INSIGHTS

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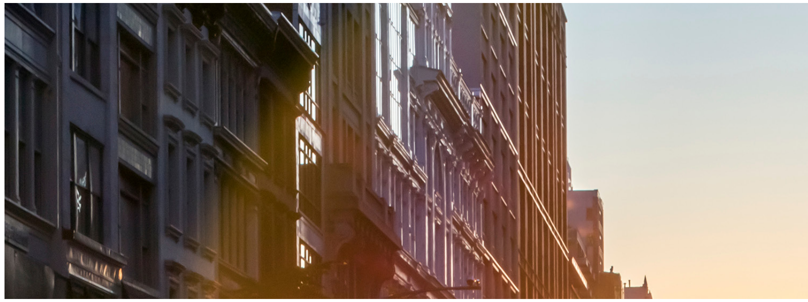
FEBRUARY 2024



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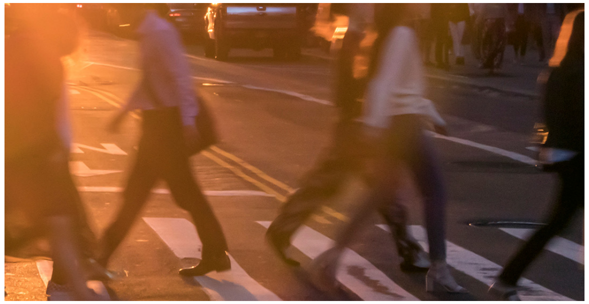

A NEW DAWN

THE OUTLOOK FOR DIGITAL ASSET HEDGE FUNDS IN 2024

EXECUTIVE SUMMARY

The digital assets fund industry has begun 2024 with the wind in its sails. The two key tailwinds? A market rebound, with bitcoin surging again and better fund performance in the space, and regulatory breakthrough, after the SEC approved the first spot bitcoin exchange traded funds.

These trends are driving improved sentiment and will be dissected in this report, supported by Fireblocks, which draws on expert testimony from native digital asset fund managers, traditional hedge fund managers and other market participants. These insights will be accompanied by data-driven insights from Hedgeweek's research survey, with respondents asked for their view on the key opportunities and challenges in the space.

Key performance headlines and drivers will be analysed in Part I, with contributions from the likes of Brevan Howard and Anthony Scaramucci on the latest innovations, sentiment and future of the sector. In Part II the impact of the SEC's spot bitcoin ETF approval will be analysed, together with implications of this move by a regulator which has recently had a negative stance towards the digital asset industry.

At a time of renewed opportunity, this report explores what's next for a sector trying to make its comeback endure, following a turbulent period marred by volatility in markets and bad actors.

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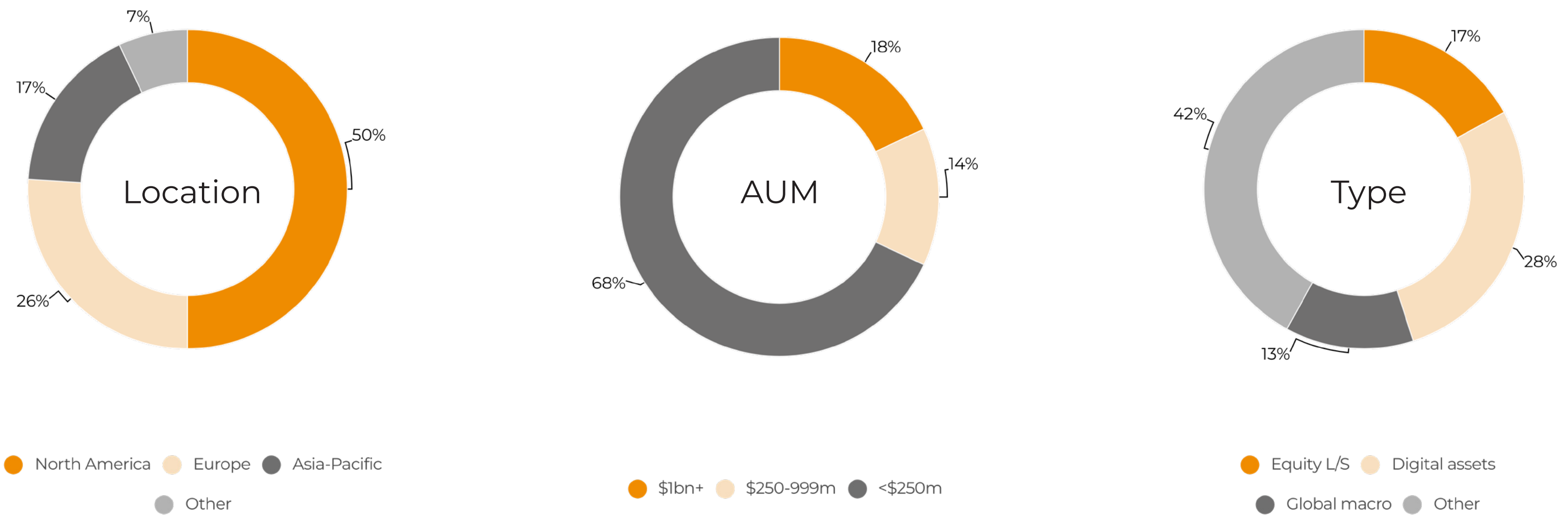


METHODOLOGY

A key source of data in this report is the results of Hedgeweek's Q4 Hedge Fund Manager Survey conducted in December 2023. Of the 76 hedge fund firms that participated in the survey, just over one quarter labelled their primary hedge fund investment strategy as focused on digital assets. Further insights in this report were gathered during interviews in January and February 2024 with named and unnamed hedge fund sources, and additional third-party research and intel.

KEY FINDINGS

1

Bullishness is back…

Interviewees were notably bullish on the sector despite recent upheaval. Survey respondents agreed, and to take bitcoin as an example, digital assets managers were four times more confident than non-managers that it could pass $60,000 in price this year – 82% compared to 21%. No crypto respondents foresaw a 2024 peak below $50,000.

2

… but caution remains

It was telling that 94% of respondents agreed that the post-FTX trend of enhanced due diligence and more robust risk management practices would endure, instead of the focus moving quickly on to innovation rather than further safeguards. A cautious approach remains the industry's priority despite more positive recent developments in the sector.

3

Spot ETFs approval boost

Interviewees welcomed the SEC's decision to approve spot bitcoin ETFs, seen as an overdue move. Attention now turns to the US regulator's next few decisions – could spot ethereum ETFs, for example, be next? Asked before the January announcement, respondents to the Hedgeweek survey were distinctly lukewarm about the US authorities' attitude to crypto, with the regulatory agenda enforcement-led to date.

