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Bitcoin ETFs: What's the Buzz?

Key Takeaways

- The recently approved Bitcoin ETFs provide a simple way for investors to gain access to the most well-known cryptocurrency, Bitcoin.
- While regulation of ETFs may ease some concerns about investing in Bitcoin, there are several risks associated with it. Be aware that the underlying Bitcoin asset is still unregulated.
- Bitcoin's extreme levels of volatility makes it a speculative asset and if appropriate for the client's risk profile should only represent a small part of an investment portfolio.

The latest buzz in the investment world is around the approval and launch of new Bitcoin ETFs.

This now makes it easier for investors to get exposure to Bitcoin without the need to set up separate trading accounts on cryptocurrency exchanges. But should Bitcoin be included in a portfolio?

A new asset class?

Bitcoin is the most established of the cryptocurrencies, and while it has gained a critical mass of investors, it's still early in its evolution.

Some argue that it's a currency as it's a form of payment exchange between two parties, or due to its finite quantities, it could be considered similar to gold and act as an inflation hedge. Others argue that Bitcoin hasn't demonstrated the traditional key characteristics of currencies, including a common means of payment and a stable store of value, nor demonstrated to be an effective inflation hedge. To date, Bitcoin is not widely used and has seen significant gyrations over the past few years, similar to the level of volatility seen in speculative stocks.

How does the ETF work?

Similar to how gold ETFs buy and sell gold bullion, Bitcoin ETFs buy and sell Bitcoin currency. It is subject to the ups and downs of the price of Bitcoin in the crypto markets.

Although ETFs are regulated by the SEC, as with anything to do with cryptocurrencies, there is always a risk around digital security and in other areas. To attempt to address some of the storage concerns, the new ETFs rely on a third-party custodian to hold the Bitcoin currency. Just as gold can be stored in a physical vault, Bitcoin is held in a digital vault by the custodian. **Note: one of the potential risks listed in ETF prospectuses is security breaches.**

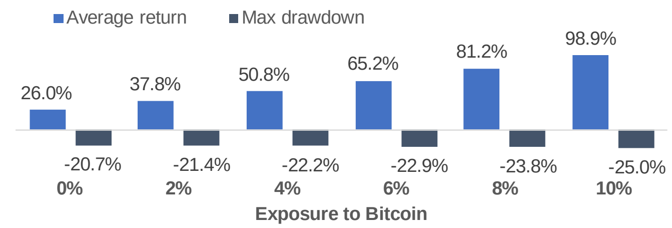
How does it fit in a portfolio?

There are two main reasons why an investor may consider including Bitcoin as part of an overall portfolio:

1. Return

Bitcoin had an incredible ride over the past five years, ending December 2023 with a return of over 1000%. But that's just half the story. During those five years, after seeing a high of 61,359, Bitcoin fell 73% over 14 months. And as of year-end 2023, it rallied back 156% but still hadn't hit its former high.

Average 3-Year Cumulative Return & Drawdown



Source: AssetMark. Adding Bitcoin exposure to a 60/40 US portfolio. Average cumulative return and average maximum drawdown over rolling 3-year periods from April 2008 – December 2023.

For illustrative use only.

If an investor can handle the gyrations and focus on performance, a 2-4% Bitcoin allocation has not significantly impacted drawdowns, while enhancing returns, as shown in the chart above. However, allocations above 5% started to see larger drawdowns.

2. Diversification

Bitcoin is not only very volatile – four times more volatile than the S&P 500 – but its relationship to US equities has also been volatile. It has moved from being positively correlated (moving in a similar direction) at a high of over 50% to being negatively correlated (moving in an opposite direction) at almost 40%.*

These two factors play an important part in assessing the optimal exposure in Bitcoin while targeting a specific level of portfolio risk. When looking at the results from a portfolio optimizer where the inputs are stocks, bonds, and Bitcoin, it's only at a level of risk of a 70% stocks/30% bonds portfolio that more than 1% exposure is taken. And at a full equity risk level, only a 5% exposure is taken. This is due to the volatile nature of Bitcoin and not allowing it to overpower the risk within a portfolio.

*Source: Bloomberg

Know what you own and the reasons why

As with any investment consideration, it's vital to fully understand what you're buying and what role it plays in a portfolio. An investor's risk appetite will determine whether to include Bitcoin in a portfolio. With its speculative characteristics, any Bitcoin exposure should be appropriately and cautiously positioned.

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Investing involves risk, including the possible loss of principal. Past performance does not guarantee future results. Asset allocation cannot eliminate the risk of fluctuating prices and uncertain returns. There is no guarantee that a diversified portfolio will outperform a non-diversified portfolio. No investment strategy, such as asset allocation, can guarantee a profit or protect against loss. Actual client results will vary based on investment selection, timing, market conditions, and tax situation. It is not possible to invest directly in an index.

Investments in equities, bonds, options, and other securities, whether held individually or through mutual funds and exchange traded funds, can decline significantly in response to adverse market conditions, company-specific events, changes in exchange rates, and domestic, international, economic, and political developments.

The digital currencies are speculative, highly volatile, and not backed by any central bank or government. Cryptocurrencies are likely to evolve over time, including potential regulation. There are unique risks associated with cryptocurrencies relating to the technology that is central to its existence.

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