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How to Play Crypto Now: 4 Things We Learned From the Crash

By Joe Light Follow Oct. 6, 2022 1:30 am ET

Illustration by Allison Vu

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Crypto isn't dead, but its core tenets are on life support. Gone is the illusion that Bitcoin BTCUSD +0.51% is an inflation fighter. The first serious bout of inflation since the 1970s has coincided with a 60% drop in Bitcoin's price over the past year. Gone too is the case that Bitcoin is "digital gold." The precious metal has cruised past Bitcoin, stocks, and bonds this year, falling just 6%.

But it would be a mistake to interpret the travails for Bitcoin as evidence that the whole industry is a blunder. Ethereum, the second-largest blockchain, just went through a major upgrade that could fuel a renaissance of crypto activity. Companies backing other blockchains still aim to establish new systems for financial products, payments, and digital assets.

Just as the internet survived the extinction of Pets.com, the crypto crash isn't an epitaph for blockchain technology. Indeed, scrape away the junk and what remains is an industry worthy of a second look. "In prior crypto cycles, you had engagement drop. Here, more people are using digital assets and building on top" of blockchains, says Bank of America crypto strategist Alkesh Shah.

Investors still need to be wary. Dogecoin **DOGEUSD +0.59%**, the "meme" token that started as a joke, retains a market value of $8 billion, similar to the equity of companies like American Airlines Group (ticker: AAL). Despite the token market losing $2 trillion in value, a lot of froth remains. "The durability of crypto assets is questionable," says Cornell University professor Eswar Prasad, a leading digital-asset expert. "But there does seem to be some durability to the technology."

Here are four lessons to consider if you're thinking of investing in crypto.

Bitcoin is still searching for a reason to exist

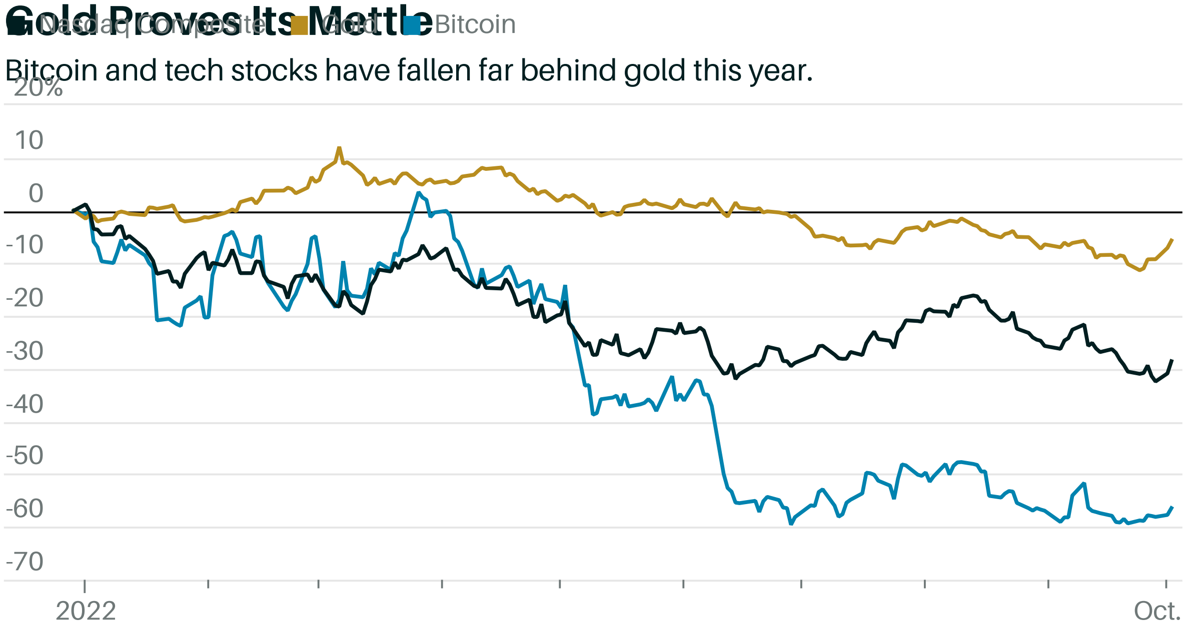
Bitcoin's supporters have spent a decade promoting its use as a currency beyond government control, as digital gold, and as an inflation hedge whose restricted supply will protect its price. The token has failed to live up to those promises.

Moreover, there's scant agreement on what Bitcoin really is: just another set of software rules, a truly revolutionary technology like the internet, or a quasi-currency that may one day be worth $500,000 a coin—as some bulls argue—up from $20,000 today.

“It makes me think of the parable of the blind men around the elephant,” says Morningstar senior analyst Madeline Hume. None of the men can figure out what an elephant really is because each can only feel a single attribute like a tusk or hide. “We are slowly stumbling toward an understanding of what Bitcoin is,” she says.

Gold Proves Its Mettle

Bitcoin and tech stocks have fallen far behind gold this year.



Source: Bloomberg

The role of Bitcoin as an alternative asset remains dubious, too. The crash punctured the belief that the crypto market can defy the macro pressures that have pushed the Nasdaq Composite Index **COMP -0.25%** down 29% this year. Bitcoin’s correlation to the Nasdaq hit a record high in September and has averaged 0.66 for the past six months, indicating that Bitcoin and tech stocks often move in unison.

Despite the drawbacks, proponents like Shah argue that Bitcoin and other cryptos are still viable long-term investments. “People are realizing that digital assets are acting as an internet operating system, like high-growth segments of the economy,” he says.

Big money flooded in. That’s no seal of approval.

