BITCOIN IN PORTFOLIOS

WATERLOO CAPITAL

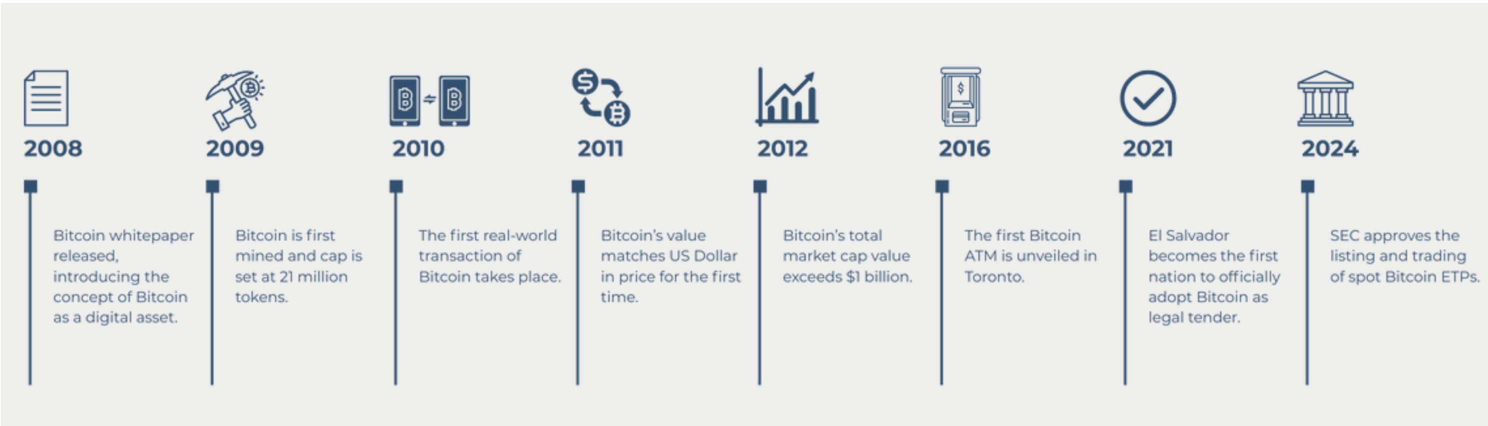
Bitcoin. It's a word that excites some and unnerves others. Once confined to the domain of Reddit forums and your eccentric cousins' Thanksgiving rants, it has now made its way into mainstream financial conversations. With recent developments, including regulatory clarity and the launch of spot ETFs, Bitcoin is becoming increasingly institutionalized. As access improves and adoption grows, its role in a diversified portfolio is worth evaluating. Despite its volatility, small, intentional allocations may offer compelling benefits – yet the analysis is far from straightforward.

Let's start with the basics. Bitcoin is a digital asset created as a decentralized alternative to traditional currency. Launched in the aftermath of the 2008 financial crisis, it operates without a central bank and is governed by software, not a government. Its supply is capped at 21 million coins, meaning no more can ever be created, which makes it inherently scarce.

Unlike dollars or euros, which can be printed in unlimited amounts, Bitcoin runs on a technology called blockchain, a public, transparent ledger maintained by a distributed global network. Using cryptography and consensus mechanisms, it allows two people to transfer value over the internet without relying on a trusted third party (like a bank). Bitcoin was the first digital asset to solve this problem at scale, and it remains the most recognized and adopted form of "internet money" today.

Bitcoin's early years were marked by skepticism and volatility. It was dismissed as a fad, used in fringe communities, and known more for its price swings than its purpose. But over the last decade, that narrative has steadily shifted.

What began as a grassroots experiment has gained traction with major institutions. Companies like Tesla and MicroStrategy have added Bitcoin to their balance sheets. Fidelity, BlackRock, and other asset managers now offer exposure through regulated investment products, including spot Bitcoin ETFs approved last year.



Much of the Bitcoin debate centers around how to classify it: is it a form of money, or an investment?

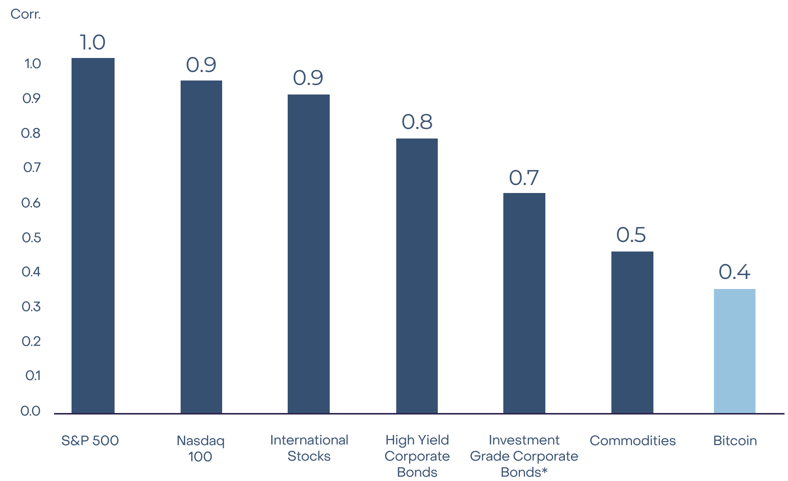
As money, Bitcoin shares many characteristics with cash or gold. It is scarce, portable, divisible, verifiable, and fungible. Its digital nature allows it to move quickly across borders, settle in real time, and operate outside the traditional banking system. In truth, it rarely functions that way today. It's not commonly used for everyday purchases, and its volatility makes it a poor short-term unit of account or stable medium of exchange.

