

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



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A recent PwC report showed that global assets under management are going to surpass \$145.4 trillion by 2025, currently at \$84.9 trillion. Investments targeting alternative asset classes will more than double to 21.1 trillion. Investors will be looking to pursue opportunities in established asset classes such as real assets, private equity, private debt (trade finance, peer-to-peer lending in particular) and hedge funds and in more niche markets including machine learning/systematic strategies and cryptocurrencies. In this perspective, we focus on cryptocurrency and systematic trading strategies due to the prevailing “phrenitis” of investors allocating to the space or being in the process of exploring the markets. In an earlier **perspective**, we examined the effects of adding bitcoin and systematic CTAs to institutional portfolios and evidenced the enhancement of the risk/return profile as both strategies have uncorrelated alpha features, desirable for investors.

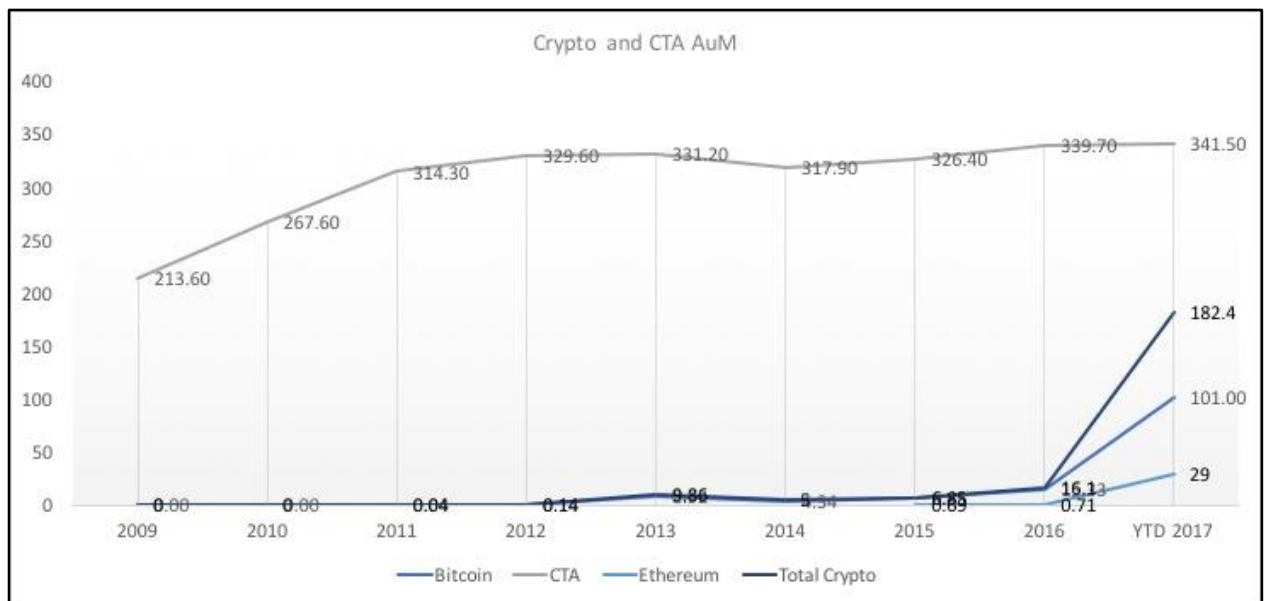


Figure 1. CTA, Cryptocurrency, Bitcoin, and Ethereum Assets under Management (\$bn) as of 30/10/2017
Source: Coindesk, BarclayHedge, Stone Mountain Capital Research

