CRYPTOASSETS: HOW LEVERAGE AND DERIVATIVES DELIVER SUPERIOR RETURNS.

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BLOCKCHAIN AND CRYPTOASSET (K) LTD.

Authored by: Patrick Kiragu Mwangi *BA, BSc., MA*

BAC(K) Ltd.

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Introduction

Cryptoassets as an asset class have emerged to provide investors, both retail and institutional, with the opportunity to take advantage of emergent blockchain technology and a fast-changing digital space. As such cryptoassets have become an additional tool to use, for not only enhancing portfolio diversification for strategic investors, but also for presenting short-term investors with the opportunity to make significant gains through tactically well-placed trading strategies.

Investing in cryptoassets, through leverage and derivatives, can significantly magnify returns (as well as losses) in both rising and falling markets through efficient use of capital and the built-in leverage nature of the financial instruments deployed. However, this also comes with high risks including the possibility of losing more than the initial investment—due to high market volatility and the possibility of liquidation or a complete loss of collateral. This latter scenario necessitates either a constant monitoring of price action or applying automated risk management tools like stop-loss orders which both, however, eat into the investment outlay.

Leverage allows for amplified gains where a small price move can be magnified into a higher change in position value, thereby, providing high returns from a small capital outlay. Derivatives, for their part, enable crypto investors use short positions to take advantage of falling prices and, conversely, take long positions in favourable markets thereby encountering profits whichever way the market moves.

Where both strategies are deployed, as with the case of leveraged derivatives (e.g., a 10x long on a futures contract), this can exponentially increase returns in a bull market but can, conversely, also lead to immediate liquidation of the investor's position where the market suddenly moves against the investor during a volatile downturn.

Thus, while leverage and derivatives are powerful tools for sophisticated investors seeking superior profits, they remain (very) high-risk strategies.

Leverage

Leverage within the cryptoasset space refers to the strategic use of borrowed capital (debt), typically another cryptoasset or stablecoin, to increase the potential return on an existing cryptoasset investment. The strategy operates on the fundamental principle that if the return generated in an investment from a borrowed cryptoasset or stablecoin exceeds the cost of borrowing that cryptoasset or stablecoin itself, this generated return increases the overall wealth (fund value) of the investor. Thus, an investor can control, say a $10,000 position with a mere $1,000 initial outlay and 10x leverage to earn above-normal return.

The advent of Decentralised Finance or DeFi within the cryptoasset space, has led to new scope in financing which allows for peer-to-peer lending and borrowing. Thus yield-farmers, as an example, are able to deposit cryptoassets in an account on certain platforms, funds which are then available for borrowing. Cryptoasset protocols that allow for this type of lending and borrowing include Compound (COMP) and Aave (AAVE).

Crypto investors today are able to take advantage of a completely decentralised ecosystem to have complete control over their borrowed funds. This is made possible via the use of 'smart contracts' that operate on open blockchain solutions such as Ethereum. Since this new development is built on public blockchain, it minimises the amount of trust required and carries with it the assurance of cryptographic verification. This reduces counterparty risk and makes borrowing cheaper, faster and readily available to a wider public. Other advantages over the traditional credit system include instant transaction settlement, the ability to collateralise digital assets and nil credit checks.

The end-result of all this is cheaper, transparent and more efficient borrowing, built into robust self-governing protocols, which then leads to enhanced profitability for crypto investors.

Collateral requirement

Collateral refers to the initial deposit required to open a leveraged position, often called ‘initial margin’. Crypto-lending platforms and Decentralised Finance (DeFi) protocols will, typically, require borrowers to over-collateralise any borrowing which means locking up cryptoassets, including stablecoins, up to 300% (or more in some cases) of the borrowed amount. These requirements are managed via the built-in ‘smart contracts' which help ensure protocol

solvency. If the collateral value drops below a set threshold, automatic liquidation occurs.

Margin-trading

Crypto margin-trading is the use of minimum collateral (required to open a trading position) to then borrow a cryptoasset or stablecoin from the exchange to amplify position sizes. This helps to enhance potential profits on market moves but equally magnifies losses when these occur.

