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The Age Of The Machines II: CTA, Bitcoin and Ethereum Markets

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The most popular and controversial topic this year within finance and tech circles is the rise of Bitcoin and crypto markets. Bitcoin jumped into mainstream and financial products like futures, options, funds, certificates, ETNs, ETFs are being designed to allow exposure to cryptocurrencies. The last one and a half month, we evidenced a huge growth of the crypto market, with its capitalisation surpassing $561bn from $182bn on the first day of November. The crypto market metamorphosed into a market bigger than CTAs, a $343bn well-established alternative investment market. Crypto market, according to CoinMarketCap, consists of 1360 cryptocurrencies, but Bitcoin and Ethereum account for around 67% of this market. Bitcoin market cap became almost three times bigger within two months, being a $318bn market now, with its price rising from $6,750 in the first day of November to $18,000. Ethereum was the fourth largest coin market in 2015 behind Bitcoin, Ripple and LiteCoin, but as we approach the end of 2017, the $66bn Ethereum market cap is nearly double of Ripple and Litecoin's capitalisation combined.

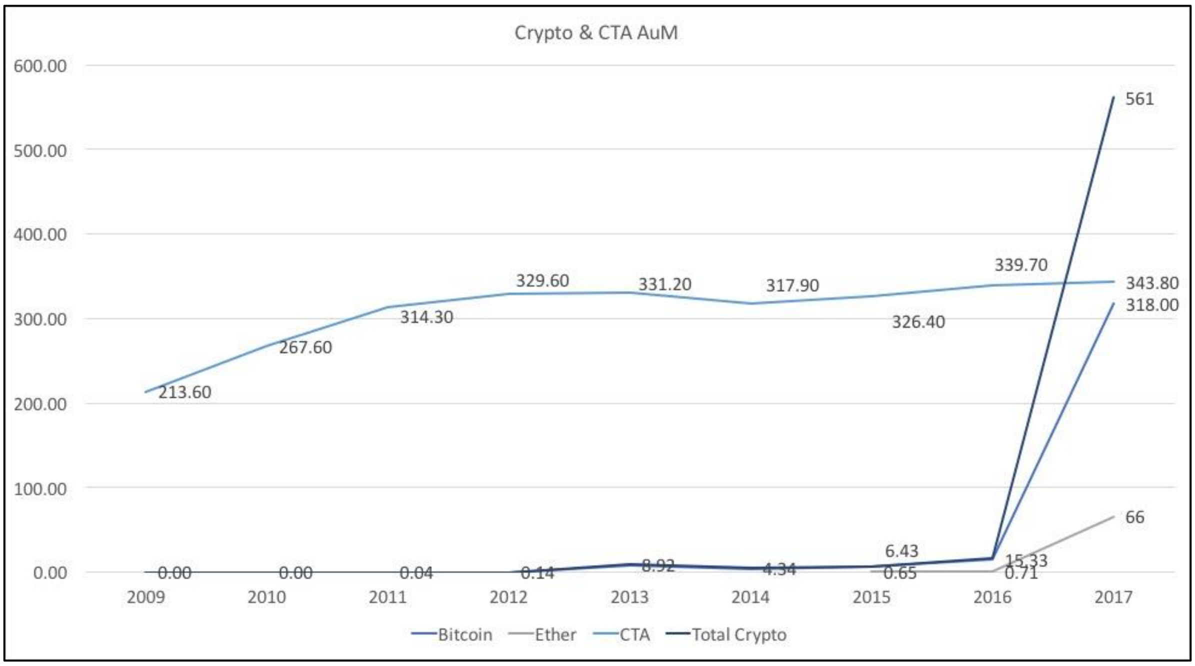

Figure 1. CTA, Cryptocurrency, Bitcoin, and Ethereum Assets under Management ($bn) as of 16/12/2017,
Source: Coinmarketcap.com, BarclayHedge, Stone Mountain Capital Research

The potential of growth in the market is huge considering the evolution of products for trading and indexing, with focus on Bitcoin and Ethereum. CBOE launched the first future contracts on bitcoin on 10th December 2017, adding interesting features to bitcoin trading, such as liquidity, transparency and clearing on a regulated market. CME Group is also launching future contracts on bitcoin on 18th December 2017 and these actions complement previous efforts of launching ETFs around Bitcoin, Ether and Blockchain. On the first trading day, more than 2,500 contracts were traded according to CBOE, and there is already a huge spread between spot and future markets.

