Five things you thought you knew about cryptocurrencies

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Key Takeaways

- After 15 years of existence, many successful boom-and-bust cycles and half a billion users, cryptocurrencies have now cemented their place as a fundamental trend, not a fad.
- While bitcoin was the first cryptocurrency, it is not the only one. The space has burgeoned into a fully-fledged asset class that can be split into eight sectors with distinct use cases.
- A lack of cash flow is not a serious reason not to consider bitcoin as an investment. Gold, oil, and the US Dollar have been used for decades, and they don't have any, either. Also, bitcoin is the exception, not the rule. Many cryptocurrencies exhibit cash flows or "buybacks", like ETH or Uniswap.
- Bitcoin's network has never been hacked or compromised. Vulnerabilities usually stem from third-party platforms or software. With institutional-grade, regulated and physically backed (in cold storage) ETPs now available to invest in worldwide, the asset class has never been more secure.
- Adding 1% of bitcoin in a 60/40 portfolio would have added 0.07% of volatility historically for an extra performance of 0.67%, making it one of the best asset allocation decisions of the last 10 years.

1. Cryptocurrencies are a fad

New technologies or new ideas, whether we're talking about cars in the early twentieth century or mobile phones in the 2000s, tend to be adopted in five phases. Adoption starts with the Innovators (2.5% of the population), then the Early Adopters (an extra 13.5%), the Early Majority (at which point 50% of the population has adopted), the Late Majority and finally, the Laggards. Fads usually struggle to get past the Early Adoption stage. Recent studies suggest that the number of direct crypto users is well above half a billion now, meaning that crypto is easily in the second half of the Early Adopter phase, if not further. In other words, crypto is not a fad but a trend.

At the end of the day, cryptocurrencies are not young upstarts anymore. This technology has been around for 15 years. They have gone through multiple price cycles and have recovered each time – emerging stronger, more diversified, and achieving new highs. With institutional-grade, regulated investment vehicles available worldwide, it's becoming increasingly hard for investors to ignore them.

