

# CRYPTOCURRENCY: TAMING THE VOLATILITY THROUGH FUND-INVESTING



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**BLOCKCHAIN AND CRYPTOASSET (K) LTD.**

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***“As cryptoassets enter the mainstream, index funds are increasingly presenting both retail and institutional investors with the opportunity to gain exposure to the cryptoasset market”***

**Investment Funds: a general view**

An investment fund is a pool of capital that a number of individual investors pay into which is then used to collectively invest in stocks, bonds, commodities, property and/or other asset classes. The fund sponsor sets up an investment fund that issues units or shares to investors. Investors buy these units or shares and the capital raised in this way is used to buy up the underlying assets. The investor does not directly own the underlying assets, but rather owns units or shares in the investment fund. Individual contributions on their own are not able to spread the money over such a large range of investments and gain the same diversification benefits at lower trading costs as they would under such a managed fund. The investment fund, therefore, affords small- and medium-sized savers opportunities to hold a stake in a large diversified portfolio and to hold stakes in assets that would be beyond their reach had they attempted to invest outside of the pooled fund.

Investment funds can be divided into those that are passively managed and seek to track the performance of a single asset or a broad-based index and those that are actively managed and seek to deliver a return over and above the broader market index i.e deliver alpha. Funds can also be divided into those that are regulated and those that are not regulated.

<b>INVESTMENT FUNDS</b>			
<i>(Largely) marketed to the public/retail investors</i>		<i>(Largely) marketed to accredited/sophisticated investors</i>	
<i>Regulated</i>	<i>Unregulated</i>	<i>Regulated</i>	<i>Unregulated</i>
<ul style="list-style-type: none"> <li>• Unit Trusts (Open-ended funds<sup>1</sup>)</li> <li>• Investment Trusts (Close-ended funds<sup>2</sup>)</li> <li>• Exchange-Traded Funds (ETFs)</li> <li>• <i>Listed</i> Private Equity Funds</li> </ul>		<ul style="list-style-type: none"> <li>• Venture Capital Funds</li> <li>• Private Equity Funds</li> <li>• Exchange-Traded Funds (ETFs)</li> </ul>	<ul style="list-style-type: none"> <li>• Hedge Funds</li> </ul>

<sup>1</sup> An open-ended fund is a diversified portfolio of pooled investor money that can issue an **unlimited** number of shares. The fund sponsor sells shares directly to investors and funds raised are used to purchase assets. The fund sponsor is also able to buy back or redeem shares sold to investors.

<sup>2</sup> A close-ended fund is a portfolio of pooled assets that raises a **fixed** amount of capital through an initial public offering (IPO) and then lists shares for trade on a stock exchange. Due to the fixed nature of capital raised, the shares in the fund will trade either at a premium or at a discount at any point in time and not necessarily be in line with the NAV of the underlying assets.

**Note:** The public and retail investors can still invest in private and unlisted companies (i.e. participate in venture capital and private equity) through the buying of shares in Unit Trusts and Investment Trusts that hold shares in these companies

This report looks at investment funds, not in the traditional finance sense, but rather through the lens of cryptocurrency, here referred to as cryptoassets. We believe the term ‘cryptocurrency’ is somewhat of a misnomer because it, erroneously, creates the assumption that cryptocurrencies are used solely as a currency or medium of exchange. By doing so, the use of the term ‘cryptocurrency’ ignores the myriad of attributes that are inherent in cryptoassets. We believe cryptoassets to represent a new asset class in and of themselves (see our [FAQs](#) webpage). Funds covered here are those that track a single cryptoasset or a broad-based index or basket of cryptoassets. Investors consider such funds to be a medium- to long-term form of investment (five years or more).

### **Investment funds in the cryptoasset space**

There are currently more than 800 blockchain/crypto investment funds around the globe. The majority are set up as venture capital (VC) funds while the remaining are hedge funds or hybrid funds. However, these investment vehicles are typically not marketed to the public or retail investors as they remain largely unregulated. There are also a handful of crypto ETFs and crypto private equity funds.

