Fidelity Compass

The Role of Bitcoin in Institutional Investments

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Pamela Ritchie, Host

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Pamela Ritchie: Hello and welcome to Fidelity Compass. I'm Pamela Ritchie. Over the past number of years there's been a growing recognition of cryptocurrencies, Bitcoin in particular, and their investment potential among institutional investors. Despite the volatility cryptocurrencies experienced last year in 2021 and Bitcoin finishing the year lower than expected, the digital currency outperformed both gold and the stock market for the third year in a row.

However, questions around regulation, appropriate allocations and security considerations have acted as barriers to some looking to invest in these digital assets. What is the role for Bitcoin in institutional investments and what is the best way to access Bitcoin and other digital assets? Helping you today to answer these questions and to discuss Fidelity's history and experience in this space, we are joined by (live version) Giles Anderson. He is Regional Director Sales and Relationship Management at Fidelity Clearing Canada and (not live) by Fidelity's Director of Global Macro, Jurrien Timmer, who's going to be part of this conversation through a series of pre-recorded videos done just in the last day or so.

Welcome to you, Giles. Great to see you.

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Giles Anderson: Thanks very much, Pamela. It's wonderful to be back on another webcast and it's also great to be here live and in-person in the office again.

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Pamela Ritchie: You're in the office. Okay, well, that's its own story but welcome, great to have you here. Start us off a little bit with how it is that Fidelity actually came to the topic, the broaching digital assets? It is not a new story, actually, for Fidelity.

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Giles Anderson: No, it's not. We were actually one of – I don't want to call it the early adopters but – the early trialers. We have a research paper out that we put out not long ago called Getting Off Zero. That seems to be the Fidelity attitude in terms of how we got to understand crypto assets and what rules we wanted to play. We have a research team in the U.S. called the Fidelity Centre for Applied Technology that does all kinds of interesting thinking and experimenting. Way back in 2013, they decided that Bitcoin and this whole blockchain concept could actually play a transformative role in finance, investing and other aspects of, call it, the monetary world. So they simply started mining Bitcoin and they didn't do it to become the world's biggest miner. They did it to learn about it. Similarly, they got into some payment proof-of-concepts where we enabled employee cafeterias where you could buy your coffee with your Bitcoin-linked wallet to your employee security pass and things like that. None of these were designed for us necessarily going to go into payments or into mining. They were designed for us to learn.

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Around 2015, we decided there was a big gap in the market when we had some Bitcoins floating around on a memory stick and we were running an experiment. It was one thing to pass that round the office and say, Hey, Pamela, what's the password for the private keys? Once we started looking for a custodian, we realized a missing part of the market was an institutional grade custodian. For an institutional investor like Fidelity, there wasn't that service provider. Crypto assets are really neat in that they've been a retail-first adoption which is very rare in our in our industry.

In 2015, we started building what we have today which is a crypto custodian and a third-party crypto trading platform. That's really the story of how we got into this, literally by trial, experiment, seeing where we could add value in the market and then once we had a good idea around that actually just getting to work and it took us three years to build out that service.

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Pamela Ritchie: Let's hold it there. I'm going to just bring in a couple of things that Jurrien said and then you and I are going to pick up the conversation just after this. When I spoke with Jurrien Timmer just a day and a half ago, we started off talking about it. I asked him actually whether he sees Bitcoin particularly as an asset class. Take a listen to what he had to say.

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Jurrien Timmer: I believe it is, let's say, an aspiring asset class. One that is, of course, volatile and that's been an impediment maybe to more widespread adoption. I think volatility is sort of inherent in the way Bitcoin has been constructed. I believe it's an asset class that is coming of age, much like gold was back in the 1970s.

I think Bitcoin has the advantage now where its network has grown so large ... it's essentially a trillion dollar asset class kind of like money is. Money is only money if we all agree that it's money, right? Bitcoin has kind of crossed that Rubicon where I think there's generally a consensus that this is something and it has the scarcity of gold which, of course, is what makes gold valuable and we've seen gold do well in recent weeks, but it has the network effects of kind of like a technology because of the adoption of the blockchain.

