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Why ETPs might be the best wrapper for crypto

WisdomTree Market Insights

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Introduction

Transparency has become one of the most important features of financial products. Investors want to understand exactly how their money is invested, what risk they are taking, and at what cost. This isn't always the case with crypto exposures; an issue which came into sharp focus with the collapse of exchanges like the now defunct FTX or Mt. Gox. As a result, crypto exchange-traded products (ETPs) are a go-to solution for providing the transparency investors are looking for. Today, ETP assets stand above $10.5 trillion US dollars globally[1].

Beyond transparency, ETP benefits including liquidity, exchange listing and product standardisation are now table stakes to developing and managing safe investment portfolios. Just like equities, fixed income, currencies and commodities before them, cryptocurrencies are the most recent asset class to benefit from the transformation that the ETP wrapper brings.

The ETP wrapper adds new dimensions to the crypto universe, including:

- **Institutional class security and custody solutions for all investors**
- **Trading incorporated into traditional brokerage and account maintenance procedures**
- **More liquid and transparent trading**
- **Transparent and reduced costs**
- **A broader array of sophisticated market participants entering the arena for these products**

The benefits of crypto ETPs

There are several elements to the crypto ETP wrapper that provide investors with benefits they can't access in other investment vehicles.

Product standardisation is a core component of the ETP structure which provides a variety of benefits that we call structural alpha. The ETP structure and its exchange listing means investors can evaluate a range of different investments across similar metrics, making it simpler than ever to add alpha to their portfolios. Soon, many of the largest traditional brokerage firms may offer the ability to transact in cryptocurrencies alongside traditional assets like stocks and bonds in response to consumer demand for easier execution, portfolio evaluation and systems management. ETPs would do the same thing for that increasing class of investors managing portfolios of ETPs.

1 Source: LSEG Lipper, 30 November 2023.

Centralised clearing and the exchange listing that ETPs provide alongside coordinated trading hours are more user-friendly for most of today's investors, reducing the need to add an alternative system into their process. ETPs offer an efficient way to track the underlying asset and don't suffer from futures' potential roll yields or investment trusts' discount to net asset value (NAV).

Institutional grade cybersecurity and safeguarding of digital assets is a key element of the best crypto ETP issuer practices. One of the most important points with cryptocurrencies is ensuring their safe storage. Various crypto vehicles have several issues such as online storage, the need to manage and remember private keys and wallets, and a lack of transparency on lending and staking activities. Some of the biggest losses of cryptocurrency assets are linked to hot wallet hacking, but also due to loss of private keys or forgetting the storage procedure. These are the best practices we've seen from some crypto ETP issuers:

Safe storage of private keys[2]

Multi-regulated custodian models

Geographic, environmental, human and device redundancies

Robust approvals process for moving the assets[3]

Lending policies are also an important point to consider. Lending cryptocurrencies can be quite risky due to a rise in hacking and loss of assets. Given assets are most at risk when they leave the vault, institutional-grade crypto ETPs tend to forbid lending.

Lower fees and costs compared to more legacy style investment products benefit investors and are a core component of the structure. Several crypto ETPs have management fees lower than 0.50% with best-in-class institutional grade crypto ranges sometimes two times cheaper than their peers or other crypto vehicles, such as closed-end funds, hedge funds, banking apps or futures contracts (due to contango).

2 ETPs are physically backed with air-gapped storage solutions in offline vaults.

3 Multi-approver signatures of the transaction with offline intervention through a multi-tier security process.

Reduced counterparty risk and management structure

With centralised exchanges such as Binance, investors don't own the assets directly but are creditors of the exchange. In the event of bankruptcy, investors are at the mercy of the liquidation process.

With structured products, investors carry the full counterparty risk of the issuer; in most cases the assets are not ring-fenced. Investors take the solvency risk to the issuing entity (usually a bank) on top of the investment risk of the digital asset. A note issued by a bank, and guaranteed by a bank, is exposed to the counterparty risk of the bank. The note could suffer from anything happening in other parts of the bank and could give rise to a default. The note could default when the digital asset investment could, in fact, have performed well, leaving the investor significantly out of pocket.

Choosing an ETP issued by a management structure whose only purpose is to issue those products eliminates much of the counterparty risk. The assets backing those ETPs are ring fenced inside a single-purpose vehicle, reducing the credit risk further. The contamination risk between the different business activities of the issuer is removed since the issuer is only performing one activity. It is key to choose a product structure that limits the counterparty risks.

The choice of the ETP manager can also be important. Choosing an issuer with recognised expertise in creating and running physically backed, listed financial products and a track record in managing their trading and liquidity, particularly in a crisis, can deliver important peace of mind to investors. Choosing an issuer with a diversified business instead of a pure crypto issuer can also help insulate against some of the volatility around the crypto space.

