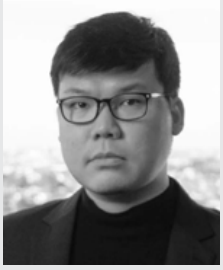


Jeff Yew, Monochrome Asset Management

Jeff is the founder and former chief executive of Australia's largest and most liquid digital asset exchange by trading volume. Under his leadership, in less than a year, Binance Australia amassed trade volumes of more than AUD$20 billion. Jeff has been active in the bitcoin markets since 2013

Pathways to gain bitcoin exposure

Jeff Yew

The growing popularity and adoption of bitcoin within daily financial infrastructure has sparked the curiosity of many individuals regarding the allocation of bitcoin within their portfolios and self-managed super funds. In its *Survey: Financial Advisors + Bitcoin*, New York Digital Investment Group revealed that "62% of clients would switch financial advisors to one that offers advice about bitcoin", but that "only 3.5% of advisory clients hold bitcoin with their advisor". These statistics illustrate both the desirability of bitcoin exposure from financial advisory clients around the world, as well as how early current investors are along bitcoin's overall adoption curve.

Beginners searching for "How do I buy bitcoin?" on Google are usually presented with a raft of deceptive, high-leverage "crypto" products, and in many instances, scams. As a result, people associate bitcoin with these scams, which often deters investors and prevents them from realising the benefits of holding bitcoin. Institutional investors will have different preferences and requirements to individuals when it comes to acquiring bitcoin, and this paper addresses those various pathways, while highlighting the benefits and risks of each.

Institutional pathways to bitcoin exposure

Exchanges

Exchanges, mostly unregulated, make up 99% of all crypto transactions and are currently the most popular way to purchase bitcoin. Exchanges utilise an order book to match buyers and sellers. Sellers 'ask' for a price, whilst buyers offer a 'bid'. When a bid and ask overlap, the exchange executes the trade. A frequent issue faced by lower-liquidity exchanges is slippage. This happens when a trader wants to execute a large buy or sell order without enough counterparties on the other side of the order book, causing extraordinary temporary price movement.

Although the world's largest bitcoin exchanges are now far more robust in the face of slippage and could accommodate a spot order worth tens of millions of dollars, such as with Coinbase facilitating MicroStrategy's first US$425 million order, there are currently no exchanges or any bitcoin institutions in the world that could facilitate a party like Vanguard or Blackrock allocating, say, 0.1% of their multi-trillion dollar portfolios to bitcoin in a lump sum without causing dramatic upside slippage.

To mitigate slippage risk on large buys, bitcoin must be purchased from multiple exchanges and brokers, or at undesirable prices. Alternatively, time-weighted average price (TWAP), a method adopted to facilitate part of the MicroStrategy order, and volume-

weighted average price (VWAP) execution strategies, assist in transacting smaller portions of a larger trade order. An over-the-counter (OTC) transaction is another option.

Exchanges hold large amounts of client funds on hot wallets to facilitate frequent withdrawal requests, which attracts potential hackers or thieves. Further, if the exchange-owners do not have proper contingencies in place, employees may be able to steal client funds. There have been at least 52 exchange hacks/inside jobs since 2011, resulting in a total of USD$2.1billion lost at time of hack. Therefore, whilst purchasing and storing bitcoin on exchanges may be the easiest pathway to gain exposure to bitcoin, it has considerable compliance, operational and custodial risk.

Brokerages

Unlike exchanges, the asset price under the brokerage model is determined by the broker, not traders. Consequently, a brokerage's business model is charging a brokerage fee or spread on top of the asset's market price. Brokerages have two predominant functions: trading with their customers directly and putting their balance sheet at risk, and/or, executing orders on behalf of customers through another platform or an exchange. In Australia, some digital currency exchange operators choose to operate as a brokerage that leverages the infrastructure of another exchange as a more cost-effective and scalable solution. Therefore, the use of a broker that transacts via an existing exchange presents a compromise on operational security for investors.

Over-the-counter (OTC)

Underneath the overarching category of brokerages, OTC trading desks provide liquidity to institutional investors, such as hedge funds, private banking institutions and high-net-worth individuals. Contrasting with centralised exchanges, OTC settlements take place between 'The desk' and the trader. Due to more competitive prices with no slippage on large orders, and the 'white glove' experience within OTC markets, institutional investors tend to prefer this method. That said, investors purchasing OTC bitcoin will need to take custody of it themselves or arrange custody with a 3rd party custodian.

Bitcoin derivatives

Another pathway to bitcoin exposure is through derivatives, such as options, futures and contracts for differences (CFD). This allows investors to achieve exposure without the responsibility of securely managing a wallet. The inherent nature of derivatives allows investors to speculate on the price of bitcoin or to hedge. While this may seem an attractive way to gain exposure to bitcoin, the three-month realised volatility of bitcoin is 86%, resulting in increased risk especially if using leverage.

In Australia, CFD products require the appropriate Australian financial services licence (AFSL) or an Australian market licence (AML) in order to be offered to Australian consumers, which are leverage constrained compared with their unregulated offshore counterparts. Given this, many traders are going offshore and using unregulated international platforms to gain access to higher risk/higher geared CFDs, which lack the investor protections of their Australian counterparts.

Proxies exchange-listed digital asset companies

Similar to derivatives, investing in companies holding bitcoin on their respective balance sheet allows investors to gain indirect exposure to bitcoin. This investment pathway is exemplified by MicroStrategy's digital asset treasury investment thesis. As shown in Figure 1, MicroStrategy's returns have closely tracked that of bitcoin, making its shares a good proxy for bitcoin. This strategy requires taking on equity risk characteristics, as it is fundamentally an investment in a company. This may result in the holding being correlated to equity markets, which may be less desirable from a diversification perspective.