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So it's a very unique asset class in that sense where it has the scarcity but it also has an exponentially growing network. I don't know of any other asset class that combines those two features. I think it is an aspiring asset class and the bigger Bitcoin gets and the further along the way we get in terms of we'll get regulation and I think that will actually ... assuming it's smart regulation ... will add validity to the asset class. As the network grows and more people are comfortable that this was not a fly-by-night operation, I think it will cement itself in the marketplace as an asset class right alongside of gold, but maybe a digital form of gold.

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Pamela Ritchie: That's what he thinks about it as an aspiring asset class, the way he sort of put that. I went on to have this conversation with him, he wrote a white paper a little over a year ago on Bitcoin and I asked him about his conclusion.

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Jurrien Timmer: My conclusion was that Bitcoin essentially from the lens of an investor, an institutional investor, Bitcoin is like digital gold. It is a real asset that protects, or hopefully protects purchasing power, especially in an era of negative real rates. By definition, when you look at it that way, to me, Bitcoin goes on the 40 side of a 60/40 portfolio.

Now, other cryptos, I think, go on the 60 side. DeFi and even Ethereum, the blockchain stuff that's more like software, like a platform, there's a lot of venture aspects to that. That, I think, goes on the venture side of an equity growth-oriented portfolio. Bitcoin, I think, is there to protect purchasing power from negative real rates in the bond market. Therefore, I think it should go on the 40 side with the caveat that, of course, Bitcoin is highly volatile and bonds tend to not be so volatile, so a little bit goes a long way. You don't need to have a big allocation, you just need a little bit and if it fulfils its value proposition and gains value at times of monetary inflation, then all you need is a little bit to kind of offset the loss of purchasing power that you would get from a bond allocation.

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Pamela Ritchie: Jurrien also talked a little bit about how he came to do his own research on Bitcoin and how he also, as Giles has mentioned a minute ago, started really with FDAS. This is digital services. Take a listen to what he had to say here.

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Jurrien Timmer: I think we were mining Bitcoin since 2015 and certainly we were very much involved by 2017. My first call, literally, was to our Fidelity Digital Asset Services colleague saying, look, I'm trying to figure this out. I'm learning from scratch because it's really the only way to do it. I can't go on Twitter to say, what do people think because there's a lot of very opinionated stuff on Twitter and it's not always backed up by solid research.

For me to maintain my own credibility as an analyst, I had to start from scratch. They helped me. They said, well, there's this thing called stock-to-flow and this guy, Plan B ... and actually, I did a podcast with Plan B a few weeks ago which was kind of fun. And so I reverse engineered the stock-to-flow model and said, okay, this is fine but it leaves me wanting more because it didn't address the demand side. And then with the demand stuff I relied on my colleagues who said, well, there's this thing called Metcalfe's Law that says that as your network grows your value grows exponentially. I'm like, okay, that's pretty cool because I've done work on S-curves many times in the past. I started playing around with internet adoption in 2000s versus the number of addresses on the blockchain for Bitcoin. They were very, very helpful in at least guiding me to how to think about it. They didn't tell me what to think but they helped me how to kind of go about essentially creating my own learning curve.

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Pamela Ritchie: It's great to get Jurrien's thoughts there. Giles, some of that you had mentioned off the top. I'm curious if we sort of break it down and go back to the idea of Bitcoin being a form of digital gold. It's certainly a term that we hear a lot about. How do you look at Bitcoin and look at it as an asset class? Any nuances from what Jurrien had said?

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Giles Anderson: I like the way Jurrien calls it an aspiring asset class because it's still young; it's still maturing. Bitcoin actually has some features that I think are better, they're a better gold than gold in some ways. I can explain that.

Jurrien also said that money is only money if we agree that it's money. Gold is that same way. Gold ended up as an intermediate store of value 2000 plus years ago to replace the barter system. If you had excess production, you could sell that excess production and actually have a store of value in gold. We've been using gold in that fashion for millennia and it's played different roles as a reserve asset in a central bank and so on and so on. Bitcoin, as Jurrien said, we're now at the point where the network's big enough that we've crossed the Rubicon.

