
Crypto loses its luster

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Key takeaways

- Bitcoin has closely tracked the S&P 500 the last 3+ years with +0.8 correlation, but with higher volatility. This held true once again in Q1 2023. Bitcoin rose 70% while U.S. equities rose 7%.
- Despite the rise in Bitcoin prices, the response by investors was muted. Both new and long-term investors were more likely to be sellers than buyers during the quarter.
- This lack of interest in crypto is apparent across asset allocation behavior as well, as the typical amount of crypto held compared to total portfolio holdings has decreased by 40%+ from their 2021 highs.

Introduction

When new asset classes emerge, it can be useful to put them into the context of whether their addition to your portfolio adds value. In other words, does the new asset have a positive expected Sharpe, and is it diversifying? Evidence is emerging that cryptocurrencies, in particular Bitcoin, are highly correlated to equity returns and therefore may not add as much value as once promised.

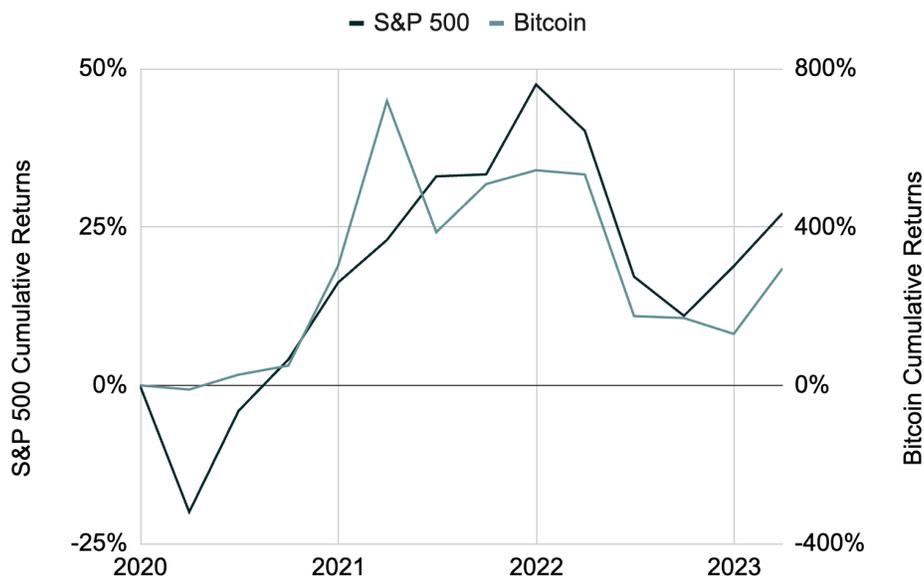
During the first quarter of the year, Bitcoin gained over 70% while equities rose 7%. Below, we plot cumulative returns for the S&P 500 against Bitcoin cumulative returns from January 2020 through March 2023. You'll see that investing in Bitcoin is very similar to buying the S&P 500 with leverage, as the monthly correlation between these two instruments has been an extremely high +0.8 since January 2020.



Exhibit 1

Bitcoin tends to move in line with the equity prices, albeit with a higher volatility

Cumulative S&P 500 and Bitcoin returns from January 2020–March 2023



Source: Yahoo! Finance

Investor behavior

We next examine investor sentiment, which is computed by taking the number of portfolios with net positive cryptocurrency-related flows in a period, subtracting the number of portfolios with net negative cryptocurrency-related flows and dividing by the total number of portfolios with crypto-related positions during that period. We only examine portfolios with greater than \$100,000 in total assets to avoid unnecessary noise.

We surmise that investors who have invested in cryptocurrencies for similar length of times likely invest for similar reasons. We showed in our Q3 2022 crypto note that new investors¹ tend to invest pro-cyclically, while long-term investors tend to employ a buy-and-hold strategy. The figure below shows how investment sentiment has changed over time. We indeed see that historically,

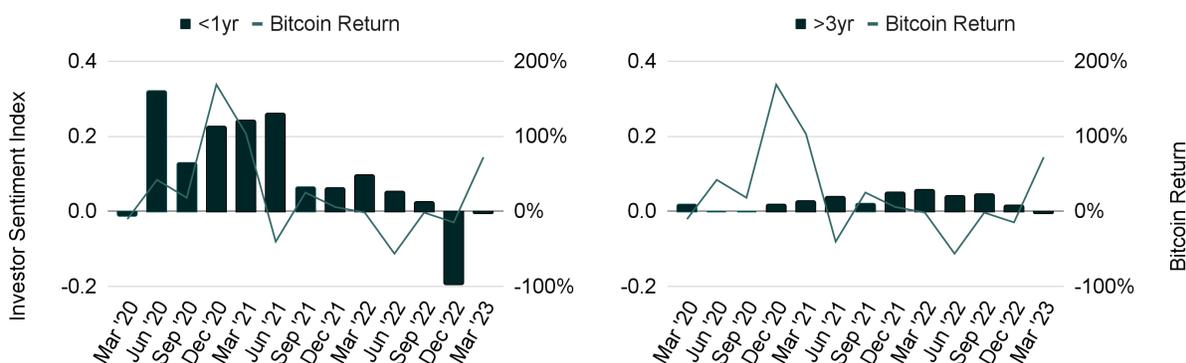
¹ We define new investors as those who have invested in crypto for a year or less, and long-term investors as those who have been invested in cryptocurrencies for at least three years.



new investors tended to buy when markets rose and slowed their behavior when markets fell. However in Q1, despite Bitcoin’s rise, new investors mostly remained neutral and were slightly more likely to sell than to buy. The investor response was equally muted for long-term holders, who were net sellers of crypto for the first time.

