One of the main proposed use cases for bitcoin in portfolios is to potentially enhance portfolio diversification and risk-adjusted returns. (UBS)

New spot bitcoin ETFs: Addressing some initial questions

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Spot bitcoin ETFs are finally here. In this article, we provide a quick overview of the ETFs and hopefully answer some of the potential questions.

In the past, bitcoin has been referred to as digital gold. Coincidently, spot bitcoin ETFs are very similar to gold ETFs. They are designed to closely track the price of bitcoin, less expenses. Expenses include the operating expenses, such as the management fee, and the trust's trading costs. The ETFs are structured as grantor trusts and are backed by bitcoin held by a custodian. The amount of bitcoin each ETF share represents will gradually decline overtime as bitcoin needs to be sold to cover trust expenses.

Similar to gold ETFs, there is the risk of theft and the custodian is responsible for the safekeeping of the assets. The custodian is only liable for losses resulting from their own negligence, fraud, or willful default in their responsibilities. Importantly, the issuer also has a role in safekeeping and in execution even if the custody and the digital asset execution partner(s) are the same. So there are more differences than are immediately apparent based on reviewing the higher level information on the ETFs. These differences may/may not lead to meaningful performance disparities between the ETFs.

From a tax perspective, spot bitcoin ETFs do not issue K-1s. While physical gold ETFs are treated as collectibles, spot bitcoin ETFs are treated as property. Therefore, capital gains are taxed at long- or short-term rates depending on the investors holding period. Separate from a shareholder buying or selling, there could be capital gains/losses reported by the issuer (reported to the shareholder via IRS form 1099-B) resulting from the sale of bitcoin to cover expenses.

Advantages

For most investors, spot bitcoin ETFs likely provide a simplified and more secure way to gain exposure to bitcoin, when compared to other approaches. The ETFs relieve investors from decisions/due diligence around custody/storage, crypto exchanges, and best execution when trading bitcoin. There's also the benefit of the enhanced liquidity from the exchange trading. While bitcoin futures ETFs also benefit from the professional management and the enhanced liquidity, they're not designed to track the price of bitcoin.

Disadvantages
Spot bitcoin ETF investors do not have direct ownership in bitcoin and are bound by market hours for trading. The simultaneous approvals of the ETFs contributed to an immediate price war prior to launch, which helped to lower the cost of spot bitcoin ETFs for investors. While spot bitcoin ETFs could provide lower cost access to bitcoin than some alternatives, direct ownership may be cheaper for long-term investors who do not regularly trade their position. In this instance, the ongoing underlying fees of an ETF may be more impactful than the higher trading costs that may come with direct ownership.

What are the risks?
The risks of spot bitcoin ETFs include all of those related to cryptocurrencies including, but not limited to, significant drawdown risk, regulatory changes, fraudulent activities, cybersecurity breaches, theft, and negative sentiment. The risks section of a spot bitcoin ETF prospectus are enough to give Freddy Krueger nightmares.

For the spot bitcoin ETFs, we also want to stress that the ETF structure doesn’t eliminate the liquidity risk of the underlying bitcoin market. ETF prices can quickly reflect the cost of trading in that underlying market. The bitcoin market is especially volatile and there may be a significant cost for investors trading in volatile, illiquid markets.

One of the main proposed use cases for bitcoin in portfolios is to potentially enhance portfolio diversification and risk-adjusted returns. However, we'd caution that bitcoin is highly volatile and there have been three major drawdowns surpassing a 70% loss since 2014.

On a go-forward basis, while it's possible that bitcoin allocations are able to improve risk-adjusted returns of a portfolio, it's certainly not without risk. In the last 10 years, even a 10% allocation to bitcoin in a balanced 60-40 equity bond portfolio would have increased the portfolio’s volatility and drawdowns to the levels of an all equity portfolio, and would have seen bitcoin drive about 50% of the portfolio’s volatility. Given the correlation to global equities and high volatility/ drawdown risk, we believe that there are more effective strategies if the objective is portfolio diversification.

Considerations for selecting a spot bitcoin ETF
UBS does not provide advice on specific virtual assets nor with the selection of spot bitcoin ETFs. Given that the ETFs are each trying to track bitcoin prices, we expect a lot of attention will be paid to fees and liquidity. Investors evaluating spot bitcoin ETFs should consider the following:

- The investment horizon dictates the relative importance of cost vs. liquidity. The longer the time horizon of the trade, the more important expenses become. The more tactical the trade, the more liquidity will matter in terms of ease of trading. We note that given shares can be created/redeemed, so there will be more liquidity than what may be apparent.
- Bitcoin is a volatile asset, so minor differences in expenses likely don’t matter much all things considered and shouldn’t sway you from an issuer that you have more comfort/confidence in their ability to manage the product.
- Given the importance of safekeeping of bitcoin and the potential for high volatility, investors may want to consider the issuer’s experience (or the issuer’s partner) within the crypto industry.

While the spot bitcoin ETFs are likely to perform similarly to each other in calmer markets, this may not be the case during more volatile markets. It remains to be seen if the issuers will be able to distinguish themselves in terms of ability to manage the product during turbulent markets.

For much more, see the full report - **Spot bitcoin ETFs: Exchange-traded funds**, published 26 January, 2024.

*If you direct a trade in a security tied to virtual currencies or cryptocurrencies, you do so on an unsolicited basis. Please note that UBS does not provide advice on specific virtual assets nor with the selection of spot bitcoin ETFs.

Important information

Appendix

Exchange Traded Funds (ETFs) Disclosure

For purposes of this report, ETFs include index-linked funds regulated under the Investment Company Act of 1940 that trade on US securities exchanges under exemptive relief from the Securities and Exchange Commission. The shares of all of the ETF issuers discussed in this Report are listed on U.S. securities exchanges. The ETFs are either open-end, registered investment companies (including UITs) operating under an exemptive order from the SEC, or collective investment vehicles, formed as grantor trusts, limited partnerships or similar structures that offer pass-through tax treatment to investors. The different structures provide different rights for investors. For example, ETFs registered under the Investment Company Act of 1940 must stand ready at all times to redeem shares (albeit only in creation unit size) whereas those ETFs that are not subject to registration under the Investment Company Act of 1940 may suspend redemptions at any time. We refer to ETFs registered with the SEC under the Investment Company Act of 1940 as "'40 Act ETFs" and to non-registered ETFs as "33 Act ETFs." All of the ETFs discussed in this Report track an index of financial instruments or provide exposure to a single commodity type.

US-registered, open-ended index-linked funds are redeemable only in Creation Unit size aggregations through an Authorized Participant, and may not be individually redeemed. Many ETFs are redeemable only on an "in-kind" basis. The public trading price of a redeemable lot of ETFs may be different from their net asset value, and ETFs could trade at a premium or discount to the net asset value. UBS AG or its affiliates act as authorized participants for many of the ETFs discussed in this report. In addition, UBS is a regular issuer of traded financial instruments and privately issued financial products that may be linked to the ETFs mentioned in this Report. UBS regularly trades in ETFs. Through these and other activities, UBS may engage in transactions involving ETFs that are inconsistent with the strategies in this report.

ETFs are subject to the same risks as the underlying securities and commissions may be charged on every trade, if applicable. This definition does not imply that ETFs are endorsed by the Securities and Exchange Commission. ETFs are sold by prospectus, which contains details about ETFs, including investment objectives, risks, charges and expenses. Clients should read the prospectus and consider this information carefully before investing. Clients may obtain more information about ETFs, including copies of prospectuses or summary, from their UBS FS financial advisor.