Why cryptocurrency allocation could be the most important investment decision in an investment portfolio right now

Published September 11, 2024

Pierre Debru
Head of Research, Europe

Key Takeaways

- Cryptocurrencies have developed into a fully-fledged asset class as operational and regulatory barriers are lifted one by one.
- Historically, the information ratio of adding cryptocurrencies to a multi-asset portfolio over long or short timeframe would have been multiple time higher than even picking the best global equity fund out of thousands over the same period.
- As adding cryptocurrencies remains the most efficient way to spend risk budget in a portfolio, professional investors continue to underweight the asset class.

After 15 years of growth and increased adoption, cryptocurrencies now represent around 2% of the market cap of all liquid assets globally[1]. With the recent listing of spot bitcoin exchange-traded funds (ETFs) in the US and Hong Kong, the listing of crypto exchange-traded products (ETPs) on the London Stock Exchange and the listing of spot Ethereum ETFs in the US, cryptocurrencies are now available through regulated vehicles almost worldwide. Whether we like it or not, cryptocurrency is an established asset class with the same claim for allocation in investors' portfolios as commodities, high-yield bonds or private credit.

Grading the quality of an investment decision in a multi-asset portfolio: the information ratio

The performance of a multi-asset portfolio is the result of a myriad of investment decisions, from the strategic allocation to the fund or security selection and going through the tactical allocation. However, not every one of those decisions has the same impact. The fund selection in US equities will tend to have a bigger impact than the fund selection in EUR high yield because of their relative weightings in portfolios.

The most often used metric to judge every decision in a normalised way is the information ratio, i.e., the ratio between the excess performance created by an individual decision and the tracking error created by that same decision versus the benchmark.

Allocating to cryptocurrencies could be the most consequential investment decision in most portfolios

It is possible to assess the impact of allocating to cryptocurrencies using such a metric. So, let's start from a classic 60/40 portfolio that invests 60% of its portfolio in Global equities (proxied by the MSCI AC World net TR Index) and 40% in fixed-income assets across currencies and ratings (proxied by the Bloomberg Multiverse TR Index). Such a portfolio (rebalanced monthly) would have returned 5.38% annualised between 31 December 2013 and 30 June 2024.

Assuming that the manager decided to allocate 1% to bitcoin in this portfolio (and therefore 59% in equities and 40% in fixed income), the annualised return of the portfolio would have increased to 6.05%, an excess return annualised of 67 bps[2] since the tracking error of such an addition (calculated on daily returns) is 69 bps[1], the information ratio of such a decision is basically 1.

How does that compare to other decisions? We need some etalon to compare. So, we looked at the thousands of funds classified by Morningstar in the peer groups Global Equity Income, Global Large Cap Value, Global Large Cap Blend and Global Large Cap Growth. We then assumed that for the equity sleeve, the manager has been able to select the absolute best Europe-domiciled fund over the period. Anyone who has tried to select a fund will know how impossible such a task would be and how much of an achievement this would be. Doing so would have created an outperformance of basically 2.5% per annum at the cost of 8% of tracking error. So, the information ratio of such a great decision is only 0.3[3]. Less than a third of the efficiency of the cryptocurrency allocation. To explain this further, if the manager added a hard constraint of a tracking error of 69bps versus the benchmark over the last 10 years, he could have made two choices:

1. Allocate 1% to Bitcoin in the portfolio. This would have added 67 bps to the portfolio's performance
2. Allocate 5% to the best fund (mentioned above) and leave the remaining 55% in the MSCI AC World. This would have added 22bps to the portfolio's annualised performance

It is pretty obvious which investment decision had the most impact, and yet it also feels like the best decision was not the most difficult (finding the best fund today for the next 10 years is such a high bar!).

Now, 10 years is a long time, and we could argue that bitcoin's performance was unusually strong in the early 2010s. So, let's look at more recent periods:

- For the last three years (that includes the latest crypto winter when Bitcoin lost more than 70% of its value), the information ratio of adding 1% of Bitcoin to the 60/40 would have been 0.65. Still twice as efficient as a perfect fund selection on 60% of the portfolio[4]
- For the last 18 months and a pretty bullish market for Bitcoin, the information ratio was 2[5].

