Monochrome Research

Pathways to Bitcoin Exposure in 2021

Research & Insights

MONOCHROME ASSET MANAGEMENT

0.25 CPD Hours | FPA Accredited

Learning Outcomes

In this session, you will learn how to navigate the different ways you and your clients can gain exposure to Bitcoin, specifically:

1. The methods used by large institutions to gain exposure.
2. The methods available for entrepreneurs, smaller investors and individuals.
3. Key risks and trade-offs associated with the presented methods.

Note: This activity meets the guidelines for qualifying CPD, and has been accredited for continuing professional development by the Financial Planning Association of Australia (FPA). This does not constitute FPA's endorsement of the activity.

Foreword

The growing popularity and adoption of Bitcoin within daily financial infrastructure has sparked the curiosity of many individuals regarding the allocation of Bitcoin within their portfolios and self-managed super funds (SMSF).[1] A survey by New York Digital Investment Group (NYDIG) revealed that "62% of clients would switch financial advisors to one that offers advice about Bitcoin", but that "only 3.5% of advisory clients hold bitcoin with their advisor".[2] These statistics illustrate both the desirability of bitcoin exposure from financial advisory clients around the world, as well as how early current investors are along Bitcoin's overall adoption curve.

Beginners searching for "How do I buy Bitcoin?" on Google are usually presented with a raft of deceptive, high-leverage "crypto" products, and in many instances, scams. As a result, people associate Bitcoin with these scams, which often deters investors and prevents them from realising the benefits of holding bitcoin. Of course, different types of users will have different preferences and requirements when it comes to acquiring bitcoin (e.g. individual vs. institutional), and this article will address those various pathways, while highlighting the benefits and risks of each.

Institutional Pathways to Bitcoin Exposure

Exchanges

Exchanges (mostly unregulated) make up 99% of all crypto transactions and are currently the most popular way to purchase bitcoin.[3] Exchanges utilise an order book to match buyers and sellers. Sellers "ask" for a price, whilst buyers offer a "bid". When a bid and ask overlap, the exchange executes the trade.[4] A frequent issue faced by lower-liquidity exchanges is slippage. This happens when a trader wants to execute a large buy or sell order without enough counterparties on the other side of the order book, causing extraordinary temporary price movement.

Although the world's largest Bitcoin exchanges are now far more robust in the face of slippage and could accommodate a spot order worth tens of millions of dollars, such as with Coinbase facilitating MicroStrategy's first US$425m order.[5] There are currently no exchanges (or, simply, any Bitcoin institutions) in the world that could facilitate a party like Vanguard or Blackrock allocating, say, 0.1% of their multi-trillion dollar portfolios to Bitcoin in a lump sum without causing **dramatic** upside slippage.

[1] In 2014, the Australian Taxation Office (ATO) recognised cryptocurrencies to be a legitimate form of investment for SMSFs, provided they comply with the fund's trust deed, investment strategy and legislation (ATO, 'SMSF investing in cryptocurrencies (bit.ly/39wh37f)', ATO, 16 March 2018, accessed 18 September 2021

[2] NYDIG, 'Survey: Financial Advisors + Bitcoin (bit.ly/3kjR3SA)', NYDIG, 31 March 2021, accessed 18 September 2021

[3] SCorporate Finance Institute, 'Cryptocurrency exchanges (bit.ly/3tQnifb)', Corporate Finance Institute, n.d., accessed 18 September 2021

[4] C Dempsey,. 'How does crypto OTC actually work? (bit.ly/3hJZEfP), Medium.com, 26 March 2019, accessed 18 September 2021

[5] S Sinclair, 'Coinbase Brokered MicroStrategy's $425M Bitcoin Purchase, Exchange Says (bit.ly/3nRULFf)', Yahoo Finance, 1 December 2020, accessed 22 September 2021

To mitigate slippage risk on large buys, bitcoin must be purchased from multiple exchanges and brokers, or at undesirable prices. Alternatively, time-weighted average price (TWAP), a method adopted to facilitate part of the aforementioned MicroStrategy order, and volume-weighted average price (VWAP) execution strategies, assist in transacting smaller portions of a larger trade order. An Over-the-Counter (OTC) transaction is another option (discussed in section 1.3).

Exchanges hold large amounts of client funds on hot wallets to facilitate frequent withdrawal requests, which attracts potential hackers or thieves. Further, if the exchange-owners do not have proper contingencies in place, employees may be able to steal client funds. There have been at least 52 exchange hacks/inside jobs since 2011, with a total of USD$2.1bn lost (at time of hack).[6] Therefore, whilst purchasing and storing bitcoin on exchanges may be the easiest pathway to gain exposure to bitcoin, it has considerable compliance, operational and custodial risk.