4

Launch plans afoot

A full 90% of digital asset managers planned to launch a new crypto strategy of some description in the next 12 months, a sure sign of revived confidence. However, it seems the traditional market is not there yet, with just 4% planning a crypto strategy – down from 31% 12 months prior. Confidence will take longer to catch up for traditional firms toying with an entry into crypto. An enduring comeback over years rather than months should support this appetite.

THE CRYPTO COMEBACK

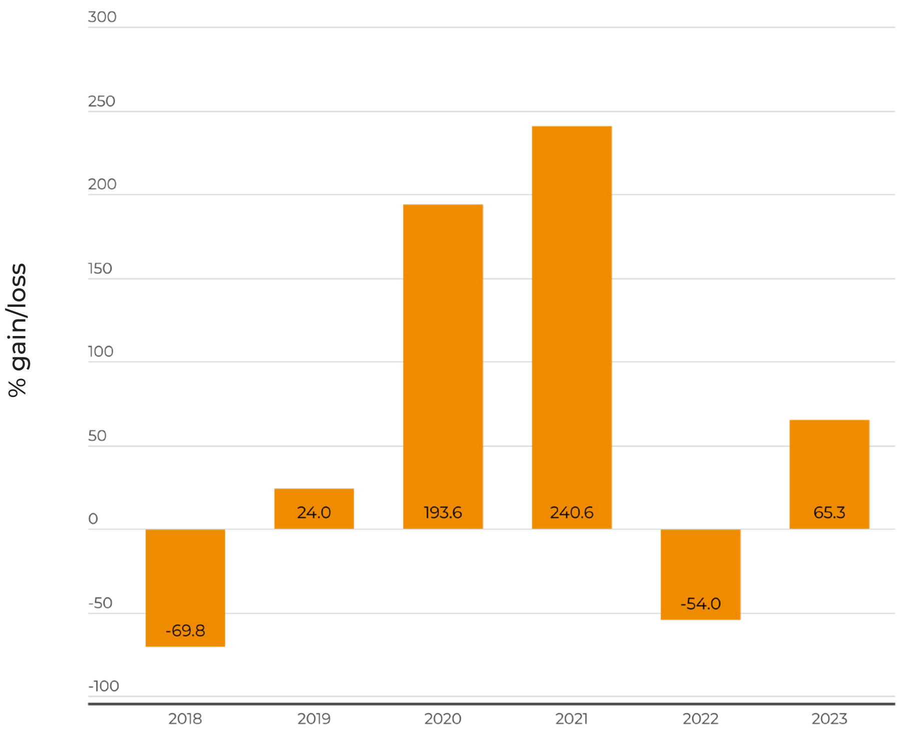
Bitcoin trebling. A wider performance rebound. The crypto mood is much improved at the start of 2024 – will it last?

Crypto is back in business: that is the message from industry participants looking to a new phase of growth for the sector after a bruising couple of years. Moving on from events like the collapse of exchange FTX and terra-luna blockchain, the digital asset industry has started 2024 in bullish fashion, with bitcoin almost treble the price of its low during the crypto winter of 2021 and crypto funds delivering strong returns.

This section explores this market comeback, which has coincided with positive regulatory news as the SEC approved the first spot bitcoin ETFs. The rebound of the digital asset hedge fund market from the crypto winter lows was well underway last year. After three years of annual gains, the HFR Cryptocurrency index posted a 53.98% loss in 2022 before gaining 65.25% last year (see Fig. 1.1).

Brevan Howard Digital was one of the main crypto managers to capitalise, with the BH Digital Multi-Strategy Fund up 44% in 2023, while the Altana Digital Currency Fund was up 120% in 2023. “There is a feeling of optimism, which feels unfamiliar in the US after the difficult

Fig. 1.1 Annual crypto hedge fund performance, 2028-2023



Source: HFR

past 18 months," says Michelle Noyes, head of AIMA Americas.

What drove the outperformance? "A lot of tokens came off very low lows," she adds. "Those who started investing at that point will have done very well, yet many funds are still off their high-water marks. We also saw a lot of the bad actors pushed out of the market and progress made on infrastructure, such as off exchange settlement solutions."

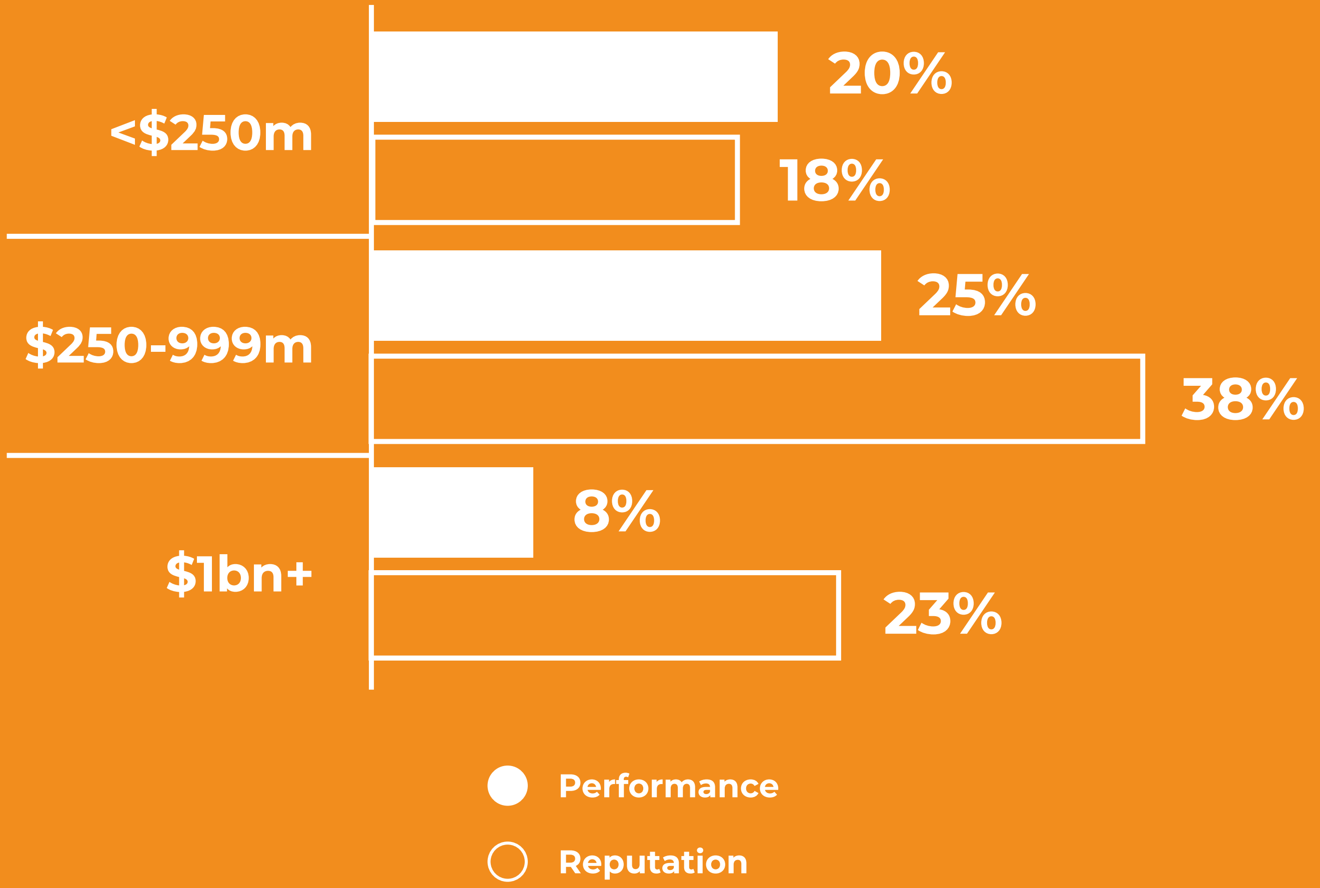
Adam Guren of Hunting Hill Global Capital in the US believes the digital asset industry has entered a new era following the market rebound and spot bitcoin ETF breakthrough. "The upcoming halving in bitcoin [which will slice the reward for mining new bitcoins], election year dynamics, and a potential rate cut cycle later in the year could contribute positively to the digital assets market, influencing price trends and creating a favourable environment for investors," he says.