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One of the really interesting things about Bitcoin and the blockchain in particular is it's totally transparent and it's totally public. When Jurrien says something like it's crossed the Rubicon, we can actually look at the number of Bitcoin miners. We can look at the hashrate, which is the guessing power they have, the compute power they have. We can look at the number of nodes on the network. We can look at the number of wallets. We can look at the amount of Bitcoin that every single one of those wallets holds.

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Pamela Ritchie: Why is it important that you can see all that?

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Giles Anderson: Well, it gives more transparency into Jurrien's point, again, crossing that Rubicon, it's only that way if we agree it's that way. We can actually see, in essence, the number of participants in it. The number of nodes which are sort of like a full copy of the ledger, it grew about 50% year-over-year. In May last year, remember, it was around 10,000 nodes. We're up around 15,000 nodes. Pretty much every metric of Bitcoin has gone up. It talks about how it's increasing its utility value to people and more and more institutions, more and more investors, more and more people are connecting to this network and using it. While the price may do this, what's been fairly constant is the adoption of Bitcoin users. That's one of the reasons why I say it's sort of a more interesting gold and has that store of value but it has all these other metrics around it that we can peek into, totally public, totally on the blockchain, and actually get a really good view of its adoption as a store of value.

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Pamela Ritchie: Really interesting. There's a lot of philosophical questions that can kind of take you off in different directions with that but it's really fascinating. Let's delve in a little bit to the regulatory environment. There is a lot of work being done on this but not all of it has come to an actual fruition. Some regulatory work has, in fact, certainly been done here in Canada. What does it take for funds to get access to it? Where is that line for regulation?

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Giles Anderson: I'm going to break Bitcoin regulation into two aspects. One, as a money and two as an investment or a store of value. In Canada, there's been little regulation around it as a money versus, say, El Salvador where Bitcoin is legal tender. What we're really lucky to have in Canada is we actually probably have the world's best or world's clearest regulations around actually investing in Bitcoin, so Bitcoin as an investment.

In Jurrien's comments, and he's a U.S. resident speaking from the U.S. there, he talked about there's no regulation. Well, President Biden this week finally signed an executive order to basically direct a number of U.S. government agencies to get going on regulating it. We're a long way ahead of that in Canada, thankfully.

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We've had closed-end funds for a couple of years on the TSX. They've performed very, very well in terms of tracking to the nav of the asset with not too much drift for the price that it's trading on on the exchange. That took a long time. The institutional manager that brought that forward was a 2.5-year battle with the OSC. When they launched it, it launched with a whimper. I happen to know a couple of the people involved in it, they were hugely upset about this, and then it took off and $600 million fairly quickly flowed into this vehicle.

Then we saw the ETFs come along. They track even closer. The ETFs are just over a year old. They've done a wonderful job and so on. If you want an exchange-listed instrument and the regulation here in Canada allows that, and I contrast that to the U.S., there's no closed-end funds on major exchanges. They trade OTC. There's no ETFs, they've all been shot down, and really anywhere in the world. We have the best investment products and the regulation around. The other aspect–

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Pamela Ritchie: Interesting. Sorry, go ahead.

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Giles Anderson: The other aspect is in March of last year, and we're getting a little bit nerdy on the regulation, but this is an important piece, the regulators in Canada, the provincial securities regulators and the brokerage regulator put out a joint staff notice last March saying that if you're going to act as an intermediary, either providing trading services or custody services in an investment-like manner to Bitcoin, in fact, crypto assets in general, you should register as an investment dealer. That's nothing like what's available elsewhere. In the U.S., FINRA dealers can't do it. It in the UK, the FCA dealers can't do it. Whereas, here in Canada, investment dealers, IIROC dealers, can now provide crypto asset services in a regulated fashion and deliver that out to institutional investors.

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Pamela Ritchie: At this point, how do we discuss what is an appropriate allocation that an institutional investor might be thinking about? There's a lot of different ways to look at this but let's start with the 1-2-3s on allocation.

