Diversification is the only free lunch, even in crypto

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Key Takeaways

- Diversification can help reduce the risks associated with investing in individual cryptocurrencies.
- A diversified crypto basket provides broader exposure to blockchain networks and decentralised finance (DeFi).
- Similar to equity investing, diversified approaches may smooth out the idiosyncratic behaviour of individual assets while retaining exposure to the broader asset class thesis.

When considering a crypto investment, your questions may be:

- What cryptocurrency or blockchain will eventually dominate? Is it still Bitcoin, popular as a hard currency, but with limited practicality as a payment system?
- Is it worth going beyond Bitcoin and Ethereum? Ethereum is the backbone of many tokens and enables a universe of decentralised applications, but it's not without competition.
- What's the next token to make headlines? New coins and tokens are frequently introduced, but while many fail, are some worth the investment?

One token that recently entered the crypto benchmark Coindesk 20 Index is Bittensor (TAO), the native token powering a decentralised network for artificial intelligence (AI). Bittensor aims to create a marketplace where AI models compete and are rewarded based on the usefulness of their outputs. Is TAO an upcoming star, or will it, in five years, be just another forgotten coin?

Exposure to blockchain technology, not a singular coin bet

If you consider investing in cryptocurrencies, it's likely based on the assumption that blockchain-based networks will gain importance over time. For example, decentralised finance (DeFi) might become a more flexible alternative to traditional financial infrastructure, such as the USD payment system, the SWIFT interbank network, or other centralised financial intermediaries.

However, just because stocks have historically compensated investors for taking on risk, it didn't automatically make Yahoo a great investment. Likewise, a potential long-term growth of DeFi[1] does not mean every coin or token will participate in that growth.

What stock investors typically do is diversify. By aggregating a broad set of companies, they smooth out idiosyncratic behaviour. In other words, the individual success or failure of specific companies tends to even out over time, while the broader equity risk premium remains.

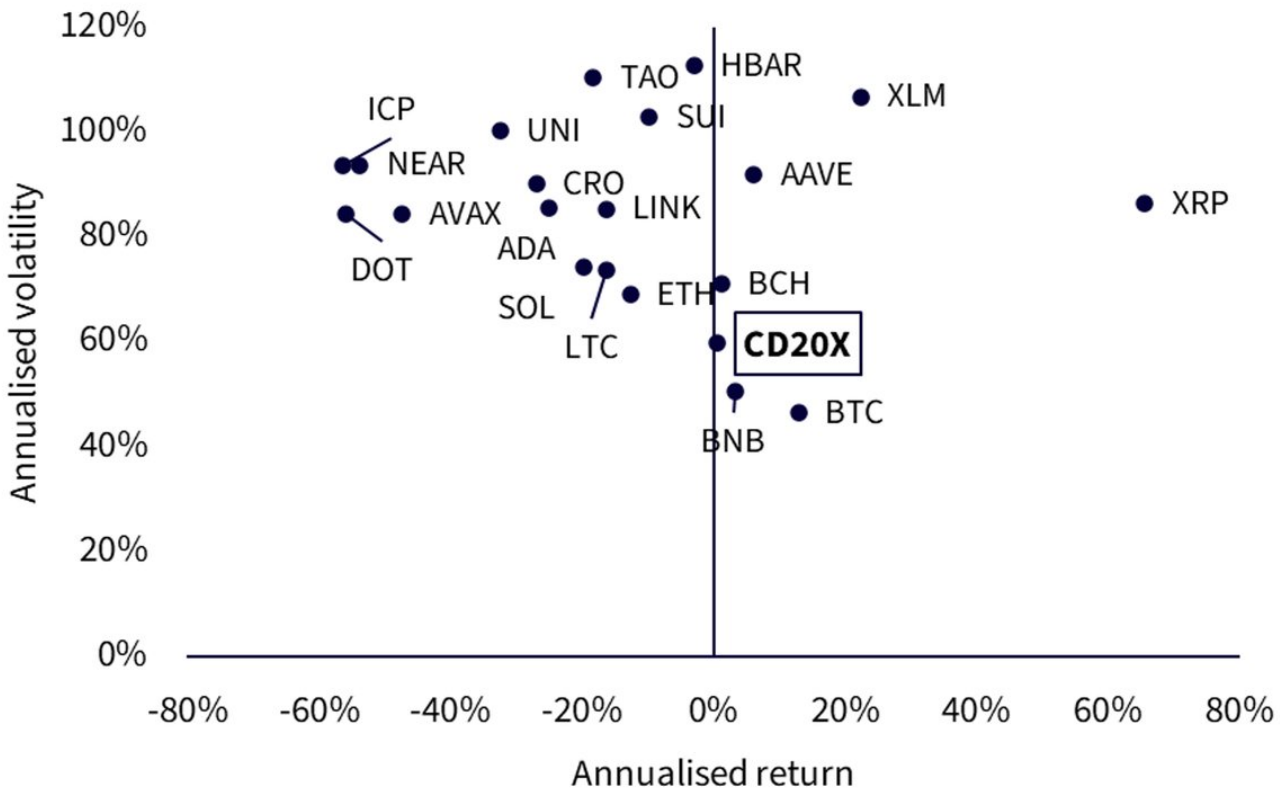
Similarly, we want to make the case for a diversified cryptocurrency basket, where investors can participate in the broader thesis of DeFi while limiting exposure to the blow-up risk of any individual coin.

The difference between a diversified investment and a single-coin bet

Coming back to the initial questions: which token should investors choose? Is the risk of a 'start-up' token worth taking?

To understand the difference between a diversified investment and a single-coin bet, we analyse the return and standard deviation of the CoinDesk 20 Index and its individual components (Figure 1). The CoinDesk 20 Index is a rules-based benchmark designed to provide broad exposure to the largest and most liquid crypto assets.

Figure 1: Risk and return of major cryptocurrencies (excluding stable-coins and meme coins)



Source: Bloomberg Finance L.P., own calculations from 30 April 2024 to 30 April 2026. **Historical performance is not an indication of future performance and any investments may go down in value.**

The performance of the broader basket (CD20X) hovers around the middle of the individual coin returns, which is unsurprising because the basket return represents the weighted average of its components. However, most individual coins display higher volatility than the basket itself. Volatility, or the standard deviation of returns, is a classic measure of risk.

Similar to a stock index like the S&P 500, the idiosyncratic behaviour of individual cryptocurrencies tends to cancel out in a diversified basket. The return, however, remains the weighted average of the components, reflecting any broader risk premium that long-term cryptocurrency holders may potentially be compensated for.

Summary

Diversification remains one of the few ways investors can reduce risk without necessarily sacrificing returns, and that principle applies to crypto just as much as traditional asset classes. Rather than relying on a single token to succeed, a diversified crypto basket allows investors to participate in the broader growth of blockchain networks and decentralised finance while reducing exposure to the risks of any individual coin.

Investments in cryptocurrencies and digital assets involve significant risk, including the possible loss of capital. Cryptocurrency markets can be highly volatile, and the value of digital assets may fluctuate significantly over short periods of time. Regulatory developments, technological changes, market sentiment and liquidity conditions may affect the value of investments. Diversification does not guarantee a profit or protect against loss.

[1] Decentralised Finance (De-Fi) refers to financial services built on blockchain networks that operate without traditional intermediaries like banks or brokers. Instead, transactions such as lending, borrowing, trading, or earning interest are powered by smart contracts, self-executing software that runs transparently on the blockchain.

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