Transparency is a core component of the ETP structure[4]. In a crypto ETP, transparency is critical, offering confidence for investors who can log in to an audited website from the issuer showing exactly how many coins are represented by the outstanding fund shares. This is standard daily practice in Gold ETPs and provides an incomparable measure of transparency. In addition, investors can regenerate NAV values, further confirming fund valuation. Nothing compares to full transparency of holdings when it comes to providing investors with confidence that they are buying the actual exposure they wanted to allocate to.

4 Up until April 2019, US listed ETPs, both active and index tracking, were required to make their holdings available on a daily basis. In April 2019 the Securities and Exchange Commission approved a new structure allowing the creation of an ETP-like product with non-disclosed holdings, but because of the lack of assets or interest by investors in this type of product, we are excluding those products for the purposes of the discussion on transparency. Only time will tell if a non-transparent structure has an impact worthy of investor assets, and what benefits of that structure may be apparent.

Portfolio transparency also has a volatility dampening effect on fund shares. Volatility is often driven by the unknown impacts of market news. ETPs are wrappers of assets, generally holding equities, bonds, commodities or currencies in various configurations. The underlying assets drive the valuation of the product and its trading price in the market. Assumptions about those potential holdings can lead to product pricing having a potential leading or lagging impact on the market for the underlying assets, whereas a full understanding of the assets in a fund makes it clear to investors that the price of the underlying assets and the transaction costs involved in attaining or disbursing those assets are the sole determinants in fund pricing. This feature has enabled ETPs to trade at or near their fair value since first listing in 1993. And it will continue to enable funds to trade at the value of their underlying assets, removing any risk of dramatic premiums and discounts. It's a simple calculation for investors to understand: the underlying assets in the fund and the costs of attaining and storing those assets, plus any additional fee, can easily be calculated to equal the price of the fund in the marketplace. Some crypto ETP issuers are exceeding transparency requirements by displaying all relevant information and more:

Coin entitlement

Staking yield[5]

Pricing methodology[6]

Required legal information

Regulatory framework is also an important added value of crypto ETPs. Crypto ETP issuers often apply their regulatory framework across all products, whereas certain other crypto vehicles don't provide basic KYC[7], AML[8] policy or liaise with regulated counterparties. ETP prospectuses are approved by European regulators under securities law and are listed on regulated European exchanges. This means they are required to display investment objectives, risks, fees and other important information for investor protection that other crypto assets may not disclose.

5 How much of it is distributed to investors.

6 Investors can check their robustness, fairness and transparency.

7 Know your customer.

8 Anti-money laundering.

Liquidity

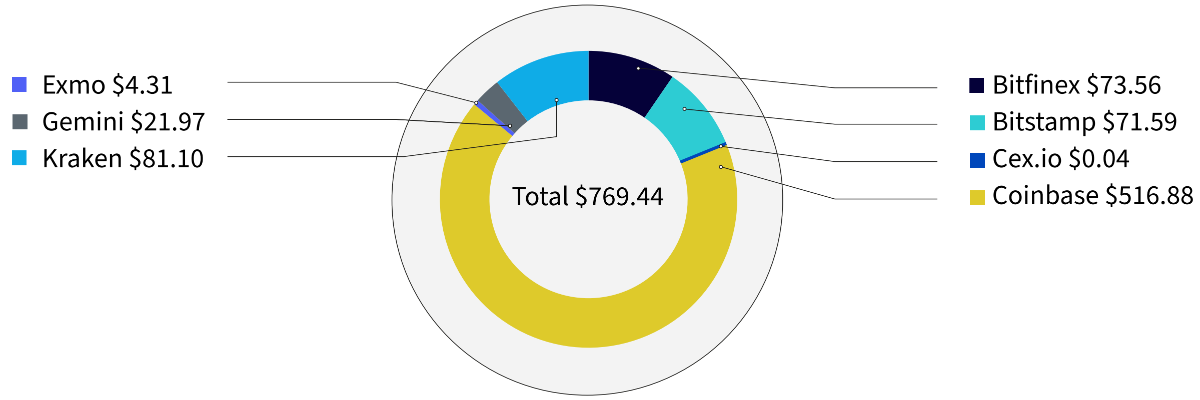
- **Liquidity** is the most discussed topic regarding the ETP structure. Whenever there is a negative article written about ETPs, at some point it focuses on ETP liquidity being unsustainable and the likelihood of it leading to a market event in future. A clear understanding of how the ETP structure works and the liquidity that develops in asset classes previously considered to have low liquidity is important, especially when considering how crypto ETPs aid the growth of a centralised liquidity pool for trading and valuation of crypto assets. When assessing the liquidity profile of any ETP, including those backed by digital assets, the best place to look is at the concept known as “implied liquidity”, and not the ADV[9] of the ETP itself. That’s because the ADV does not provide visibility of where an ETP's liquidity really comes from - its underlying assets.
- **Implied liquidity** is a metric designed to answer the question “what’s the maximum amount of a given ETP I could trade without having a price impact on any of the underlying securities?”. The metric considers each underlying constituent’s relevant weight in the ETP’s index and its average trading volume. While there's no formal threshold in percentage terms of average daily volume for a particular constituent, beyond 20-25% of ADV in any one constituent might represent a significant proportion of daily volume and risk, shifting the price of the constituent and subsequently the NAV of the ETP.

