CARTWRIGHT
PENSION TRUSTS

Boost your Insurance Portfolio with Bitcoin

It is the role of investors and stewards of capital to manage the investment portfolios that they are given the privilege of overseeing, to the best of their ability. In practise, this means calling on their experience, expertise of others and their own knowledge of capital markets and behavioural heuristics to formulate an investment strategy. This strategy aims to balance risk and reward with the aim to deliver the best possible outcomes for underlying investors.

During the portfolio construction process, investors review all available asset classes, and decide whether - and to what extent - each asset class is appropriate in order to best achieve the objective of the portfolio. As Bitcoin continues its transition from a peripheral technological achievement to a globally-accepted store of value, it will be increasingly considered as a legitimate institutional asset class. It will be spoken of as freely as equity, credit, property and gold.

Why consider a small Bitcoin allocation in your Insurance Portfolio?

Asymmetric Investment Potential: Bitcoin offers potentially substantial returns for a small (e.g. 2-5%) allocation, whilst allowing for the majority of the investment portfolio to remain in highly liquid and liability matching assets.

Insurance portfolios - both life and non-life - are broadly managed to ensure that the assets are sufficient for future policyholder claims. This consists of the modelling and the matching of liabilities with a large section of the portfolio. The remainder of the portfolio is often invested into risk assets such as to provide returns which will hopefully, over time, outpace policy holder claims. Bitcoin could be one of these risk assets, if held for the medium to long term. As Bitcoin adoption increases, returns may continue to meaningfully outpace almost all other asset classes, strengthening the investment portfolio against future liabilities and/or allowing a release of reserves to the shareholders.

Enhanced Inflation Protection: Bitcoin has been, and in our view will continue to be, an effective hedge against monetary inflation, protecting against what appears to be an ever-increasing issuance of new money.

It could be argued that formal inflation measures do not capture the full impact of rising prices and costs of living. Formal inflation measures do not fully capture the significant increases in money supply over time. Of all the USD that exist, over 40% have been created in the last four years. Therefore, even inflation protected assets, like Inflation linked bonds, do not keep pace with the debasement of the underlying currency. Assets like equities generally capture formal inflation relatively well, due to the flexible pricing power that many of these businesses have. However, even equities haven't kept pace with increases in money supply. The unique property of Bitcoin – having a hard supply cap of 21m – allows it to capture debasement more effectively.

Enhanced Diversification: Bitcoin's low correlation with traditional asset classes like equities and bonds provides exposure to an additional risk premium within the portfolio.

Aside from the upside potential in the price of Bitcoin, it can bring an additional risk exposure (that's a good thing) to the portfolio which doesn't already exist. This new risk premium being introduced, reduces other risk premia in the portfolio, and offers diversification through low correlation to existing assets. Including Bitcoin on a variety of multi-asset portfolios has been seen to improve the Sharpe ratio.

Furthermore, there are some extreme scenarios which are not typically modelled but could have a significant impact on the insurer's viability, such as a reset of the monetary system and the deflation of the monetary premium within traditional assets such as equities, real estate and bonds. Bitcoin is likely to become a safe haven asset (possibly alongside physical gold) in these scenarios and so can help to hedge these risks.

"Barbell" The Risk/Return Profile: Exposure to a higher risk/higher return asset such as Bitcoin, in combination with lower risk assets such as bonds, means that a 'medium' risk/return portfolio can be created whilst still matching liabilities.

Insurance portfolios often require a large allocation to fixed income exposures. This leaves only a small portion of capital to invest for growth or targeting higher returns. It means that this growth section must be worked as hard as possible and could arguably take on a higher degree of risk than more traditional assets. The lower risk fixed income assets would dilute the volatility of the Bitcoin creating a somewhat balanced overall risk exposure.

Reduced Counterparty Risk: If held correctly, there is near zero counterparty risk involved with the custody of Bitcoin, reducing counterparty risk within the overall portfolio.

There is no issuer of Bitcoin – in the same way that there is no issuer of gold. The asset is produced by specialist computers ("bitcoin miners") and once it is purchased by investors, there is near zero risk (we're talking specifically *counterparty* risk here) to losing the asset once it is in your possession. This is in contrast to most debt instruments: fixed income type instruments will usually have a counterparty, i.e. the entity to whom the invested capital is paid. There is nearly always some degree of risk that the counterparty will not meet its obligation to make interest payments, or worse, repay the principle – i.e. default on the debt. Despite there being some very high-quality counterparties (e.g. the UK government; very stable global corporate issuers) there still exists counterparty risk that the government cannot repay or that the corporation goes bust. This risk does not exist with a Bitcoin investment – you hold the underlying asset, and it cannot be defaulted on. This is a double-edged sword, however, and it does mean that the *custody* of any Bitcoin needs a much higher focus than with traditional assets.

It is Highly Liquid: Bitcoin's market trades 24/7 with deep liquidity, enabling quick access should funds need to be liquidated (and likewise invested) at short notice.

