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INVESTMENTS

Wealth management in the age of digital assets: How financial advisors can find opportunities amongst disruption

JAMES McDONALD | TYLER SALATHE

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DEAR READER,

Welcome to edition 51 of the Capco Institute Journal of Financial Transformation.

The global wealth and asset management industry faces clear challenges, and a growing call for innovation and transformation. Increased competition, generational shifts in client demographics, and growing geopolitical uncertainty, mean that the sector needs to focus on the new technologies and practices that will position for success, at speed.

There is no doubt that technology will be at the forefront of a responsive and effective wealth and asset management sector in 2020 and beyond. The shift to digitization, in particular, will see the speeding up of regulatory protocols, customer knowledge building, and the onboarding process, all of which will vastly improve the client experience.

This edition of the Journal will focus closely on such digital disruption and evolving technological innovation. You will also find papers that examine human capital practices and new ways of working, regulatory trends, and what sustainability and responsible investment can look like via environmental, social and corporate governance.

As ever, I hope you find the latest edition of the Capco Journal to be engaging and informative. We have contributions from a range of world-class experts across industry and academia, including renowned Nobel Laureate, Robert C. Merton. We continue to strive to include the very best expertise, independent thinking and strategic insight for a future-focused financial services sector.

Thank you to all our contributors and thank you for reading.

A handwritten signature in black ink, appearing to read 'Lance Levy', with a stylized, flowing script.

Lance Levy, **Capco CEO**

WEALTH MANAGEMENT IN THE AGE OF DIGITAL ASSETS: HOW FINANCIAL ADVISORS CAN FIND OPPORTUNITIES AMONGST DISRUPTION

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ABSTRACT

The advent of digital assets has led to the creation of new financial products with the ability to fundamentally change where and how wealth is invested. For wealth managers, the new asset class and varying products present both a challenge and opportunity. On one hand, digital assets allow retail investors to personally invest in tokenized alternative assets with minimal capital, diminishing the need for a financial advisor or broker. On the other hand, new product classes such as cryptocurrencies and security tokens can be added to wealth managers' existing portfolios as means to diversify holdings and corner an increasingly demanded market of blockchain-based assets.

This paper should be viewed as a starting point for wealth managers who are concerned about potential business disruptors or growth opportunities associated with digital assets. We will review cryptocurrencies, stablecoins, initial coin offerings, and security token offerings, and discuss their significance for wealth managers. We will also focus on an increasingly popular application of security token offerings, termed tokenization, and discuss how wealth managers may use tokenized products to supplement portfolio offerings.

While the full effect of digital assets to a wealth manager's business is still yet to be determined, forward thinking financial advisors will need to be prepared for this asset class marketplace in order to avoid potential disruption. Financial advisors should take proactive strategic steps, such as enhancing their digital capabilities or upskilling their staff on the benefits of digital assets, to ensure that they are well equipped to serve their clients' changing needs.

1. INTRODUCTION

The past few years have experienced a rapid expansion of the use of digital assets within global financial markets. With momentum fueled by retail investors on various online digital exchanges, the total market capitalization of globally-traded cryptocurrencies has increased threefold between March 2016 and March 2017.¹ By 2018, that number grew by another 500 percent.² During this period, the Chicago Mercantile Exchange (CME), the world's largest derivatives

exchange, began listing futures and options for institutional buyers on the most liquid cryptocurrency, bitcoin.³ Fidelity and other asset managers⁴ established independent "digital asset" departments within their companies. Multiple banks and asset managers were reported to be setting up internal cryptocurrency trading desks. And, then in early January 2018, the global cryptocurrency market plummeted, losing 83 percent⁵ of its market capitalization and the value of bitcoin within the next year.⁶

¹ Rauchs, M., and G. Hileman, 2017, "Global cryptocurrency benchmarking study," Cambridge Centre for Alternative Finance, <https://bit.ly/2VWedSK>

² <https://bit.ly/2lBJtPn>

³ <https://bit.ly/2PZFz7g>

⁴ <https://bit.ly/2TQ2TVX>

⁵ <https://bit.ly/3aCw0TC>

⁶ XBTUSD <GO>, GP <GO>, 12-18-2017 – 1/18/19. Bloomberg Terminal. Accessed: 2/16/20.