Brokerages

Unlike exchanges, the asset price under the Brokerage model is determined by the broker, not traders. Consequently, a brokerage's business model is charging a brokerage fee orspread on top of the asset's market price.[7] Brokerages have two predominant functions; trading with their customers directly and putting their balance sheet at risk, and/or, executing orders on behalf of customers through another platform or an exchange. In Australia, some digital currency exchange (DCE) operators choose to operate as a brokerage that leverages the infrastructure of another exchange as a more cost-effective and scalable solution. Therefore, the use of a broker that transacts via an existing exchange presents a compromise on operational security for investors.

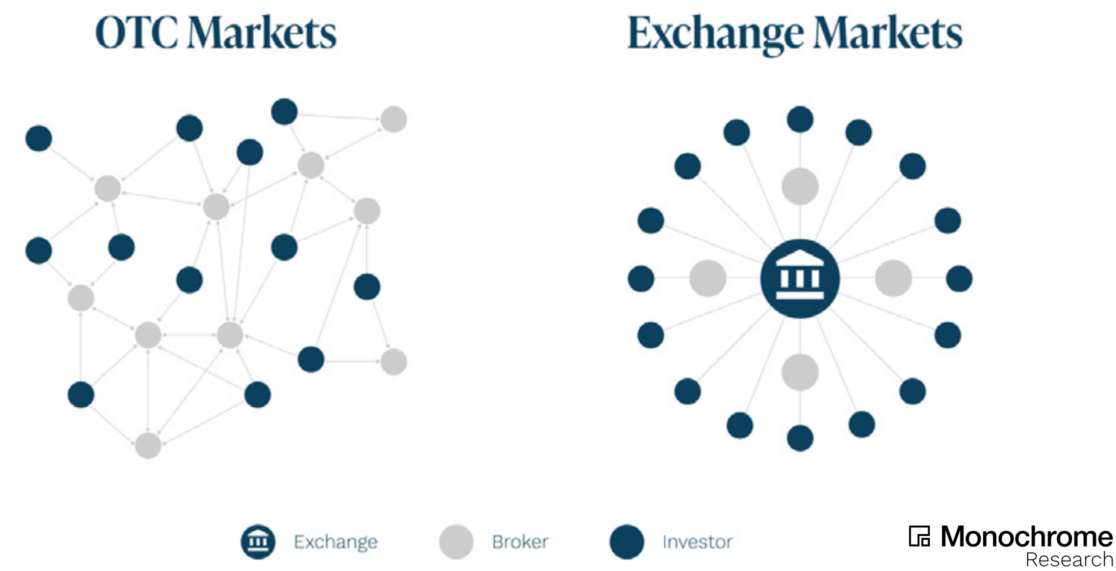
Over-the-Counter (OTC)

Underneath the overarching category of brokerages, over-the-counter (OTC) trading desks provide liquidity to institutional investors, such as hedge funds, private banking institutions and high-net-worth individuals. Contrasting with centralised exchanges, OTC settlements take place between "The Desk" and the trader. Due to more competitive prices with no slippage on large orders, and the "white glove" experience within OTC markets, institutional investors tend to prefer this method.[8] That said, investors purchasing OTC bitcoin will need to take custody of it themselves, or, arrange custody with a 3rd party custodian.

[6] CryptoSec, 'Documented Timeline of Exchange Hacks (https://cryptosec.info/exchange-hacks/)', CryptoSec, 19 August 2021, accessed 18 September 2021

[7] River Financial, 'Brokerages vs. exchanges (https://bit.ly/2VPlFSr)', River Financial, n.d, accessed 18 September 2021accessed 18 September 2021

[8] C Dempsey,. 'How does crypto OTC actually work? (bit.ly/3hJZEfP), Medium.com, 26 March 2019, accessed 18 September 2021



Source: Focus. The World Federation of Exchanges. *ETFs and the making of the modern market.*

Bitcoin Derivatives

Another pathway to Bitcoin exposure is through derivatives, such as options, futures and Contracts for Differences (CFD). This allows investors to achieve exposure without the responsibility of securely managing a wallet. The inherent nature of derivatives allows investors to speculate on the price of Bitcoin or to hedge.

