Global Investment Strategy Team

Cryptocurrency investing hits a milestone

Key takeaways

- The first cryptocurrency-linked exchange-traded fund (ETF) has begun trading on the New York Stock Exchange. This opens up a new, liquid path to cryptocurrency investing.
- Importantly, although this ETF has registered with the Securities and Exchange Commission (SEC), a filing should not imply that the SEC has validated or approved of the offering.[1]

What it may mean for investors

- Nevertheless, the increasing number of ways to own cryptocurrencies broadens the market and should help the industry to evolve and mature. This latest development reinforces our view that cryptocurrencies have become viable investments.

The cryptocurrency industry has reached an important milestone, as the SEC has allowed the first U.S. cryptocurrency ETFs to begin trading. Also helping draw attention to the industry recently, the SEC approved the first ETF that seeks to track leading publicly-traded cryptocurrencies.[2]

We have been expecting to see more regulatory news in 2021, after a busy 2020. Most notably in 2020, banks received regulatory permission to custody cryptocurrencies, and the investment industry and regulators took additional steps to extend a legal and oversight framework. Our May 12, 2021 report, "The investment rationale for cryptocurrencies", also noted that "[we] expect more availability as the industry and investors come to understand better the trends toward digitization in economic activity and the demand for cryptocurrencies and blockchain technologies."

[1] "Investor Alert: Beware of Claims That the SEC has Approved Offerings," SEC, April 2019.
[2] Lee, Isabelle, "The SEC just approved the closest thing to a US bitcoin ETF you can buy, for now", Business Insider, October 7, 2021.

The announcement is significant, not only for the launch of these exchange-traded products, but for the evolution that they represent. Even before this latest announcement, greater regulatory clarity and rising interest in digital technologies had accompanied a wider variety of cryptocurrencies, investor participation, and increased market capitalization. We expect additional registrations for cryptocurrency ETFs to increase the size, diversity, and ultimately the stability of this market.

As digital transactions become more common across the economy, more cryptocurrencies should gain stability, which should strengthen their case as investable assets. Still, risks are part of every investment decision, and our May 2021 cryptocurrency investment rationale listed what we believe are among the most prominent:

- Operational risks, such as handling and storing cryptocurrencies
- Technology failures
- The cost of heavy energy consumption to produce
- Price volatility has decreased but remains at levels far above traditional benchmark indices, such as the S&P 500 Index
- Consumer protections that are still evolving, including difficulty in recovering funds sent to the wrong person or place, and losing access to one's private key or access code
- Evolving regulation

Against these risks, education can support investors who approach these unique, complex, and evolving assets. To that end, we have begun a series of reports with the goal of increasing investor understanding of cryptocurrencies. The first of these reports, "Cryptocurrency Q&A – the basics", published June 29, 2021, is available now. We plan to offer more to explain the growing importance of digital assets in the economy, and how cryptocurrencies are one of a set of technologies driving these changes.

We believe it is also important to see the benefits and challenges of this expanding set of investment choices, to understand the available options for what they are. The benefits of the ETFs include liquidity, visibility, and accessibility for investors who do not qualify for a private placement. As these features attract more investors to the cryptocurrency market, we expect the market's growth to help reduce the overall volatility of cryptocurrency prices.[3]

Topping the list of challenges, the initial ETFs will take their exposure not directly, but through futures contracts. That is, the inaugural ETFs do not give the investor direct ownership, but seek to track the price through the futures market. As many commodity investors can attest, futures-based ETFs can at times struggle to track the underlying asset.

We continue to see cryptocurrencies as investable assets – for now through a private placement, but possibly later through U.S.-based ETFs based on spot prices (should the SEC give approval). A private placement today can give investors direct, or spot, exposure, which we believe is best for tracking. And select private placements can safeguard cryptocurrencies by storing them away from the internet and cryptocurrency exchanges, in what is known as cold storage. Looking ahead, however, the next evolutionary step for cryptocurrency ETFs may be to lessen the tracking problem by seeking liquid structures that seek secure exposure to the spot market. We look forward to keeping up with the benefits and challenges as the industry grows and changes.

The important point is that we see cryptocurrencies as investable assets with broadening options for taking exposure, both today and in the future. Our reports and our investment professionals are ready to help with the education process.

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[3] As more investors gain cryptocurrency exposure, we have seen a falling percentage of those who buy or sell on any given news, which, in turn, has reduced price swings. For more, please see "The investment rationale for cryptocurrencies", Wells Fargo Investment Institute, May 12, 2021, page 6.

Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve.

Virtual or cryptocurrency is not a physical currency, nor is it legal tender. Bitcoin and other cryptocurrencies are a very speculative investment and involves a high degree of risk. Investors must have the financial ability, sophistication/experience and willingness to bear the risks of an investment, and a potential total loss of their investment. An investor could lose all or a substantial portion of his/her investment. Cryptocurrency has limited operating history or performance. Fees and expenses associated with a cryptocurrency investment may be substantial. Cryptocurrencies are sometimes exchanged for U.S. dollars or other currencies around the world, but they are not backed or supported by any government or central bank. Their value is completely derived by market forces of supply and demand, and they are more volatile than traditional fiat currencies.

An investment in an exchange–traded fund (ETF) will fluctuate and shares when sold may be worth more or less than their original cost. ETFs are subject to risks similar to those of the underlying investments and may yield investment results that, before expenses, generally correspond to the price and yield of those underlying investments. There is no assurance that the price and yield performance of the investment can be fully matched. All investing involves risk including the possible loss of principal.

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