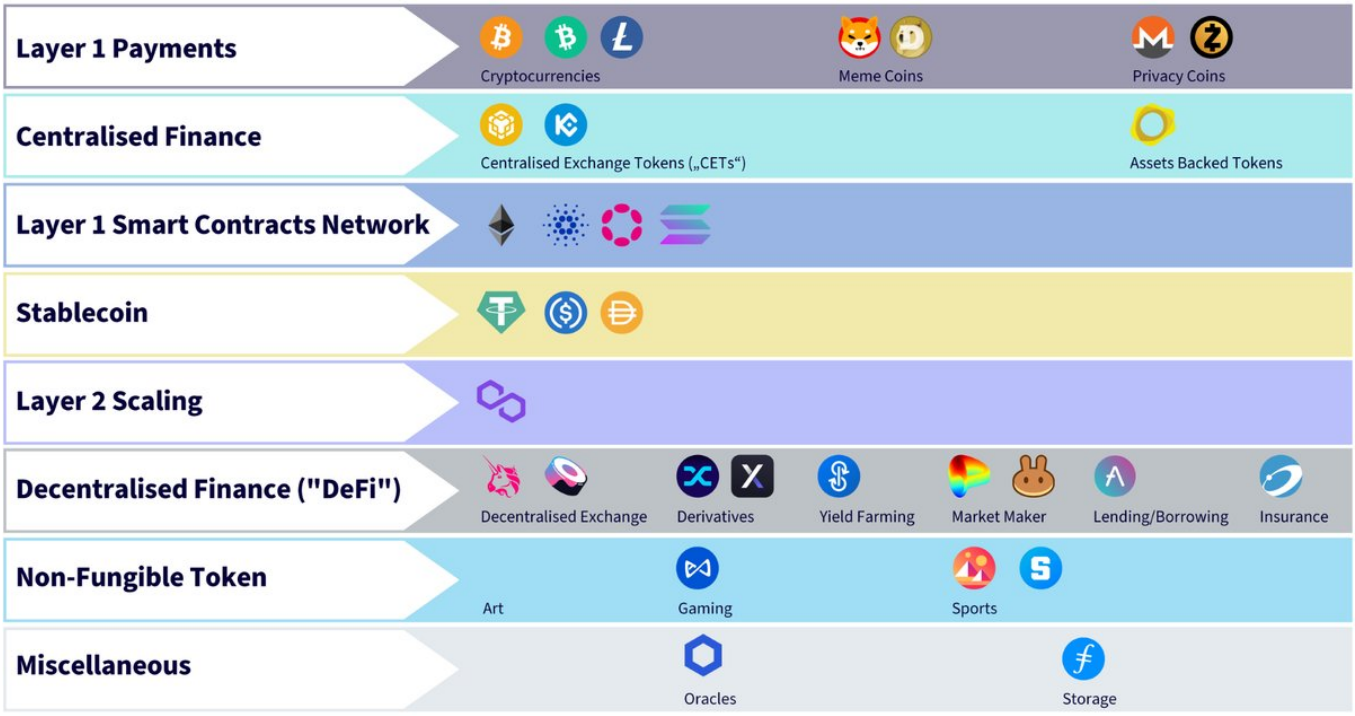
2. Crypto is just about bitcoin

While bitcoin enjoys superior name recognition, the crypto asset class has evolved far and wide. In fact, bitcoin represents barely half the space's total market cap. The space has grown so large that we track it using our own taxonomy at WisdomTree. Think of it as the "global industry classification standard" but for crypto. Guided by the use case of each family of crypto assets, we have developed eight categories that help us track the space, understand how the different assets evolve, and build baskets.

In a nutshell:

- **Layer 1 payments** allow you to transact digitally. Bitcoin is, of course, the main player in the category.
- **Centralised finance** represents tokens issued by private companies. They can be used to deliver incentives to users or are backed by physical assets and deliver exposure to those assets.
- **Layer 1 smart contract networks**, the most famous of which are Ethereum and Solana, provide the infrastructure for building decentralised apps.
- **Stablecoins** are tokens designed to mimic existing fiat currencies.
- **Layer 2 scaling** are protocols aimed at increasing the capacity of layer 1 networks (in terms of number of transactions, for example).
- **Decentralised finance** apps run on Layer 1 Smart Contract Networks and aim to deliver traditional finance services like exchanges, lending/borrowing, derivatives and more.
- **Non-fungible tokens** can be likened to digital collectables.

Figure 1: WisdomTree Digital Asset Taxonomy



3. Cryptocurrencies have no real use or value

Contrary to common belief, digital assets are used commonly in the real world, which allowed us to build the taxonomy described above.

Bitcoin allows one to make payments to anyone in the world without a middleman and without care for capital control in place. While we often hear the contrary in developed countries, where currencies are strong and currency movement is free, bitcoin is used extensively and has become a de facto currency for any part of the world where capital control and hyperinflation are everyday issues. In countries facing high inflation or hyperinflation, stablecoins have become the refuge of choices for millions of everyday users. Revenues are stored in stablecoins until the last moment when they must be converted back to local currencies to purchase goods. Since those stablecoins run on Layer 1 networks, those networks are also automatically used extensively. These are only two of a myriad of use cases from which half a billion crypto users are already benefiting.

It is hard to argue that something that is so widely used is worthless. But of course, if value must equal cash flow, then bitcoin is at a disadvantage. Taking a step back, though, investors have been investing in gold, oil, or US dollars for decades (centuries even), and those assets do not have cash flow either. So, clearly, serious investors can apply other models to assess those assets. If cash flow is that important, though, as mentioned earlier, crypto is not all about bitcoin. Ethereum, the second biggest cryptocurrency, created the “burn” nearly three years ago (EIP – 1559), which means that every time a transaction happens on the blockchain, transaction fees are paid in the form of ETH being destroyed (burned). This reduces the total amount of ETH available, leading to increased value for the remaining ETH in the same way that buybacks push the price of stocks higher. Over the last three years, 4.3 million[1] of ETH supply has been burned (the equivalent of $12.1 billion).

4. Investing in crypto is not secure

There is a vast difference between the security of crypto themselves (i.e. the blockchains) and the ecosystem around it. Bitcoin has a 99.98% uptime record since its launch and has never been breached or hacked. Misconceptions around the security of bitcoin stem from issues with third-party businesses that use bitcoin when they fail, are hacked, or because they are outright scams. How users and investors interact with digital assets is critical to their security. For investors, regulated vehicles are now available almost globally in the form of exchange-traded products (ETPs). WisdomTree has offered such institutional-grade physically backed crypto ETPs in Europe since 2019. We apply our deep-rooted commodity expertise to craft institutional-grade crypto offerings that are physically backed and benefit from a cold-storage, multi-custodial framework, ensuring a secure and diversified custody solution. Such vehicles offer a large array of protections for investors who want to invest in digital assets.