While this may seem an attractive way to gain exposure to bitcoin, the three-month realized volatility of Bitcoin is 86%,[9] resulting in increased risk especially if using leverage. In Australia,CFD products require the appropriate Australian financial services licence (AFSL) or an Australian market licence (AML) in order to be offered to Australian consumers, which are leverage constrained compared with their unregulated offshore counterparts.. Given this, many traders are going offshore and using unregulated international platforms to gain access to higher risk/higher geared CFDs, which lack the investor protections of their Australian counterparts.[10]

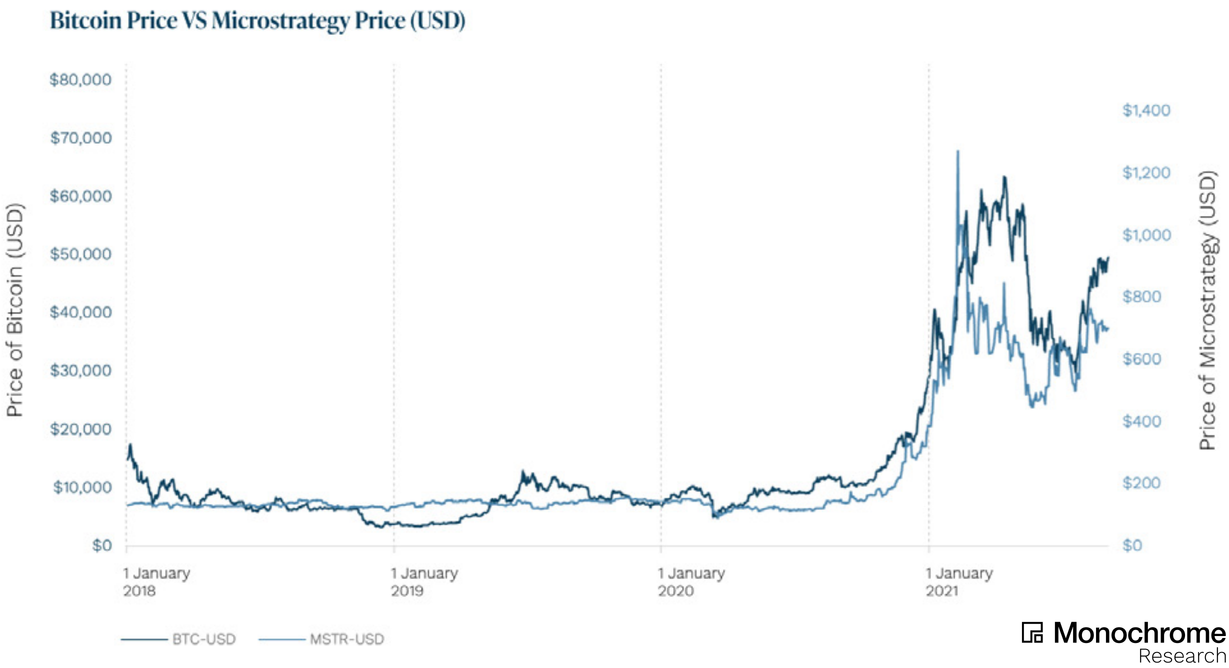
Proxies Exchange-listed Digital Asset Companies

Similarly to derivatives, investing in companies holding Bitcoin on their respective balance sheet allows investors to gain indirect exposure to Bitcoin. This investment pathway is exemplified by MicroStrategy's digital asset treasury investment thesis.[11] As shown in Figure 1, MicroStrategy's returns have closely tracked Bitcoin's, making their shares a good Bitcoin proxy. This strategy requires taking on equity risk characteristics, as it is fundamentally an investment in a company. This may result in the holding being correlated to equity markets, which may be less desirable from a diversification perspective.

[9] M Fox. 'A decline in bitcoin's volatility makes it more attractive to institutions and supports a $130,000 long-term price target, JPMorgan says (https://bit.ly/3hKB3Ya)', markets.businessinsider.com, 1 April 2021, accessed 18 September 2021.

[9] Australian Securities & Investments Commission (ASIC). 'Warning: Trading crypto-asset related financial products through unlicensed entities (bit.ly/3zl1Sbn)', ASIC, 18 August 2021, accessed 18 September 2021

[8] M Roddy, 'Why MicroStrategy has successfully become the best bitcoin proxy around (bit.ly/3AmsBFP)', Holon Global Investments, 23 February 2021, accessed 18 September 2021



Exchange-Traded Product (ETP)/ Exchange-Traded Fund (ETF)

Exchange-traded products (ETP) are a class of stock exchange listed investment vehicles of which exchange traded funds (ETF) are a subset.[12] Single-asset ETPs trade on exchanges and track the price of a specific asset. A Bitcoin ETP tracks the price of Bitcoin. This provides Bitcoin exposure via a regulated product, without the requirement of self-custody. An ETP provides a familiar investment vehicle for traditional investors and seamlessly integrates within their respective portfolio. Furthermore, a Bitcoin ETP presents investors with an opportunity to take long or short positions, while taking place in a familiar, traditional exchange environment.

