RAINER MICHAEL PREISS IS AN INVESTMENT ADVISOR BASED IN SINGAPORE.

CRYPTOCURRENCIES AS PORTFOLIO DIVERSIFICATION

AS BITCOIN and cryptocurrencies gain ever more media coverage, many who never invested in crypto are asking whether cryptocurrencies could provide meaningful portfolio diversification to traditional portfolio asset allocation. To answer this, one must look both backwards and forward. Backward looking to determine past correlations and a risk-reward profile, and forward looking to understand the real risk of central bank mistakes and government debasement of fiat currencies.

Diversification—or portfolio insurance—focuses on the volatility of an underlying security, plus its correlation with core market assets, and how it impacts a portfolio's risk-return characteristics over the long-term or during extreme macroeconomic or market stress. The main reasons for Bitcoin's portfolio diversification are: investability, politico-economic features, returns correlation and risk-reward profile.

Research has shown that investors prefer outcomes with known probability distributions compared to those where probabilities are unknown. Bitcoin has insufficient data to regard it as a safe haven. However, for its risk-return profile, no other asset worldwide can match Bitcoin's optionality.

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Bitcoin has a near-zero average correlation with other asset classes over the past five years, compared with a small average positive correlation of traditional hedges such as inflation-linked bonds, commodities, gold and Japanese yen. Portfolio diversification is based on correlations, and historically many assets were negatively correlated. One negative side effect of trillions of dollars of quantitative easing (QE) is the distortion of the price discovery mechanism. Traditional asset class volatility has been suppressed by large amounts of short volatility strategies from investors looking for yield enhancement in a low interest rate world.

The U.S. is about to follow this unprecedented monetary policy experiment with an unprecedented fiscal policy experiment (Trump tax cuts)—which could destabilize traditional asset class relationships. Historically, stocks and bonds trade in opposite directions. The February stock market sell-off was triggered by a sell-off in the bond markets—so both stocks and bonds declined. The notion that low volatility assets like bonds are safe and high volatility assets like Bitcoin are risky is now being reconsidered. Many investors feel Bitcoin is volatile even if its volatility has been mostly to the upside—Bitcoin's one-year return is 811%.

Famous investor George Soros attributed his stellar investment performance to the insight that you profit when rules of the game change. An asset allocation investment into crypto is just such a bet on a change in the rules of finance. If the status quo remains, then Bitcoin has no place in your strategic asset allocation. However, if global debt levels are unsustainable and the U.S. dollar and other fiat currencies face debasement, then you must have crypto for strategic asset allocation. Since you cannot QE gold nor Bitcoin, it is a perfect diversifier for stocks and bonds.

Money is the ultimate network effect, and possibly one reason why some government officials worry about the mass adoption of Bitcoin. Cryptocurrencies have evolved from a curiosity in 2009 to a legitimate investment case in 2018. Cryptocurrencies are the summit of decentralization of counter-party risk, and an escape from highly indebted nation state fractional reserve banking system. Take that into account, for when the international monetary system needs to be re-anchored, and what that could mean for your savings and strategic asset allocation. F