In addition, existing tech/FinTech VC firms are expanding investments into blockchain startups and launching their own blockchain funds; and as some blockchain companies mature, private equity funds are beginning to get involved. 2017 was a record year for the launch of new crypto funds with over 290 new funds setting up. This was more than triple the number of funds launched in 2016. In fact, several of the top performing hedge funds in 2017 were crypto funds. To date, crypto hedge funds are the fastest growing segment of the hedge fund industry. 2018 sustained the high pace of new crypto fund launches seen in 2017 with more than 230 launched in that year. The pace, however, slowed down in both 2019 and 2020 compared to 2017 and 2018.

The growth in assets under management (AUM), over recent years, within crypto funds is a result of three primary factors: the launching of new crypto funds, net inflows to existing funds and changes in the value of portfolio assets. The last factor was particularly prevalent in the last half of 2017 and the first quarter of 2021. Generally, crypto funds tend to underperform individual cryptoassets in bull markets and outperform them in bear markets when one ignores the research costs involved.

However, notwithstanding this growth in the number of crypto funds, the vast majority of them remain small. Half have less than \$10 million in AUM and all their AUM combined makes up less than 1% of total hedge fund AUM. Despite this, there are a number of crypto funds with over \$100 million in assets including [Pantera Capital](#), [Galaxy Digital Assets](#), [Altpabit Fund](#) and [Polychain Capital](#).

Almost half of all crypto funds are based in the United States. The others are in jurisdictions like the UK, China/Hong Kong, Singapore, Switzerland, Canada, Australia, and Germany. A small number are also setting up in offshore jurisdictions like the Cayman Islands and the British Virgin Islands.

In the US most crypto funds are not registered with the [Securities and Exchange Commission](#) (SEC) due, largely, to a general lack of regulatory certainty and a lack of cohesion<sup>3</sup> between the various regulatory bodies. Furthermore, since most crypto fund launches have been small, most qualify as exempt advisors and are not required to register with the SEC. The top cities for crypto funds are all cities that have significant existing hedge fund and venture capital industries and include San Francisco, New York, London, Singapore, Hong Kong, Zurich and Chicago.

### **Crypto index funds**

In the traditional sense, tracker or index funds are a specific type of fund designed to mimic the movements of a particular equity index such as the US S&P 500 equity index or the UK FTSE 100 equity index. This tracking is achieved by replicating the make-up of the securities that are in the benchmark indices with the securities the fund manager has selected for investment in their index fund. The performance of the replicated fund to the benchmark index is monitored closely to ensure that the variability between the index fund and its benchmark is minimised. A measure of this variability is the tracking error, which reveals how closely the fund is matched to the equity index.

Management costs for tracker funds should be relatively low. The fund only requires passive management because the criterion for inclusion of a particular stock in the fund portfolio is simply that a share forms part of the index. Tracker funds have become very popular in recent years because of the growing body of research highlighting that passive index tracker funds tend to outperform, on a consistent basis, many funds that are actively managed. The key advantage of a passive strategy is that the transaction costs of revision or chasing alpha (trying to get abnormal excess returns through active management) are minimised.

***As cryptoassets enter the mainstream, index funds are increasingly presenting both retail and institutional investors with the opportunity to gain exposure to the cryptoasset market. In this space, index funds are now being employed to track the activity and performance of specific cryptocurrencies or basket of cryptocurrencies to meet a variety of risk and return objectives of different client types.***



Crypto index funds also resonate better with traditional investors in comparison to their investing in individual<sup>4</sup> cryptoassets. Due to their inherent ability to reduce volatility, track the market, and provide dynamic risk-adjusting exposure, they are helping investors participate in the

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<sup>3</sup> The [Commodity Futures Trading Commission](#) or CFTC has given guidance that it considers cryptoassets like Bitcoin and Ethereum to be commodities and may, therefore, have certain jurisdiction over crypto funds. The SEC has also suggested it considers most Initial Coin Offerings (ICOs) to be security tokens and hence under their remit.