The main issue faced by a Bitcoin ETP/ETF in Australia is regulatory clarity and service provider readiness preventing the creation of these ETPs. The timeline for these challenges to be resolved is dependent on regulatory approval.[13]

Regulated Investment Trusts

Regulated investment trusts provide a familiar investment vehicle, whereby units can be purchased in a managed fund with cash and redeemed at a later date. Similar to a real estate or gold fund, a Bitcoin fund presents a simplified solution for wholesale investors seeking digital asset exposure. The **Monochrome Bitcoin Fund** is an example of a managed investment trust, which targets a near 100% allocation to Bitcoin.

When purchasing units through a managed fund, an investor outsources many of the associated risks associated with direct Bitcoin holdings, such as key storage and management, for a manage-

[12] R Bowerman, 'ETFs vs ETPs (https://bit.ly/3hGQOPW)', Vanguard Australia, 26 May 2020, accessed 18 September 2021

[13] ASIC, 21-153MR ASIC consults on crypto-asset based ETPs and other investment products (bit.ly/3AlUb5W)', ASIC, 30 June 2021, accessed 18 September 2021

ment fee. Furthermore, the fund is governed by an experienced investment committee, providing an additional layer of security and trust for investors. This allows investors to gain exposure to Bitcoin via traditional frameworks, without facing the aforementioned challenges. Additionally, investment trusts directly address individuals' concerns regarding banking and cyber-security risks. Due to the familiar and regulated nature of units in a trust, estate planning can also be a far simpler proposition compared to a direct holding.

Individual & Entrepreneurial Pathways to Bitcoin

In addition to many of the above tools, individuals and entrepreneurs have a few additional ways of getting exposure to Bitcoin that institutions don't have access to, or which are mostly unsuitable. All methods below require the user to take immediate custody of their own bitcoin.

Bitcoin Mining

Bitcoin mining is as technically difficult to undertake as it is to describe. Although turnkey solutions now exist to allow tech-savvy entrepreneurs to start a sustainable and profitable mine for a few hundred thousand dollars, the harshly competitive nature of the Bitcoin mining industry means that only the best miners survive the "Bitcoin Rollercoaster". Mining is not suitable for investors looking for passive exposure to Bitcoin. One might instead invest in one of the several publicly traded Bitcoin miners as a proxy to mining themselves.

Earning Bitcoin

At the individual level, earning simply means getting paid in Bitcoin for doing something. Whether it's your wage, selling something, or even earning Bitcoin rewards when using your credit card. In terms of Bitcoin entrepreneurship, it's simply getting paid in bitcoin for a product or service - endless possibilities.

Peer to Peer (P2P)

Peer to peer (P2P) trading describes transactions occurring directly between two parties, with no middleman. Parallels can be made between P2P transactions and Facebook Marketplace, where users can post ads with their asking price and wait for a bidder to make an offer.[14]

Whilst there are now a few robust online P2P markets with reliable escrow systems in place, since many P2P transactions are executed in person, there may be some risk of foul play during the transaction process.

[14] Binance, 'Intro to peer-to-peer trading: What is P2P trading and how does a local bitcoin exchange work? (bit.ly/3zqVwXL)', Binance Blog, 25 March 2021, accessed 18 September 2021

Peer to Peer (P2P) Markets.

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Bitcoin ATM

Despite fees of up to 15%,[15] Bitcoin ATMs provide a convenient, fast and familiar experience to trade bitcoin. Similar to a regular ATM, this method is designed for small, everyday transactions and is not suitable for large purchases of Bitcoin. Bitcoin ATMs remain a small market.

Conclusion

Upon consideration of the various pathways to gain Bitcoin exposure outlined within this report, each respective pathway has identifiable strengths and weaknesses. A common issue amongst the outlined investment vehicles is security, where most pathways to purchase Bitcoin require taking custody of the bitcoin. Managing wallets can be a hindrance to many investors, due to technical and compliance reasons. However, regulated investment trusts provide a familiar and secure investment vehicle to gain exposure to Bitcoin, while being easily compatible with financial advisors, estate planners and accountants.

[15] FindBitcoinATM, 'Pros & cons of using a bitcoin ATM to Buy & Sell Bitcoin (https://bit.ly/3zlERVJ)', FindBitcoinATM, 5 June 2018, accessed 18 September 2021

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