Figure 1 highlights the growth of CTA and cryptocurrency (in particular Bitcoin / Ethereum) markets, which all stand at all-time high AuM, while still attracting interest and inflows from (institutional) investors. With volatility as measured by CBOE’s VIX index and yields being extremely low for a long period of time, investors are looking for strategies generating high returns. IMF estimates around \$500bn in volatility products, and many of the volatility strategies apply systematic rule-based trading. The current low volatility environment deteriorates the performance of CTAs, but low or negative performance does not prevent inflows in the strategy. According to coinmarketcap.com, there are 1238 cryptocurrencies with total market capitalisation of over \$182bn, with bitcoin with \$106bn accounting for over 58% of total market cap and Ethereum following with \$29bn. Institutional investors deploy currently none or only tiny fractions of their assets in cryptocurrencies due to the largely unregulated market structure. According to Autonomous NEXT, there are 124 hedge

funds pursuing crypto strategies as of October 2017 with an overall AuM of just over \$2.3bn. The majority of crypto assets are therefore held by individual non-institutional investors. Despite global tightening of regulations and markets being shut down by regulators (e.g. China closed bitcoin exchanges and stopped all Initial Coin Offerings (ICOs)), bitcoin transactions have increased alongside its price as evidenced in Figure 2. The fact that large institutions have still not been involved with bitcoin investing reveals huge growth potential for the asset class and combined with its limited supply of 21m, economics 101 teaches us, that the price should increase. Sovereign wealth funds manage approximately \$7.5tn, which combined with almost \$63tn from major pension and insurance funds gives us a total of \$70tn. A good illustration of the growth potential of the market would be if one large institution invests just 1% of its assets into bitcoin. If one of the larger sovereign wealth funds with \$1tr in assets invests only one percent of AuM in bitcoin, its AuM would be almost 10% of the market current capitalisation. A one percent investment of one of the large global asset managers for pensions and insurers like BlackRock with \$5.7tn in assets, would lead to an increase of market cap by almost 60% in bitcoin. The fear of missing out and the further advancement of the crypto markets could be leading growth for institutional investors. CBOE and Gemini Trust are already cogitating the launch of bitcoin trading products such as futures.

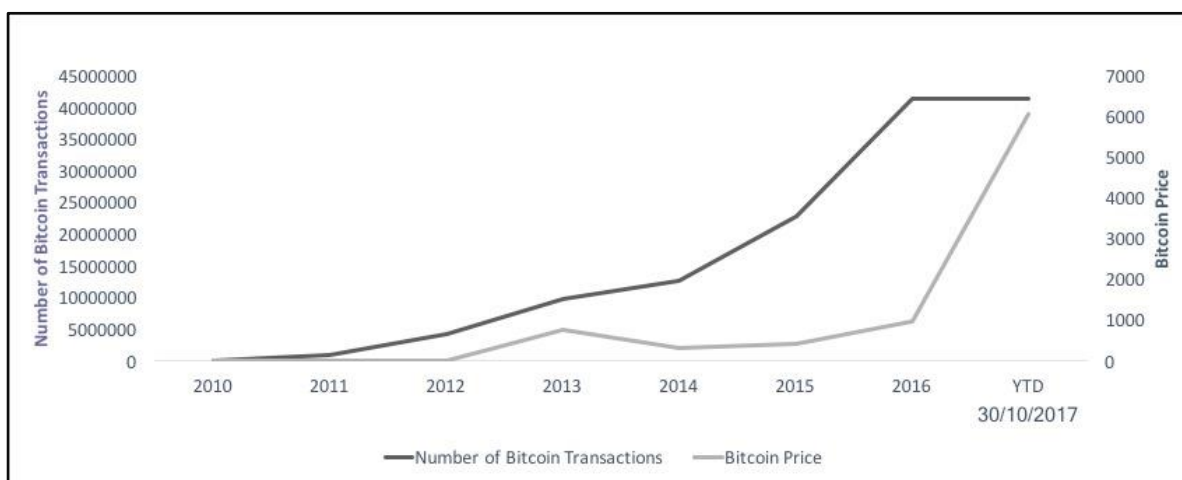


Figure 2. Bitcoin Price in U.S. dollars and Number of Transactions as of 30/10/2017, Source: Coindesk, Blockchain Luxembourg, Stone Mountain Capital Research

ICOs are predominantly launched on basis of tokens within smart contracts on the Ethereum blockchain. There are currently 348 tokens in circulation with a tendency for almost exponential growth in the number of offerings. Ethereum is not limited in supply like bitcoin, but rather constitutes a platform for the implementation of real world contracts in the digital space. The new issuance of tokens and adoption of smart contracts on the Ethereum blockchain has the effect of dilution of the initial concept of limited supply in bitcoin, but leads naturally to further increases of cryptocurrency assets. Indicative of the growth is the \$2.6bn raised so far for ICOs as seen in Figure 3, which surpassed the respective VC fundraising for internet companies.