Exchange-traded product (ETP)/Exchange-traded fund (ETF)

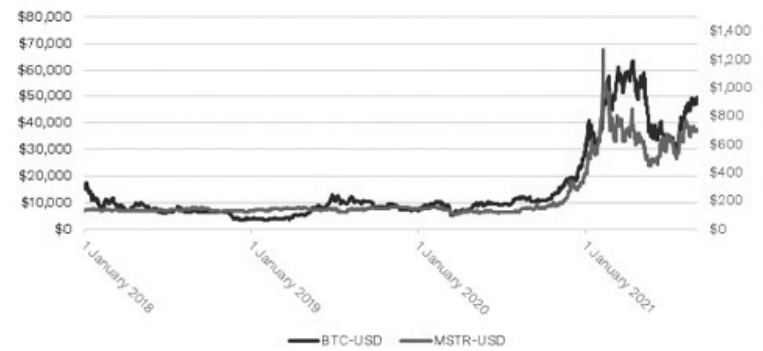
Exchange-traded products (ETP) are a class of stock exchange listed investment vehicles of which exchange traded funds (ETF) are a subset. Single-asset ETPs trade on exchanges and track the price of a specific asset. A bitcoin ETP tracks the price of bitcoin. This provides bitcoin exposure via a regulated product, without the requirement of self-custody. An ETP provides a familiar investment vehicle for traditional investors and seamlessly integrates within their respective portfolio. Furthermore, a bitcoin ETP presents investors with an opportunity to take long or short positions, while taking place in a familiar, traditional exchange environment.

The main issue faced by a bitcoin ETP/ETF in Australia is regulatory clarity and service-provider readiness that may prevent the creation of these ETPs. The timeline for these challenges to be resolved is dependent on regulatory approval.

The quote

Whilst purchasing and storing bitcoin on exchanges may be the easiest pathway to gain exposure to bitcoin, it has considerable compliance, operational and custodial risk.

Figure 1. Bitcoin price versus MicroStrategy price (USD)



Source: Monochrome Research

The quote

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On 30 June 2021, ASIC released *Consultation Paper 343 Crypto-assets as underlying assets for ETPs and other investment products* (CP 343) to gain stakeholder feedback on its proposals prior to publishing final information for product issuers and market operators on how they can meet their regulatory obligations.

Regulated investment trusts

Regulated investment trusts provide a familiar investment vehicle, whereby units can be purchased in a managed fund with cash and redeemed at a later date. Like a real estate or gold fund, a bitcoin fund presents a simplified solution for wholesale investors seeking digital asset exposure. The Monochrome Bitcoin Fund is an example of a managed investment trust, which targets a near 100% allocation to bitcoin.

When purchasing units through a managed fund, an investor outsources many of the associated risks associated with direct bitcoin holdings, such as key storage and management, for a management fee. Furthermore, the fund is governed by an experienced investment committee, providing an additional layer of security and trust for investors. This allows investors to gain exposure to bitcoin via traditional frameworks, without facing the aforementioned challenges. Additionally, investment trusts directly address concerns regarding banking and cyber-security risks. Due to the familiar and regulated nature of units in a trust, estate planning can also be a far simpler proposition compared to a direct holding.

Individual & entrepreneurial pathways to bitcoin

In addition to many of the above tools, individuals and entrepreneurs have a few additional ways of getting exposure to bitcoin that institutions do not have access to, or which are mostly unsuitable. However, each of the following methods require the user to take immediate custody of their own bitcoin.

Bitcoin mining

Bitcoin mining is as technically difficult to undertake as it is to describe. Although turnkey solutions now exist to allow tech-savvy entrepreneurs to start a sustainable and profitable mine for a few hundred thousand dollars, the harshly competitive nature of the bitcoin mining industry means that only the best miners survive the 'bitcoin rollercoaster'. Mining is not suitable for investors looking for passive exposure to bitcoin. One might instead invest in one of the several publicly traded bitcoin miners as a proxy to mining themselves.

Earning bitcoin

At the individual level, earning simply means getting paid in bitcoin for doing something. Whether it is your wage, selling something, or even earning bitcoin rewards when using your credit card. In terms of bitcoin entrepreneurship, it is simply getting paid in bitcoin for a product or service.

Peer-to-peer (P2P)

Peer-to-peer (P2P) trading describes transactions occurring directly between two parties, with no middleman. Parallels can be made between P2P transactions and Facebook Marketplace, where users can post ads with their asking price and wait for a bidder to make an offer.

Whilst there are now a few robust online P2P markets with reliable escrow systems in place, since many P2P transactions are executed in person, there may be some risk of foul play during the transaction process.

Bitcoin ATM

Despite fees of up to 15%, bitcoin ATMs provide a convenient, fast and familiar experience to trade bitcoin. Similar to a regular ATM, this method is designed for small, everyday transactions and is not suitable for large purchases of bitcoin. Bitcoin ATMs remain a small market.

Conclusion

Upon consideration of the various pathways to gain bitcoin exposure, each respective pathway has identifiable strengths and weaknesses. A common issue amongst the outlined investment vehicles is security, where most pathways to purchase bitcoin require taking custody of the bitcoin. Managing wallets can be a hindrance to many investors, due to technical and compliance reasons. However, regulated investment trusts provide a familiar and secure investment vehicle to gain exposure to bitcoin, while being easily compatible with financial advisors, estate planners and accountants. **FS**