CANADIAN ASSOCIATION OF ALTERNATIVE STRATEGIES & ASSETS

DIGITAL ASSETS: EVOLVING TO MEET THE NEEDS OF TODAY'S INVESTORS

Innovative assets have become mainstream for centuries. Options on olive presses, railroad bonds, common equities, financial futures, credit derivatives, and digital assets were all borne of an investor need.

We would like to thank the following CAASA members for helping to make this paper possible:

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About CAASA & This Paper

Inclusive, Active, and Pan-Alternative

The Canadian Association of Alternative Strategies & Assets (CAASA) was created in response to industry requests for a national group to represent the Canadian alternative investment participants, including investors, asset managers, and service providers. CAASA is inclusive in that it welcomes participation from all companies active in the space (400+ members in 2024) who might want to participate in committees and working groups — or simply attend member events — without their employer being a member of the association.

CAASA is very active, organizing numerous conferences, webinars, socials, and podcasts throughout the year. Pan-alternative, for CAASA, encompasses all alternative strategies and assets including hedge funds/alternative trading strategies, private and public real estate (funds and direct), private lending, private equity, infrastructure, development and project finance, digital assets/crypto-assets, weather derivatives and cat bonds, and all aspects of diligence, trading, structuring, dealing, and monitoring alternatives in a stand-alone portfolio and as part of a larger investment strategy.

As with all our papers, we use an external writer to draft it from interviews with participating members and it represents, in the end, our views and not necessarily that of every participating member.

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What is a digital asset?

Followers of technology and financial news have heard of cryptocurrencies but perhaps not everyone has heard of digital assets. Online tokens, whose ownership is recorded on distributed ledgers not managed by any central organization, were originally conceived as a type of digital money. The idea that these assets were a form of money, meant to be exchanged for goods or services, is built into the names of the currencies themselves, and into the industry's jargon – Bitcoin, Litecoin, initial coin offering.

But as the technology has matured, and as new applications and use cases have been discovered, it became clearer that a more appropriate term for this category is digital assets.

Although it is certainly still possible to purchase goods and services with Bitcoin, other digital asset technologies like Ethereum, which allow for enforceable contracts and financial services to be delivered in the absence of a centralized authority, make it clear that these are not just currencies. They are assets with value derived from the usefulness of the underlying technology, and from investor confidence in the asset's value.

These assets can certainly be volatile, and doing due diligence on digital assets is different in fundamental ways from doing due diligence on assets purchased on the public markets. But for forward-thinking investors, there is alpha to be captured by allocating to this innovative category of investments.

Are digital assets going mainstream?

The first digital asset, Bitcoin, and the technology which powers it, the initial Bitcoin blockchain, was invented by a programmer (or group of programmers) who remains anonymous, known only as 'Satoshi Nakamoto'. In its early years, Bitcoin was treated more as a curiosity, associated first with technology enthusiasts and then with organized crime where it became associated with illegal markets like Silk Road and payouts to hackers holding networks hostage with ransomware.

The technology works in a decentralized fashion. Bitcoin's blockchain – its ledger of transactions, dating back to the launch of the technology - exists simultaneously across many different computers across the world. Every time there is a transaction, it is appended to the end of the ledger.

Once enough transactions are appended, they are grouped as a "block", which begins with a "hash" (a unique cryptographic signature) of the previous block (which itself contains a hash of the block before that, and so on). That block is then "hashed" using the same cryptographic algorithm, and a new block begins. The integrity of the distributed ledger is maintained through cryptographic math: in order to create a false transaction, a dishonest actor would have to 'hash' the entire blockchain, from the beginning, across the entire bitcoin network, to ensure the network's 'consensus' was around the false transaction, not the true transaction. This is a very difficult task, and one that grows more difficult as more computers join the Bitcoin network.

This structure allows transactions to be conducted in the absence of a state or a company guaranteeing the ledger's integrity. It is a form of decentralized finance – or DeFi – in comparison to traditional finance, or TradFi, which relies on centralized organizations and laws. Blockchain technology has advanced significantly since the early aughts, but the basic structure remains the same.

To be sure, bitcoin remains used by criminals. But today, legal uses of blockchain technology far outweigh illegal uses, and not all of those uses are as currency.