Eurekahedge and Hedge Fund Research (HFR) have developed indices on crypto markets with the underlying constituents being investment managers trading cryptocurrencies directly since 2013 and 2015 respectively. The low volatility environment suffocates CTAs, which desperately seek volatility trades making the crypto space more appealing to them, especially Bitcoin and Ethereum that have already traded financial products with currently the highest trading volume. Examining weekly data since September 2015, we observed relatively high correlation of 0.89 between the two coins, in which period both coins' price rose 787 times for Ethereum and 78 times for Bitcoin respectively. Apart from the price rise, Ethereum surpassed bitcoin in terms of transactions number in 2017 for the first time in its short life, indicating the potential of the coin.

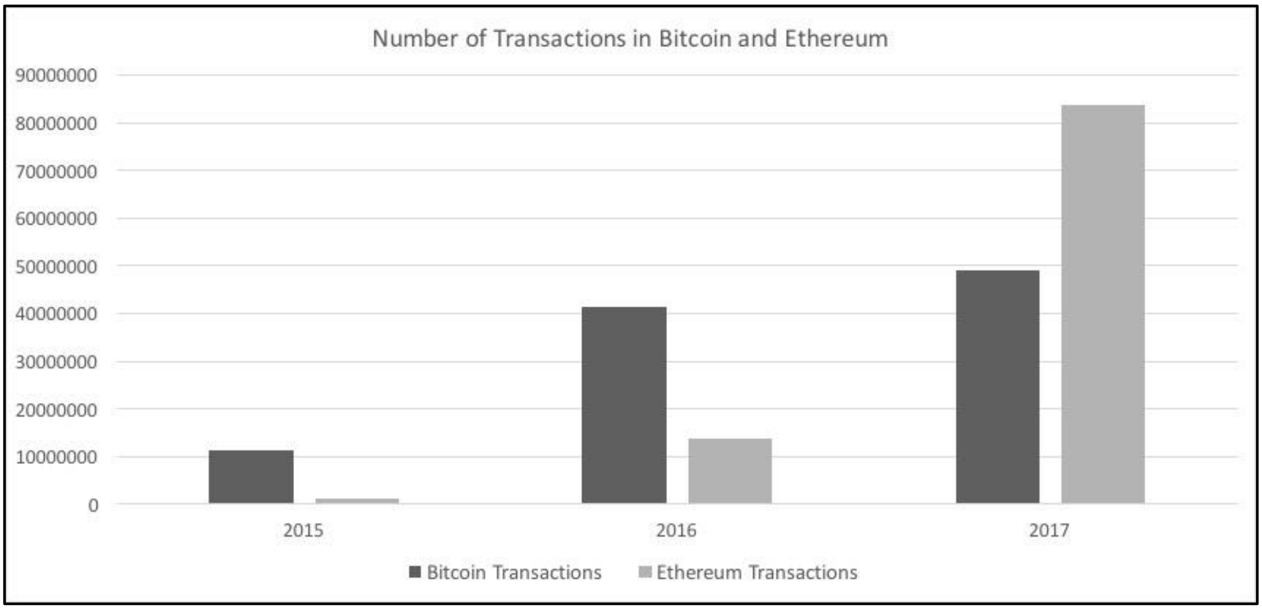

Figure 2. Bitcoin and Ethereum number of transactions from August 2015 to December 2017,
Source: Etherscan, Blockchain Luxembourg, Stone Mountain Capital Research