Gautam Sharma, CIO and CEO at Brevan Howard Digital, is cautious on whether the space has entered a "new dawn" moment. "The reality is that the committed builders and developers have continued to innovate on building scalable infrastructure and experiment with interesting new use cases that leverage public blockchains. The space has made significant progress in the last two years to further improve scalability and reduce transaction costs, so in some sense we are in a 'new phase' of the industry."

KEY FINDING

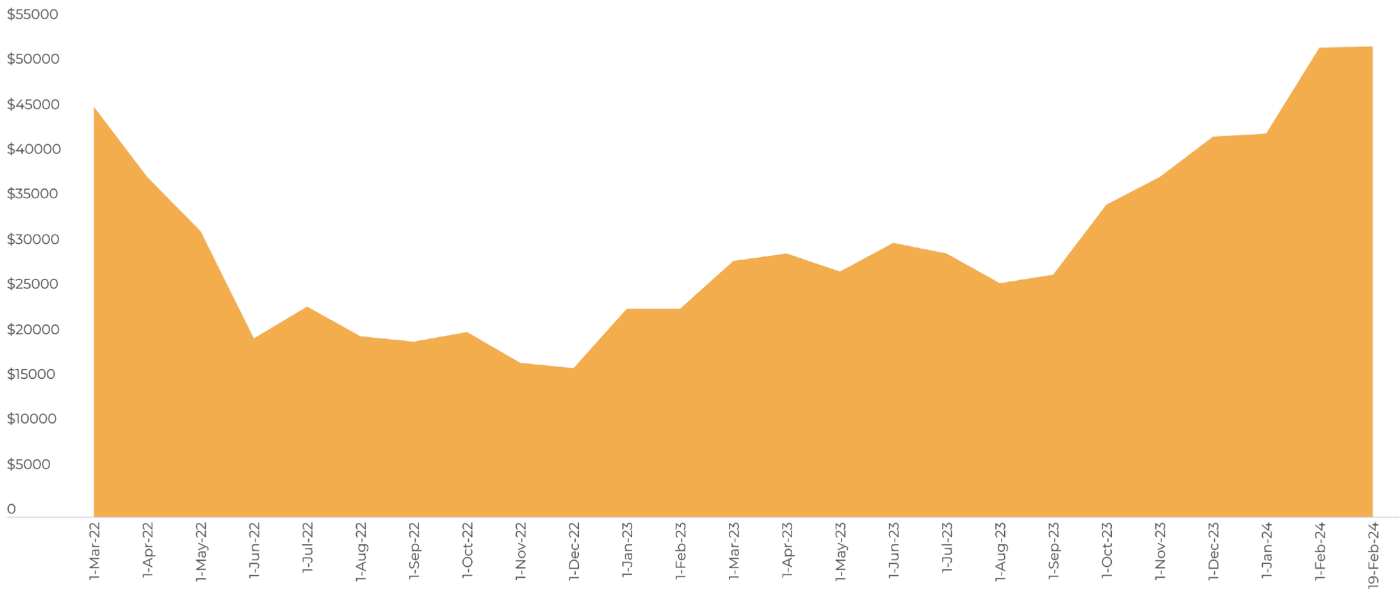
Mid-sized hedge funds worry more about performance and reputational risk in the digital assets space than their bigger peers

Proportion of hedge fund firms that said performance or reputation were the ‘biggest risk’ in relation to the digital assets industry by firm AUM:



IN INSIGHTS

Fig. 1.2 Monthly bitcoin price over the 24 months to 1 February 2024



Analyst note: *Closing price adjusted for splits and dividend and/or capital gain distributions.*

Source: Yahoo

The huge rebound in bitcoin was a key driver of the sector's upsurge (see Fig. 1.2), but sophisticated crypto managers rely on more than the sector's core currency. Peter Habermacher, CEO at London-based Aaro Capital, which invests in multiple crypto funds, points out that most active managers actually underperformed it in 2023.

"But that's to be expected given bitcoin is the star performer out of the bear market, while high-returning active crypto managers add alpha by selecting the best performing altcoins, which tend to underperform in early bull markets, but notably outperform bitcoin over the market cycle.

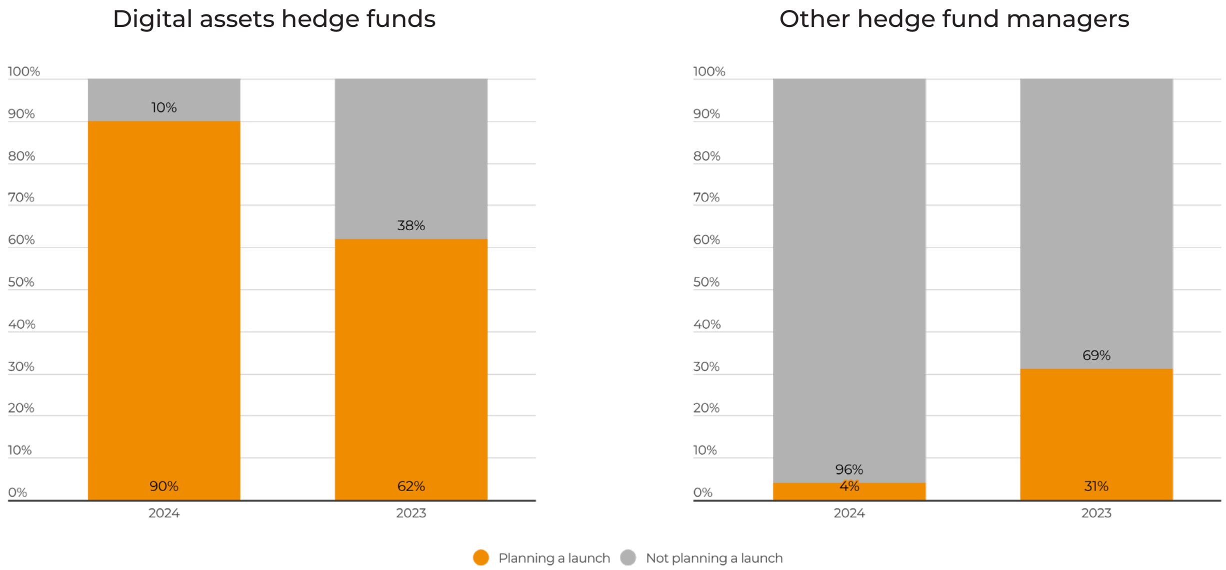
"The phenomenon of bitcoin driving the wider market out of a bear market resembled what we saw in previous cycles."

