Market Research

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Bitcoin ETFs: A New Way to Invest in Crypto

All amounts in $US unless otherwise stated.

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Event overview

As of January 11th, 2024, the US Securities and Exchange Commission (SEC) has approved the listing and trading of spot bitcoin exchange-traded product shares. With this announcement, more than 11 spot Bitcoin ETFs from issuers such as Fidelity Investments and Blackrock Inc. debuted, with the aim to promote fairness and competition, into the $7 trillion ETF industry.

Bitcoin Breakdown

Bitcoin has its origins in 2009 when an anonymous developer group, Satoshi Nakamoto, announced the now famous Bitcoin Whitepaper on bitcoin.org. The topic of cryptocurrencies is very complex with intricate working however the fundamentals are easy to understand. Everyone is familiar with widely circulated fiat currencies such as USD, CAD, and the Euro. Where fiat currencies deviate from cryptocurrencies is that fiat currencies are controlled by their respective governments who control the number of monies in circulation. Comparatively, cryptocurrencies like Bitcoin have their initial rules set by the developer, where they are then governed by a peer-to-peer network made up of a chain of automated programs on computers. This network of programs maintains the blockchain and performs the necessary tasks for it to function. Throughout this entire process, there is no oversight or regulatory board besides the users themselves who store the information required for the blockchain to run. Hence a common term for cryptocurrency is decentralization as there is no centralized governing body. Instead, the infrastructure and information of the blockchain itself is spread throughout a network of computers instead of a central database.

On an individual level, cryptocurrencies are stored on wallets such as MetaMask and Coinbase much like any other bank account. To exchange cryptocurrencies, one would connect these wallets to Decentralized Exchanges (DEXs) such as Binance or Coinbase which act as the clearing house to ensure that transactions are executed properly. On these DEXs, cryptocurrency is traded much like any other stock, albeit quite a bit more volatile than regular securities. This volatility is exactly what attracts investors as the potential growth is unprecedented in comparison to traditional financial instruments such as stocks, bonds, and other equities. Bitcoin's unregulated and decentralized nature allows for anonymous transactions, which some see as advantageous, but others view as facilitating illicit activities. This anonymity raises questions about whether cryptocurrency should be regulated. Proponents argue that regulation undermines the decentralized finance (DeFi) system's purpose, leading to volatility in Bitcoin prices.

ETF Exposition

Since their inception in the early 1990s, Exchange-Traded Funds (ETFs) have revolutionized investment options. Originally developed to provide investors with an alternative to mutual funds, ETFs combine the features of stocks and mutual funds. The first ETF, the Standard & Poor's Depositary Receipt (SPDR), tracked the S&P 500 index, allowing investors to gain exposure to a broad market index with the flexibility of trading shares throughout the day on stock exchanges. To this day, the SPDR remains one of the most popular ETFs actively traded.

ETFs operate by pooling money from investors to purchase a diversified portfolio of assets, such as stocks, bonds, or commodities. Unlike mutual funds, ETF shares can be bought and sold throughout the trading day at market prices, providing flexibility to investors. Additionally, ETFs typically have lower expense ratios compared to mutual funds, making them a cost-effective investment option. By offering exposure to a wide range of assets, ETFs allow investors to build diversified portfolios tailored to their investment objectives and risk tolerance.

