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Digital currencies are here to stay

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Early institutional adopters will reap the rewards

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Asia is leading the way in digital currencies globally. Asian investors on Asian exchanges are providing much of the volume in digital currency trading. Around a third of all Bitcoin trades take place in Japan alone, which at times has overtaken the US as the country with the most Bitcoin traded by volume.

Digital currency markets in Asia continue to see high volumes of trading; indeed due to high levels of demand, the price for currencies such as Ether, XRP and Bitcoin are often notably higher than in European or US markets.

Asian regulators have been the first among their peers internationally to regulate digital currencies. In April 2017, Japanese authorities passed legislation defining some digital currencies as a form of payment, thus legalising their use. In September, China banned initial coin offerings (ICOs), while South Korea recently announced increased oversight and regulation of the space.

We at BitSpread – which is a leading global market maker in the digital currencies space, responsible for over a billion US dollars in trading every month – welcome appropriate regulation of the sector. We recognise that such oversight will increase the confidence of investors in digital currency markets.

So far, those investors entering the digital currency space have been predominantly either retail investors, high net worth individuals (HNWI), or family offices. The question is when will the time be right for major institutional investors, including those based in Asia, to enter the space?

Institutional uptake

It is undoubtedly the case that the space is potentially attractive for institutional investors. The returns generated have been striking, and the lack of correlation between the asset class and others would make it a powerful diversifier in institutional investor portfolios.

However, institutions rightly have many concerns. Inevitably, the extraordinary rise in value of some currencies (last year, the value of Bitcoin swelled from around US$800 in January to $16,500 in December) has led some to say that the whole space is a bubble.

What I would say in response to that is that bubbles have historically been associated with major, revolutionary new advances in technology. It happened with dot.com, for example, and yet the companies which emerged from that dominate the landscape today. Compared to those giants, the leading digital currencies are still undervalued.

And there is no question that digital currencies are here to stay. The idea behind peer-to-peer electronic cash decentralised networks is to enable an irreversible, fast, and cost-efficient means of payment for global e-commerce. The ability of digital currencies to eliminate the “middle man” on transactions and to dispense with exchange rate volatility will have a profound impact on world trade.

Another concern that institutions have is that they do not understand the space, because everything is so new. As a relative veteran of digital currencies, having been in the sector for over five years, I think they are right to be concerned.

There is no doubt that the complexity of digital currencies does mean that an institutional investor considering the space should either invest in expertise in-house, or bring in highly experienced partners as fund managers.

Institutional investors also worry that many of the fund managers in the space are inexperienced. I think investors are also right to be worried here. Very few funds unite experts from both financial and technical backgrounds. Some funds have been established by technical experts who don’t have the requisite “traditional” financial, legal or regulatory expertise.

Conversely, other funds are run by financiers looking to “ride the cryptocurrency wave”, but this has unfortunately led to the establishment of risky directional funds, holding large long-only positions, which are highly vulnerable to market volatility. Some have generated huge returns, of course, but risk blowing up in the next downturn.

Market-neutral approach

One way to avoid such speculative investing is to take a market-neutral approach which is not impacted by market movements in either direction. We have been market leaders in this approach, which involves a quantitative trading strategy and cross-market arbitrage to exploit price differentials between blockchain asset exchanges by acting as a market maker.

We are able to maintain a net flat exposure when trades are executed, keeping us immune from drawdowns. By acting as the leading market maker in the space, we are able to bring liquidity to the sector and contribute to its development.

Finally, another legitimate concern many institutional investors have is that prospective partners in the space do not have the appropriate operational infrastructure or risk management systems in place.

We operate a proprietary trading and risk management system backed by robust operational infrastructure. We have undertaken painstaking due diligence on all the exchanges and only operate with the highest-quality partners.

In some respects, digital currencies are mirroring the development of hedge funds in terms of investor base. At one point back in the 1990s, it was nearly all HNWIs and family offices who were investing in hedge funds, but when institutional investors began to start investing in the early 2000s they were joined by their peers in great numbers and now dominate the space.

I think we will see a similar development with digital currencies. Those pioneering institutional investors that have the foresight to get in early and the wisdom to do so with appropriate care will reap the rewards.

Cedric Jeanson is founder and CEO of BitSpread