IIMI Independent Investment Management Initiative

Digital Assets: Boutiques Express Their Scepticism

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Contents

Executive Summary

- 96% of IIMI members said they do not currently trade crypto-currencies or digital assets, while 83% added they had no plans to do so moving forward.
- Among the main concerns about crypto-currencies cited by IIMI members are their excessive volatility (22%); absence of fundamentals (35%); and the existence of poor quality crypto service providers, together with counterparty risk (26%).
- A further 11% of IIMI members said they were uncomfortable about the lack of regulatory oversight of crypto-currencies.

Introduction

In a macro environment where revenue-generating opportunities have been fairly limited, it is no surprise that investors are searching for alpha in some of the more esoteric corners of the market. In some instances, investors – both retail and institutional – have accumulated positions in digital assets, such as crypto-currencies.

This paper by the Independent Investment Management Initiative (IIMI) argues that crypto-currencies and StableCoins need to be subject to stringent oversight and regulation. Additionally, the paper will examine some of the benefits and challenges of other digital assets - namely security tokens and CBDCs (central bank digital currencies).

A quick note on definitions

Digital assets are diverse. They can broadly be defined as follows:

Digital Asset	Definition
Crypto-currency	A privately issued digital currency underpinned by complex cryptography, which is traded on decentralised networks utilising Blockchain technology. Common examples here include Bitcoin; Ethereum; etc.
StableCoin	A privately issued digital currency whose value is directly correlated to a tangible asset such as a fiat currency, commodity or other financial instrument. They are theoretically designed to be less volatile than crypto-currencies, but this has not always been the case. Common examples here include Tether, Dai, Binance USD, etc.
Central Bank Digital Currency (CBDC)	A digital currency issued by a Central Bank, otherwise known as a digital fiat currency. Most CBDCs are in the so-called experimental or proof of concept stages, but some markets have gone live with them. According to the Atlantic Council, CBDCs are live in Nigeria and a handful of Caribbean countries – including the Bahamas.[1]
Security token	A security token is a digital form of a traditional investment – including an equity or bond or a fund unit, or any other tangible asset, both liquid or illiquid. Tokens are typically issued and traded on Blockchains. Tokenisation is in the experimental stages of development although there have been a small number of issuances (i.e. digital bonds).

1 Atlantic Council

Negligible appetite for digital assets among IIMI members

Over the last few years , a number of industry surveys have found there is growing appetite among institutional investors for digital assets, including crypto-currencies. Most of this activity is being driven by trend-following or quantitative hedge funds, dedicated crypto-funds, family offices and wealthy individuals. While a handful of large institutions may have small holdings of crypto, they are firmly in the minority camp.

There is little – if any trading of crypto-currencies – by IIMI members, either in their client portfolios or on their own personal accounts, according to a survey conducted by IIMI. The IIMI survey found that 96% of its membership do not trade crypto-currencies or any other form of digital assets within their client portfolios. Furthermore, 83% of IIMI members said that they had no intention of trading crypto-currencies or any other type of digital assets within their client portfolios in the future either.

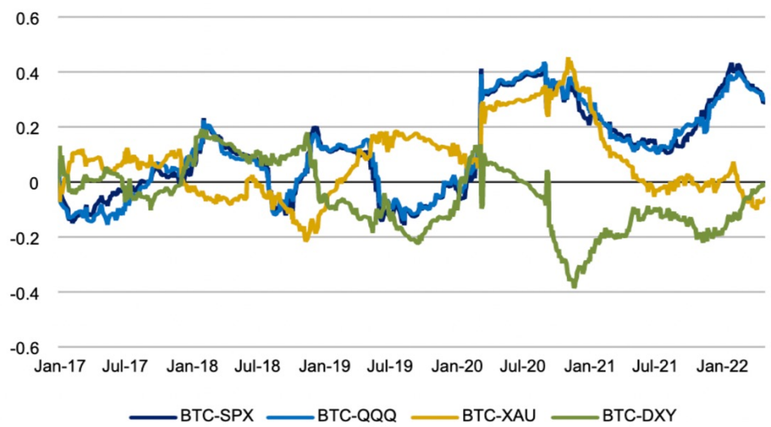
"While I am aware of crypto-currencies being traded by a few alternative asset managers, they do not fit within our portfolios. Our mandate is long only equities, and crypto-currencies are simply not compatible," says one IIMI member. Others are more blunt in their assessment of crypto-currencies. "We do not believe crypto-currencies have any investment value. They are purely speculative, and should not be considered by any serious investors," highlights an IIMI member.

The trepidation towards crypto-currencies among IIMI's membership is justified. The risks of crypto-currencies have been extensively covered insofar as they are highly volatile, while the processes determining how they are priced and valued are not transparent. Previous arguments that crypto-currencies are an effective inflation hedge have now been totally undone following the recent volatility, with analysts arguing that Bitcoin trades are risk assets, which are increasingly correlated to equity market movements.

22% of IIMI members said the excessive volatility underpinning crypto-currencies was the biggest deterrent preventing them from participating in the market. The IIMI survey found 35% of its membership avoided crypto-currencies because of the lack of fundamentals around their pricing and valuations.

