capital pool," describing the plans as a reflection of a "rapidly improving perception of this asset class by European regulators and recognition of the structural growth potential associated with this new asset class".

Europe more broadly will also benefit from the introduction of Markets in Crypto-Assets (MiCA) regulation in 2022, Union Investment portfolio manager, Daniel Bathe, points out, stating that this "will provide increasing regulatory certainty for EU investors in crypto assets and thus for technological adoption".

A regulatory gap

However, Crachilov notes that whilst some countries, such as Germany and Switzerland, have made "great progress in formalising legal frameworks", others are lagging behind.

Adding to this, Insight Investment head of currency solutions, Francesca Fornasari, warns that there is also a "significant risk of market manipulation as cryptocurrencies are currently outside the remit of most regulators, as well as a high probability of increased regulation or drastic change".

"Then comes the risks for institutional investors that regulatory interventions compromise the fate of some crypto assets," Candriam head of ESG, David Czupryna, adds. "Whilst hard to predict, the likelihood of such intervention seems quite high, in one way or another. And such in-meddling could very well destabilise the valuation of some crypto assets and send their price sharply downwards."

Wisdom Tree quantitative research associate director, Florian Ginez, agrees that investors are often reluctant to act due to a lack of regulatory clarity, suggesting that the accelerated adoption of digital assets by regulated financial institutions "should and will" encourage regulators to establish frameworks to alleviate this challenge.

However, whilst the UK Financial Conduct Authority (FCA) recently suggested that the "tide of regulation is turning all over the world", it remained unclear as to whether it may have more of a remit to regulate the issue or promotion of speculative digital tokens in future.

Speaking at the Cambridge International Symposium on Economic Crime, FCA chair, Charles Randell, stated: "In regulating the online world, we need to strike the right balance between fostering innovation, providing an appropriate level of protection and allowing individuals the freedom to take decisions for which they are responsible. We also have to recognise that effective regulation of a digital world requires international cooperation and common standards. It will take a great deal of careful thought to craft a regulatory regime which will be effective in the decentralised world of digital tokens."

A volatile market

Regulation is not the only issue for pension schemes to consider, however, as Fornasari warns that limited market liquidity and limited custodial services present further challenges for investors, in addition to concerns around the "extreme volatility" that has emerged amid the "huge" price increase seen since 2017.

Czupryna agrees, arguing that no matter investors' views on the asset class, "nobody can discuss the fact that they represent highly volatile instruments, with a non-negligeable risk of short-term downsides".

However, Crachilov suggests that a market-neutral arbitrage strategy could be "an excellent way of having exposure to this asset class while minimising the volatility".

"With 13 YTD return and volatility of below 5 per cent it would provide strong source of uncorrelated returns for pension schemes," he says.

DeVere Group founder and CEO, Nigel Green, also identifies bitcoin in particular as being the digital asset that would be most appealing to European pension schemes currently, as it not only acts as a "shield against inflation", but is also frequently branded "digital gold" due to its safe haven attributes.

"In addition, it can serve as a diversifier as it is uncorrelated to other asset classes;" he continues, "it can counteract pensions schemes' typical lack of transparency as it is traded on the blockchain, a shared and decentralised ledger; and it has an enormous potential upside as younger generations are 'digital natives' and geared towards technology."

An internet revolution

And there is an advantage in moving sooner rather than later, as Ginez, explains: "Starting with bitcoin or ether allows investors to start working with the asset class, build up expertise and opportunities to engage with service and product providers. This helps investors build the knowledge and confidence that will be required to explore the space as it develops."

Czupryna warns, however, that whilst the interest by pension schemes is understandable given "paltry investment returns and stagnating growth", it is important to "take a hard look" into the base characteristics of any crypto assets being considered using the tools of prudent investors.

"This would mean analysing counterparty risk, credit risk, regulatory risk, market risk, and maybe adding to these 'classic' risks the reputational risks faced by the pension fund itself," he continues. "If the risk-return profile of a given crypto assets stands out after undergoing such stringent but basic scrutiny, it could then constitute an interesting diversification option." ■

Mining for modern gold

"FROM AN ENVIRONMENTAL, social and governance (ESG) standpoint, crypto assets can hardly be seen as a monolithic reality," Candriam head of ESG, David Czupryna, warns, explaining that the best known of these assets, bitcoin, is coded in a way that requires a growing quantity of processing power to mine additional coins.

Indeed, GlobalBlock sales trader, Marcus Sotiriou, points out that bitcoin's carbon footprint is currently equal to the country of Columbia, also noting that, as the crypto industry is still very young, this information is not being communicated by a central body.

"However, these risks are publicly displayed by analysts, as well as the reasons why these risks may not be significant for long-term investors," he clarifies, stating that the total energy consumption of the cryptocurrency industry is around half that of gold mining, which has "never been a consideration when investing in gold".

And change is already taking place; Nickel Digital Asset Management co-founder and CEO, Anatol Crachilov, notes that some 79 per cent of bitcoin miners already use some form of renewable energy in their energy mix, and over 40 per cent of miners use renewable energy sources only.

"This is set to increase further, as ongoing relocation of miners from China is usually associated with switchover to green sources," he suggests. "Moreover, most of other crypto assets are relying on a different, far less energy-intensive consensus protocols. For example, ethereum is currently migrating to a proof-of-stake protocol, reducing energy use by a staggering 99 per cent."

Despite this environmental progress, Sotiriou warns that there is also the "often-mentioned use of bitcoins to finance shady operations in the underworld".

"No institutional investor wants its name associated with such illegal activities," he says, warning that there is a "very tangible risk" that regulators might force more transparency upon bitcoin holders based in their jurisdiction, "blowing to the surface the murky world of underworld financing and sending the valuation of these crypto assets downwards".