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Giles Anderson: Luckily, there's a fair amount of research emerging on that and helping guide people. We put out a Fidelity paper, which I referenced already, called Getting Off Zero. I like the catch line there, "Let's get going and try a bit." In there you'll find an analysis where they look at a 60/40 portfolio. Unlike what Jurrien was saying, where he firmly believes it's on the debt side, the 40 side, in the analysis they did, they took the percentage allocation evenly from equities and fixed income and they did a historical analysis as if you'd allocated 1, 3, 5, 7, and 10%. They looked at its effect on the rate of return, the maximum drawdown on the portfolio, the Sharpe ratio, and so on. Bitcoin, obviously, performed quite well during that timeframe so obviously the more you allocated, the better your portfolio did.

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I think where the learning is is looking at Sharpe ratio and the maximum drawdown and what you realize is what Jurrien was hinting at, it actually doesn't take a lot of Bitcoin in a portfolio to make a meaningful difference to that portfolio. It was a really interesting learning. The CFA society did a very similar paper. You can find it on the CFA Society website. They, again, same kind of concept, let's look at historically if we had allocated X, Y, and Z. You can find those papers and it gives you an idea of where you might want to start, depending on the type of portfolio that you manage.

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Pamela Ritchie: One question is just the actual logistics. I think you referenced this before we talked about this. The actual plumbing of how front office, back office, actually goes about doing this. Can you talk about ... there must be some barriers and actually just some concerns because it is new territory.

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Giles Anderson: Sure. As I said, the ETFs are there. They trade like an equity, they are an equity. They're very easy to access. Really, from that concept you're looking only at volatility and how do you manage an increase in volatility in your portfolio. Those white papers that I referenced talked about what does it look like if you balance once a quarter versus once a year and so on, and they give some great guidance. What we're seeing here and I think we're at, I call it the ketchup bottle moment in Canada, take a ketchup bottle and you try and shake it on your fries and a little bit comes out, a little bit comes out and then you pump it more and more and eventually a huge dollop comes out. I don't think we're too far from that huge dollop point.

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What I mean by that is, when I referenced a year ago or just about where the regulations were really made quite clear on IIROC dealers delivering this out as a service to investors. Fidelity, because of the work we've done, we were the first to complete that. But in fact, there were 70 firms that put their name down with the OSC and IIROC to say, we would like to start down this process. You'll start to see those other firms emerge from the regulatory work they're undergoing now, so I think you're going to see a huge proliferation of service providers.

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Our service certainly is available to other IIROC dealers who then can, in turn, service their institutional and retail clients. There's always going to be a bit of latency from that regulatory announcement last year. We're nearing the end of that tunnel. We're out, others will be out soon and we will provide it. At that point, then we give the institutional investors a lot more options on who they want to connect to, who they trust as a custodian, who they trust for trading and they can actually start to look at building meaningful positions in their portfolios with service providers that are fully regulated and who they trust.

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Pamela Ritchie: What can you share just on broad comments on what it's like for institutional investors to get into this? What do they need to put in place, for instance, or people even to have on board?

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Giles Anderson: We do an annual survey at Fidelity of institutional investors. It started out U.S., got a bit of Canada, than they added Europe, and last year they also added Asia. The survey's on attitudes towards digital investment. It encompasses more than just Bitcoin but we can use that as a proxy. The barriers to wider adoption were really regulation, which we've already touched on, the sort of trust on the custodian and then the third one was market manipulation. Those were three of the biggest impediments. If we look at the impact of the regulation coming out, we really mitigated, I think, probably all three. We now have fully regulated custodians by a national brokerage regulator. In terms of market manipulation, there's clear rules on how the markets are to be run and you have to be authorized as a crypto trading platform. Then really, again, that security of custody.

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Now, what we're talking about is encouraging the back and middle office to look at who they would want to partner with, what kind of connections are involved. Bitcoin is a bit of a different asset but there's certainly ways to we do this as a service provider. We keep the crypto specific actions away and make it look much more like a regular custodial relationship to the institutions. Jurrien talks about portfolio allocation in the front. I'm sort of a little bit more involved in the plumbing, so I actually encourage those people. At the same time, you're thinking about how might you allocate to it in a portfolio, is getting the middle and back office people involved in talking to their custodial provider, looking at how it might look so that they can support the portfolio management on the front end.

