Rodney’s Take

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Don’t Get ‘Rolled’ by the Bitcoin ETF

It finally happened. The Securities and Exchange Commission (SEC) recently approved an exchange-traded fund (ETF) connected to the price of cryptocurrency Bitcoin. I say “connected” because the relationship isn’t direct, it’s derivative, and that’s a problem.

SEC Chairman Gary Gensler has been hesitant to approve funds that hold cryptocurrencies, because the digital dollars aren’t regulated. No banking or investment laws cover Bitcoin, Litecoin, Ether, Cardano, or even Tether, which is supposed to trade one-to-one with U.S. dollars, and no laws cover the exchanges on which these cryptocurrencies trade. Without oversight, Gensler fears that investors will be subject to wild price swings and actions by unsavory market participants.

But investors have been clamoring for a way to get exposure to Bitcoin and other cryptocurrencies without the hassle of a digital wallet. What’s a regulator to do? We now know the answer: find a loophole.

ETF sponsor ProShares developed an offering that’s not directly based on Bitcoin. Instead, the ProShares Bitcoin Strategy ETF (NYSE: BITO) buys Bitcoin futures contracts, which are regulated by the Commodities Futures Trading Commission (CFTC). Sure, the price still flies around based on whatever happens in the unregulated digital world, but the futures contracts are regulated, which provides a veneer of respectability.

Unfortunately, it also guarantees that investors will underperform.
Futures contracts almost always trade in “contango,” which means that the contract to deliver in the future costs more than the asset does today in the spot market. Historically, this makes sense. A person selling a contract to deliver corn in a month must store the corn for 30 days, which costs money, and must have the corn on hand, so he can’t do other things with the cash tied up in the crop. But none of those concerns exist in the digital world. Bitcoin futures trade higher than the spot price, because investors think the price has a good chance of going higher.

The difference between the future and the spot price is where the problem lies.

BITO buys the front-month futures contract and therefore pays a slight premium over the current spot price. Today that premium is about 1%. As the contract expiration date gets closer, the futures price gravitates toward the spot price, and the two converge on the expiration date. Over that time, BITO loses the 1% premium it paid for the futures contract. Just before expiration, BITO sells the current futures contract and buys the contract expiring next month, a practice called “rolling,” and again pays a 1% premium.

If the premium remains the same, over the course of a year, BITO will lose 12% just to the roll. Whether or not they make money overall depends on the price of Bitcoin. If it’s up more than the average futures premium for the year, they’ll earn a profit. Unfortunately, Bitcoin could be up 10% on the year and yet BITO investors could still lose.

There are other ways to gain exposure to Bitcoin without establishing a digital wallet. In our Home Run Portfolio at HS Dent, we bought the Grayscale Bitcoin Trust (Nasdaq: GBTC), but it comes with other issues. The trust can’t readily sell any Bitcoin, so it currently trades at a discount to the price of Bitcoin, but that might change soon. Grayscale filed last week to convert the trust into an ETF. With BITO trading, it will be hard for the SEC to argue against it, but not impossible. If the SEC allows the conversion to go through, then the discount on GBTC should disappear instantly. Investors will be left with the hefty 2% management fee, but at least they won't get rolled.

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Got a question or comment? You can contact us at info@hsdent.com.