Aaro reduced its market-neutral exposures in favour of a more bullish approach in the first half of 2023 to take advantage of the increasing price trend.

Confidence in the space has been bolstered by the improved performance. Nine-tenths of digital asset managers are now working on new products, compared to 62% a year ago (see Fig. 1.3).

"On the trading front last year we incorporated a long/ short quant strategy that captures both upside and downside trends in bitcoin and

Fig. 1.3 Hedge fund firms planning to launch a digital assets product in the next 12 months



Analyst note: *Survey respondents were asked in December 2023, 'Do you plan to launch a digital assets hedge fund strategy in the next 12 months?'. For 2023 numbers, the survey took place in January and February 2023.*

Source: Hedgeweek Manager Survey Q4 2023

ethereum while minimising drawdowns," says Samed Bouaynaya, portfolio manager with Altana. "Without using leverage the strategy produced exceptional returns during a volatile period and we are looking to expand it further this year."

REMAINING OBSTACLES

But for mainstream hedge fund managers operating in traditional asset classes, there is less confidence for the time being. Just 4% are considering digital assets products, compared to 31% making plans a year ago.

What is holding them back? Fears over investor appetite (35%) and regulation (33%) were the top concerns for traditional hedge funds (see Fig. 1.4). The same two are the key worries for digital asset managers, though interestingly investor appetite was seen as a bigger obstacle by this group (35%), with regulation just behind, 33% picking it as the top concern.

This suggests more confidence among crypto managers after recent progress on the regulatory front, which has not necessarily fed through into the mainstream yet. Custody risk is still seen as a big obstacle after the scandals of 2021 and 2022, with 17% of mainstream hedge fund respondents selecting it (and 10% of digital asset funds).

“

There is a feeling of optimism, which feels unfamiliar in the US after the difficult past 18 months

Michelle Noyes
Head of AIMA Americas

"New funds are being launched, but I'm not hearing of fund flows and stampeding interest as happened in 2021," says Noyes. "There are a number of investors actively monitoring and wanting to gain increasing confidence in this new cycle before allocating.

"They will also want to understand any operational risk, especially in light of the past cycle's fraud and bankruptcies."

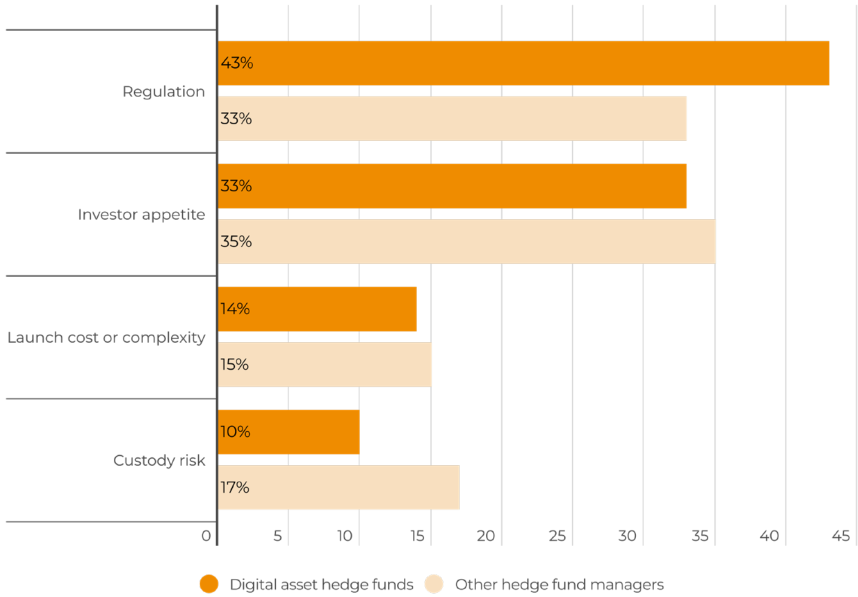
Strong returns and regulatory progress will help, practitioners believe.

"The better performance and positive regulatory news will lead to greater investor demand coming into the space this year," says Habermacher. "Advertising by the likes of BlackRock and Franklin Templeton during this ETF price war will be seen by lots of people who haven't been paying attention to crypto. That will help, as people move on from the FTX implosion."

BH Digital's Sharma describes the bitcoin ETF approval as a "significant milestone" for the digital assets space. "Not only does it allow convenient access to the asset from a much larger investor base, but it also draws attention and mind share from both the retail and institutional investor communities as they see the ETF being offered by some of the most renowned financial players."

Anthony Scaramucci, founder and managing partner at SkyBridge Capital, is more bullish than ever on the future of the industry.

Fig. 1.4 Biggest obstacles to launching a digital assets product according to hedge fund firms



Analyst note: *Survey respondents were asked in Decemeber 2023, 'What do you see as the greatest obstacle to launching a digital assets hedge fund strategy currently?'*

Source: Hedgeweek Manager Survey Q4 2023

"

With so much innovation, it is inevitable a lot of the industry – and regulators – will be catching up

NEIL CHOPRA
Strategy & Business Solutions Director
Fireblocks

What is your take on the digital asset landscape?

I've been in the crypto/blockchain space since 2017, so have experienced the ebbs and flows of recent years. There is no doubt it has been a positive few months, on the back of turbulence from a markets and industry practice perspective.

The pause in growth allowed those in the space to consolidate and evaluate. With so much innovation, it is inevitable a lot of the industry – and regulators – will be catching up a lot of the time. But the pause has allowed time for improved standards and a strong market and regulatory structure to bed in.

Are we on the cusp of a new phase of growth?

