CFA LEVEL 1

Alternative Investments

Introduction to Digital Assets

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DIGITAL ASSET INVESTMENT FEATURES

Big Picture Overview

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- Digital assets have **distinct investment features** compared to traditional asset classes.
- **Volatility, valuation, liquidity, and market efficiency** play key roles in assessing their attractiveness.
- Understanding these features is critical for **portfolio management, risk assessment**, and client communication.
- CFA candidates need to assess whether digital assets offer **diversification, risk, or return enhancements**.

Uncertain Valuation

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Valuing Digital Assets Is Difficult

- Unlike stocks, **no intrinsic cash flows** (e.g., dividends) exist for many digital assets.
- Popular models: **Stock-to-flow (S2F)**, **Metcalfe's law**, network utility models.
- Most models lack consensus — results **vary widely** based on assumptions.
- Implication: Investors face **high uncertainty** in pricing and fair value estimation.

Liquidity Considerations

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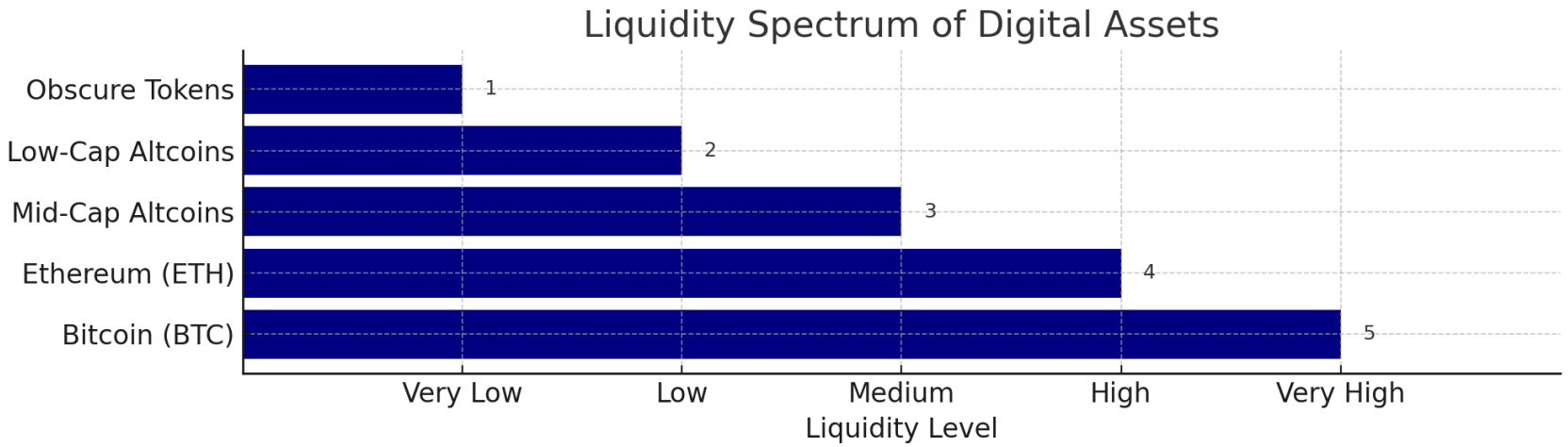
Liquidity Varies Across Digital Assets

- Top assets (e.g., Bitcoin, Ethereum) are **liquid with deep exchange markets**.
- Many altcoins are **thinly traded**, leading to **price slippage and execution risk**.
- Liquidity depends on **exchange listing, trading volume, and regulatory clarity**.



Market Efficiency

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Market Efficiency Remains Evolving

- Crypto markets are still **relatively inefficient** compared to traditional ones.
- Prices may reflect **herd behavior, sentiment**, or **limited arbitrage opportunities**.
- No definitive evidence of persistent **alpha opportunities**, but **inefficiencies persist**.
- Implication: Active traders may find edges — but at **higher risk**.

Correlation with Traditional Assets

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Low Correlation – Diversification Potential

- Historically, digital assets show **low correlation** with equities, bonds, and gold.
- Suggests possible **diversification benefit** in multi-asset portfolios.
- But correlation is **not stable** — tends to increase in **market stress periods**.
- Important for CFA candidates to treat **diversification claims with nuance**.