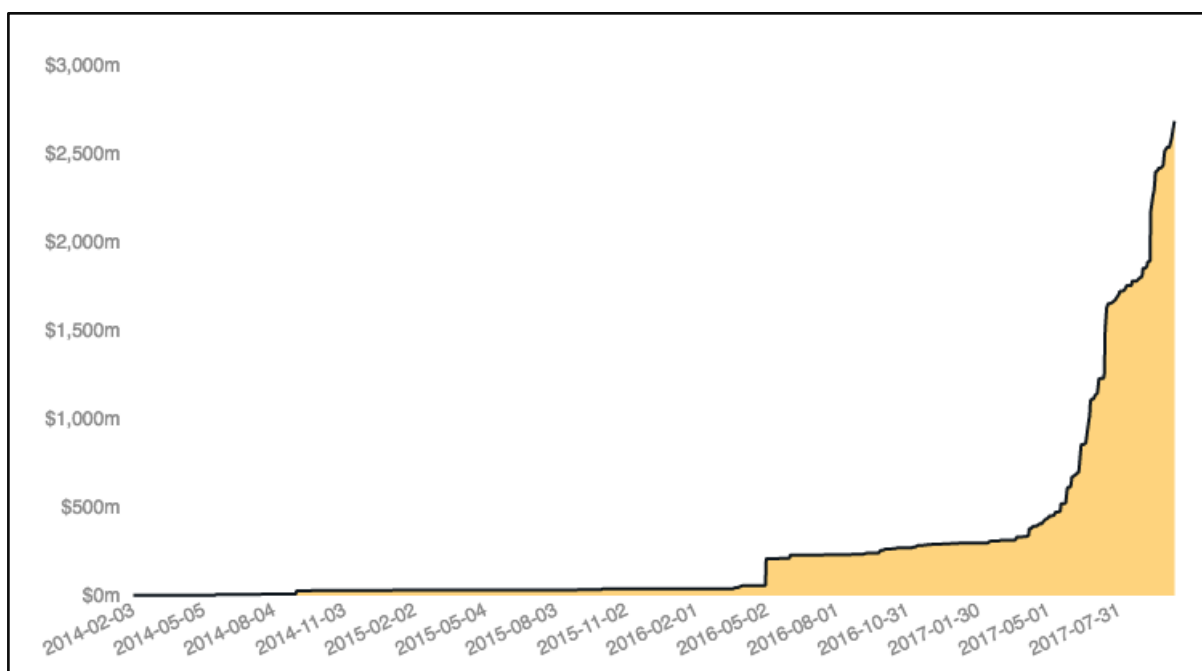


Figure 3. ICO Fundraising, Source: Coindesk ICO Tracker

On the other hand, CTAs are much more established as an asset class and hedge fund strategy and resemble a typical macro approach but in a more systematic fashion. CTAs trade across multiple markets and asset classes from equities and fixed income to currencies and commodities. CTAs are mainly considered as long-term trend follower, but there has been a lot of differences between CTAs relying on trading time horizon and style. In terms of style, CTAs vary from trend followers and pattern recognisers to contrarian and purely option-based trading. Recent performance has been disappointing, but the low volatility and lack of trends environment reversal will boost the asset class. The key considerations for CTA investing is the increased transparency and liquidity offered alongside diversification, risk/return profile enhancement and profits across different market environments and crisis events.

In Stone Mountain Capital, we have seen a recent trend: systematic CTA managers have started exploring the cryptocurrency markets with their trading algos. As volatility in their traditional asset classes is pretty much at all-time lows across the board, unregulated cryptocurrency markets constitute attractive sources of volatility for CTAs, required for the systematic production of return. The development of coin lending for shorting, spread trading, futures and options and the further regulation of crypto markets will be another source for letting CTAs and crypto strategies grow further together and should lead to further increases of institutional assets in the crypto markets.

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