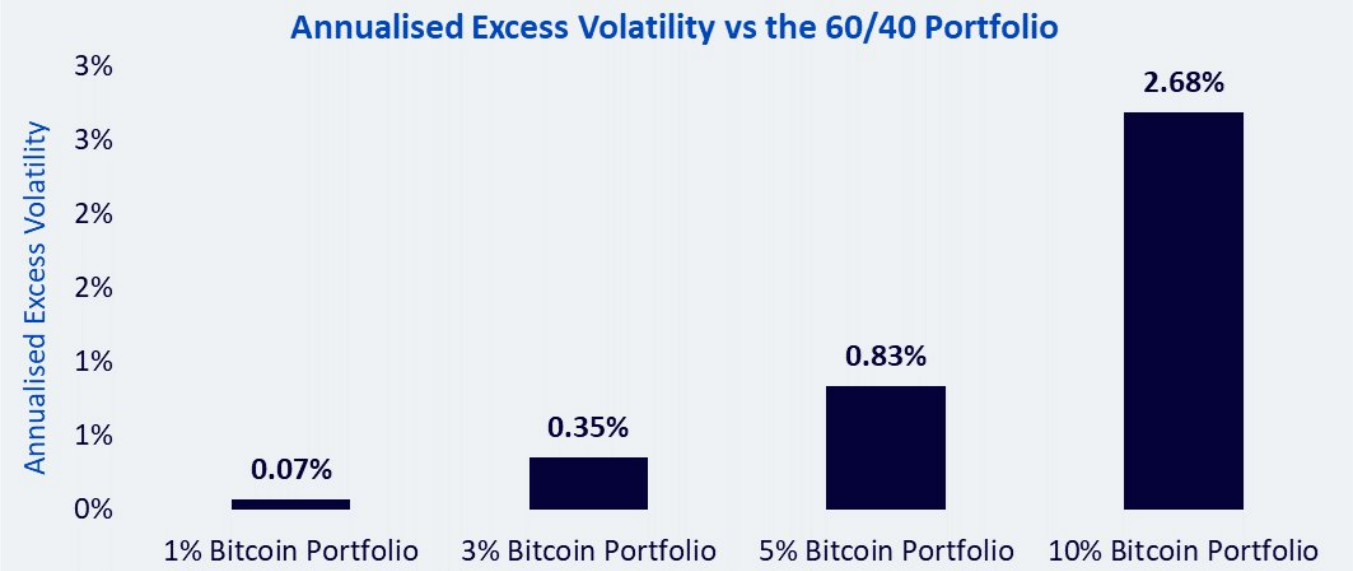
5. Volatility is too high to be included in multi-asset portfolios

Bitcoin’s volatility is high[2] at 69% over the last 10 years or so. However, it is also a highly diversifying asset as well. Its correlation with equities over the same period is only 16.6%, and its correlation with commodities is 13%. So, while as a stand-alone asset, it could appear that bitcoin is a high-risk asset, this is not the case in the context of a multi-asset portfolio. In fact, figure 2 shows the change in volatility when a small

portion of bitcoin is added to a 60/40 portfolio (60% in MSCI All Country World and 40% in Bloomberg Multiverse). Adding 1% of bitcoin does not add 0.69% of volatility to the portfolio but only 0.07%, thanks to the diversification effect[3].

Adding 1% of bitcoin to the portfolio creates around 0.7% of tracking errors while creating 0.67% of annualised performance versus the 60/40 portfolio without bitcoin. This means that the information ratio of the decision to add bitcoin to the portfolio is almost 1, an excellent ratio that very little investment decision would lead investors to obtain.

Figure 2: Impact on volatility to add bitcoin in a 60/40 portfolio



Source: Bloomberg, WisdomTree. From 31 December 2013 to 30 April 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.**

Conclusion

Cryptocurrencies have been around for more than 15 years, but they remain significantly misunderstood in the traditional investment world. One of the key reasons is that, for a long time, it was easy to ignore them and dismiss them as a fad. However, this time has passed. With regulated, physically backed ETPs available in Europe since 2019, spot bitcoin ETFs approved in the US early this year (soon to be followed by Spot Ethereum ETF) and the very recent listings of crypto ETPs on the London Stock Exchange, the institutionalisation of crypto is well on its way. It is high time that investors move on from prejudice and misconceptions and start treating crypto like the new asset class it is, or they risk being left behind.

[1] Source: Ultrasound.money. As of 3 June 2024.

[2] Source: Bloomberg, WisdomTree. From 31 December 2013 to 30 April 2024. In USD. Based on Daily Returns. **Historical performance is not an indication of future performance and any investment may go down in value.**

[3] Bitcoin in multi-asset portfolios, WisdomTree. February 2024.

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