Bitcoin can be bought and sold within minutes, all day, every day. The market to trade Bitcoin does not close overnight or on weekends and has deep liquidity. Investment into Bitcoin requires no lock up period of any kind, unlike many of the more traditional alternative risk premia assets and strategies (think property, infrastructure, private markets). Even gold is somewhat illiquid, if held directly – this is one of the many reasons why Bitcoin improves upon gold as money. It would require significant time (never mind the cost and security elements) to move meaningful amounts of gold around without the exposure being financialised (remember that using financialised gold like ETFs then incorporates counterparty risk). £1 billion worth of Bitcoin can be moved across the world, in circa 10 minutes, requiring no counterparty, for usually less than £5.

What about the regulation?

Insurance and Solvency II

Solvency II is part of the regulatory framework which governs UK Insurers and insurance portfolios. It is partly designed to ensure that insurance companies retain sufficient capital to cover any risks that they are exposed to – be it operational risk, market risk and credit risk amongst others.

This legislation means the insurance portfolio managers and investment committees must be very selective over which assets are to be held in the portfolio. This is to not only provide sufficient assets for policy holder - or reinsurance - claims, but also because it will impact the capital required to be held by the insurance company. The requirement is due to the capital reserves regime, to protect against a negative event impacting policy holders' rights.

If simply added to the portfolio, Bitcoin will no doubt increase volatility (at least in the near future) and likely increase capital reserve requirements. Though the capital requirement may increase in the short term with an allocation to Bitcoin, if the asset does continue to provide outsized returns, this would allow for the trimming of Bitcoin profits over time to rebalance exposures. This trimming of profits would allow for the reserve requirement to then fall back to a lower level given the growth of the overall portfolio, whilst improving the insurer's long-term financial strength.

To invest into Bitcoin within an insurance portfolio, therefore, brings with it a variety of considerations. In addition to the capital reserve requirements, investing into the asset also raises the discussion of custody – something that is often little thought of in traditional asset classes. There are various options for Bitcoin exposure and some of them include new ways of thinking about securing assets with direct custody options, although there are also the ETFs that offer a more simplistic (though arguably less secure) exposure. As the reader will well understand however, volatility is not the only risk measure – it is inflation that is arguably the greater risk to asset values, and therefore policy holders, over the longer term.

When used as one of the many asset class building blocks during the portfolio construction process, Bitcoin could be included in the portfolio in such a way as to deliver higher expected returns across a more diverse portfolio, but with lower overall risk exposures - all whilst still maintaining the required liability matching profile.

Environmental, Social and Governance factors

There have been numerous accusations against Bitcoin regarding the amount of energy that it uses and its impact on the environment. It has also come under pressure from its (much of it historical) links to nefarious activities.

The fact is that Bitcoin does use a large amount of energy. However, so does the use of many technologies around the world – the traditional banking system and gold mining uses a lot of energy, as does air conditioning and washing machines. The appropriate use of energy is a very subjective issue – is the luxury of not having to hand wash clothes more valuable to society than an independent monetary network. Some will say yes, many will say no.

Although the Bitcoin network uses significant energy, it is arguably worth it because of the numerous positive ESG benefits:

It can be used to de-risk renewable energy projects. Renewable energy is often produced in waves (excuse the pun). Think of wind turbines during strong winds or solar panels during the middle of the day – during peak production times, much of the energy produced is actually wasted because the excess energy cannot be effectively stored. By including a Bitcoin miner within the proposed green energy project, investors know that any and all excess energy can be immediately monetised into Bitcoin - and then translated into any required currency - through mining, reducing waste and therefore creating a higher expected rate of return to the renewable projects. This higher expected rate of return makes the project more likely to be actioned. There are more examples of such environmentally positive impacts of Bitcoin.

The social positives are manyfold – the network allows for individuals around the world to avoid totalitarian regimes and capital controls (think political protestors); it allows for cheaper and safer remittances from migrant workers to their families in developing countries; it allows for domestic abuse victims to more easily escape their situations (financial

coercion is a large component of domestic abuse). There are more people in the world with access to mobile phones than bank accounts. A mobile phone is all that is needed to have a Bitcoin 'account', and so the technology has meant that many of the world's unbanked now have access to digital payments and savings infrastructure.

Knowledge is Power

Bitcoin may not be suitable for all investors, but we see it as a fiduciary responsibility for portfolio managers and stewards of capital to consider the asset class alongside the more traditional asset classes, and to develop an informed view of its unique properties and the potential impact it could have for all stakeholders.

The best next step is usually to explore how a small allocation to bitcoin can financially impact your portfolio, to see if it is worth further consideration and a deeper dive. As the specialists in this area, we stand ready to assist as needed.

Contact us today to discuss how Bitcoin can complement your insurance portfolio's investment strategy, to help both bolster returns and diversify risk exposures.

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