Real estate remains one of the most well-understood alternative assets, but liquidity can prove a challenge. However, if real estate assets, or fractions of those assets, can be tokenized – that is, converted to tokens existing on a public or private blockchain – liquidity can be achieved by transferring ownership of those tokens.

Strong institutions and the rule of law are critical for business to be conducted: they allow people who do not know each other to trust each other, because the law will ensure that contracts are enforced.

We are fortunate to have strong institutions in Canada, but this is not the case for much of the world. Smart contracts on the Ethereum blockchain are enforceable irrespective of the strength of local institutions, allowing commerce to be conducted, and trust to be established. For its part, Bitcoin can be used to store, or transfer, value irrespective of the stability of local financial institutions, giving it a quality similar to gold.

These use cases, and more, have led to substantial retail interest in the space. And while digital assets remain largely a retail phenomenon, institutional players have begun to allocate to them. These include smaller players like family offices, but also giants: in March, it was reported that investment giant BlackRock planned to incorporate Bitcoin ETFs into its Global Allocation Fund. It is joined in this allocation by insurers and other institutional players.

Trading platforms, and investment funds, are beginning to produce investment products with an institutional focus, to capture that institutional market.

"We're confident that most governments will be introducing new legislation on regulation over the next 18 months. And that's what's exciting in this industry. Regulators understand that crypto is here to stay, and they understand they need legislation to update our financial system. And they're making smart advancements towards enacting policy that will empower local economies to leverage digital assets."

Lucas Matheson
Chief Executive Officer
Coinbase Canada

What is the value of a digital asset?

With substantial interest from retail investors and increasing interest from institutions, it is fair to ask where the value of these assets comes from. The answer is as varied as the digital asset space itself.

Some digital assets, like the so-called 'meme' coins like DogeCoin, are truly speculative, where it is difficult to say that the asset has an intrinsic value.

But for the more mainstream digital assets, like Bitcoin, a more compelling story can be told. Mathematically, there can only ever be 21 million bitcoins – the supply is finite. And with almost 20 million bitcoins in circulation, there are only a few bitcoins left to "mine". (New bitcoins, or fractions of a bitcoin, are awarded to the bitcoin 'miner' – participant in the blockchain – that completes the cryptographic processes that maintain the blockchain the fastest.)

This finite supply makes Bitcoin similar to gold, in that it is theoretically a hedge against inflationary fiat currencies. While skeptics may argue that a finite supply does not guarantee value, it is simply a fact that bitcoin has consistently achieved high valuations despite crashes, with BTC trading at more than 90,000 CAD in early June 2024, with valuations never dipping below 20,000 CAD throughout the lulls of 2023. While skeptics may not believe Bitcoin has value, the market disagrees.

However, some digital assets may have something like a fundamental value.

Ethereum, and similar protocols, allow for more than just transactions: with additional 'layers' built atop the basic blockchain (so-called Layer 2 and Layer 3 solutions), they allow for applications to be developed and used by end users. These include smart contracts, but also financial services like loans, gaming, the trading of Non-Fungible Tokens (NFTs) and more. All of these services are delivered in a decentralized manner.

These applications, and their real-world utility, give Ethereum tokens are source of real-world value. If Ethereum could potentially be the basis for a new financial system, then Ethereum tokens, which power that financial system, have an intrinsic value.

"Bitcoin's value lies in its scarcity, security, and decentralization, offering financial sovereignty and a hedge against market volatility. With Coinsquare Alpha, investors can enhance diversification and tap into Bitcoin's revolutionary potential."

Robert de Jaray
Head of Institutional Sales & Trading
Coinsquare

"I can go right now on the Ethereum network, through multiple lightning protocols, and I could borrow up to $1 billion if I wanted to, as long as I had $1.25 billion in collateral. It's all an over-collateralized loan, all secured by a smart contract. It doesn't matter what my race is, it doesn't matter what my religion is, it doesn't matter what my credit score is. We take access to financial services for granted in Canada. But imagine you are in a less developed country, with little access to money, and all of a sudden, through your phone, you have access to money through a stable coin, and the global market where you can borrow these funds."

Gregory Benhaim
Portfolio Manager
3IQ Asset Management

Public confidence

With the advancement of blockchain technology, and with institutional interest in the space growing, digital assets are approaching the mainstream. This is happening despite a series of bad news stories – from the bottom falling out of the market for NFTs, to the revelations of criminal activity at FTX, which was once one of the world's largest digital currency exchanges.

