Key Operational Considerations for Crypto Investment Managers

As demand for crypto offerings intensifies, asset managers entering this market are facing new operational challenges that are unique to this emerging asset class. This article highlights regulatory, valuation, performance, and safekeeping aspects of traditional managers' operations that require a special approach when it comes to digital currencies.

WHERE ARE WE NOW?

Despite a wild ride in 2022, cryptocurrency is still top of mind for both institutional and retail investors. In April 2022, Fidelity announced plans to allow up to 20% of 401(k) portfolio investment in crypto. Additionally, other institutional investors are starting to consider digital assets as part of their strategies to capitalize on the growing demand from investors. But setting up a crypto offering is not the same as starting a large-cap strategy. Crypto operational challenges, not typically presented by traditional or even alternative asset classes, are a new frontier. Investment managers can learn from their peers and predecessors, avoid making the same mistakes, and go in understanding operational risks involved in managing crypto.

CONSIDERATIONS

REGULATIONS AND VALUATION

Regulators have been slow to address the growing crypto market, but they are picking up steam. On the heels of President Biden's 2022 digital assets executive order, SEC Chairman Gensler announced plans to register and regulate crypto exchanges and potentially separate asset custody to minimize investor risk. While regulators are trying to put a framework in place, managers are left to their own devices in navigating performance reporting and marketing their crypto track record to prospective investors.

Even valuation remains ambiguous. With crypto markets being open 24/7, there is no official closing time at which the value of cryptocurrencies is recorded, and managers must decide what time to strike the NAV. Some use midnight UTC rates as "closing" value, but others may use midnight local time, arguably preventing prospective clients from making an apples-to-apples comparison of track records from different managers for similar strategies.

PERFORMANCE

Several features unique to crypto can present challenges to performance calculations. Airdrops, for example, involve blockchain-based projects and developers sending out free tokens to members of their communities in a bid to encourage adoption. When managers get an airdrop, they have a choice of whether to claim it or not, and if there is value assigned to the claimed airdrop, whether to include it in performance calculations or leave it out.

Lending

Some investors are in it for the long haul and look to reap the benefits of an increase (hopefully) in the value of their crypto investment, while acting as banks. These investors turn over their holdings to lending companies and pocket interest on the loans. Per Barron's, lending Bitcoin can generate annualized yields from 3% to 8%. Managers must decide how this income fits into the broader picture of their performance.

Trading Fees

While managers of traditional assets are moving away from charging commissions on trades altogether, trading fees for crypto, depending on the timing, can be exorbitant. Managers must decide whether they need to set caps or whether tokens are bought and sold regardless of the trading costs, and how then are these costs reflected in performance.

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Track Record

For managers new to the game, it's not always clear when performance track record should start, and it is hard to accept that one cannot simply pick an arbitrary date for the start of performance. Firms must show the good, the bad, and the ugly from inception. Given the unconventional trading methods and lack of third-party support, retaining records for performance must be intentional from the very beginning. Unsubstantiated returns can land managers in hot waters with the SEC and upend part of a track record.

Attribution

Dissecting and analyzing crypto returns is another operational aspect, which can be challenging given limitations of performance systems that exist today. This will likely be a manual process until technology can catch up to the needs of crypto managers.

SAFEKEEPING

Finally, no matter how well-executed performance calculations may be, the safety of crypto investment will require some thoughtful consideration. Each currency has inherent vulnerabilities depending on the resilience of the coin system and the blockchain governance, and the underlying code of the currency being free from critical vulnerabilities. Unlike traditional securities, your crypto investment can vanish simply due to bad code, so managers should establish a due diligence process to minimize this risk. Additionally, the choice between self-custody and third-party custodian, is not a typical one for traditional managers but is an important consideration for managing crypto. Self-custody enables managers to maintain complete control over their cryptocurrencies via cold storage (a way of holding tokens offline), which offers strong protection to the assets, otherwise vulnerable to hacking, but only to the point of how secure these assets are from accidental loss of private keys.

By the same token, pun intended, third-party solutions via hot storage (accessible online) offer state-of-the-art and ever-evolving security systems. However, those third-party custodians are also the primary targets for hackers.

HOW MERADIA CAN HELP

Evaluating the various approaches and considerations discussed above will likely involve rigorous research and considerable time commitment. Whether your firm has an immediate need or a long-term strategy to manage digital assets, Meradia's team of experts can help navigate the challenges of operational processes and transformation. Our consulting team has decades of experience optimizing investment management operations and performance.

Natasha Romanova, CIPM
is a performance expert supporting Meradia's clients through operational transformation. For over a decade, Natasha has worked with dozens of asset managers on performance calculations and reporting. She has helped firms achieve and maintain their GIPS compliance as well as advised on industry best practices. She has the unique ability to establish relationships with stakeholders at all levels of an organization and effectively execute projects.

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