<sup>4</sup> Websites or platforms like [CoinMarketCap](#), [WorldCoinIndex](#) and [CryptoCompare](#) that list the price and capitalisation info on various cryptoassets are ideal for acquiring instant price information as well as acting as a good source of information for benchmarking, monitoring and comparing the growth of the various cryptoassets.

evolution of cryptoassets as a means to creating value and wealth without having to endure the daily volatility observed with individual cryptoassets.

Thus, rather than investing directly in coins and other digital assets, the investor buys shares in the crypto index fund. The fund manager then applies their industry knowledge and expertise to invest client money in multiple cryptoassets, depending on the fund's index. This reduces risk for the client because they have their money invested in a more diversified cryptoasset portfolio than would have been the case had they invested themselves. It is also a cost-effective way of protecting the investor's finances against the volatility of this market. Another major benefit is that the index fund does all the work, tracking variables like price, performance and capitalisation of various cryptoassets in accordance with the client's preference for risk exposure. However, a crypto index fund is not suited for active trading, but rather, remains a tool for those investors seeking long-term gains through passive investment.

Despite these obvious advantages, many crypto index funds are limited to accredited investors meaning the average investor is not able to participate or buy shares of these index funds. The most common criteria for accredited investors are that the individual or entity made over \$200,000 in the previous two calendar years or that the individual or entity has a net worth in excess of \$1,000,000 excluding their primary (property) residence.

For fund managers deciding on an index strategy, the most important part remains the asset selection stage which involves deciding which cryptoassets should be in the index.

### ***Full replication***

This index fund type seeks to fully replicate an index representing 100 per cent of the weighting of all listed cryptoassets (measured in market capitalisation) on exchanges. The fund will hold within it cryptoassets in exactly the same proportion as the size of the companies within that index. This means that the fund will mirror the performance of the index as closely as possible. However, a full replication strategy is advantageous only when dealing with indices that can be easily replicated. It provides broad exposure to the market ensuring better diversification and lower turnover costs. On the flip side, however, these advantages disappear when dealing with complex or illiquid markets such as the cryptocurrency market.

The number of cryptoassets on exchanges is, however, upwards of 10,000. Most of these are insignificant small-cap cryptosassets that would not move the index much and will have miniscule weights in the index compared to the larger cryptoassets<sup>5</sup>. As such these miniscule cryptoassets will be costly to acquire for most fund managers and the cost of acquiring them will typically outweigh the tracking benefit of owning them. As such there are practically no cryptofunds that perform full replication.

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<sup>5</sup> Depending on the state of the market (bullish or bearish), Bitcoin alone accounts for 40-50% of the total cryptomarket weighting, while Ethereum accounts for 15-25%. Almost 100% of the total cryptomarket weighting is concentrated in the top 10 cryptoassets by market cap.

### ***Stratified sampling***

Stratified sampling<sup>6</sup> or representative sampling involves choosing investments that are representative of different characteristics of the complete basket of cryptoassets. The fund manager then chooses investments that mimic those characteristics. The number of cryptoassets contained in this fund should be lower than that for full replication since the fund will not need to track every single cryptoasset. This should reduce transaction costs and, therefore, help avoid such costs eroding overall performance. Examples of stratified sampling include:

#### *Stratification by size or market capitalisation*

In general, the most common way to select assets for inclusion in a crypto fund is to prioritise those with the highest market cap. That means calculating the highest market caps and including the relevant cryptoassets in the fund. Calculating the market cap of each individual cryptoasset can be time-consuming, so services like [CoinMarketCap](#) can be used to accelerate the process. Examples of funds that track a market index based on the size of the constituent cryptoassets, and hence provide access to investors looking for asset allocation by size, include:

- [Grayscale Digital Large Cap Fund](#)
- [Bitwise 10 Large Cap Crypto Index \(BITW\)](#)
- [Bitwise 20 Mid Cap Crypto Index \(BITW20\)](#)
- [Bitwise 100 Total Market Crypto Index \(BITW100\)](#)
- [Circle Invest](#)
- [Bitpanda Crypto Index \(BCI25\)](#)

However, the cryptocurrency market is still dominated by a few major players. Such disparity can lead to a lack of diversification in a crypto fund when allocating by market cap. A square-root market cap or evenly-allocated crypto fund strategy may be used to amplify diversification; or, alternatively, a minimum-weight for each constituent in the crypto fund implemented thereby allowing every cryptoasset an opportunity to make a healthy contribution to the crypto fund performance. An example would be setting a minimum threshold of 5% for a top 10 by market cap crypto fund. Each asset that would have held less than 5% of the weight in the fund will get bumped up to 5%. The remaining allocations will then be allocated based on market cap to distribute the funds.

Similarly, there are also times when the fund manager may want to provide a cap on the maximum amount a single cryptoasset can be allocated, again so as to maintain a reasonable level of diversification. An example would be a maximum weighting of 25% on a top 10 by market cap crypto fund. The result of this restriction would be to cap any cryptoasset which holds over 25% of the market cap to 25%. Once capped, the remaining cryptoassets will have their allocations determined based on their prevailing market valuations.

#### *Stratification by sector*

The breadth of crypto sectors is now almost as diverse as that in traditional markets thereby presenting fund managers with the opportunity to develop an overarching strategy and roadmap for selecting cryptoassets at the right stage to invest in. As the crypto market continues to mature, it is

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<sup>6</sup> A stratified sampling approach is an indexing strategy whereby a fund manager divides an index into different "cells" that represent different characteristics of the index. The fund manager then chooses investments that mimic those cells.

unlikely that incoming sophisticated investors will jump into all cryptoassets at once (as retail investors have done previously) but will rather scale into certain sectors incrementally.

[Cryptoslate](#) tracks data, information and analytics on a slew of crypto sectors it has compiled and, therefore, provides an invaluable tool for crypto fund managers, seeking to allocate client funds by sector, to inform their client portfolios.

Crypto index funds that offer sector concentration include, but are not limited to:

- [Bitwise DeFi Crypto Index Fund](#)
- [Bloomberg Galaxy Crypto Index \(BGCI\)](#)
- [Pantera Capital Digital Asset Fund](#)
- [Pantera Liquid Token Fund](#)