As an investment, Bitcoin has drawn attention for various roles:

- Store of value due to its capped supply
- Inflation hedge in a world of monetary expansion
- Diversification via lower correlations with traditional assets
- Exposure to network effects through blockchain technology

While it's not yet used widely for everyday transactions, Bitcoin's growing acceptance and infrastructure suggest it may serve as both, though its utility depends on how investors choose to engage with it. Bitcoin doesn't behave like traditional investments. It doesn't generate income, it's highly volatile, and its correlation with stocks and bonds can vary over time. But that's precisely why we think it can play a unique role in portfolios. When building diversified allocations, investors aim to combine assets in a way that balances expected risk, return, and correlation to maximize risk-adjusted performance. Adding Bitcoin follows the same logic.

5-Year Risky Asset Correlations with S&P 500



*Excess Returns I Source: Bloomberg, Grayscale Investments. Data as of July 15, 2024. Additional indices include MSCI All Country World Index, Bloomberg-Barclays High Yield Bond Index, Bloomberg-Barclays Investment Grade Bond Index, Bloomberg-Barclays Investment Grade Bond Index, Nasdaq 100 (NDX), and S&P/GSCI. Past performance not indicative of future results.

Bitcoin is not something we view as a core portfolio holding or a traditional alternative like infrastructure or private equity. Instead, we see it as a distinct, opportunistic asset - one that provides potential upside, exposure to a growing digital financial system, and diversification benefits when sized appropriately. Its fixed supply, rising institutional adoption, and increasing presence in macroeconomic discussions make it an asset that's becoming harder to ignore. However, Bitcoin's high volatility means that even small allocations can meaningfully impact a portfolio's risk and return profile. For that reason, we believe any crypto allocation should remain small enough to avoid derailing long-term objectives in the event of a major drawdown, while ensuring it is part of a well-diversified overall strategy.

We ran three portfolio scenarios to illustrate this point. Historically, even small allocations to Bitcoin have improved both total returns and risk-adjusted returns. For example, over the past 6 years, portfolios with a modest Bitcoin allocation outperformed a traditional 60/40 portfolio on both a cumulative and annualized basis. Importantly, the improvement wasn't just in headline returns - the key takeaway was the enhancement to risk-adjusted performance, as measured by the Sharpe ratio.

Growth of $100 Portfolio

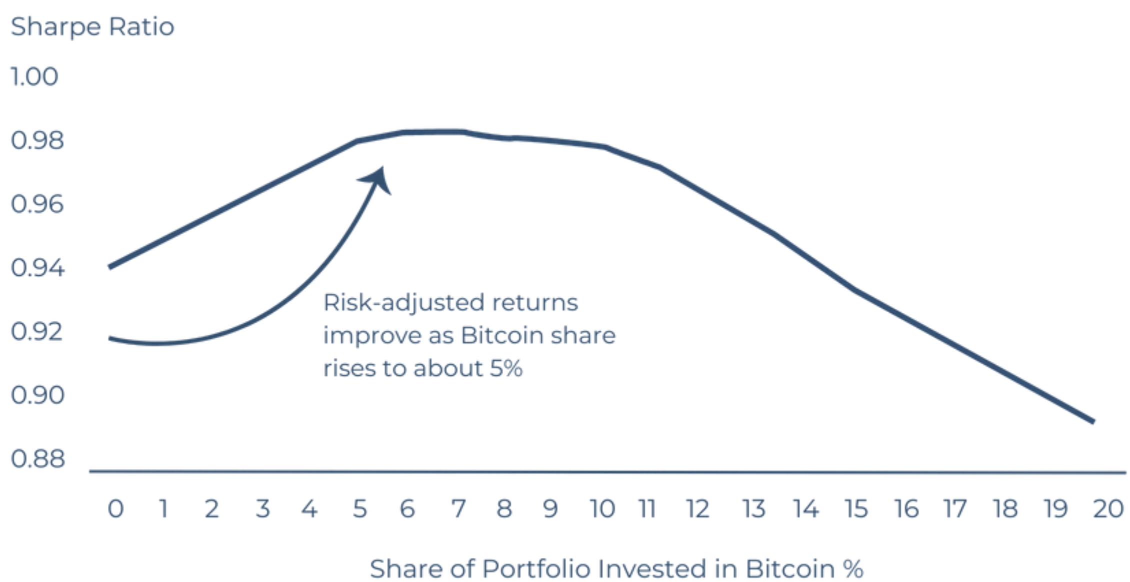
	60/40	59/40/1	58/39/3
Total Return (Cumulative)	86.36%	92.72%	106.71%
Excess Return vs. 60/40	-	6.36%	13.99%
Total Return Annualized	11.81%	12.44%	13.73%
Risk (Annualized Standard Deviation)	12.6	12.6	12.3
Portfolio Sharpe Ratio	0.75	0.8	0.92
Maximum Drawdown	-21.7%	-21.7%	-21.4%

