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How Should Family Offices Approach Digital Assets?

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"Fear of Missing Out" (aka FOMO) is that anxious feeling of not being included in something with others, such as an interesting or enjoyable activity. The concept was originally used to describe social behavior, a form of self-inflicted peer pressure to participate in social activities. More recently the term has been taken up by the behavioral finance community to describe how investors follow the trades of others in order to "not miss out" on the next big thing. FOMO is a common experience, but in the world of investing it is usually associated with poor decision-making. After all fear rarely provides a solid basis for clear, rational decision making.

FOMO as a buy/sell discipline produces less than stellar results.

The massive breakouts in Bitcoin and other digital assets in the past few years have created many FOMO inducing moments. At The Family Office Association ("TFOA") members experienced such a moment in late 2017. TFOA often hosts dinners for our family office members to meet with industry experts and learn from leading practitioners about a variety of topics. Over the years we have found that one of the best ways to diligence a manager is during a private dinner where questions and ideas can be openly asked and answered. Our dinner conversations tend to be both candid and fun; and our diverse membership of experienced family office CIOs, CEO's, Principals and Presidents provide unique and different perspectives.

For this particular dinner we invited the head of a relatively new crypto fund to host a dinner for members in the private room of Pappas Bros. Steak House in Houston, TX. An impressive oak paneled room with wine racks from floor to ceiling offered members the intimacy of a closed door private meeting and the perfect setting for friends and colleagues to visit. The theme of the dinner was "The Facts, not Hype, of Crypto and Blockchain." At the time the fund's assets under management were small, around $40M, but the founder was exceptionally knowledgeable about the space and members were keen to learn more about what was really going on and how they should best position themselves. The conversation was fascinating. Many questions were asked, steak eaten, and wine drunk. However, it was perhaps a little early in the evolution of crypto for some of the more skeptical participants to see how this interesting new technology might translate into a viable asset class. Other members saw the potential for asymmetric upside and followed up with the manager after dinner to learn more. The skepticism of those members who chose not to invest wasn't entirely misplaced as, five years later, digital assets are still perceived by many to be pure risk capital. After all, not many assets maintain a valuation range from zero to infinity, which is what digital assets currently appear to offer. For those that didn't choose to invest, it is understandable that at that time the opportunity appeared too aspirational and too technical. Five years ago, there was still much to understand about this new asset class. Today, the fund manager who hosted that dinner now overseas an investment business with more than $6.5 billion in assets under management (with much of that growth from investment performance). Like we said, the experience created a FOMO inducing moment!

In hindsight it was an obvious bet, but the fact of the matter is that in 2017 the most common question surrounding crypto was simply "what is crypto?" Today the question is more along the lines of "what is your crypto strategy?" The conversation has moved considerably in five years. Having said that, and despite how much more knowledgeable we all are today, many family offices are still in the process of developing their own approach to digital assets.

According to UBS' 2021 Global Family Office Report, 13% of family office respondents have already invested in cryptocurrencies, and an additional 15% have it under consideration.[1] Family offices are ahead of institutional investors, who are just now

[1] Report available at: https://www.ubs.com/global/en/global-family-office/reports/gfo-r-21-4-client.html

beginning to dip their toes into the space, but the asset class still remains outside a traditional asset allocation. As family offices continue to develop their post covid allocation strategies in parallel with the increasing awareness and adoption of digital assets from a broad spectrum of investors (from retail to institutional), it is more important than ever for families to consider how digital assets may or may not fit into their allocation strategies. To that end we would like to offer some perspectives to help frame how family offices might approach the topic.

1. Risk Capital

First and foremost, digital assets should be considered pure risk capital. And from a family office perspective, it makes sense to frame a crypto strategy within the overall risk capital budget. Digital assets are new, largely unregulated, and based on technology that is quickly evolving. The lack of regulation has made it exceedingly difficult to invest with conviction for any professional investor or those with a fiduciary responsibility to others. This framework is changing, and institutional investors are beginning to allocate a portion of their risk budget toward digital assets. The continued development of institutional fund strategies is accelerating that process. From a risk calculation perspective, a relatively small allocation can yield tremendous upside.

New coins and tokens can be quickly developed with open source coding, but the resilience of these new coins is largely based on how many people invest, adopt, and remain committed to a particular coin. This means that many emergent coins are very much tied to the success of their marketing campaigns. Therefore, picking coins carries the same kinds of risks as betting on horses at the racetrack – while they look promising, with great form, there's no guarantee they won't fall at the first furlong – so finding experts in the space and investing in the underlying technology seems more prudent than simply following Reddit discussion boards or other online communities.

Crypto bears have pointed to China's recent regulations and the banning of miners while bulls point to El Salvador's President Bukele who named Bitcoin legal tender for the country in 2021. The more established crypto currencies, like Bitcoin and Ethereum, have established a much larger and stickier share of the market. In the case of Bitcoin, the algorithm is designed to produce a fixed number of total coins, which will be completely mined by around 2140. Although the technology is new, the concept of limited supply serving as a store of value is not. However, if your primary motivation toward Bitcoin is as a store of value, then you must be mindful of how you plan to access that store of value. This is as much a question of privacy and security logistics as it is technology. Physical wallets allow you hold your coins but add an additional layer of risk. If the drive is lost or destroyed, your coins are gone as well. On the other hand, in a situation where you need access to your coins quickly, nothing can beat the speed and efficiency of a digital wallet that you fully control.