### *Stratification by low correlation*

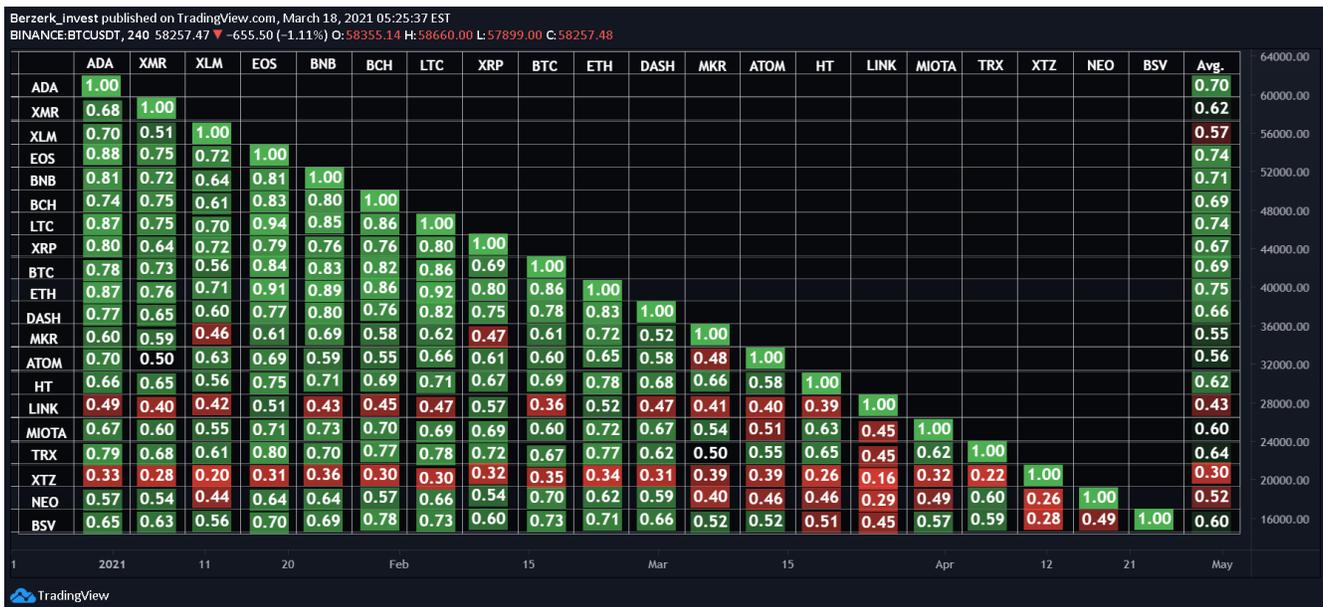
Correlation theory works in part because it establishes a statistical relationship between different assets in an economy. However, because cryptoassets are such a new asset class, it's difficult to establish their correlation to other asset classes within the broader economy. Not enough time has elapsed to establish predictable patterns of behavior between them. Further, among cryptoassets with substantial valuations, correlation is an on-and-off affair with bitcoin prices setting investor and price momentum in crypto markets for most of the last decade. Despite this, as other cryptoassets have continued to garner popularity with developers and investors, the impact of the price of bitcoin on the market at large has continued to wane.

In addition, bitcoin's correlation with stocks and gold is also declining<sup>7</sup> as the token scales fresh peaks, bolstering arguments that cryptoassets offer portfolio diversification benefits to an expansive portfolio; and in terms of Bitcoin and digital coins versus other traditional risky asset classes, the diversification benefits remain intact as the average correlation among cryptoassets themselves continues to drop.

[Coinmetrics](#) and [TradingView](#) provide useful first tools for tracking correlations between cryptoassets and act as invaluable sources of information for fund managers seeking low-correlated cryptoassets to populate their funds.

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<sup>7</sup> The 90-day correlation of the S&P 500 index and Bitcoin dropped to about 0.21 in February 2021 from a peak above 0.50 in October of 2020.



Correlation chart on some of the top cryptoassets in 2020 and 2021

Source: TradingView

A number of crypto funds have been set up to take advantage of low correlation between cryptoassets themselves and between cryptoassets and traditional asset classes. These include:

- [CoinShares Gold and Cryptoassets Index \(CGCI\)](#)

### Stratification by factor-matching

In the traditional sense, factor-based funds offer the potential to achieve specific risk and return objectives by purposely and explicitly ‘tilting’ portfolios toward certain stock characteristics like value, recent momentum, higher quality or lower stock prices. They, however, carry significantly more risk than is experienced when investing in the broader stock market since factor returns can be cyclical and typically lead to sharp and lengthy periods of underperformance compared to the broader stock market.

Within the cryptoasset space, common factors used to inform a factor-based index fund include age, liquidity, pre-mining, exchange-concentration and smart-contract protocol. Examples of crypto funds adopting this investment strategy for their clients include:

- ✘ [Bloomberg Galaxy Crypto Index \(BGCI\)](#)
- ✘ [Morgan Creek Digital Asset Index Fund](#)

### Crypto-specific indexing

The objective of this type of funds is to track the underlying value of the specific cryptoasset. These funds, typically, have a very high expense ratio (up to 2% of AUM) partly to cover the extra cost of safekeeping the underlying cryptoasset. They are, typically, also open only to accredited investors.

