EFFICIENT GROUP

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CRYPTOCURRENCIES, AN ALTERNATIVE ASSET CLASS

As market, economic, and finance experts, we often get asked questions about investing in alternative assets, from property to cryptocurrencies. Because these assets fall outside of the scope of many of the regulatory bodies of traditional finance in South Africa (SA), we can, at best, use our expertise to inform and to educate clients; we cannot give advice. We hope that clients can use our expertise as part of the research that they do to make the best asset allocation decisions.

Over the last couple of years, we have been receiving ever more questions about investing in cryptocurrencies. The reasons have less to do with managing risk and reward through diversification, and more to do with getting rich quick. Basically, all the wrong reasons for investing. From this perspective, we would usually discourage individuals from investing in cryptocurrencies. The reason for this is twofold: It is still a very young industry, and it is not sufficiently regulated (albeit self-regulated), so there are still too many horror stories that make headlines around the world. However, before you simply write off cryptocurrencies as an alternative investment, it should be noted that an article was published last year to show that, when applying the modern portfolio theorem (which is the foundation of traditional asset management), a 1% to 5% investment in Bitcoin can improve an individual's risk/reward multiple in the long term. But, even then, many who invest in the realm of traditional finance find it difficult to value (understand) cryptocurrencies.

It is worth noting that an initial coin offering (ICO) is very different from an initial public offering (IPO). An ICO is not for companies who have proven themselves capable enough to earn the trust of the public, like those companies who eventually offer an IPO on a stock exchange. We have found that a better comparison is to view cryptocurrency investments as venture capital investments: Extremely risky with a very small probability of success, but with a substantial payout if they do succeed. As such, these investments should never be made with money that an investor has borrowed, or with money that an investor is not willing to lose completely.

That being said, it is unfair to compare the crypto market with the dot-com bubble of the early 2000s. Although there are unutilised projects, many do have wide-ranging use cases that are already adding value to the lives of many millions of individuals: Consider VeChain (transparent supply chain management), Helium (decentralised 5G using radio frequencies), and Aave (decentralised finance). Also, many of these projects are trying to address the shortcomings in the traditional sectors that they represent. It would, therefore, not make sense for them to do things in a traditional way and to subject themselves to the pattern and rules that they believe are fuelling the very inefficiencies that they want to overcome.

Cryptocurrency projects play into the long-term theme of individualism, which includes self-sufficiency and self-expression (consider the digital art craze that continues until today). Transparency and decentralisation include individual expression and power, as well as a healthy distrust towards central authorities. They also play into the trend of equality and accessibility. Many cryptocurrency projects and investors believe that traditional sectors, especially finance, favour a select few at the cost of the majority.

However, as with venture capital investments, it is difficult to pinpoint exactly what you are investing in. Often you will hear venture capitalists say that they invest in a person and are less concerned about where that person ends up pivoting a business into. A good example is the early investment that Softbank's Chief Executive Officer, Masayoshi Son, made in Jack Ma, the founder of Alibaba. This is another reason why traditional investors should not attempt to compare ICOs with IPOs, and shares with cryptocurrencies: You are not purchasing future earnings as only a small number of crypto projects, like play-to-earn gaming, distribute profits. What you are doing is playing into the long-term trends that the crypto market represent. What you are buying is adoption, that is, the more a certain project or its underlying token is used (demanded), the higher the price of that token will often go. You are also buying scarcity and deflation because many cryptocurrencies have a limited supply and have built-in deflationary (burning) protocols. In many instances, a token allows the holder governance over the use/direction of that project; much like shares give shareholders partial ownership of a firm. You are also buying an alternative to the traditional offering, which many believe can address the current shortcomings and develop into a superior offering.

Currently, after a substantial correction, the cryptocurrency market is still $2 trillion in size, excluding the enormous non-fungible token (NFT) marketplace. It is also being adopted faster than the internet was. Although it is a young, unregulated market, it would still be unwise to simply put your head in the sand and ignore it.