In absolute terms, the amount the crypto investor trades depends on the margin amount available to them. The higher the amount of the trade, the greater the margin amount required by the exchange to complete the trade.

Margin-trading is effective where the crypto investor can either go long, buying a cryptoasset with leverage with the expectation that its price will rise particularly in a bull market; or going short, by selling a borrowed cryptoasset expecting its price to fall in a bear market and, thereby, enabling them to profit from the price difference.

Amplification of risk and return

Leverage in the cryptoasset space acts as a powerful multiplier, aiming to 'disproportionately' increase potential return on investment by enabling the investor control large positions with a relatively small initial capital deposit (margin). However, similarly, losses are magnified if the investment underperforms.

The combination of high volatility and leverage can, therefore, lead to rapid liquidation and the loss of the entire crypto investment within a short period of time. Higher leverage amounts translate into more volatility for the crypto trades, meaning that the promise of high profits is offset by the risk of losing significant amounts of money.

Tax efficiency

Interest payments made on borrowings of cryptoassets are often tax-deductible, reducing the effective cost of borrowing and increasing net profitability. However, such tax-deductibility depends on how the borrowed crypoassets are used. Where borrowed cryptoassets are invested in other income-producing cryptoassets or in staking, the interest payable becomes tax-deductible. In contrast, if borrowed cryptoassets are used for personal use, interest is not tax-deductible.

Additionally, where certain cryptoassets are underperforming, these can be sold off to create capital losses which can then be used to offset against gains in the same tax year or carried forward to reduce future tax liabilities.

Further, avoiding frequent trading and opting to HODL instead, helps reduce the number of taxable events while allowing for substantial gains to accumulate. Such a HODL strategy also leads to treatment as capital gains when the cryptoassets are eventually sold. This means less overall tax paid as compared to frequent trading where gains may be classed as income and, therefore, lead to a higher overall tax charge.

Liquidation risk

Within DeFi in particular, leveraged crypto positions require a 'maintenance margin'. If the market moves against the investor and the account value falls below the required 'maintenance margin', the exchange may liquidate the crypto investor's position to recover the borrowed funds. The amount of collateral ('maintenance margin') matched with the level of leverage will determine the risk of liquidation. The higher these are, the higher the risk of liquidation.

Derivatives

Derivatives are financial instruments whose value changes in response to the change in an aspect of the underlying asset. This could be the interest rate, the price, the foreign exchange rate or some other variable of the underlying asset. They now provide another avenue, within the cryptoasset space, where they can be used in crypto investment management to hedge against adverse price movements in the underlying; as well as to change asset allocation in line with emergent market opportunities.

Crypto derivatives, thus, enable the crypto investor take advantage of favourable cryptoasset price movements, coming with built-in leverage where the investor is able to take large positions with a minimal investment; primarily, the premium paid to purchase the crypto derivative instrument. Given this very same advantage, crypto derivatives have also helped bring additional trading volume to the crypto market.

This 'latent' participation in the wider crypto market through trading crypto derivatives helps deepen the market, allowing for both greater market participation from new entrants and increased liquidity.

The fact that crypto derivatives don't require a broker or intermediary, but rather hinge on the terms of contract programmed into 'smart contracts', further reduces cost to the crypto investor and allows for greater profitability. Settlement automatically takes place on-chain when the terms of the contract are fulfilled.

Capital Efficiency

Capital efficiency within crypto derivatives refers to the ability to maximise on trading positions while minimising the amount of collateral (capital) required to hold those positions. It enables investors achieve exposure to price movements without needing to fully fund the entire value of a cryptoasset. Crypto investors are, thus, able to maintain exposure while keeping the majority of their capital available for other opportunities. For example, with crypto options, paying a premium for the right to buy or sell allows for high capital efficiency with capped downside risk (limited to the premium paid).

Thus, in this case, crypto options will mitigate against a cryptoasset loss by allowing the exercise of a call option when the market turns against the investor. In the event the price of the underlying crypto favours the investor, the investor will allow the option to lapse, leaving the premium to buy the option, in the first instance, as the only cost to them.