The sudden shift from crypto-optimism to pessimism within financial markets led to a pivot from traditional cryptocurrencies such as bitcoin to multi-use digital assets and securities. It also allowed regulators such as the U.S. Securities and Exchange Commission (SEC) to better define regulatory requirements for digital assets,⁷ provide guidance to those seeking to issue and trade them,⁸ and fine fraudulent and predatory digital cryptocurrency firms.⁹ While today the market capitalization of cryptocurrencies is smaller than in 2017, the various uses of digital assets and their applicability to financial markets have grown considerably.

To those managing investment portfolios for themselves or others, the growth of new types of digital assets presents both a disruption possibility and a unique opportunity. For example, an increasingly interesting way digital assets can be utilized is to tokenize tangible alternative assets such as real estate, providing digital ownership that can eventually be further fractionalized and freely traded on secondary exchanges. Illiquid asset markets encumbered by high barriers to entry and slow title transfers could see an approved individual investor buying 1/10,000th of an ownership stake in an alternative with the click of a button. Fractionalized alternative ownership coupled with cryptocurrency holdings could thus present a new and growing market for those seeking to further diversify any investment portfolio. Because of the digital nature of these assets, not only do they provide new products to invest in but can also change how asset managers invest and in what ways they reach their clients.

In this article we will provide an overview of tokenization, future opportunities for wealth managers and their clients, and how financial advisors can best respond to the new world of digital assets.

2. IMPACT OF NEW DIGITAL ASSET PRODUCTS

It is important for wealth managers to understand the complete scope of products that the new digital assets world offers when determining the best response strategy. With the collapse of the cryptocurrency markets and subsequent shift towards multi-purpose digital assets, wealth managers should

develop specific responses for each of these new products. We detail these products below and potential opportunities for wealth managers.

2.1 Cryptocurrencies, initial coin offerings, and security token offerings

2.1.1 CRYPTOCURRENCIES

Cryptocurrencies are in many respects the simplest form of digital assets – digital tokens that are traded and understood similar to global commodities. Cryptocurrencies such as bitcoin have been classified by the Commodities Futures Trading Commission (CFTC) as such¹⁰ and are freely traded in new digital retail marketplaces, or in the form of listed futures¹¹ and indices.¹² Due to the rise of firms that provide exchange and custody services, such as Coinbase or Gemini, potential investors are able to easily open cryptocurrency wallets online and purchase widely-traded tokens using U.S. dollars or other fiat currencies from their bank accounts.

It is prudent here to highlight why wealth managers should expect client interest in digital asset products. The U.S. is currently undergoing one of the largest wealth transfers in its history, with millennials set to inherit over U.S.\$68 trillion from their predecessors, holding five times as much wealth as they have today.¹³ With more than half a million millennials already with six figures and growing, it is an important target group for wealth managers who traditionally service a clientele whose average age is 64.¹⁴

Not only are millennials inheriting wealth en masse, they are also increasingly gravitating towards cryptocurrencies for investment opportunities. A report by Charles Schwab comparing equity holdings by generations found that the Grayscale Bitcoin Trust is ranked as the fifth most held equity asset by millennials.¹⁵ According to a survey conducted by the financial services company eToro, 43 percent of millennial respondents active in online trading trust cryptocurrency exchanges more than their traditional equities counterparts; double that of Gen X respondents.¹⁶ Even for those millennials that do not trade themselves, one-third said they would trust cryptocurrencies over the stock market. The same

⁷ <https://bit.ly/2TD2PKF>

⁸ <https://bit.ly/39At5e5>

⁹ <https://bit.ly/2PY8JDz>

¹⁰ <https://bit.ly/3330ewD>

¹¹ <https://bit.ly/33306gD>

¹² <https://bit.ly/2W05D5V>

¹³ <https://bit.ly/3alCjFj>

¹⁴ <https://bit.ly/2wJqIXy>

¹⁵ <https://bit.ly/2TBW9fM>

¹⁶ <https://prn.to/2PYqLFX>

study found that 59 percent of millennials who do not trade cryptocurrencies said they would invest if offered by a traditional financial institution.

These statistics can be packaged in any number of ways, but the story is clear: millennials are inheriting large amounts of wealth and with their strong interest in cryptocurrencies they will likely look for digital asset diversification when investing with their financial advisors.

2.1.2 INITIAL COIN OFFERINGS

Initial coin offerings were the original and most popular way for firms to raise funds to finance blockchain-based projects. At the time, people generally viewed an initial coin offering as the crypto-asset equivalent of an initial public offering (IPO) allowing retail investors the ability to participate. The newly issued coins are bought with widely traded cryptocurrencies such as bitcoin and ethereum, and in some cases can even be purchased with traditional fiat currencies.