2. Patient Capital

Family offices are uniquely positioned to take advantage of investments over a long time frame. Many have the luxury of being able to deploy capital over generations. While Bitcoin prices may swing wildly on any given day, if your conviction about Bitcoin is based on a belief that it is Gold 2.0 and a better store of value, it's not unreasonable to conclude that given the limited supply and algorithmic nature of the blockchain, the ultimate value of Bitcoin move higher over the long term.

Currently the IRS treats virtual currencies as property, and they are taxed in accordance with capital gains. However, other government agencies are arguing for different classifications. Not surprisingly, the SEC sees digital assets as securities while the CFTC believes they are commodities. While it is reasonable to assume a "J-Curve" pattern with the asset class in relation to future regulation – the assumption being that regulation will eventually drive down valuations as some investors don't agree with the regulatory framework, but that over time regulation will make it easier for institutional investors to move in with greater force, thus raising long term valuations far above the initial dip – nobody knows exactly what the time frame for such a development might be. In the meantime, digital assets remain risky by nature but over the long term winners will emerge and there can be no denying that blockchain technologies offer a tantalizing prospect for decentralized finance and smart contracts.

3. Flexible Capital

In addition to patient capital, families also have access to flexible capital, namely, they can deploy capital with a flexible mandate that does not only require profit maximization, but also take into consideration legacy and impact. From this perspective, an allocation to digital assets must fit within an impact investing or ESG framework. An investment in digital assets should be flexible in the sense that it may generate positive or negative social or environmental returns, but it should also be tactically flexible given the rapidity of development within the space. Today, each Bitcoin requires energy consumption totaling 1173 kWh/ per transaction, which in U.S. energy terms would equal about six weeks' worth of average household electricity.[3] Other coins and new technologies are significantly driving down the energy load for transactions. Questions around energy usage will continue to be a feature in the discussion around digital assets. It is a complex topic. While digital assets appear to use more energy than other forms of currency, the total energy load to mine for gold or run a global fiat banking system is also vast. The relative impact of digital asset energy usage needs to be weighed against the environmental costs of producing other stores of value, like gold mining, which rely on heavy machinery and industry. And digital assets have the ability to utilize forms of energy and electricity that would otherwise be wasted or are currently underutilized. Of course, heavy industry also benefits the economy by creating jobs. Given the complexity of the subject, the many competing narratives probably tell you more about personal biases towards crypto currencies than anything else.

For family offices, what is most important is understanding what the question of digital energy means for you, and this question highlights the importance of flexible capital. If a family office can't reconcile the energy requirements of certain digital assets against their ESG mandate, there may be other strategies that better align with their goals. For example, Bitcoin mining operations that seek to stabilize and more efficiently utilize the

[3] According to a report from Money Super Market: https://www.moneysupermarket.com/gas-and-electricity/features/crypto-energy-consumption

electricity grid may be one such example. Indeed, the speed at which new technologies are coming online to solve these issues is startling, even within the context of a disruptive sector. On the other hand, placing too much faith in technology to solve problems is a common fallacy, so it is prudent to approach new solutions with a certain amount of skepticism[4].

Beyond FOMO

Trains or tulips? As we think about digital assets in the context of the long history of capitalism, examples of transformative industries like the 19th century railway industry come to mind; followed quickly by the famous 17th century Dutch tulip craze with its ultimate and inevitable flop. Will digital assets prove to be more like the former or the latter?

Perhaps it's still too early to say, but even if one's convictions are on side of trains rather than tulips, it's important to remember the rail industry took many years and saw many failures before stabilizing into a successful system of logistics and travel. History teaches us that family office allocators can't afford to make decisions based on hype or excitement. Fortunately, in addition to all the FOMO around this asset class, there is also a growing body of knowledge and resources to help develop strategies for prudently allocating to digital assets.

[4] Additional information on cryptocurrency energy usage can be found in the New York Times: https://www.nytimes.com/interactive/2021/09/03/climate/bitcoin-carbon-footprint-electricity.html and Harvard Business Review: https://hbr.org/2021/05/how-much-energy-does-bitcoin-actually-consume

Since the Great Recession, the market size of crypto currencies has swelled from zero to trillions of dollars. That's a lot considering only a few years ago Bitcoin investors were perceived as fringe actors in a speculative technology with mysterious origins and a uniquely libertarian philosophy. Many of these pioneers are now immensely rich and the future for crypto, decentralized finance, blockchain, and the metaverse, seems boundless and unlimited. While family offices should proceed with caution, today there is no excuse for not "going down the rabbit hole" to better understand digital assets and develop an approach that fits their strategic asset allocation goals and objectives.

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