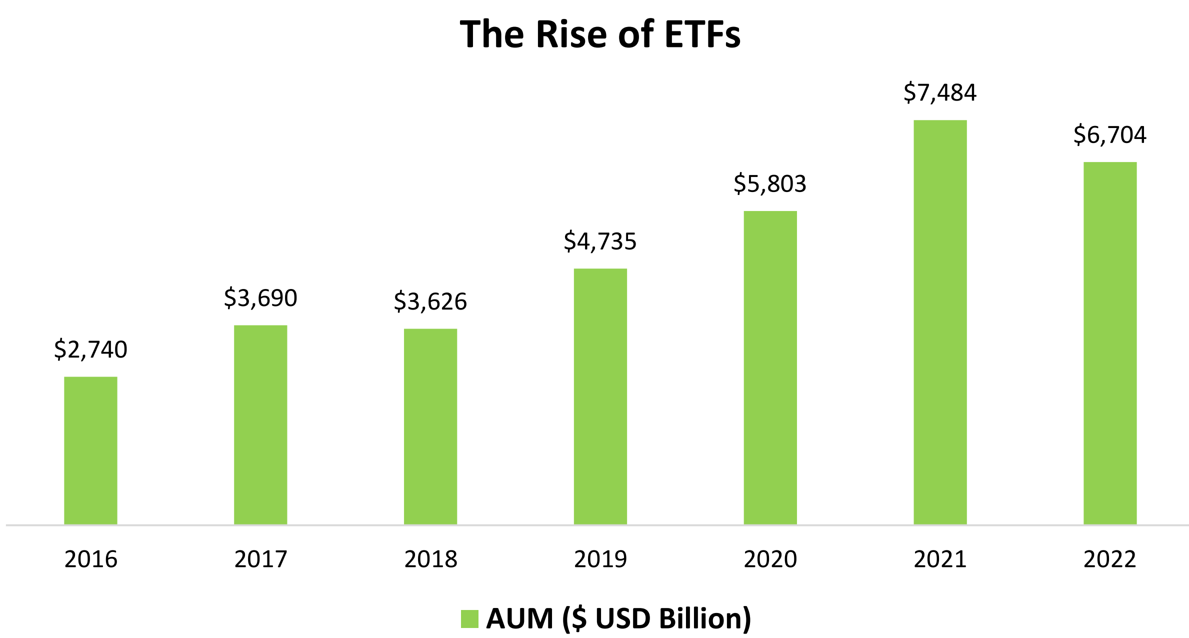

Exhibit 1: ETFs growing from $2.7k to $6.7k AUM from 2016 to 2022. (Oliver Wyman, 2024)

The history of Bitcoin ETFs is a decade in the making with the first attempts to launch a Bitcoin ETF dating back to 2013, but initial proposals faced rejection from the SEC due to concerns about market manipulation and lack of oversight in the cryptocurrency space. However, the landscape since then has started to change and as regulatory attitudes evolved, institutional interest in Bitcoin grew. In October 2021, Canada became the first country to approve a Bitcoin ETF, allowing investors to gain exposure to Bitcoin through a regulated investment vehicle. Following suit, on August 2023, an American judge ruled that the SEC did not provide sufficient reasoning for rejecting previous Bitcoin ETF applications pivotally allowing the commencement of trading activity for Bitcoin ETFs.

Product Introduction – The Controversy

On January 10th, 2023, the Commission approved the listing and trading of several spot bitcoin exchange-traded product (ETP) shares from various applicants, including so-called authorized participators such as BlackRock, Fidelity, Ark Invest, WisdomTree and Grayscale. This signaled another major step of the crypto asset, offering investors greater exposure to a more diversified portfolio of assets without needing to store the underlying assets.

Bitcoin ETFs, or ETFs in general, are a type of security that tracks the underlying performance of an asset or commodities. There are two types of Bitcoin ETFs, future ETFs and spot ETFs.

Future ETFs track the price of Bitcoin through futures contracts, agreements to buy or sell a crypto asset at a specific time in the future. They provide investors with exposure to Bitcoin through derivatives contracts. While futures Bitcoin ETFs are useful in volatile markets as they are commonly used for hedging, speculation and arbitrage, they come with the risk of expiry and rollover.

Spot Bitcoins ETFs, on the other hand, track the fluctuation of Bitcoin's spot price, according to indexes supplied by companies such as CF Benchmarks (Bloomberg, 2024). Spot ETFs provide investors with exposure to ownership of the underlying asset, Bitcoin, without the complexities of buying and storing cryptocurrency.

One of the most distinct differences between spot and futures Bitcoin ETFs is the way they handle the underlying asset. While futures track the price of Bitcoin and its investors have no ownership of the asset, spot Bitcoin ETFs directly own a portion of Bitcoin that is held by the fund, called a custodial wallet. These fundamental differences influence their different exposure of risks and market impacts.