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Pamela Ritchie: I wonder if we can just go back to FDAS a little bit. This is physically located where? This is outside of Boston or this is within ... what sort of resource is that even for you on a regular basis?

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Giles Anderson: What we did at Fidelity is we basically built a global service provider for crypto assets and then we deploy it regionally based on the local regulations. Here in Canada, all of our crypto capabilities are actually delivered through our regulated IIROC broker dealer, which is called Fidelity Clearing Canada. We're an institutional brokerage where we provide services to other institutions, be they portfolio managers, other brokerages, institutional asset managers, and so on. As much as we have this capability within FDAS, we actually deliver it out locally in the UK and Canada and so on. We're really lucky here in Canada to have the regulations we do. It allows us to ... my colleagues in the other parts of the world, they're hugely jealous of what we have and the regulation. It sounds funny to say that kind of thing but that's the truth. They're envious of what we have.

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Pamela Ritchie: It's really interesting. Anything, just broad comments, again, to look at ... there's much discussion of various different asset classes that all of us look at and everyone has been discussing for a long time. The story of where we are in the markets and therefore the case for Bitcoin. Any comments there of why it's useful now? Is it just getting to that point of crossing the Rubicon or what else is going on in the markets that point to this alternative?

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Giles Anderson: One of the things that's different about Bitcoin than gold, which is one of the things it's compared against, is Bitcoin has other use cases which are really, really interesting. There's a payment network, for instance, that sits on top of Bitcoin. It's the Bitcoin Lightning Network. The coins that are used for the payments are programmatically linked to the coins on the Bitcoin network below. There's an explosion of things like this happening in the digital asset community in general but Bitcoin for sure. So you have all these really interesting use cases on Bitcoin as well as this store of value. You now can start to use it as a base layer for other transactions in the financial services system. That's actually, again, why we think this getting off zero is a great concept because it's not just Bitcoin as a store of value, it's Bitcoin potentially transforming huge swaths of our investment industry, no matter what part of the industry you're in and to build up that knowledge base, Jurrien talked about going down the rabbit hole, there wasn't a lot of resources, he had to teach himself, et cetera, et cetera. I would encourage everyone to think that way. Unlike, say, in institutional equity portfolio management, there's quite a lot of them in Canada. There's not as many people with Bitcoin capabilities in Canada or Bitcoin history, so you really need to pick up the white paper, talk to the providers, get going, look at the other use cases for it. That's the part that I would encourage because it truly is we're still at that early stage where a huge amount of transformation is yet to come.

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Pamela Ritchie: Any sort of timeline on those? You say we're getting closer to perhaps a real critical mass of sorts but is it being accelerated, do you feel, or that we're...

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Giles Anderson: Yeah.

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Pamela Ritchie: –just at that point? Yeah, it is.

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Giles Anderson: If you look at, again, all those metrics that I talked about that you can see in the Bitcoin blockchain, they're accelerating rapidly. The amount of venture capital being put into building software solutions on top of blockchains, that's gone completely elliptical. It really is we're at the turning point here. That's why we keep coming back to the "getting off zero." Start with a little bit. It's not just about managing it in your portfolio but coming to terms on here's how it behaves, here's how we use it, it's used, here's how I need to set up my internal controls, and all the other things that go along with managing a portfolio.

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Pamela Ritchie: Giles, I want to thank you for joining us today. Very, very interesting to have some time with you and thanks for sharing your thoughts.

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Giles Anderson: Oh, thanks so much, Pamela. Have a great day.

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Pamela Ritchie: Giles Anderson joining us today. Thank you for tuning in today and please join us for our next webcast which is on March 23rd. We will be introducing you to the person in many of the clips that you just saw there, of course, Director of Global Macro, Jurrien Timmer, will be back for discussion on what's moving markets and ultimately what he sees as lying ahead. As always, if you have any suggestions for future topics, do please let us know and share your ideas with us. Thanks for joining us. I'm Pamela Ritchie.