Growing mainstream interest in the face of bad headlines may seem counterintuitive – but in fact, this is evidence that the industry is maturing. Prior to FTX, investors were attracted by promises of outsized yield. After FTX, attitudes changed, with investors demanding to see higher-quality infrastructure, compliance, and cooperation with regulators. This shift in demand from investors is beginning to move digital assets from a 'wild west' mentality to a mentality that is closer to that of traditional finance.

Canada was one of the first countries to regulate digital assets. Spot Bitcoin ETFs were approved in Canada in 2021, with the United States only following suit this year. This first mover advantage gives Canadians a leg up on the competition as global capital markets open up to crypto, and as ETFs allow money from the traditional financial system to be invested in digital assets much more easily.

"It can be difficult to convince a risk or compliance team at a large traditional finance firm to dive in the water when the regulations are not always clear. The lawyers and advisors might say that it's okay, but if you can't convince the risk and compliance team, they're going to wait until they see that certainty. Regulatory certainty is still evolving."

Chris Meader
Head of Fund Administration
Formidium

"If you look at the history of financial markets, frauds have happened throughout history. I believe that negative or malicious activity happens in asset classes around the world. Crypto is just uncomfortable, because it's new, because it doesn't have the maturity, and because it didn't have the big institutions behind it. But those big institutions are beginning to allocate, and their CEOs are going on TV talking about why this is a unique asset class, and they are starting to build some of their products on blockchains. They are putting their names and reputations on the line for this, and people are starting to pay attention."

Didier Lavallee
Chief Executive Officer
Tetra Trust

"It all changed after FTX. Before FTX, investors asked: 'show me your performance numbers. How aggressive can you be in performance?' After FTX, it's been more about security and maturity before results. Investors are asking: show me how you're going to protect my money, and then show me how you're gonna make me money."

Pascal St-Jean
President & CEO
3iQ Asset Management

"With enhanced regulatory scrutiny, improved security measures, and just more transparent business practices, reinforcing investors' trust. When you match that with the launch of a spot Bitcoin ETF, to me, that signals what is to come: progression along an adoption curve."

Robert de Jaray
Head of Institutional Sales & Trading
Coinsquare

Who should allocate?

The digital asset market has been dominated by retail investors from the beginning, and despite allocations from institutional players, it remains dominated by retail investors today. But there are digital asset plays that will suit a great variety of investors.

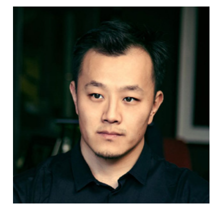
Digital assets, like most alternatives, provide a source of return that is uncorrelated with the public markets, allowing an investor to truly diversify. But they can also provide more aggressive investors with sources of outstanding yield.

This yield can certainly be achieved through a long-only buy-and-hold strategy: witness Bitcoin's fantastic growth. But it can also be achieved through the employment of more sophisticated active approaches like systematic, long-short or trend following strategies, which seek to turn digital assets' volatility into a strength. There is also an emerging field of digital asset derivatives, such as futures, options or swaps, where traders can place bets on the direction that a digital asset's price will travel – thereby allowing them to hedge against volatility.

There is one type of investor who should not touch digital assets – and that is an investor with a short earning horizon, or a low tolerance for risk. Despite the fact that the industry is maturing, digital assets' price remains volatile, and any investor looking to allocate must be able to bear a drop in price. Investors with a short investment horizon, or a low tolerance for risk should hold small amounts, say less than 2% of their investment portfolio or perhaps none if they have no tolerance for volatility. Despite the high volatility the leading digital asset of multi-year horizons have rewarded investors in this alternative asset space.

"80% of the wealth in Canada is managed by professional money managers and wealth advisors. From a catalyst perspective, education is going to be the enabler for mainstream adoption. Right now, investment advisors lack the education and tooling to execute a strategy involving digital assets for their clients, even if they want to. What's important in Canada is that we serve as education and awareness for the investment community, so they can speak to their clients about digital assets and how to diversify into this new asset class."

Lucas Matheson
Chief Executive Officer
Coinbase Canada



"Volatility is the price you pay for return. With our strategies, to generate outperformance, you either take on that volatility and earn a higher return, or produce a lower return with lower volatility."