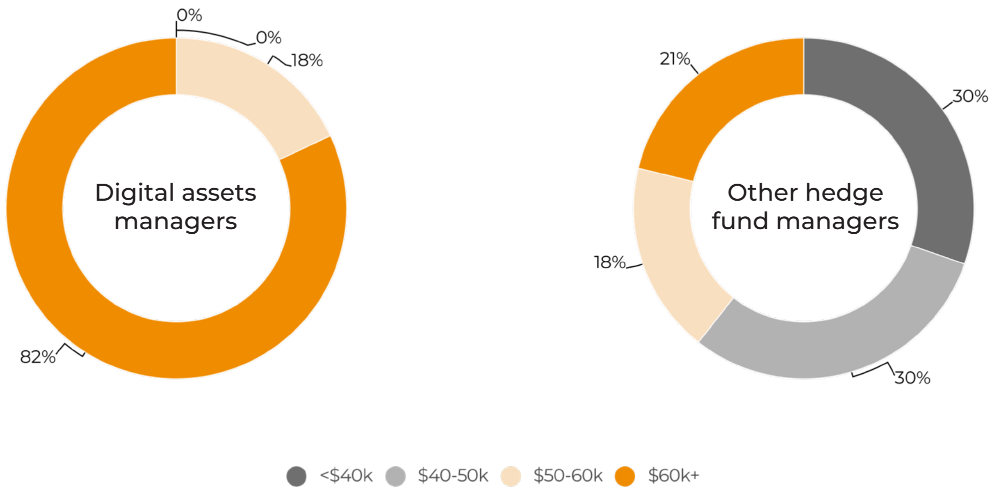
I think the ETF inflows into the space suggest so. Traditional institutions are being pulled into the space. What I'm conscious of internally at Fireblocks is a strong focus on building the plumbing and pipes to support crypto, especially the ETFs that are coming, to reassure the mainstream. So that as tokenized assets come online and we start to get this concept of non-custodial wallets, digital identity and everything we're building on the innovation side will converge and tie together at some point in the future.

At Fireblocks, we're in the unique position to support traditional institutions in building the foundations to support the entire lifecycle of a tokenised asset, everything from issuance, to custody, to trading, to clearing and settlement.

What about crypto-natives?

I think the innovation on that side, particularly over blockchain deployment, will now accelerate. We plan to skate where the puck is going. To enable all of these use cases, we have to engage with all of these different markets, the innovators and the initial adopters of the technology. Institutional trading around crypto is certainly the most evolved at this point. But people are still cautious, post-FTX. Risk management is clearly top of mind for this segment as they look to monetise the next bull run. Things like off-exchange, diversification of key management systems, security in DeFi operations are all very important to crypto institutions to mitigate risks.

Fig. 1.5 Hedge funds' predictions for bitcoin price peak in 2024



Analyst note: *Survey respondents were asked in December 2023, 'Where will bitcoin's price peak in 2024?'*

Source: Hedgeweek Manager Survey Q4 2023

"The past year was fraught with criminal trials, bankruptcy filings and SEC scrutiny of the crypto industry. We view this from a glass half-full perspective, and believe the events of 2023 will lead to much needed regulatory clarity in 2024, particularly regarding the classification of which digital assets are considered commodities vs. securities. This clarity will drive institutional investors, such as hedge funds, pension funds and banks, to see cryptocurrencies as a trustworthy investment vehicle."

Macro and geopolitical volatility could help. "As we head into 2024, an election year, and continue to experience economic uncertainty and geopolitical tension, investors will be forced to be more open to alternative investment ideas, including digital assets. bitcoin is becoming more like digital gold and will be viewed as a safe haven amid rising global conflict and economic upheaval."

Digital asset managers are confident the bitcoin bounce will continue, with 82% seeing a price peak above $60,000 this year (see Fig. 1.5). For traditional hedge funds, 60% don't see it going above $50,000, and just 30% above $60,000.

Altana's Bouaynaya says the sectoral bull market is only just commencing. "We think we're at the beginning of a bull market given many factors – not just the spot bitcoin ETF approvals but also the bitcoin halvening coming in April. The abating inflation worldwide will also make central bank officials ease their monetary policies."

A WATERSHED MOMENT

The SEC's decision to approve the first spot bitcoin ETFs in January 2024 was heralded as a breakthrough moment of credibility for the digital asset space. What happens next?

Is crypto truly becoming mainstream and could the US now become a major hub, providing regulatory certainty? This section explores the regulatory environment in a US election year, institutional allocator interest in the space and the potential impact on a widening opportunity set.

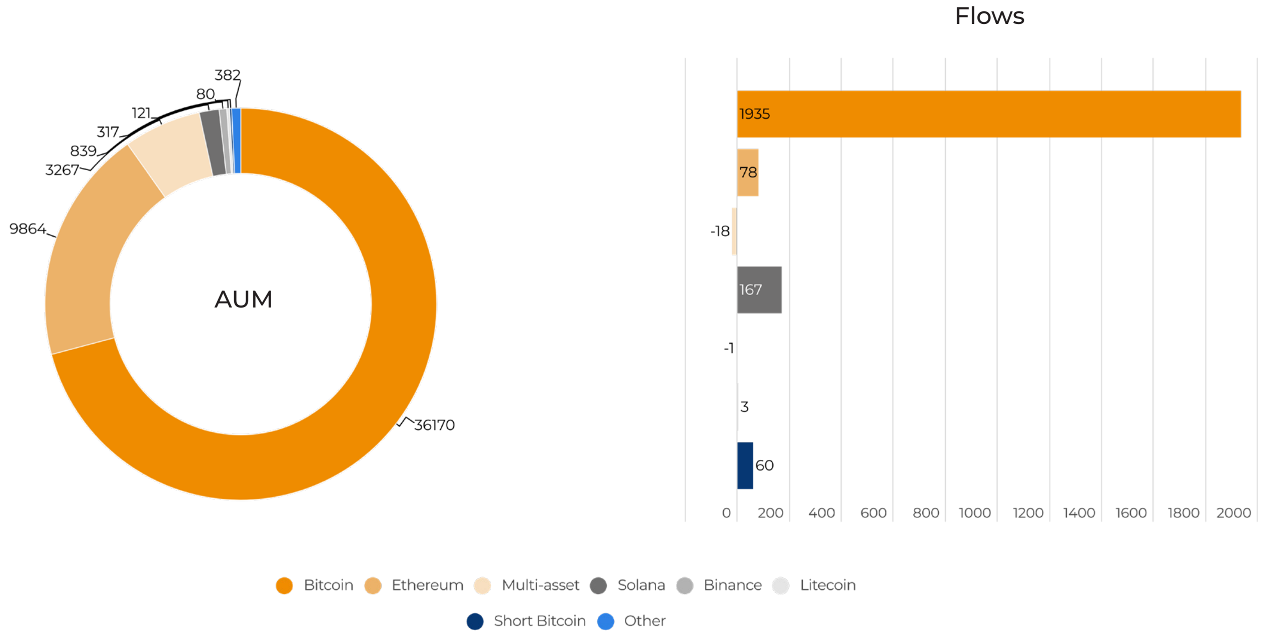
The SEC's announcement in early January 2024 surprised many, despite the increasing uptake of cryptocurrencies, led by bitcoin. There were strong calls to authorise the trading by regular investors of bitcoin price moves, but SEC chair Gary Gensler's perceived opposition to the sector and regular critical comments made it seem unlikely.