Exhibit 2

New and long-term crypto investors were more likely to sell than they were to buy crypto in Q1
 Investor sentiment for long-term (>3yr) and new (<1yr) investors in crypto, Bitcoin returns, Q1 2020–Q1 2023



Source: Addepar

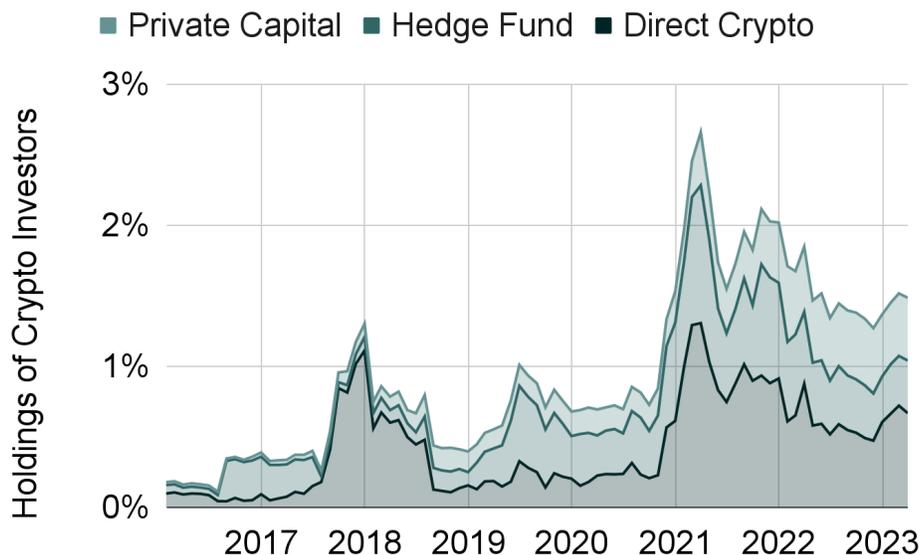
This evidence that investors are moving away from the asset class is further substantiated by examining trends in total cryptocurrency and blockchain-related holdings by investors. As seen in the figure below, total crypto holdings have fallen by over 40% among crypto investors.



Exhibit 3

Crypto holdings' portfolio shares have decreased over 40% from their 2021 highs

Crypto holdings held by crypto investors, percent of total assets, 2016–2023



* Hedge funds and private capital firms included here are defined as those with relatively large portions of their overall assets invested in cryptocurrencies and blockchain-related technologies.

Source: Addepar

Thus far, we've discussed cryptocurrencies as an asset to be held for its risk-return profile. However, we're also interested in the potential that the technology underlying these currencies could become a new, more secure and less risky medium of exchange governed by central banks. Currently, digital payments are completed both between banks and between nonbank financial institutions (think Cash app and Venmo). Settling payments between nonbanks introduces both liquidity and credit risk, and therefore, the Federal Reserve is exploring the possibility of a U.S. digital currency as a new, cheaper alternative to mitigate that risk². This could be run through the use of well-regulated stablecoins, and may potentially make it easier to complete instant, domestic interpersonal transfers, and decrease the costs associated with transferring money internationally. More on this to come as we watch the conversation unfold.

² Board of Governors of the Federal Reserve System, 2022, "Money and Payments..



Conclusion

We've examined how investors have lost some of their interest in cryptocurrencies and blockchain-related technologies. Despite the 70% rise in Bitcoin during the quarter, investors were more likely to be sellers than buyers in the first part of the year and crypto as a percentage of total holdings continued to decline. This could perhaps be due to crypto offering few return characteristics, other than leverage, that differ from other risky assets such as equities.



References

“Money and Payments: The U.S. Dollar in the Age of Digital Transformation.” Board of Governors of the Federal Reserve, January 2022



Asset classifications

Asset class	Sub-asset class
Cash	Cash Cash equivalents
Fixed income	U.S. Treasuries and Agencies U.S. TIPS U.S. investment-grade credit U.S. high yield U.S. bank loans International developed markets Emerging markets Opportunistic Other fixed income Unknown fixed income U.S. municipals/tax exempt
Equities	U.S. equities Global equities Developed markets–Americas Developed markets–EMEA Developed markets–Asia Pacific Emerging & frontier markets Other equities Concentrated equity positions Unknown equities
Mixed allocation	Asset allocation vehicles Held-away accounts
Alternatives	Hedge funds Concentrated alts positions Private equity & venture Real estate funds Other alts Unknown alts
Private business	Direct private companies
Direct real estate	Direct real estate
Other	Collectibles Direct loans Unknown Liability



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