Kevin Jiang
Chief Investment Officer
Virgo Digital Asset Management

Due diligence

Investors interested in digital assets may be attracted by the promise of outstanding return, but intimidated by the very different way in which digital assets behave. For example, bitcoins are stored at addresses on the bitcoin blockchain, and once a transaction is made, it is irreversible, irrespective of laws. In such a different environment, how can an investor know that the fund's underlying assets are secure?

Canada has led the way for investors to benefit from digital assets being delivered in the traditional wealth channel overseen by securities regulators. This fund disclosure framework can give great comfort to investors seeking to understand the details of their investments.

Improved infrastructure is also bolstering investor confidence. If institutional players are demanding to see institutional-quality infrastructure before they allocate capital, a series of firms are lining up to provide digital asset funds with that infrastructure: custody, safeguarding of assets, escrow, and other services.

The digital asset space has seen malicious actors attempt to take advantage of the decentralized nature of the technology to defraud investors: witness Quadriga, one of Canada's biggest cryptocurrency exchanges, where the organization held custody of all investors' assets, and was therefore able to steal them. Improved custody infrastructure safeguards against this possibility.

Investors should also ensure that a fund is compliant with relevant laws. Reputable financial institutions – and reputable digital asset funds – comply with Know-Your-Customer (KYC) and Anti-Money Laundering (AML) regulations, providing another layer of security.

"The digital asset market fundamentally starts with custody: you need a place to store your assets for them to be secure. The reason regulated custody comes into play is because there have been issues, historically, with malicious actors like QuadrigaCX, a trading platform where all the custody was done by the owner of the platform, which allowed him to leave with all the assets. With regulated organizations like Tetra, our financial trust structure means that we have no legal rights over the assets. The underlying assets we secure are, and will always remain in our client's name. We continuously monitor transactions for any suspicious activity, further contributing to the trust in the digital asset infrastructure.

And, to minimize the risks to our client assets at all times, notably those associated with single points of failure, Tetra was built on the premise of diversification of third party providers, offering the flexibility needed for sound custody."

Didier Lavallee
Chief Executive Officer
Tetra Trust

"Our firm was built with the view that fund administration needs better technology. And with our technology, we were able to embrace digital assets. The digital asset world operates differently from traditional finance. As an example, many accounting platforms may only support up to 4 or 6 decimal places, and many digital assets are issued or priced with more precision. And the infrastructure is different. It's a world that doesn't push information to you. Rather, you need to pull it. Traditional finance will send you data feeds via FTP or Swift, but in the digital asset world, many of the counterparties have APIs and other tools which you need to pull and translate information."

Chris Meader
Head of Fund Administration
Formidium

How much to allocate

Due to the varied nature of digital assets, it is difficult to know how much an investor should allocate to them. This will depend on the investor's investment objectives, their earning horizon, and their need for liquidity.

Unlike private equity or real estate, the field is still new, and best practices are still being developed. A 2022 survey by the Ontario Securities Commission revealed that although about 1 in 10 Canadians (13%) were invested in digital assets, 53% of those investors had under $5,000 in digital assets, and about one third (36%) said they had under $1,000. Digital assets have a place in many Canadians' portfolios, but it remains a small place.

Firms interviewed for this paper estimated that digital assets remain beneath 1% of all invested assets in Canada. Whatever the appropriate allocation might be for any individual investor, it is clear that there remains a lot of upside in the space

.

"Our research shows that allocations of 1% to 10% from a traditional 60% equity and 40% bond mix is appropriate to benefit a 4 year or longer investment horizon, Higher exposure is appropriate for those with a higher risk tolerance and longer horizon. Digital assets are a young transformative technology that have significant room to grow and impact the world"

Shaun Cumby
Chief Executive Officer
Virgo Digital Asset Management

Conclusion

Digital assets have come a long way since the publication of Satoshi Nakamoto's whitepaper on Bitcoin. From digital currency to digital asset, the industry has begun to grow beyond the "wild west", through regulatory action and through investor demands for more robust infrastructure.

We have seen major institutions allocate to digital assets. Despite their volatility, it is clear: these are no longer speculative assets, but a type of asset which has a place in a forward-thinking investor's portfolio.

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