Assessing implied liquidity becomes a bit more nuanced when dealing with ETPs that don’t hold constituents such as publicly traded equities. The concept, however, applies just the same to all ETPs that may hold underlying securities such as fixed income or digital assets. In both cases, it’s best to look closer at the underlying constituent. While digital assets are still a nascent asset class, there are resources giving an idea of trading volumes. The figure below shows some of the most reputable digital asset exchanges which publish trading data.

Condensing this data shows that for the last 30 trading days, physical Bitcoin volumes have been approximately $769m in total across these exchanges. When using the implied liquidity metric, in theory, an investor could trade up to $192m without having price impact on the underlying asset[10]. Given there’s also highly liquid, publicly listed futures available on Bitcoin, it actually has a fairly high liquidity profile, all of which may be easily and securely accessed in an ETP wrapper. While implied liquidity is an estimate metric which every investor should investigate further, it does give an idea of an ETP’s liquidity profile which isn’t always clear at first, and certainly isn’t by looking at the volume of the ETP alone.

9 Average daily volume.
10 Source: Bitcoinity, 29 December 2023.

Figure 1: 30-day average volume ($M)



Source: Bitcoinity.org, 29 December 2023. **Historical performance is not an indication of future performance and any investments may go down in value.**

Gold ETPs provide an indicative roadmap for cryptocurrency ETP development

The introduction of gold ETPs in 2004 was a perfect example of asset class democratisation. “Before the gold ETP came along, there were a number of ways to invest in gold, which included buying direct bullion, gold certificates, gold coins, gold savings plans and purchasing shares of gold mining companies. Each of these ways to gain exposure to gold came with its own advantages and disadvantages; however, there was no way of owning physical gold simply and cost-effectively.”[11]

In the cryptocurrency marketplace, anyone can register with a digital exchange to buy and sell these assets. In order to protect them, you need to find a wallet to use as storage. That wallet also needs storage so you don't misplace it. Beyond the admin of sourcing storage, the issue is that the assets won't be protected by the traditional safety of institutionalised custodians. The fees to implement these procedures can create a great amount of slippage on your portfolio’s performance and record-keeping also needs to be incorporated into your portfolio management infrastructure, further complicating the holdings.

The introduction of gold ETPs helped the gold investment market grow to more than $160 billion USD[12] in assets under management which are safely protected in a standardised wrapper

11 Alchemist Issue Seventy, 10 Years on. The Gold ETP that spawned a 200 Billion Industry, Nik Bienkowski.

12 As of 10/10/2023, Bloomberg reported known holding of gold in ETPs of 87 million troy ounces and based on a LBMA PM price of US$1857/oz.

so investors can utilise gold for diversification across a variety of strategies. At the same time, gold ETP fees have declined with each new fund launch as is typical of the ETP universe. The introduction of cryptocurrency ETPs gives investors another way to introduce these assets into their portfolios whilst benefitting from the safety and security of standardised investment products.

We believe concerns about ETPs leading cryptocurrency pricing could also help investors understand the pricing of crypto in the same way the pricing of fixed income ETPs disbanded the mystery around those instruments to provide a real-time understanding of bond pricing.
In an asset class with multiple digital exchanges with varying pricing levels, unclear liquidity and potentially fictitious volumes, crypto ETPs have centralised fragmented liquidity and provided a real-time price gauge representing the true costs of investment, helping investors navigate a world with many regulated and unregulated exchanges. Additionally, ETPs gatekeep the underlying assets so they don’t have to move between exchanges where risks tend to increase, and insurance companies aren’t able to protect the investments.

As we move towards a more digital world and develop new investible assets, there’s an expectation that traditional market infrastructure and authorities will pivot so investors can access them in transparent wrappers at lower costs with all the protections they expect from global markets.

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