Examples of these funds include:

- ✘ [Bloomberg Galaxy Bitcoin Index](#)
- ✘ [Bloomberg Galaxy Ethereum Index](#)
- ✘ [Bitwise Bitcoin Fund](#)
- ✘ [Bitwise Ethereum Fund](#)
- ✘ [Pantera Bitcoin Fund](#)

### **Custom-indexing**

There are times when the fund manager wants to include specific cryptoassets in a fund even if they don't abide by their asset selection methodology or strict selection criteria. An example would be where the fund manager wants to create a fund of the top 10 cryptoassets by market cap, but based on their research, they have a strong belief that the cryptoasset currently ranked 15 by market cap has a strong use-case for the future. In this case, they would structure a fund that includes cryptoassets from rank 1 to 10, but that also includes the cryptoasset which is currently ranked 15 by market cap.



Similar to 'inclusions', there are times when the fund manager may want to exclude a cryptoasset from a fund even when the cryptoasset strictly meets the criteria to be included in the index. Examples of cryptoassets that are typically excluded from crypto funds are stablecoins like Tether (USDT), USD Coin (USDC) and Binance USD (BUSD). Since most

people place their funds into cryptoassets to get exposure to digital assets and earn long-term returns, keeping stablecoins in a crypto fund may not achieve the desired results since stablecoins, by their very construct, are pegged to the value of USD. This, notwithstanding, stablecoins are a key hedge against value loss in a bear crypto market.

Another example of an 'exclusion' is where the fund manager's strategy dictates that no forks should be included in an index. In this case, it is their prerogative to eliminate cryptoassets that are forks of other cryptoassets from the crypto fund.

### **Crypto Exchange-traded Funds**

Exchange-traded funds (ETFs) allow investors to trade index portfolios in the same manner that shares are traded on a listed exchange. Quite unlike units or shares in the typical investment funds, which can only be traded once a day when Net Asset Value (NAV) is calculated, ETFs trade throughout the day during market-open hours. They are designed to track an underlying index which may be a stock index, bond index or any other asset class whose underlying securities and composition can be replicated or even constructed through sampling techniques. As their popularity has grown, they are increasingly being used to track industry and sector indices as well. They remain attractive to investors because of their low expense ratios, virtually zero tracking error to a benchmark and share-like trading properties. For a small or even large investor an ETF is, therefore, an efficient and quick way to get exposure to an underlying stock index, bond index or any other popular trading instrument without having to go to a lot of trouble buying individual securities.

Similar to traditional ETFs, crypto ETFs have emerged that track the value of a basket of one or more cryptoassets or digital tokens. Instead of trading on a cryptocurrency exchange, like typical cryptoassets do, crypto ETFs are traded on a traditional exchange like the NYSE or Nasdaq. However, this ease of use comes with some hefty management fees- typically 2%, which is, for example, five times the fees charged by gold ETFs at 0.4%. Over the long-term such expenses eat away at returns in a way that would be absent were the investor to hold a cryptoasset directly.



Despite this, investor preference for ETFs is buoyed by the fact that they fall under regulatory oversight serving to boost investor confidence in them. In the US, for example, they fall under the U.S. Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA) regulations, providing both retail and institutional investors with a sense of credibility and safety when investing in them. Thus, with the investment physically backed and in the custody of regulated entities, crypto ETFs help mitigate the risk of fraud and help avoid the pitfalls associated with scams, exchange collapses, hacks and similar failures seen in the industry. Crypto ETFs can therefore be bought, held and sold using a normal brokerage account and the investors do not need to go through the challenges of setting up a cryptocurrency wallet or trading on unregulated cryptocurrency exchanges. Furthermore, the regulated nature of crypto ETFs makes them eligible for investments via government-regulated tax plans which are typically tax-efficient in their construct.

With traditional ETFs, the fund provider must own the underlying assets that they are tracking in order to sell shares to investors who buy a portion of the fund. However, shareholders do not own the underlying assets in the fund. In the same manner, crypto ETF providers must 'own' the underlying digital tokens or coins (e.g. Bitcoin or Ethereum) in order for them to be allowed to sell crypto ETF shares to investors.