Risk and Return Tradeoff

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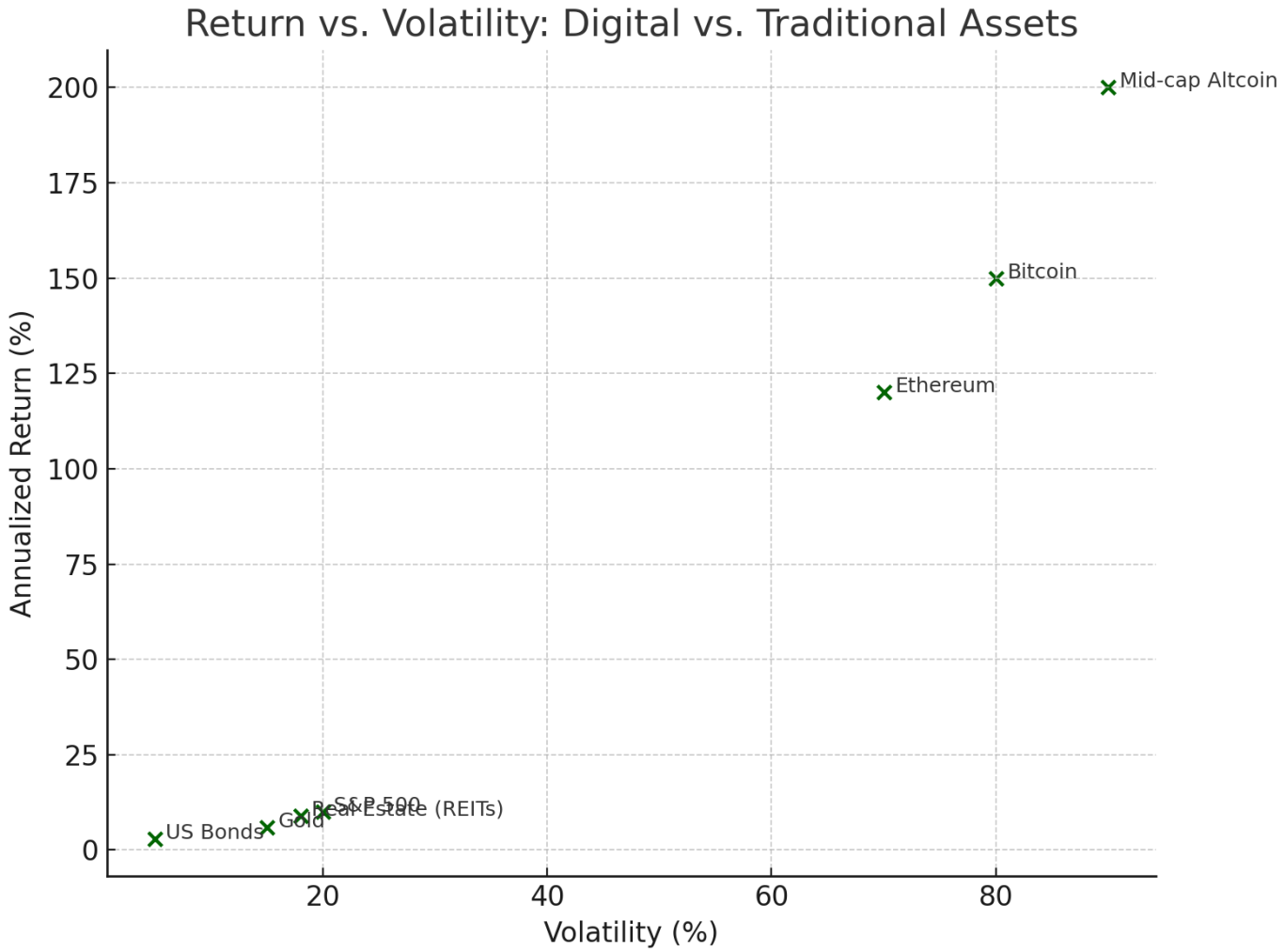
Risk–Return Profile Is Unconventional

•Digital assets can deliver **extraordinary returns** — but with extreme **drawdowns**.

•Past performance shows **asymmetric return distributions** (fat tails, skew).

•Most portfolios require **downside protection**, such as stop-loss or allocation limits.



Key Takeaways

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- Digital assets are **volatile, illiquid, and hard to value** — risk management is key.
- They offer **potential diversification** benefits, but correlations can shift quickly.
- Liquidity and market efficiency vary — not all digital assets are equal.
- Treat them as **speculative** and **emerging** asset classes requiring deep due diligence.

Practice Question 1

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Which of the following best explains why digital assets are considered difficult to value?

A. They have high trading volumes

B. They offer regular dividends

C. They lack intrinsic cash flows

D. They are regulated by central banks

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A. They have high trading volumes

B. They offer regular dividends

C. They lack intrinsic cash flows

D. They are regulated by central banks

Correct Answer: C

Most digital assets don’t produce cash flows, making traditional valuation models unsuitable.

Practice Question 2

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Which factor contributes most directly to digital assets' high volatility?

A. Stable investor base

B. Global monetary policy

C. Regulatory uncertainty

D. High liquidity

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Shifting regulatory actions and legal interpretations cause rapid changes in sentiment and price.

Practice Question 3

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Which statement about liquidity in digital asset markets is most accurate?

A. All digital assets are traded with low slippage

B. Bitcoin and Ethereum are among the most liquid digital assets

C. Liquidity does not affect trading risk

D. Digital assets are only traded on centralized exchanges

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Correct Answer: B

Top assets are more liquid; others may face significant slippage due to thin order books.

Practice Question 4

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A portfolio manager adds digital assets for diversification. What should she consider?

A. Digital assets always reduce portfolio risk

B. Correlation with traditional assets may rise in market crashes

C. Digital assets are perfectly negatively correlated with stocks

D. Crypto returns are normally distributed

Practice Question 4

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C. Digital assets are perfectly negatively correlated with stocks

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Correct Answer: B

In times of stress, correlations tend to spike across asset classes, including crypto.

You Mastered

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- High volatility and valuation difficulty
- Liquidity differences and market efficiency gaps
- Risk–return characteristics and portfolio implications
- Diversification potential and evolving correlations

"The difference between winning and losing is most often not quitting."— Walt Disney