His announcement indicated there has not been a wholesale change of heart on the topic of crypto. "While we approved the listing and trading of certain spot bitcoin [exchange-traded product] shares today, we did not approve or endorse bitcoin," Gensler said in a statement. "Investors should remain cautious about the myriad risks associated with bitcoin and products whose value is tied to crypto."

That said, many think it simply had to happen. Peter Habermacher of Aaro Capital describes it as "an expected step, a matter of when not if, but nonetheless very important. Most regulators have clear frameworks for crypto now, but the US has been the outlier with its enforcement-based approach."

For Michelle Noyes, head of AIMA Americas, it was notable how smoothly the launch proceeded as millions of dollars rushed into

Fig. 2.1 Cryptocurrency AUM and flows by asset in 2023 ($m)



Analyst note: *Other comprises XRP, Cardano, Polkadot, and others.*

Source: Coinshares

these new vehicles offered by leading financial institutions. “In terms of both trading and flow metrics, the launch was one of the most successful ever for an ETF and the execution has been smooth.” Some analysts think fresh allocations could exceed $10bn in net inflows by the end of the year.

But there will be bumps along the way. “It is rarely a straight line to price recovery, and many expect ongoing market volatility as in previous path cycles,” adds Noyes. “And while the ETF approvals were broadly considered a win, regulatory hurdles do remain, especially in the US. The Coinbase litigation is being closely watched as is the progress of the SEC’s proposed changes to custody regulation.”

The retail move mirrors what has been happening in the institutional space. Strong flows into digital assets, led by bitcoin, were one of the key themes of 2023, with CoinShares putting the assets under management at $51bn (see Fig. 2.1).

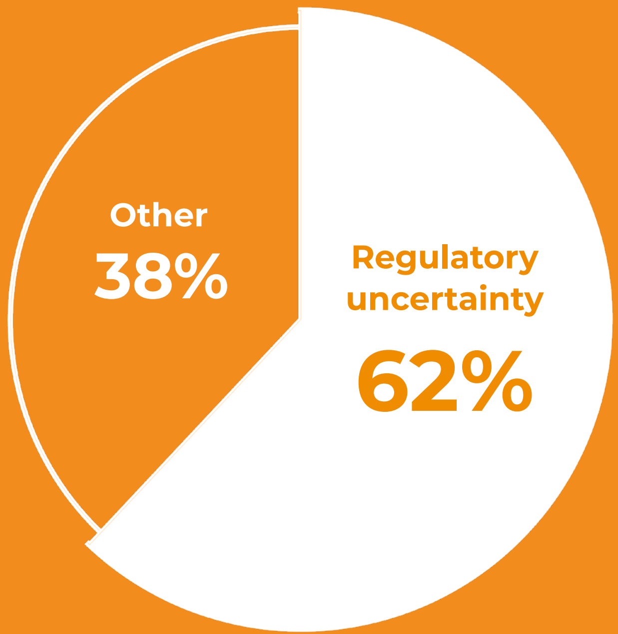
Some indication of the size of the ETF opportunity lies in the $7tn size of the ETF market, a favoured way for US retail investors to gain exposure to traditional asset classes. Now bitcoin has joined them, after longstanding worries over liquidity, price manipulation and the sheer volatility sometimes inherent in crypto markets being too much for retail investors to handle.

The spot ETF approval has without a doubt improved sentiment and pipeline in the digital asset space,” says Russell Thompson, co-founder and CEO, Liberty Road Global. “Firstly, it applies pressure to the most vulnerable part of the market, the spot market, and

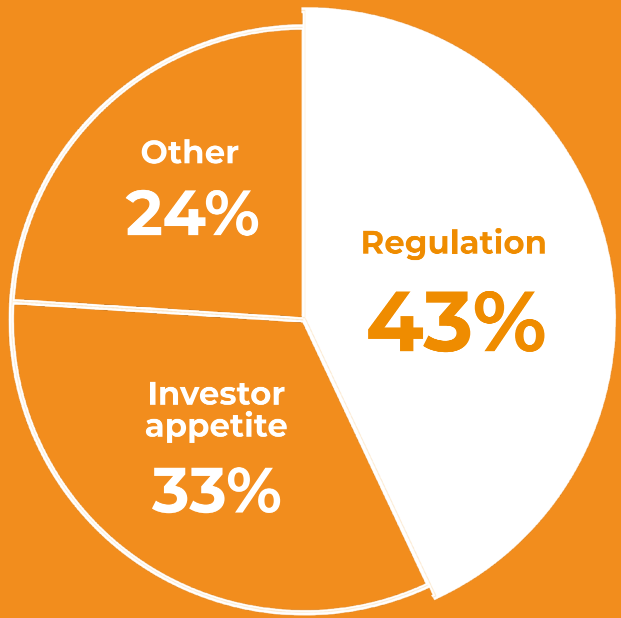
KEY FINDING

Regulation in crypto world is a key worry facing $1bn+ hedge fund firms – and holding back new launches

Proportion of $1bn+ firms naming regulatory uncertainty as biggest risk



Proportion of digital assets firms naming regulation as biggest obstacle to launching new funds



INSIGHTS

while the derivative market is deeper and has more liquidity, the spot market drives price direction so it has been an undoubted factor in the improved performance. A very underappreciated secondary impact of this will be the ability of large institutional players to start allocating bitcoin into their multi strategy portfolios including the likes of pension plans, endowments etc.