Conversely, the crypto investor will exercise the put option where the market experiences a bearish trend and, therefore, mitigate their loss. Where the market does not decline as expected, the crypto investor will simply allow the put option to lapse.

Derivatives volatility

In the case of crypto futures contracts, trading volumes can mimic those of their spot markets counterparts. Since price fluctuations of the underlying cryptoassets can be especially high during volatile stretches, crypto futures can trade at a significant premium or discount to spot prices, thereby, providing an avenue to earn superior profits when compared to holdings of the underlying.

Crypto derivatives pricing is also influenced by large price swings to the upside in the underlying, which can bring with it even larger profits for crypto derivatives-holders due to the built-in leverage nature of derivatives. Bitcoin's average Sharpe ratio at 0.96, for example, indicates better risk-adjusted returns compared to traditional indices like the S&P 500 at 0.65. This high volatility- return relationship becomes even more pronounced with crypto derivatives, compared to the underlying, due to their built-in leverage.

DEXs, derivatives and disintermediation

Decentralised Exchanges (DEXs) are De-Fi platforms that facilitate peer-to-peer trading by relying on automated 'smart contracts' to execute trades without involving a trusted intermediary (the cryptoassets exchange). By avoiding intermediaries, crypto investors save on brokerage and commission fees as well as custodial costs. Combining this with capital-efficiency that comes with crypto derivatives, crypto investors are able to walk away with gains that would not have been possible under traditional legacy trading.

Regulation and risk mitigation

Due to the high volatility inherent in crypto derivatives, which can lead to substantial losses especially when using leverage to increase market exposure, choosing regulated exchanges (e.g CME and CBOE) can help provide some degree of security and oversight helping to manage some of the risks.

This is a significant point in a volatile ecosystem with wild price swings and offers a measure of confidence and recourse to institutional investors who comprise the majority of traders in these crypto derivatives. Such regulation, further, helps attract investors who would otherwise have shied away from investing, thus helping to broaden the market and improve liquidity.

In the case of crypto futures trading and due to their heavy use of leverage to execute trades, government agencies in various jurisdictions have stepped in to regulate the maximum leverage amount allowed at regulated exchanges and trading venues. This aims to curb excessive risk-taking and ensure these crypto products operate in safe, regulated environments. Further, due to cryptoassets' risky and volatile nature, the margin amounts required for trading crypto futures will remain generally higher than those for traditional assets.

However, the reality of crypto derivatives is that approximately 97% of crypto derivatives trading occurs on unregulated or offshore exchanges, with major platforms including Binance, Bybit and OKX. These platforms offer high leverage, often exceeding 100x, and lack the requisite KYC/AML checks. Regulated alternatives, such as CME, represent only but a small fraction of total market activity.

Last word!

By enabling crypto counterparties agree on the price and terms of contract today (using 'smart contracts') for future delivery, crypto derivatives help reduce future uncertainty on investment outcome, thereby, creating better demand for cryptoassets and improving liquidity in the market. Further, these crypto derivatives offer the crypto investor the ability to speculate on a wide range of crypto-based products and make large bets on price movements using the built-in leverage nature of derivatives.

Elsewhere, the application of crypto derivatives allows for profits to be earned regardless of the general movements of the crypto market, including by holding both long and short positions. A short position, in a bearish market, may involve borrowing cryptoassets and selling them at the current market price with the aim of buying them back later at a lower price to pocket the difference.

Combining both leverage and derivatives as a hybrid investment strategy, for example using high leverage on a crypto-native perpetual futures contract, further magnifies the effect of price movements. Small favourable movements can lead to extraordinary profits since the level of initial outlay is minimal; while at the same time, the crypto investor is able to benefit from the price action of the underlying (cryptoasset) by merely incurring the cost of the premium paid for the derivative itself. Conversely, however, adverse market movements can lead to rapid liquidation of the entire position.

As a result, combining both these strategies should remain the preserve of seasoned crypto investors who also have relatively deep pockets and are, therefore, able to absorb the impact of an unexpected adverse market movement or a 'black swan' event.

Resources

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