Exhibit 15: Bitcoin's correlation with SPX, QQQ, XAU and DXY

180-day rolling correlation between bitcoin and the S&P 500, Nasdaq 100, gold and USD



Source: Glassnode, Bloomberg

Data: 1/1/17 - 5/3/22

Courtesy of Bank of America Global Research

Macro concerns aside, there are risk constraints precluding IIMI members from trading crypto-currencies. "Crypto-currencies are unregulated and they are traded on unregulated exchanges and trading venues. As an investment manager, our mandate requires us to trade on regulated exchanges only," says an IIMI member. The lack of regulation was cited by 11% of IIMI members as being the main reason as to why they eschewed crypto-currencies.

Counterparty risk is another red flag for investors, especially as there are concerns about the calibre of some of the providers supporting trading in or servicing of crypto-assets. 26% of IIMI members said the abundance of poor quality crypto service providers, together with counterparty risk, was a major problem.

For instance, a number of crypto-exchanges have suffered massive losses following cyber-attacks, leaving customers out of pocket. Moreover, there is also a lack of clarity in the US about the rules on asset segregation at crypto-custodians and traditional custodians offering crypto-custody services, in marked contrast to the existing investor protections in the traditional securities world.

It is clear that some sort of regulation of the crypto-asset market and the service providers supporting it is necessary. This is already happening in the EU following the introduction of MICA (Markets in Crypto-Assets) regulation, which will impose new requirements on crypto-asset (including StableCoin) issuers and servicers. Under the provisions, crypto-asset providers will need to protect customer wallets and will be liable should crypto assets go missing.[2]

Following on from the collapse of several StableCoins earlier this year, there is growing scrutiny into their operations too, including further probing of the reserve assets which they purportedly hold to maintain their pegs. This comes amid growing concerns that volatility in the StableCoin market could spill over into traditional financial markets.

As such, regulation is warranted in this area, although MICA appears to have this covered. The MICA rules "will protect consumers by requesting StableCoin issuers to build up a sufficiently liquid reserve with a 1/1 ratio and partly in the form of deposits. All so-called StableCoins will be supervised by the European Banking Authority (EBA) with a presence of the issuer in the EU being a precondition for any issuance."[3]

Stricter supervision of crypto-currencies and Stablecoins is something which IIMI fully supports.

2 European Council
3 European Council

Tokenisation – potential to grow in asset management

In comparison to crypto-currencies and StableCoins, tokenisation is still in its relative infancy. So what is it? Tokenisation is a process whereby a tangible or intangible asset (E.G. equities, bonds, real assets) is converted into a digital token, which can be fractionalised and transacted on a Blockchain.[4]

A number of experts believe tokenisation could also be applied to fund shares or units.[5] The main selling point of fund tokenisation here is that it allows for fractional ownership, enabling investors to buy into funds but at significantly lower cost than what they would normally. With the funds industry still struggling to draw in younger retail investors, tokenisation could be a way to rectify this problem.

Younger people are starting to invest their savings – evidenced by the surge in day trading – which means tokenisation could be an effective distribution tool for this particular demographic. However, appetite among IIMI members is limited here.

While 33% of members thought tokenisation would take off, more than 50% expressed uncertainty about its prospects. Furthermore, 63% of respondents said they had no interest in tokenising their funds even if it does make them more attractive to retail, whereas only 4% said they would tokenise their funds. **This is largely because IIMI members sell mostly to institutions** – where tokenisation is not really applicable.

Although tokenisation may not be entirely relevant for IIMI members, the technology could be useful for more retail-focused managers, who are looking to win mandates from younger investors.

4 Investment Association
5 Investment Association

CBDCs as an efficiency enabler

For many, CBDCs could be used to drive efficiencies in post-trade processes, allowing for asset managers to net operational savings at a time when their margins are falling. So how do CBDCs work? Unlike retail CBDCs – which are effectively a digital version of cash – wholesale CBDCs can be leveraged by financial institutions.

The Depository Trust & Clearing Corporation (DTCC) highlights: “Since many financial institutions have access to "electronic reserves" or account balances held at applicable central banks, a CBDC could provide benefits such as improved efficiency for cross-border payments, 24/7 access to payment systems, the potential for a reduction in settlement and counterparty risks. In addition, a CBDC could potentially provide atomic settlement, a conditional settlement that occurs if delivery and payment are both received at the same time.”

These benefits – assuming CBDCs take off – could be felt downstream by asset managers, allowing them to obtain cost benefits at a time when margins are being squeezed.

Calls for action

- IIMI members are sceptical about the merits of unregulated crypto-currencies, and we welcome further regulatory oversight of this marketplace, including greater oversight of crypto-asset service providers - especially in light of recent events.
- Although IIMI’s membership is largely agnostic about tokenisation, this technology has the potential to improve access to retail investment in the future.

About IIMI

The Independent Investment Management Initiative is a think tank that offers an independent, expert voice in the debate over the future of financial regulation.

Founded in 2010 as New City Initiative and relaunched as IIMI in 2021, the IIMI counts amongst its members some of the leading independent asset management firms in the City and the continent. The IIMI gives a voice to independent, owner-managed firms that are entirely focused on and aligned with the interests of their clients and investors.

Over the last decade, an old fashioned "client-centric" approach has enabled entrepreneurial firms in the Square Mile and beyond to emerge as a growing force in a financial industry dominated by global financial giants. Now, more so than ever, these firms play a key role in preserving the stability and long-term focus of the financial sector, which is of benefit to society at large.

Today IIMI is comprised of over 40 leading independent asset management firms from the UK and the Continent, managing approximately £500 billion and employing several thousand people. IIMI Singapore was launched in 2019.

About the Author

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