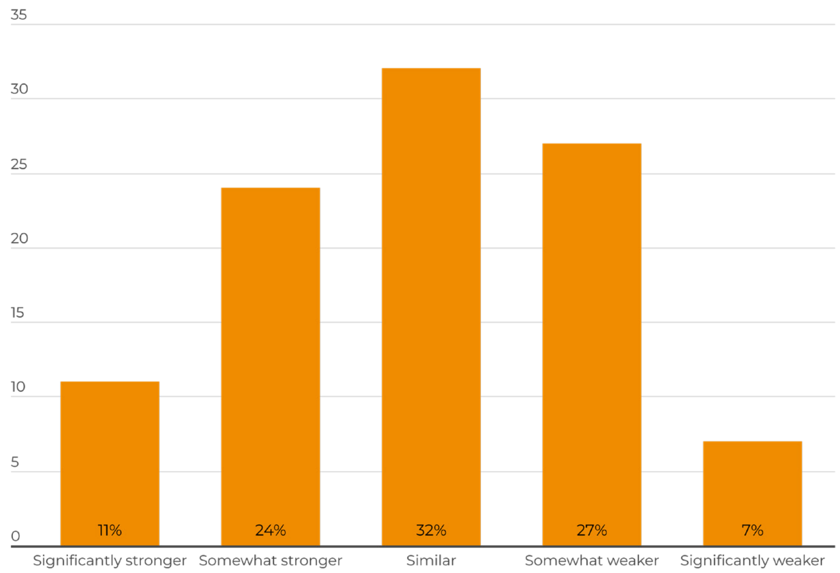
CAUTIOUS INSTITUTIONS

But for all the progress, inflows and regulatory change, opinion is split on institutional interest in crypto, with roughly the same proportion seeing it significantly or somewhat stronger in 2024 as weaker. Almost a third (32%) see it as similar, meaning opinion is split three ways on investor sentiment (see Fig. 2.2).

Samed Bouaynaya, PM of Altana Digital Assets Fund, is positive: "We are already having more investor meetings than last year. An approval of a spot ethereum ETF will normalise the investability of the asset class even further. Ethereum is a composable chain and its applications can be valued with decentralised finance model which resonates well with TradFi analysts compared to bitcoin that is a store of value asset with no cash flows."

Gautam Sharma says bitcoin ETF approval is a "significant catalyst" for client interest. "We expect that interest to continue to pick up further over the course of the year. We are already seeing multiple efforts from institutions exploring real world asset tokenization and the adoption of stablecoins for payments, which we expect to push the space further towards mainstream

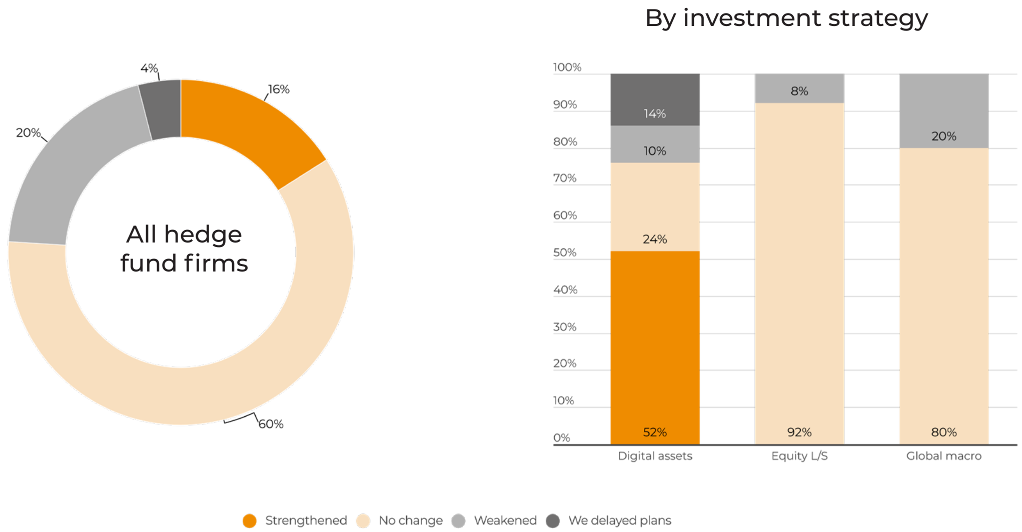
Fig. 2.2 Institutional investor interest in digital assets compared to 12 months ago, according to hedge fund managers



Analyst note: *Survey respondents were asked in December 2023, 'In your experience, how does institutional investors' appetite for digital asset investment products compare to this time last year?'.*

Source: Hedgeweek Manager Survey Q4 2023

Fig. 2.3 Impact of turbulent events on digital asset product development plans



Analyst note: *Survey respondents were asked in December 2023, 'How have events within the digital assets industry over the past 12 months affected your firm's interest in developing digital assets products and/or services?'.*

Source: Hedgeweek Manager Survey Q4 2023

acceptance. It is a matter of when and not if anymore."

Adam Guren of Hunting Hill Global Capital and SkyBridge Capital founder Anthony Scaramucci also see more institutional interest on the horizon.

"To further encourage mainstream acceptance, our ongoing commitment includes educational initiatives highlighting the practical use cases of digital assets and blockchain," says Guren.

"Additionally, our focus on navigating evolving regulations reflects our dedication to ensuring institutional-quality products that meet the highest standards in the rapidly evolving digital assets landscape."

Scaramucci predicts that the institutional adoption of bitcoin and other digital assets will be accelerated by the SEC's approval of the spot bitcoin ETF.

"This investment vehicle will restore trust in the industry and traditional financial institutions will get in on the action. Having these assets supported by institutional industry giants, will bring a spotlight to the powers of the underlying technology of the blockchain and its potential to transform the world as we know it."

The events of the past year have certainly impacted the digital asset sector plans of some, with 20% saying their interest in doing so is weaker as a result and 4% even delaying plans (see Fig. 2.3). That said, the majority (60%) say there has been no change and 20% say their plans have strengthened.

A compelling majority of 94% says the post-FTX trend of enhanced due diligence and more robust risk management practices, which have dominated in 2023, will endure in 2024 (see Fig. 2.5). This suggests a more cautious mood going forward, with just 6% saying the focus should now be on innovation, moving away from more new safeguards.

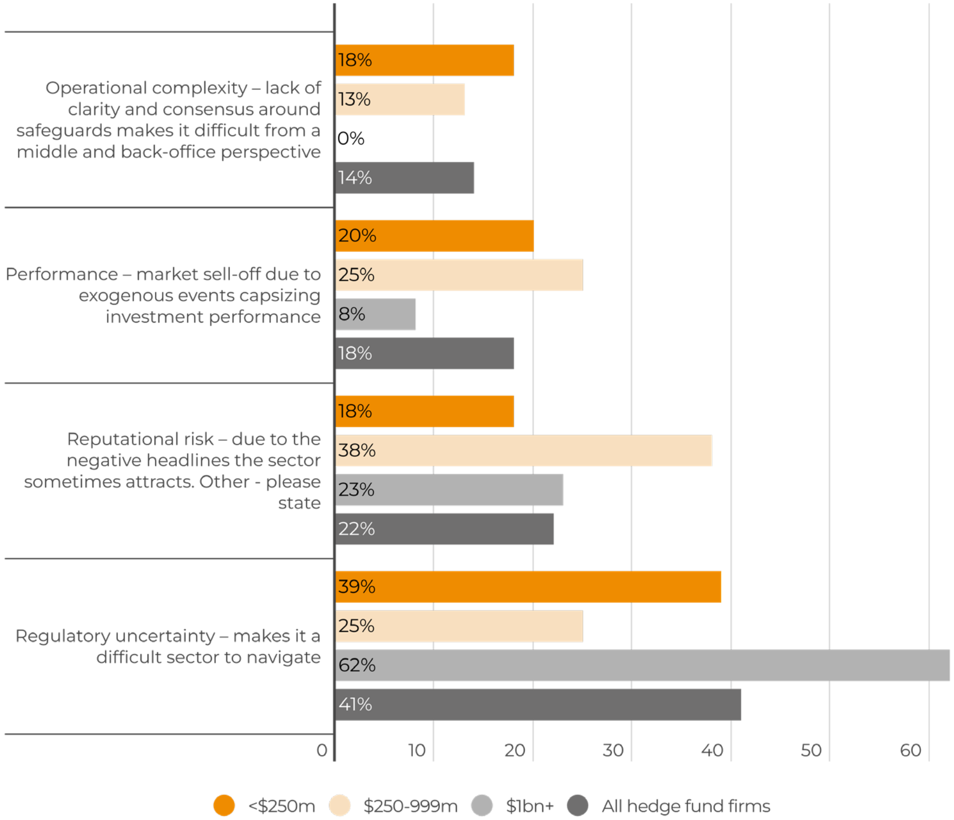
Is the US now seen as a more reliable hub for the sector? Respondents to Hedgeweek's survey – sent before the SEC's approval