Conclusion

The institutionalisation of cryptocurrency is well on its way. Operational and regulatory barriers are being lifted one by one, making crypto a new full-fledged asset class for investors to consider. Looking back at the impact of adding crypto to a portfolio and looking forward at the remaining road left toward full

adoption, it is clear that among the myriads of investment decisions necessary to run a portfolio, the allocation to cryptocurrencies will be among the most, if not the most influential. And yet, most institutionally managed multi-asset portfolios remain structurally underweight the asset class (not to say uninvested). Final investors are noticing and wondering why their managers are not making the most influential decisions for their hard-earned money.

Source

[1] Bloomberg, WisdomTree. Historical performance is not an indication of future performance and any investment may go down in value.

[2] Bloomberg, WisdomTree. From 31 December 2013 to 28 June 2024. In USD. Based on Daily Returns. The 60/40 Global Portfolio is composed of 60% MSCI AC World and 40% Bloomberg Multiverse. **You cannot invest directly in an index. Historical performance is not an indication of future performance and any investment may go down in value.**

[3] Bloomberg, WisdomTree. From 31 December 2013 to 28 June 2024. In USD. Based on Daily Returns. The 60/40 Global Portfolio is composed of 60% in the best European funds (over the same period) as highlighted in Morningstar when looking at the four peer group listed in the blog and 40% Bloomberg Multiverse. **You cannot invest directly in an index. Historical performance is not an indication of future performance and any investment may go down in value.**

[4] Bloomberg, WisdomTree. From 30 June 2021 to 28 June 2024. In USD. Based on Daily Returns. The 60/40 Global Portfolio is composed of 60% MSCI AC World and 40% Bloomberg Multiverse. **You cannot invest directly in an index. Historical performance is not an indication of future performance and any investment may go down in value.**

[5] Bloomberg, WisdomTree. From 31 December 2022 to 28 June 2024. In USD. Based on Daily Returns. The 60/40 Global Portfolio is composed of 60% MSCI AC World and 40% Bloomberg Multiverse. **You cannot invest directly in an index. Historical performance is not an indication of future performance and any investment may go down in value.**

Important Risks Related to this Article

Important Information

Marketing communications issued in the European Economic Area ("EEA"): This document has been issued and approved by WisdomTree Ireland Limited, which is authorised and regulated by the Central Bank of Ireland.

Marketing communications issued in jurisdictions outside of the EEA: This document has been issued and approved by WisdomTree UK Limited, which is authorised and regulated by the United Kingdom Financial Conduct Authority.

WisdomTree Ireland Limited and WisdomTree UK Limited are each referred to as "WisdomTree" (as applicable). Our Conflicts of Interest Policy and Inventory are available on request.

For professional clients only. The information contained in this document is for your general information only and is neither an offer for sale nor a solicitation of an offer to buy securities or shares. This document should not be used as the basis for any investment decision. Investments may go up or down in value and you may lose some or all of the amount invested. Past performance is not necessarily a guide to future performance. Any decision to invest should be based on the information contained in the appropriate prospectus and affer seeking independent investment, tax and legal advice.

The application of regulations and tax laws can offen lead to a number of different interpretations. Any views or opinions expressed in this communication represent the views of WisdomTree and should not be construed as regulatory, tax or legal advice. WisdomTree makes no warranty or representation as to the accuracy of any of the views or opinions expressed in this communication. Any decision to invest should be based on the information contained in the appropriate prospectus and affer seeking independent investment, tax and legal advice.

This document is not, and under no circumstances is to be construed as, an advertisement or any other step in furtherance of a public offering of shares or securities in the United States or any province or territory thereof. Neither this document nor any copy hereof should be taken, transmitted or distributed (directly or indirectly) into the United States.

Although WisdomTree endeavours to ensure the accuracy of the content in this document, WisdomTree does not warrant or guarantee its accuracy or correctness. Where WisdomTree has expressed its own opinions related to product or market activity, these views may change. Neither WisdomTree, nor any affiliate, nor any of their respective officers, directors, partners, or employees accepts any liability whatsoever for any direct or consequential loss arising from any use of this document or its contents.