Unlike the shares sold in an IPO, initial coin offerings generally do not give their purchasers any ownership in the issuing company. Their value is instead indirectly linked to the success or failure of the blockchain project. Depending on the structure and purpose of the underlying tokens, certain ICOs are not required to register as security token offerings with the SEC. Some, such as TurnKey Jet, Inc., structure their tokens as utility tokens that function as transferrable software licenses by providing their holders with access to the company's decentralized applications (DApps).

This distinction does not mean that all token offerings characterized as initial coin offerings are inherently unregulated by the SEC, nor does it exempt companies from registration requirements if they characterize their tokens as utility tokens in name only. In fact, the SEC has increasingly scrutinized and enforced its oversight on initial coin offerings, such as with the cases of Telegram¹⁷ and Kik.¹⁸ As a result of this increased regulatory scrutiny and the high failure rate of previous initial coin offerings, the potential disruption to wealth managers and the role that these "securities" play in a diversified portfolio remains to be seen.

2.1.3 SECURITY TOKEN OFFERINGS

Simply put, security token offerings are regulated coin offerings, used to raise funds for a blockchain project or to release equity/cash in a physical asset. Security token offerings have great potential and new use-cases are still

emerging. Just as digital certificates are offered to equity investors in an IPO, ownership information for security token offerings is recorded on the associated blockchain and issued to the owner as a security token. The same regulations that govern traditional IPOs and associated securities would apply to tokens offered through security token offerings. Conversely, an initial coin offering may structure their digital assets as utility tokens to avoid having to register their token offering with the SEC. More information on this distinction can be found in our paper detailing initial coin offering registrations with the SEC.¹⁹

One of the more interesting applications of security tokens is their ability to tokenize otherwise illiquid assets. We explore the potential benefits of tokenization below.

3. TOKENIZATION

3.1 Benefits of tokenization

Tokenization can be defined as the creation of security tokens that represent legal ownership in an underlying tangible product, effectively "tokenizing" an otherwise non-digital asset. The idea behind tokenized securities is that easily transferrable ownership will help make traditionally illiquid and inaccessible assets more accessible to retail investors, thereby allowing their incorporation into both retail trading and portfolio construction activities. Once tokenized, valuable alternative assets, such as buildings or expensive pieces of art, can be divided into digital fractional shares. Increasing the number of direct interests in any one asset decreases the minimum investment requirement, thus circumventing the traditional cost and specialization barriers associated with illiquid alternatives markets.

While all assets can theoretically be tokenized, the alternative investments space would greatly benefit from fractionalized ownership and a more efficient transfer of rights. Specialized due diligence costs, closing fees, transaction complexity, and opaque data sources all contribute to illiquidity in alternatives markets. The ability to tokenize and fractionalize traditional asset ownership would allow for increased market liquidity, more data transparency, and lower barriers to entry for market participants. For wealth managers, it means the ability to potentially include easily-transferrable alternative asset ownership as part of portfolio offerings. We elaborate on some of the key characteristics and benefits of tokenized assets in the following sections.

¹⁷ <https://bit.ly/33cUWuF>

¹⁸ <https://bit.ly/2luHDA7>

¹⁹ <https://bit.ly/330I6nW>

3.1.1 INCREASED LIQUIDITY

Distributed ledger technology (DLT) allows for the bilateral exchange of security tokens without a central mediator, bank, or clearinghouse. Once tokens are created and distributed by the original owner of an asset, they can then be traded on other secondary markets without the participation of the original token distributor, making traditionally illiquid investments easier to exchange. With lockup periods on fund investments and costly processes involved in the transfer of alternative asset ownership, the ability to digitally represent the ownership rights in these assets and transfer them within minutes would drastically change how their markets operate.

For traditional retail investors or small wealth managers looking to gain exposure to alternative assets such as real estate, hedge funds, or private equity, large amounts of up-front capital and established networks are required to successfully invest. Alternatives such as REITs or fund-of-funds exist and provide additional liquidity but they generally do not provide investors full decision-making control in the underlying asset holdings. With tokenization and fractionalization, investors can invest smaller amounts of capital in individual assets, promoting accessibility that creates more liquid secondary markets.