Overall, despite SEC approval of the ETFs, we still see general criticism towards crypto assets from authorities. It is also important to note that the SEC is by no means approving listing standards for crypto asset securities. The SEC has commented on the investments in crypto asset securities and warned investors of the lack of existing protection exposed them to significant risks.

Moreover, the chair of SEC Gary Gensler has reiterated his concerns about the lack of regulatory oversight of Bitcoin and potential for fraud and manipulation. Charlie Munger, vice chairman of Berkshire Hathaway Inc., has also been vocal about his skepticism and criticism against cryptocurrency, particularly Bitcoin. Rooted in his traditional value investing approaches, Munger tends to prioritize business with stable and predictable fundamentals, strong competitive advantages, reliable cash flows, and sustainable growth prospects, while cryptocurrencies such as Bitcoin seemingly go against all these values.

Janet Yellen, U.S. Treasury Secretary, has also voiced her opinion on the crypto industry in a brief portion of her testimony back in February. Yellen stressed that digital assets have potential vulnerabilities and risks and has made several statements regarding cryptocurrency regulation and its use in illicit activities. While Yellen recognizes the potential benefits of blockchain technology and digital currencies in improving financial inclusivity and efficiency, she remains cautious about the rapid growth and speculative nature of cryptocurrencies like Bitcoin.

Bitcoin Market Overview

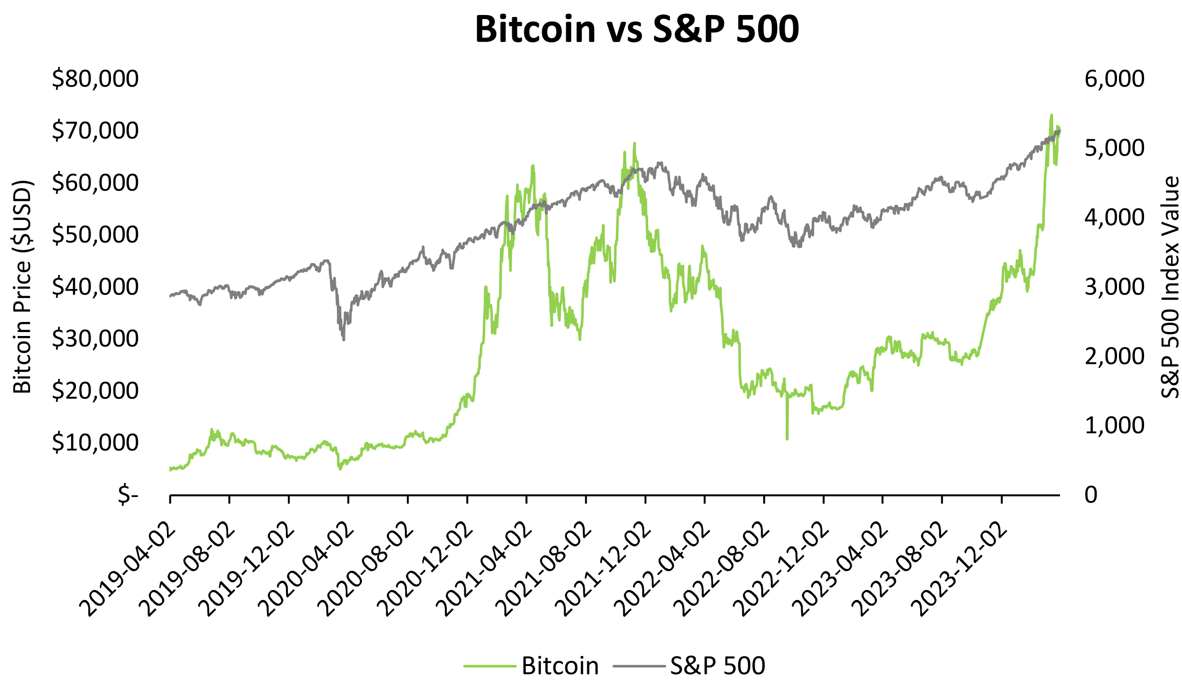

Exhibit 2: Bitcoin vs S&P 500 5 Year Trend (Yahoo Finance)

When comparing the 5-year price graphs of Bitcoin and the S&P 500 in Exhibit 2, a contrast in volatility becomes evident. While the S&P 500 generally shows a more stable trajectory (barring events such as the 2020 stock market crash), Bitcoin's graph shows extreme volatility with rapid spikes and falls. This difference in volatility shows the contrasting nature of these financial instruments: the S&P 500 which consists of a portfolio of well-established companies, tends to reflect more stable economic trends and investor confidence, while Bitcoin is influenced by factors including cryptocurrency market sentiment and the regulatory environment.