Before the crash, one of crypto’s big selling points was that it had attracted institutional capital from pension funds and venture capital firms. Why would these sophisticated funds plow savings and investment into crypto companies built on flimsy promises of revenue and profits? The thinking, at the time, was that they wouldn’t. That created a selling point to lure even more capital from retail investors.

But the big money got burned, just like many small investors, as the market burst. Take Celsius Network, a crypto-lending firm that attracted more than $20 billion in client deposits, partly on the pitch of paying yields as high as 18%. Celsius is now operating under bankruptcy protection, its CEO has quit, and thousands of investors are trying to recoup their savings.

> **“Bitcoin might double in price if there’s a CFTC-regulated market.”**
>
> — CFTC Chairman Rostin Behnam

Yet eight months before Celsius halted customer withdrawals in June, the company raised $400 million in a funding round that included Caisse de dépôt et placement du Québec, the second-largest pension fund in Canada. “No one would be investing this amount of money in Celsius if there was any serious concerns that what we’re doing is not legit and is not following all the regulations," the former CEO, Alex Mashinsky, said in a video livestream a few days after the funding announcement.

The pension fund has since marked down its Celsius investment. Charles Emond, head of the 392 billion Canadian dollar ($288 billion) fund, said during an August press conference that the losses were "not even a rounding error in our returns," according to the Montreal Gazette, though he has said he's considering legal options after writing off the fund's $150 million investment. Celsius didn't respond to a request for comment.

Venture capital firm Andreessen Horowitz—the largest backer of crypto start-ups in Silicon Valley—may also be suffering. The firm invested more than $7 billion in crypto start-ups, including $314 million in tokens issued by Solana Labs. The Solana **SOLUSD +0.39%** token spiked to $259 in November but now trades at $33, declining amid concerns about the network's security and ability to scale. Andreessen and the Solana Foundation declined to comment.

Venture funds expect most of their bets to flop, while hoping that one will be the next Meta Platforms (META). Retail investors shouldn't take solace in a venture capital riding shotgun with them, says David Nage, a portfolio manager for crypto investment firm Arca. "If it's a larger fund and smaller check, the amount of bandwidth and support given to that project is fairly low," he says.

Separate blockchain infrastructure from tokens.

Many big companies are betting that blockchain technology will survive long after the purely speculative tokens have vanished. The thinking is that blockchains and related digital assets offer ways of reaching new markets—whether its videogames, financial products, or new iterations of art, music, and video repackaged as nonfungible tokens, or NFTs.

The plans range from the trivial to dead serious. On the one hand, Starbucks (SBUX) last month said it would roll out "digital collectible stamps" that give its most loyal customers "access to immersive coffee experiences." That isn't likely to move the needle for a company on track for $33 billion in sales this year.

On the other, Swift, the interbank messaging system that handles trillions of dollars in global transactions, is testing a system that would allow messages to direct token transfers. If it works, banks could start sending money over blockchains with a method they already use to transfer traditional funds.

"We're in a crypto winter but we're definitely not in an infrastructure winter," says Will Peck, head of digital assets at exchange-traded fund provider WisdomTree Investments (WETF). "Everyone is still talking about building blockchain-based infrastructure." WisdomTree itself just launched a short-term Treasury fund that trades on the blockchain, the Short-Term Treasury Digital fund, which it says can allow for faster clearing and settlement.

Investing in companies serving the crypto industry is less risky than buying tokens. One standout is Silvergate Capital (SI), a bank that's developing services for crypto brokerages, financing firms, and others in the industry. Silvergate managed to grow its crypto customer base through the crash. Its net income is expected to grow 72% in 2023 to $277 million.

The stock trades at two times book value, well above the bank industry average. But Wall Street still loves it; the average price target is $129, implying 63% upside from its current price around $79.

Other crypto-related stocks include Signature Bank (SBNY), PayPal Holdings (PYPL), Block (SQ), and Coinbase Global (COIN). Aside from Coinbase—the big digital-asset exchange—these companies are all building crypto services alongside their core businesses.

Granted, crypto stock performance has been hideous. The Amplify Transformational Data Sharing BLOK -1.00% ETF (BLOK), the largest ETF holding crypto-related companies, is off 50%. That counts as a victory against rivals like the Global X Blockchain ETF (BKCH), off 70%.

Shah says investors should view crypto as a way for large companies to future-proof their earnings. "The incumbents that are embracing the technology, doing pilots or getting educated, could do well over the next five to 10 years," he says.

Regulation could really help.

Even as others experiment with crypto, most banks have stayed on the sidelines. A recent Basel Committee report found that large banks held only 9.4 billion euros ($9.2 billion) worth of crypto exposure on their books, a pittance of overall assets.

One big reason? They can't dive in without regulatory clarity. But that may be coming. Regulators are now developing rules for financial institutions to own crypto and offer crypto-related services to clients. Legislation in the Senate, for example, would direct federal agencies to put most of the crypto market under the jurisdiction of the Commodity Futures Trading Commission. Other bills address whether the Securities and Exchange Commission should police exchanges or whether crypto banks should gain access to the Federal Reserve's core services.

Without more regulatory certainty, a large slug of companies won't touch crypto. Today, if an executive tries to get approval for a legally ambiguous crypto product, the in-house lawyer "is going to choke on his breakfast," says Charley Cooper, managing director at R3, a blockchain software firm.

Rules with bipartisan support in the Senate have a decent chance at passing next year. The proposals also appear aligned with the Biden administration's recently announced regulatory framework for the industry.

A level playing field between crypto upstarts and banking firms would be a win for Wall Street. And it could trigger a wave of investment as legal protections for institutions and consumers settle in.

"Bitcoin might double in price if there's a CFTC-regulated market," said CFTC Chairman Rostin Behnam in September. Sounds impressive? That would still leave Bitcoin 40% below its peak price.

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