3.1.2 EFFICIENCY AND DATA AVAILABILITY

The process for buying and selling many alternative assets includes intermediaries with opaque sources for data and fees. Non-digital procedures, a high degree of specialization necessary to perform operational functions, and months-long clearing and settlement processes make ownership transfers within the alternatives market inefficient and costly. Digital security tokens instead have information recorded on an immutable ledger available to those who participate in the transaction, and other additional parties in some cases. Ownership rights, financial transaction information, and previous title transfers can be made available to the potential buyer who is in turn vetted as a credible market participant.

Compared to the alternatives space, equity markets have an abundance of information available on public and private platforms that a variety of investors can use to make investment decisions. It is much easier to access stock performance information than that of an antique art piece or apartment duplex because of the data and tools currently

available. Security tokens and their resulting secondary markets would perform a similar function for alternative assets. Smart contracts could record a variety of underlying financial data on each asset, with digital exchanges providing individual investors access to information that is not currently as readily available for assets such as real estate or art.

3.1.3 FRACTIONALIZATION

Fractionalization can be understood as the ability for digital securities to be infinitely divisible. As the number of security tokens released on a blockchain platform is entirely customizable, ownership stakes in the underlying assets can be divided and represented by any number of tokens. With each ownership stake digitally recorded on a distributed and immutable ledger, traditionally high-cost assets can be divided amongst a marketplace of investors. As full ownership of the underlying asset is no longer necessary, the fractionalization of tokenized assets would immediately lower barriers to entry for alternative asset investors. Fractionalization can also potentially lead to efficient diversification within the alternatives market via structuring new types of products with various types of direct alternative interests. This new type of alternative structured product may be highly attractive to individual investors as it further lowers the specialization and capital requirements normally associated with investing in alternative assets.

4. STABLECOINS

A stablecoin is a type of cryptocurrency that attempts to reduce price volatility when investing in digital assets. Normally, stablecoins are backed by a reserve asset such as a fiat currency, as is the case with StableUSD and Paxos Standard Token, both listed on Binance's exchange.²⁰ This allows an investor to easily trade into and out of highly volatile and speculative cryptocurrencies without having to go through the lengthy process of converting to traditional fiat currencies.

If a wealth manager is serious about responding to the world of cryptocurrencies and tokenized assets, stablecoins will be a necessary part of any solution. Whether it is offering price stability to clients invested in illiquid cryptocurrencies, or simply accessing tokenized alternatives, stablecoins provide wealth managers with the likely conduit between traditional investments and the digital asset world.

²⁰ <https://bit.ly/2v4QYLI>

5. HOW WEALTH MANAGERS CAN RESPOND

Digital assets and digitally formatted securities will likely serve as a disruptive force to a current wealth manager's business. Tokenization, stablecoins, and the emergence of new cryptocurrencies require wealth managers to change the way they view both traditional and digital assets, and further progress the latter as viable investment vehicles to integrate into the modern customer's portfolio. With the shift to digital assets and the general trend for millennial investors preferring digitally native securities, wealth managers should take action now in order to remain competitive.

We detail below various actions financial advisors and wealth management companies can take today to prepare for the digital asset world of tomorrow.

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By preparing today for the digital asset wealth management market of tomorrow, wealth management companies can evolve and adapt, turning a potentially disruptive technological movement into a growth opportunity.

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5.1 Strategies for wealth managers to survive and adapt

It is critical that wealth management companies view digital assets opportunistically, maintaining an open mind to the associated technological change and the potential impact digital assets may have on traditional portfolio management. Viewing these new products in a productive light, wealth managers can prepare for the likely scenario of a client enquiring about their advisor's digital asset capabilities. In a survey conducted by Bitwise, a leading provider of index and beta cryptoasset funds, nearly 80 percent of wealth management companies surveyed reported that clients had inquired about digital assets in 2018.²¹

Advisors can begin to take strategic actions today and better prepare themselves to support future digital asset capabilities. The same Bitwise survey found that 20 percent of companies surveyed planned to include cryptocurrencies in their portfolio offerings. By acting now, when the prevalence of digital assets is low and the industry is still in its infancy, advisors can ensure that they are current on what capabilities they need to offer in order to stay competitive.

Below are some proactive strategies that wealth managers can use in order to stay ahead of digital asset disruption and how advisors could start integrating them into their practices.

