COULD THE ETF WRAPPER DEMOCRATIZE CRYPTO INVESTING?

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In the 28 years they've been around, ETFs have democratized asset classes that they wrap.

It is said that the idea of ETFs was born from an SEC report dissecting the stock market crash of 1987. The SEC concluded that if there was an exchange-listed instrument representing a basket of stocks that could be used as a hedge, a new ecosystem of liquidity would develop and alleviate pressure and volatility on the underlying securities during down drafts. So, ETFs were essentially created as liquidity shock absorbers.

The unintended benefits of this great innovation were the transparency and accessibility that ETFs brought to all asset classes and investment strategies.

The ETF wrapper has allowed all levels of investors access to the likes of stocks in South Korea, bank loans, gold, and hedge fund strategies, with a brokerage account. In that easy accessibility, ETFs centralize and amplify liquidity as well as bring transparency and efficiency to costs and execution.

The ETF wrapper will be no different in the world of cryptocurrencies and bring all these benefits to bear on one of the newest asset classes such as bitcoin. This wrapper of the masses will bring accessibility, transparency, and liquidity to this new world.

Before we dive in, our focus in this post is on the structure of investing in cryptocurrencies, not the underlying asset class itself. As we've covered in other blogs, bitcoin is a volatile asset and is not suitable for all investors. At minimum, it should be evaluated in the context of a diversified investment strategy.

But clearly, investors are interested in gaining exposure to the asset class and the potential returns it can provide. We believe informed investors should be able to access bitcoin in their brokerage accounts in a secure, cost-efficient and user-friendly way, rather than accessing the asset in ways that have higher costs and risks, some of which are hidden.

With that said, let's look at each benefit a little closer.

Accessibility

A theoretical investor has a few choices to buy bitcoin directly today. Many of our readers have already done so. Dedicated cryptocurrency 'exchanges' like Coinbase and Gemini are popular. Fintech firms, such as Robinhood and Square, have also enabled crypto trading in their apps.

A crypto 'exchange' is not a technical regulatory term in the U.S., but rather representative of a certain combination of user features and licensed money transfer entities. In most cases, users have a claim to cryptocurrency held by the respective firm, almost analogous to 'street name' holdings.

While there are important differences, these methods largely *feel* like a traditional retail brokerage where investors can buy and hold an asset in their account through a digital interface.

There are also other ways to buy and hold the asset that feel more different. Unique to crypto, one can hold the asset – technically with their own private keys – themselves away from any institution. As numerous media articles have detailed, self-custody carries its own risk – you lose your 'password' (i.e., private key), you lose the ability to access your bitcoin. The blockchain analytics firm Chainalysis estimates that ~20% of outstanding bitcoin supply are considered lost and unrecoverable.

The key point we are making here, no matter which option you choose above, is that buying a cryptocurrency like bitcoin directly in the U.S. will be outside of one's standard investing account and experience -- new account, new processes, new passwords, new risks.

Furthermore, these options are largely closed off from retirement accounts like IRAs and 401Ks. The Investment

Company Institute estimates roughly 21% of Americans' financial assets are held in these accounts. Many Americans are effectively unable to access this asset class with their wealth. This is even more challenging for WisdomTree's financial advisor clients investing on behalf of investors. Their workflows and policies are built around traditional brokerage accounts, and it is just not possible to deviate from them.

Numerous alternative vehicles have stepped in to try to fill this demand. These alternatives include funds or other accounts that invest in bitcoin -- over-the-counter (OTC)-traded trusts, private funds, separately managed accounts -- and even publicly traded corporations that have invested part of their corporate treasury in bitcoin (like MicroStrategy). These options all have their benefits and, we believe, their drawbacks depending on the circumstances of the investor.

As ETF true believers, we may be biased, but we believe a well-structured ETF can lessen these costs and risks of investors seeking to gaining exposure to an asset like bitcoin. The ETF fund manager would be responsible for overseeing the custody and security of the bitcoins with, preferably, a regulated third-party custodian. Investors could manage their bitcoin investment in the same brokerage account as all their other stocks, bonds and ETFs. And, as we'll discuss in greater detail below, ETFs consistently trade in-line with their underlying assets.

Transparency

The ETF structure not only gives you transparency into what is actually in the fund on a daily basis, but also transparency of trading costs (in the form of bid/ask spreads), as well as relative costs (in the form of premium/discounts to its net asset value (NAV)).

Transparency into the bid/ask spreads as well as that of premium/discounts will give the investor more information and power to choose the most cost-efficient structure. In mutual funds, you don't know how much the portfolio manager is paying in spread when money is added and redeemed from the fund, and that bid/ask spread drags down the value of the entirety of the mutual fund for all. When you purchase an ETF, you know exactly how much you have paid to enter and exit the investment, and your transaction does not affect any other shareholders.

Perhaps more importantly, ETFs are designed to reduce the likelihood of premium and discounts with its open-ended nature as well as the ability of market makers (called Authorized Participants) to create and redeem on a daily basis. This keeps the ETF trading more in line with its NAV, or value of its holdings.

As a case in point, there are a few OTC-traded trusts in the marketplace now offering exposure to bitcoin. These trusts, critically, are effectively close-ended – they only allow subscriptions (i.e., creations) to accredited investors and they do not allow redemptions. Unlike ETFs, they do not trade on a national securities exchange, but they are available to non-accredited investors on the 'over-the-counter' markets. Accredited investors may sell their shares 'over-the-counter' once they have 'seasoned' for a period of 6 or 12 months. Over the past year, the trusts have traded in a range from a discount up to a 40+% premium, with premiums at certain points in an OTC product's life *at over 100%*. That means at its height, an investor was paying 100+% more than what bitcoin was worth to gain access.