“

[Bitcoin ETFs] will restore trust in the industry and traditional financial institutions will get in on the action

Anthony Scaramucci
Managing partner, SkyBridge Capital

Fig. 2.4 Looking back – views on sectoral risks before the SEC's approval of spot bitcoin ETFs



Analyst note: *Survey respondents were asked in December 2023, 'What is the biggest risk you see in the digital assets space?'*

Source: Hedgeweek Manager Survey Q4 2023

was revealed – had been lukewarm, at best. Regulatory uncertainty was viewed as the leading risk factor for the space, highlighted by 41% of managers – and an overwhelming 62% of $1bn-plus firms (see Fig. 2.4). Reputational risk (22%) and performance (18%) were the other key concerns.

Aaro Capital's Peter Habermacher hopes there will be a new set of crypto-specific regulations from the US at some point, with several proposed bills currently in congress. "The SEC was almost forced post-Grayscale court ruling to approve the spot ETFs, but it is nonetheless a major step, and demonstrates the infrastructure is now secure enough for US retail investors."

Practitioners agree the spot bitcoin ETF were a major step and expect more to follow, maybe with an ether equivalent to begin with. But US regulatory caution means it may not be quick.

"I think the interesting element of this now from a regulatory perspective is how do they regulate if at all the technology and we're seeing sort of different perspectives from different jurisdictions," says Neil Chopra, who leads strategy and business solutions at Fireblocks.

"The concept of crypto as a market and blockchain as a technology is key. Because if you look at a lot of the traditional institutions like banks, they see the value in a more efficient technology that can be leveraged for traditional assets. Whereas more on the asset manager side, I think their first foray into this will be either exposure or access to crypto assets themselves directly."

2024 plans

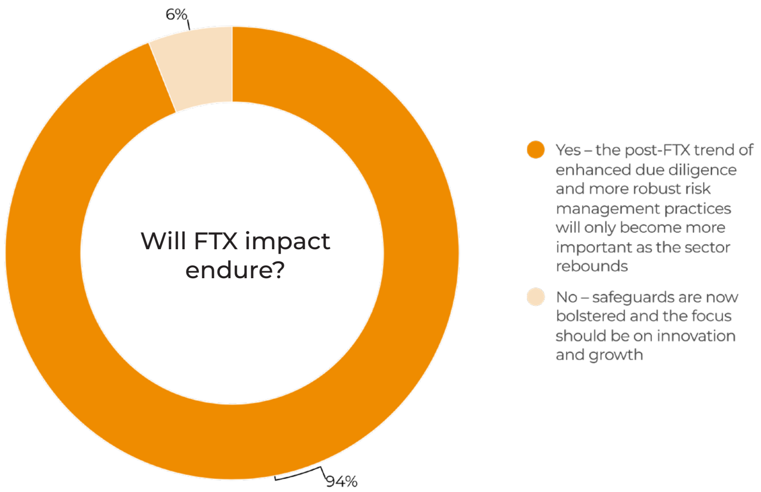
The crypto sector is not sitting on its laurels heading into the rest of 2024.

Gautam Sharma of Brevan Howard Digital aims to capitalise on the significantly improved market liquidity, especially in the derivatives space. “With several upcoming catalysts in the majors such as Bitcoin halving, expected Ethereum tech upgrades, re-staking, and potential Eth ETF approval, we will be looking to leverage derivatives to express our short to mid-term views on these assets in a risk-managed way.”

On the infrastructure side he continues to see innovation on scaling blockchains while reducing transaction costs and expects this to be a big theme this year. “We also expect ZK proof-based solutions to further the infrastructure upgrade theme in the space. This will also unlock many uses cases across social economy, stablecoins, gaming, and real-world asset tokenization that will be economically viable for developers and users.”

For Adam Guren of Hunting Hill Global Capital, the overarching theme is a commitment to identifying investments with tangible use cases for digital assets and blockchain technology. “Our current focus revolves around financial services and consumer brand customer engagement. We are poised to navigate dynamic regulatory landscapes in the US, explore lucrative DeFi yield opportunities, and begin emerging blockchain initiatives with a sustainability focus.”

Fig. 2.5 Will the post-FTX trend of enhanced due diligence and more robust risk management practices endure?



Analyst note: *Survey respondents were asked in December 2023, ‘Will the post-FTX trend of enhanced due diligence and more robust risk management practices, which have dominated this year, endure in 2024?’.*

Source: Hedgeweek Manager Survey Q4 2023

CONCLUSION

2024 is set to be a defining year for the digital asset fund industry. It began during an ongoing crypto rally, which supported performance, and a plethora of new opportunities for managers to explore. Hedgeweek survey respondents and interviewees were notably bullish, though there was a contrast between 'crypto natives' and those from more traditional finance backgrounds. Risk management will be key going forward as the industry looks to move on from fraud and volatility-linked incidents which have damaged trust. Progress in these areas will help bring mainstream managers onside.

The SEC's decision to approach bitcoin spot ETFs has already acted as a spur to allocator confidence and industry growth. Bitcoin halving, the possibility of more crypto spot ETFs and the upcoming US elections were also identified as key moments which could generate more opportunities ahead. As Anthony Scaramucci points out, geopolitical volatility can help the sector as it strengthens the safe harbour credentials of crypto. But an unrelenting institutional focus will be key. Investors have enough uncertainty in their portfolios and the wider market and business landscape without wanting to worry about negative crypto incidents.

The industry will have the best chance of enduring success if it can develop its track record of better performance and an institutional mindset in the coming years.

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