Given that Bitcoin is the largest, most liquid and most well-known cryptoasset, it is no surprise that the majority of crypto ETFs track this coin. However, as the segment expands, issuers are setting up ETFs that provide exposure to the price of [Ethereum](#), [Ripple](#) and other [altcoins](#).

While the liquidity of an ETF is directly linked to the liquidity of the underlying asset class, the size of a fund can also be an important consideration for investors. In Europe, the largest Bitcoin ETF is also the oldest and most expensive – the [Coinshares Bitcoin Tracker Euro \(Bitcoin XBTE\)](#) (*Nasdaq Stockholm Stock Exchange*)

Other crypto ETFs include:

- [Coinshares Bitcoin Tracker One \(Bitcoin XBT\)](#) (*Nasdaq Stockholm Stock Exchange*)
- [Coinshares Ether Tracker One \(Ethereum XBT\)](#)/ [Coinshares Ether Tracker Euro \(Ethereum XBTE\)](#) (*Nasdaq Stockholm Stock Exchange*)

- [CI Galaxy Bitcoin ETF \(BTCX\)](#) (Toronto Stock Exchange)
- [BTCetc Bitcoin Exchange Traded Crypto \(BTCE\)](#)<sup>8</sup> (Frankfurt Stock Exchange)
- [Purpose Bitcoin ETF \(BTCC\)](#)<sup>9</sup> (Toronto Stock Exchange)
- [Purpose Ether ETF \(ETHH\)](#) (Toronto Stock Exchange)
- [CI Galaxy Ethereum ETF \(ETHX\)](#) (Toronto Stock Exchange)
- [Evolve ETFs \(ETHR\)](#) (Toronto Stock Exchange)
- [Bitwise Crypto Industry Innovators ETF \(BITQ\)](#) (New York Stock Exchange Arca)

Similar in construct to crypto ETFs are tokenised crypto index funds which are crypto funds, consisting of a basket of cryptoassets selected by given criteria specific to the provider, and whose performance is tracked by holding a single token much in the same way one is able to hold an ETF share. The major difference with crypto ETFs is that most of these funds are not regulated. Fund holdings in these tokenised crypto index funds are re-balanced periodically to ensure the fund objectives are continually met. Examples of these funds and relevant tokens include:

- [Crypto20](#) (C20 token)
- [StratumBlu](#) (Blue token)

### **Rebalancing**

Tracker funds have to periodically change their composition owing to cryptoassets falling below certain capitalisation thresholds or a constituent cryptoasset folding up. When new cryptoassets are added to or removed from an index, the tracker fund needs to adjust its composition immediately to reflect the updated constituents in the index.

Threshold-based rebalancing is a portfolio management strategy used to maintain a set of desired target allocations without allowing the asset weightings to deviate excessively. When one of the individual constituents of the portfolio crosses outside the bounds of the desired allocations, the entire portfolio is rebalanced to realign with the target allocations. For example, a specified allocation of 30% BTC means the target allocation is 30% BTC for the portfolio. During a portfolio rebalance, trades are executed such that at the end of the rebalance 30% of the portfolio value is held in BTC. The bounds around each allocation are the 'threshold'. Set by the fund manager the threshold, therefore, prevents excessive deviation from the target allocations.

In addition to reducing risk, rebalancing can also bring increased returns. A recent [study](#) has shown that threshold rebalancing boosted performance by up to 305% over a buy-and-hold strategy.

The alternative to threshold rebalancing is periodic rebalancing which uses a time interval to determine when the next rebalance should take place. If the fund manager chooses weekly or monthly rebalances, then the crypto fund will rebalance on a weekly or monthly basis respectively. Periodic rebalancing also ensures that investors can avoid 'portfolio drift,' which exposes them to higher risk relative to their target asset allocation.

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<sup>8</sup> This ETF launched in the middle of 2020 and has seen the most interest from European investors in 2021, leading the flow league table with \$585 Million of new flows so far in 2021.