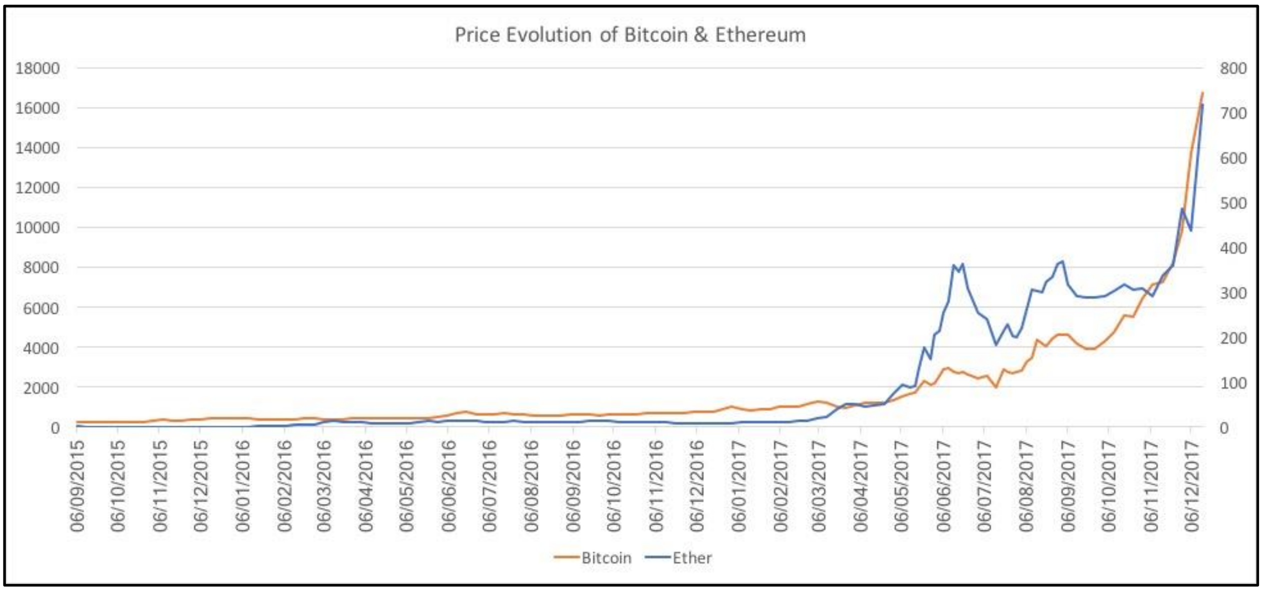

Figure 3. Bitcoin and Ethereum price evolution, Source: Coindesk, Stone Mountain Capital Research

CTAs are struggling compared to their cryptocurrency peers, considering they both apply an algorithmic approach to the markets they target. CTAs are in their majority trend-followers and positioned long volatility, which remains at all-time lows across traditional major asset classes equities, bonds, rates, fiat currency and commodities. Comparing CTAs and crypto funds according to HFR data, we evidence nearly zero correlation and massive discrepancy in their risk-adjusted ratios, with crypto funds exploiting the huge volatility in the market in their favour. We see a trend in 2017 for CTAs trying to improve recent years' bad performance and starting to apply their algorithms in the crypto markets in the 'search for volatility'. The recent development of bitcoin futures, options and spread bets will support more CTAs entering the crypto markets. Autonomous Next reported more than 124 hedge funds pursuing crypto strategies as of October 2017 accounting for overall over $2.3bn in AuM, while Preqin reports 1,191 CTAs and BarclayHedge states CTA AuM with $343bn. With the futures launched, and ETFs on their way, an overlap between the two strategies may be inevitable as they will compete in the same systematic space.

The Ethereum blockchain constitutes the basis of the majority of Initial Coin Offerings (ICO), via which $3.75bn have been raised so far, out of which around $3.4bn have been raised in 2017 alone. Ethereum is facilitating the implementation of real world contracts in the digital spectrum by the 'smart contracts' on its blockchain. The fundraising momentum cooled after the decision of People's Bank of China to ban all ICOs and recent fraud investigations from the SEC.