The recent premiums/discounts on various OTC bitcoin products have ranged widely, with some trading at a significant discount and others trading at a significant premium at different points in time. This divergence showcases the idiosyncrasies of the operations and market structure of these products, none of which are to the benefit of retail investors in our view and raise significant investor protection issues that the ETF structure addresses. In the weeks that bitcoin ETFs have begun trading in Canada, we have seen them trade more in line with the value of their underlying holdings which strengthens our view that the benefits of the ETF structure will translate in this new burgeoning asset class

Liquidity

Considering ETFs were born from a need for extra liquidity, it should come as no surprise that the ETF wrapper provides an extra layer of liquidity for any asset class or strategy it represents.

For cryptocurrencies, we believe ETFs will also bring a level of efficiency similar to what we've seen in fixed-income products.

Like bonds, cryptocurrency liquidity is fragmented and traded on many different exchanges. There isn't one centralized place to see the best bid or offer or to aggregate liquidity. Because the ETF is exchange listed, centralization happens by default. An ETF investor in crypto will have the benefit of not only the liquidity of the cryptocurrencies on the regional exchanges, but also that of the market makers supporting the ETFs. In the stock and bond world, that new ETF ecosystem of market makers has brought hundreds of billions of dollars of balance sheet in additional liquidity to the asset classes. The listing exchange will also require a centralization of the best bid and offer and a look into centralized liquidity.

The ETF wrapper has changed the way we invest. It has dramatically brought down costs to access many different asset classes and investment strategies, as well as made many of these asset classes easily accessible.

The additional liquidity has made the investment more secure and now we can easily invest in all manners of asset allocation strategies to individual themes from Apps on our phones and one brokerage account. This ETF wrapper will certainly transform the way we access and use cryptocurrencies in our investment portfolios, and bring costs savings to us all.

Important Risks Related to this Article

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There are risks associated with investing, including the possible loss of principal. Crypto assets, such as bitcoin and ether, are complex, generally exhibit extreme price volatility and unpredictability and should be viewed as highly speculative assets. Crypto assets are frequently referred to as crypto “currencies,” but they typically operate without central authority or banks, are not backed by any government or issuing entity (i.e., no right of recourse), have no government or insurance protections, are not legal tender and have limited or no usability as compared to fiat currencies. Federal, state or foreign governments may restrict the use, transfer, exchange and value of crypto assets, and regulation in the U.S. and worldwide is still developing. Crypto asset exchanges and/or settlement facilities may stop operating, permanently shut down or experience issues due to security breaches, fraud, insolvency, market manipulation, market surveillance, KYC/AML (know your customer/anti-money laundering) procedures, noncompliance with applicable rules and regulations, technical glitches, hackers, malware or other reasons, which could negatively impact the price of any cryptocurrency traded on such exchanges or reliant on a settlement facility or otherwise may prevent access or use of the crypto asset. Crypto assets can experience unique events, such as forks or airdrops, which can impact the value and functionality of the crypto asset. Crypto asset transactions are generally irreversible, which means that a crypto asset may be unrecoverable in instances where: (i) it is sent to an incorrect address, (ii) the incorrect amount is sent or (iii) transactions are made fraudulently from an account. A crypto asset may decline in popularity, acceptance or use, thereby impairing its price, and the price of a crypto asset may also be impacted by the transactions of a small number of holders of such crypto asset. Crypto assets may be difficult to value, and valuations, even for the same crypto asset, may differ significantly by pricing source or otherwise be suspect due to market fragmentation, illiquidity, volatility and the potential for manipulation. Crypto assets generally rely on blockchain technology, and blockchain technology is a relatively new and untested technology that operates as a distributed ledger. Blockchain systems could be subject to internet connectivity disruptions, consensus failures or cybersecurity attacks, and the date or time that you initiate a transaction may be different than when it is recorded on the blockchain. Access to a given blockchain requires an individualized key, which, if compromised, could result in loss due to theft, destruction or inaccessibility. In addition, different crypto assets exhibit different characteristics, use cases and risk profiles. Information provided by WisdomTree regarding digital assets, crypto assets or blockchain networks should not be considered or relied upon as investment or other advice, as a recommendation from WisdomTree, including regarding the use or suitability of any particular digital asset, crypto asset, blockchain network or strategy. WisdomTree is not acting and has not agreed to act in an investment advisory, fiduciary or quasi-fiduciary capacity to any advisor, end client or investor, and has no responsibility in connection therewith, with respect to any digital assets, crypto assets or blockchain networks.

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DEFINITIONS

SEC : U.S. Securities and Exchange Commissio.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Cryptocurrency : a digital or virtual currency that is secured by cryptography, which makes it nearly impossible to counterfeit or double-spend.

Bitcoin (the currency) : A digital currency (also called a cryptocurrency) created in 2009, which is operated by a decentralized authority as opposed to a traditional central bank or monetary authority.

Fintech : Describes new tech that seeks to improve and automate the delivery and use of financial services

Over-the-Counter (OTC) : A security traded in some context other than on a formal exchange such as the NYSE, TSX, AMEX, etc.

Bid/Ask Spread : This is essentially the difference in price between the highest price that a buyer is willing to pay for an asset and the lowest price for which a seller is willing to sell it.

Premium : When the price of an ETF is higher than its NAV.

Discount : When the price of an ETF is lower than its NAV.

Net Asset Value (NAV) : The calculated assets minus liabilities divided by shares outstanding. NAV is the straightforward account of the actual assets in the fun.

Market maker : Someone who quotes a buy and a sell price in a financial instrument.

Creation and Redemption Process : The process whereby an ETF issuer takes in and disburses baskets of assets in exchange for the issuance or removal of new ETF shares.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.