<sup>9</sup> This crypto ETF run by Purpose Investments had attracted more than \$12 billion as at May 2021

Due to the volatility of the cryptocurrency market, more frequent rebalancing tends to outperform longer intervals while the need-based nature of threshold rebalancing has demonstrated superior performance when compared to periodic rebalancing.

## **Benefits of crypto index-investing**

### *Simplicity*

One advantage of crypto index funds for investors is the ease of managing the investment. Investors don't have to spend time analysing the various cryptoassets as this workload is left to the professional fund manager.

### *Diversification and better risk management*

Fund investing enables investors diversify their portfolios by putting their money in different cryptoassets, thereby helping to reduce risk while increasing returns on their capital. Such diversification enables the investor potentially increase their return on investment without taking on additional risk.

### *Difficulty of generating alpha*

Empirical evidence comparing historical returns of actively-managed funds in traditional finance, relative to passively-managed funds, indicates that fewer than 10% of all active funds are able to earn a positive alpha over a 10-plus year time period; and this percentage falls once taxes and fees are taken into consideration. In other words, alpha is hard to come by, especially after taxes and fees. Crypto funds are no different.

### *Better predictability*

Index-funds deliver a more predictable performance as a result of algorithm-tracking and the analysing of real-time market data. This is due to their ready access to a pool of top-quality professional management with high-quality research and information tools and resources.

### *Economies of scale*

Since the fund manager is able to raise significant capital from multiple investors and purchase large number of securities, economies of scale are achieved in this way and the lower transactions costs transferred to the investor in lower fees than would be the case were the investor to go in themselves.

## **Risks and disadvantages of crypto index-investing**

### *High management fees*

Crypto funds are a costly method of investing due to their management fees that can reach 2.5% annually or more. This serves to erode returns.

### *Illiquidity*

Illiquidity can affect all types of investments but in the specific case of cryptoassets, the high price volatility means that there may be long periods of fund illiquidity especially when negative market sentiment is prolonged. The crypto fund may also not be able to sell its investments during such periods to fulfil redemption requests.

### *Currency risk*

Most crypto funds are situated in the US. Investors in these funds from outside the US stand to lose from loss of value of their investments where their national currencies depreciate relative to the US dollar (USD). This currency risk is made worse by the volatility of cryptoassets when measured in USD.

### *Poor governance and a lack of transparency*

Generally, funds are less conducive to meeting legislative and regulatory duties regarding active ownership, engagement and voting because the investor owns units or equity shares in the fund but not the underlying assets. Legislation surrounding anti-money laundering (AML) and know-your-customer (KYC) protocols may not be observed as much within the cryptoasset space due to both the nascent nature of the industry and a lack of consensus across the various jurisdictions around the globe.

### **Last word!**

Combining different cryptoassets in a portfolio helps reduce risk through diversification. Such benefits are enhanced through the selection of weakly correlated assets. By diversifying and finding an appropriate combination of cryptoassets, the fund manager can also, to some extent, immunise a portfolio against the possibility of cyclical underperformance. Often underperformance is likely to be confined to particular cryptoassets (or sectors) and since other cryptoassets (or sectors) may be either uncorrelated or negatively correlated, the impact of a bearish market will be lessened by the degree of diversification and the skills used in the index-construction and asset allocation process.

To date, the cryptoasset space continues to mature with the emergence of increasingly innovative fields like Decentralised Finance (De-Fi) including yield-farming and non-fungible tokens (NFTs). These developments continue to increase the scope and scale of diversification and opportunity available to crypto fund-managers in meeting their client mandates.

However, ultimately, the secular trend of cryptoassets may mean that it is not about which cryptoassets are chosen within any fund, but rather whether the fund manager is invested in cryptoassets as a whole. This notwithstanding, in the mid- to long-term, such zeal will need to be matched by a great deal of heart as cryptoassets are far less stable and far more volatile than the average asset class. An index fund that makes the most of diversification of low-correlated cryptoassets will invaluablely present some of the best options for both professionals and investors seeking to allocate capital to this new asset class.

This industry has still some road to travel.

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