5.1.1 EDUCATION AND ADAPTION

The viewpoint that digital assets (whether tokenized assets or cryptocurrency type assets) belong in a portfolio is not likely to gain rapid popularity overnight. The required infrastructure is not institutionalized within wealth management, the underlying distributed ledger technology and regulatory structures are still in their infancy, and there is not widespread understanding of the many capabilities that digital assets provide. This, however, should not deter wealth managers from adopting a strategy geared towards upskilling themselves and their staff in digital asset capabilities that exist in the market today. By taking a proactive learning approach, wealth managers can adopt new capabilities as they become available.

Some of the actions that wealth managers can take include educating the necessary investment staff, attending conferences and community events geared towards digital assets, hiring outside agencies to conduct workshops and training sessions, and incentivizing employees to learn about digital assets and associated capabilities. Integrating these strategies into day to day processes for employees will help foster a culture where ongoing education of digital assets is encouraged. As client demand grows, investment professionals will be better equipped to answer questions in an advisory role or act on investment requests.

5.1.2 ENCOURAGE SPECIALIZED PARTNERSHIPS

Wealth management firms concerned about the impact of new digital products on portfolios should begin developing specialized partnerships with key companies operating in the digital asset space. We highlight two forms of specialized partnerships:

²¹ <https://bit.ly/2wHVC2A>

- **Platform partnerships:** digital assets require a high-level of security and encryption to custody the tokens and ensure no fraudulent activity occurs. The new technology and infrastructure required to support digital asset capabilities is complex and the expertise to build solutions in-house may not be available to all institutions. As a solution to this complex barrier of entry, wealth managers can look to partner with market participants who provide platform related digital asset services, such as a securities marketplace, issuance provider, or exchange. These partnerships will also help smaller wealth managers scale their digital asset practices without requiring significant investment in additional resources or expertise. By connecting with emerging companies like Securitize, Bitwise, or TZERO, wealth managers can quickly integrate required infrastructure for digital assets into their practices and service their clients without significant investment.
- **Specialized product partnerships:** product partnerships will be important for wealth managers to meet the increased demand for in-house product knowledge and specialists. As the concepts of digital assets and tokenization become adopted more broadly, the ability to participate in direct investment becomes more accessible to retail investors. For example, a client may be interested in owning a piece of a multi-family rental property in Rome, Italy, or partial ownership in the music streaming rights of a popular new song. Certain digital products that were not previously looked at through an investment lens may now be viewed as investable. Thus, wealth managers will increasingly need to seek specialized partnerships with brokers and a new class of product and investment specialists.

If incumbent firms look to begin forging these relationships sooner rather than later, they will gain a competitive advantage with regards to the products they can offer their investor segments. This allows an initially defensive strategy, geared at mitigating the disruptive impacts of digital asset adoption, to become offensive and serve as a customer acquisition tool via offering unique investments in a variety of products that may not be available elsewhere.

5.1.3 INVEST IN DIGITAL ASSET GROWTH

While the above strategies will be beneficial to wealth managers as the digital asset landscape develops and evolves, it will be equally important for market participants to

continuously invest in enhancing digital asset capabilities. This type of broad strategic guidance can vary, and firms should optimize their investment selection processes by finding projects that will provide the greatest return on investment. We see two general investment categories:

- **Externally focused investment:** externally focused investment refers to investments that enhance a firm's connectivity with market participants external to the firm. For example, investment in a service from a well-respected digital asset custodian, such as Coinbase Custody or BitGo, rather than building a custodial solution in-house. Firms can also invest in a variety of other asset market services such as exchange connectivity and execution, specialized research services, broker-dealer services, and full-service based solutions that incorporate critical market functions into a single product. Focusing on investing in the right external services allows wealth management firms to enter the digital asset market in a financially conservative, flexible manner that can be scaled based on client demand.
- **Internally focused investment:** internally focused investment is rooted in the idea of investing in the relationship between the wealth management firm and the customer interested in digital assets. This could include investment in a customized client portal that allows for a holistic dashboard view into traditional assets (equities, fixed income) as well as non-traditional assets (private company ownership, cryptocurrencies, and other new types of digital products). Internally focused investments seek to provide a deeper and more meaningful customer relationship between the wealth manager and the client. Making internal investments to build a more enhanced digital asset customer experience will be a differentiating factor as this landscape continues to mature.

6. CONCLUSION

The future client base of wealth management companies is uniquely interested in the world of digital assets and cryptocurrencies. While the institutional market for these products is still relatively in its infancy, client interest exists and provides a potential market for early adopters to take advantage of. By preparing today for the digital asset wealth management market of tomorrow, wealth management companies can evolve and adapt, turning a potentially disruptive technological movement into a growth opportunity.

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