Markets in a Minute:
Crypto vs. Back to Basics?

Conversations and news stories about cryptocurrencies and Bitcoin have been hard to avoid over the past two years. You've probably heard it all from someone telling you that Bitcoin will eventually replace traditional reserve currencies, that a new meme coin is going to the moon, or that crypto is just another form of gambling. But how has the recent rise and fall of crypto-related companies and exchanges shifted the outlook on crypto? Let's find out in this week's Markets in a Minute.

While Bitcoin and other cryptocurrencies were rising rapidly, it was tempting to ignore the challenges and unknowns of these assets to get in on the quick returns. But now that prices are falling and companies are imploding, those challenges are becoming impossible to ignore. We've published several pieces on the many challenges and associated investor risks.

Key Takeaways:

- The failure of crypto-related businesses such as FTX, BlockFi and Terra-Luna has highlighted a void in regulatory oversight and transparency in the world of digital currencies;
- Some of these companies failed to properly segregate clients' assets and it's often not clear which government has oversight responsibilities;
- Rather than chase the latest crypto headlines, investors would be well served to stick with a "back to basics" approach to their portfolios.

Since those reports were published, crypto-related companies such as FTX and BlockFi have begun winding their way through bankruptcy court. With that journey, crypto's lack of regulatory oversight is now front and center.

It has been widely reported, for instance, that FTX didn't have the most basic corporate governance or controls in place, no functioning board of directors, and no audited financials. In a matter of days, the value of FTX went from an astonishing $32 billion to nothing. While some of these lapses are likely particular to FTX, that company's experience does highlight some broader risks associated with digital assets that investors would do well to learn from.

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Segregation and Lending of Client Assets

In traditional banking and asset management, segregating a client's assets from another client's and from the financial institution itself is paramount. If a client, for instance, deposits $10,000 into a traditional brokerage account, custodians and broker-dealers have extensive accounting controls to ensure a client will have access to those funds.

Many financial institutions have programs to use customer funds for commercial purposes, including lending and trading, meaning that they often hold only a fraction of their customer assets at any given time and allow clients to earn incremental income. These programs require clients to opt in and sign additional disclosure agreements. Regulators also maintain a keen eye to ensure companies follow those procedures, undergo regulatory examinations, and produce audited financial statements.

In contrast with these traditional methods of oversight, the crypto world has no governing body to oversee the many intermediaries who facilitate investment in cryptocurrencies, and it is left to individual companies to police themselves.

Jurisdiction

While regulators and lawmakers in the US have been slow to draft regulations surrounding the digital world, given that cryptocurrencies are not tied to a particular country, it's not always clear who has authority. FTX, for instance, was based in the Bahamas, and now Bahamian officials are battling with US-based bankruptcy courts for jurisdiction and what few assets remain. BlockFi based its non-US operations in Bermuda, where a bankruptcy process is running in parallel to the one in the US.

Heightened Volatility

These recent experiences have highlighted another challenge with cryptocurrencies: volatility. FTX had a sister company - Alameda Research. While FTX ran an exchange where individuals could buy and sell digital assets, Alameda would invest in and trade those currencies. Recent reports have revealed that about half of the $16 billion in assets that Alameda had access to was invested in smaller cryptocurrencies, crypto-related startup businesses, and venture capital funds (some of which even had investments in FTX), while the other half of those assets was in a single cryptocurrency, or token, that FTX had itself created called FTT. Let's leave aside, for a moment, that many of those FTT tokens actually belonged to end customers.

When Bitcoin and other cryptocurrencies, such as FTT, started to fall earlier in 2022, Alameda's assets fell in tandem. Then in late 2022, as some of FTX's issues came to light, investors who owned FTT started selling - driving the price even lower - and Alameda's value began to evaporate in spectacular fashion.

This dramatic decline in value highlights the challenge of being able to determine the value of a cryptocurrency. A stock, for instance, will be valued on the company's ability to earn money over the long term. A bond will be valued on its ability to deliver income based on a company's credit ratings. A country's currency will rise and fall based on things like the long-term economic growth of the country and interest rates. By contrast, cryptos are heavily based on sentiment, which works great when sentiment is improving, but terrible when opinions have turned negative.

What Will Likely Happen Next with Crypto?

With the fallout of FTX and other crypto exchanges, we will likely see a push for more regulations and oversight of these companies. What those regulations might be remains unclear. The US government has yet to even determine how to classify cryptocurrency—whether it's a security, commodity, or something else entirely. While a broader regulatory regime will take time, policymakers are taking some steps. The Biden Administration has been developing new laws and regulations to crack down on crypto-enabled cybercrimes and block transactions on, for instance, Russian exchanges associated with criminal activity.

As technology advances, Central Banks around the globe, including the Federal Reserve, have begun exploring, researching, and developing Central Bank Digital Currencies (CBDCs) that would ideally offer some of the benefits of cryptocurrencies. Benefits could include faster transactions, broader access to financial instruments and verification of transactions through blockchain technology. Unlike cryptos, CBDCs would likely offer the consistency and oversight of more traditional financial products.

Some countries are much further along in the process than others. This month, India is introducing a pilot program of a digital rupee that will have the same value and legitimacy as a banknote or coin. Switzerland began testing its own CBDC late last year.

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What's an Investor to Do?

Most investors have little to no direct exposure to digital currencies. As such, these headlines around FTX and others will have little impact on their portfolios and investors would be well served to take what we like to call a "back to basics" approach to investing.

- ✓ The most important thing an investor can do is trust the process. While stock and crypto markets may react to daily headlines, wealth is created over time.
- ✓ Diversify your portfolio but don't chase "fads". Don't look to scoop up certain risky assets simply because they've declined significantly from their highs – there's no guarantee that a single asset will ever reach its previous heights. Build a diversified portfolio that can withstand shifts in the market and position yourself for long-term growth.
- ✓ Take your portfolio in for a check-up. It's critical that your portfolio reflects your financial goals and your risk tolerance. Speak with your financial advisor to ensure your portfolio is tailored to your unique circumstances.