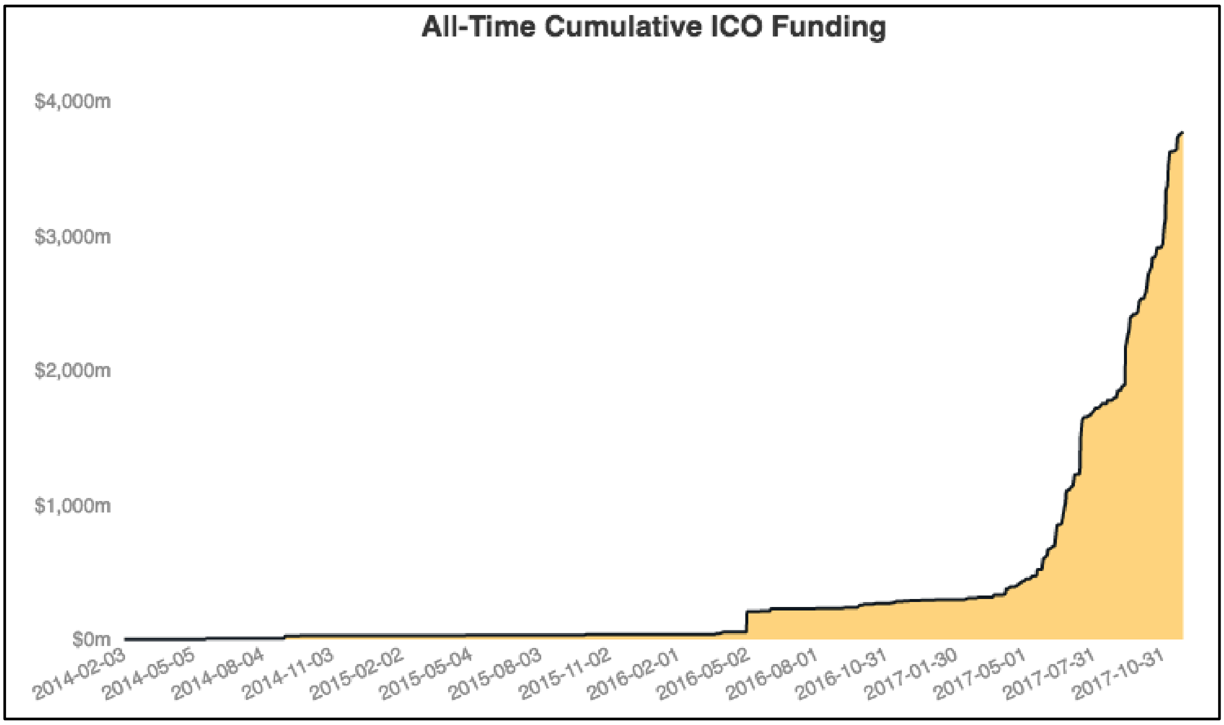

Figure 4. ICO Fundraising, Source: Coindesk ICO Tracker

The access to crypto markets is becoming easier with mobile wallet and payment providers like Revolut adding Bitcoin, Ethereum and Litecoin, and banks like Swissquote adding Bitcoin, to their platforms providing seamless exchange of fiat currency into crypto currencies. These factors have added volume to the market with the pricing clearly being affected. The launch of further futures, options and derivatives will allow for deep price discovery and correct inefficiencies in pricing. This will also led to institutional money inflow, and in Stone Mountain Capital we have evidenced unprecedented interest in the space from institutional investors since the summer of 2017. Volatility and security were always the main issues of the crypto market combined with the fundamental problem of a definition of its real value. Its unregulated nature discourages the evolution of the market, but first steps for regulation were made and we expect more to follow in the near future, which will be a positive development for crypto markets. The crypto world will not suddenly transform into a regulated environment, but Bitcoin and Ethereum are on the right direction. Futures are the starting point, ETFs probably the continuation of the journey. There is currently a set of pending ETF applications in the U.S. based on the bitcoin futures and underlying crypto markets and we expect the first approvals early in 2018, which should provide further liquidity and volume to crypto markets based on the investability of crypto market from institutional investors.

A frequent and practical question is the way of getting exposure to cryptocurrencies either by buying directly in a crypto wallet or by buying financial products around them. Buying directly could prove complex and tricky, especially when the individual or firm do not possess the technological knowledge on security matters and storage of the coins in a wallet or on / off the exchange. Trading is 24/7 and requires constant monitoring and risk management. The biggest misconception is the store of value, as having a crypto wallet is not equal to storing currency, but rather a transaction record on the blockchain. In case of a market crash or run on the crypto market, there are questions around market liquidity and certain wallet providers might face technological challenges of keeping their service online, leading to potential delays for investors trying to sell their positions. Alternatively, there are listed certificates on exchanges that track Bitcoin and Ethereum prices, private and listed funds that invest directly in cryptocurrencies and since the 10th of December, CBOE future contracts are available for trading. The list of products requesting approval to be launched is long and the most notable example is the Winklevoss Bitcoin Trust (Bitcoin storage), Ether ETF (Ether storage), Rex Short Bitcoin ETF (futures) and RealityShares Nasdaq Blockchain ETF. Currently, bitcoin products trade on a premium, including CBOE futures, which trade at the moment on a premium of around $1000, listed Bitcoin funds in OTC and certificates that track the price of Bitcoin and Ethereum. Worth mentioning is the ability to trade pre- and after-market in a very thin and illiquid market, where volatility is much higher than normal trading hours and price inefficiencies occur, which can be exploited. Cryptocurrencies constitute an interesting and evolving asset class with further growth potential due to the just commencing inflows from institutional investors, but bear large risks due to the unregulated nature of crypto markets, complexity, security concerns and the general market structure and liquidity. As a diversifier in a portfolio of traditional equities and bonds, cryptocurrencies can deliver uncorrelated alpha.

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