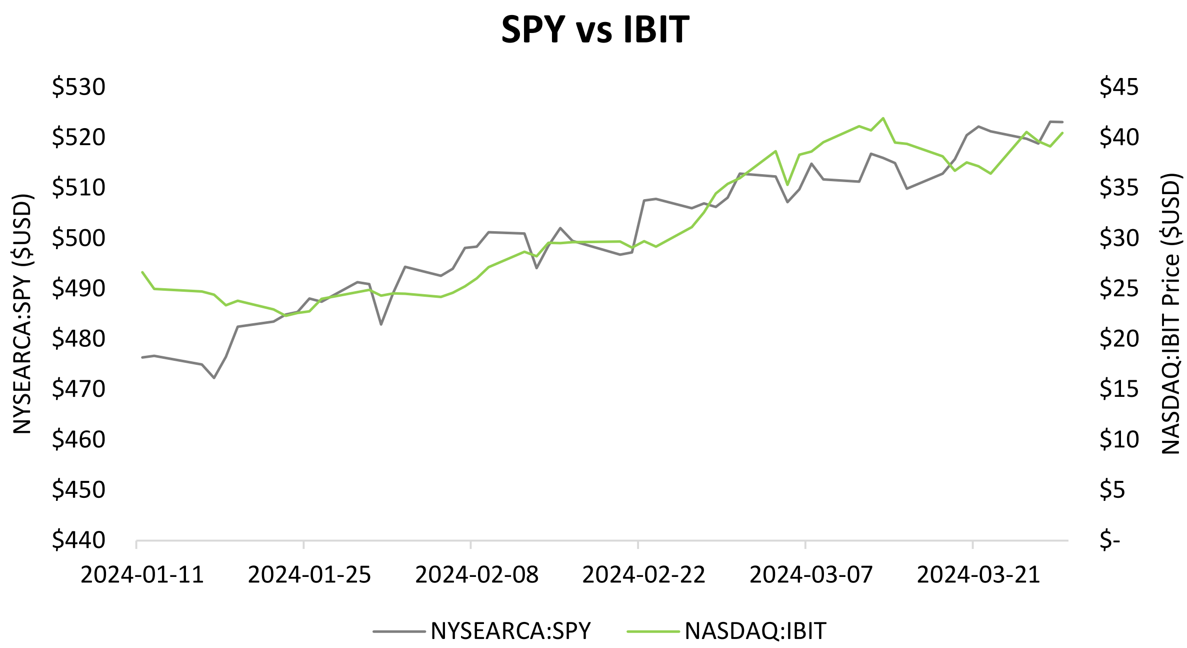

Exhibit 3: SPY vs IBIT 3 Month Trend (Yahoo Finance)

The above graph compares the SPDR S&P 500 ETF and Blackrock's Bitcoin ETF: IBIT, it is evident that in recent months the market has performed well and investor speculation about both the overall stock market and Bitcoin has mostly been positive leading both ETFs to perform well. However, as shown by Exhibit 2, Bitcoin is much more volatile than the S&P 500 meaning that in the coming months we will likely see IBIT deviate from SPY given that IBIT is hedged on Bitcoin's performance.

Parting Thoughts

As investors look to the future, the idea of Bitcoin ETFs gaining popularity is interesting. While Bitcoin's ups and downs might scare off some investors, ETFs offer a way to invest in Bitcoin without dealing with the complications and security risks of owning it directly. Bitcoin ETFs could bring Bitcoin closer to traditional finance, making it more accessible to a wider range of investors. But whether people will fully embrace Bitcoin ETFs is uncertain, as factors like regulations and new technology continue to shape the cryptocurrency market. It is a reminder that investing is always changing, and Bitcoin ETFs are just one part of that evolving landscape.