Source: Waterloo Capital. Bloomberg. Traditional 60/40 portolio is based on S&P500 index and Bloomberg Barclays US Treasury Index. Bitcoin returns are based on Bloomberg Bitcoin Index. Data from 2019-2024. Inspiration from Grayscale Investment. Simulated or hypothetical performance results have significant limitations. They are based on past market data and benefit from hindsight, which actual investing does not. These results do not reflect actual trading or the costs of managing a portfolio, including the impact of market factors like liquidity. There is no guarantee that future conditions will resemble those used in the simulation, and results may differ materially. Past performance, whether real or simulated, is not a reliable indicator of future results. The period shown was selected based on data availability.

Grayscale, an industry leader in crypto investing, conducted more research to better quantify this effect. Their simulations evaluated how adding Bitcoin to a traditional 60/40 portfolio impacted the Sharpe Ratio. Grayscale's simulations, based on historical Bitcoin returns since 2014, found that as Bitcoin was gradually added to a traditional portfolio, the Sharpe Ratio improved steadily up to an allocation of about 5%. This is where the diversification benefit is strongest as Bitcoin's historically low correlation with stocks and bonds helps spread out risk while offering upside potential.

However, this benefit doesn't scale linearly. Beyond the 5% mark, the portfolio's Sharpe Ratio begins to decline, as Bitcoin's high volatility starts to overpower its diversification advantages. In other words, a little Bitcoin goes a long way, but too much can add additional risk without delivering proportionate returns. It's also worth noting that maximum drawdowns are similar in this sample set but could increase with greater

Sharpe Ratio as Bitcoin Added to 60/40 Portfolio



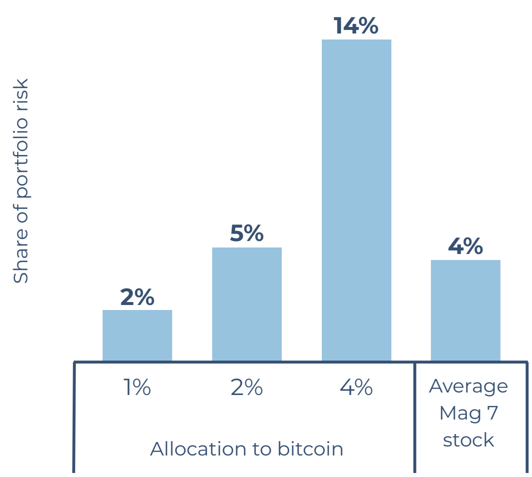
Source: Greyscale Investments. For illustrative purposes only. These results are hypothetical in nature and do not reflect actual returns achieved by an investor. See Technical Appendix for additional disclosures regarding hypothetical performance. Expected returns for 60/40 portfolio based on historical returns for S&P 500 Index and Bloomberg-Barclays US Treasury Index. Indexes are unmanaged and it is not possible to invest directly in an index. Returns to cash assumed to be zero.

BlackRock conducted similar research, approaching the question from a portfolio construction perspective. They noted that the Magnificent 7 stocks, mega-cap tech names that dominate market performance, serve as a useful comparison. These individual stocks, despite being part of a diversified equity allocation, contribute disproportionately to overall portfolio risk for the average investor.

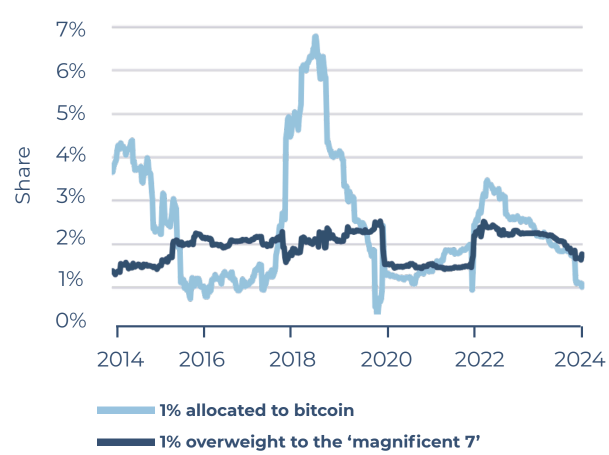
In a traditional 60/40 stock and bond portfolio, each of the Magnificent 7 names contributes, on average, a similar amount of risk as a 1–2% allocation to Bitcoin. The takeaway is consistent: a small allocation to Bitcoin can be reasonable from a risk-budgeting standpoint.

By allocating no more than 2% to bitcoin, investors would introduce a very different source of return and risk while managing risk exposure to bitcoin. However, increasing that exposure significantly causes Bitcoin's share of total portfolio risk to rise sharply, mirroring the concentrated risk seen in dominant single-stock holdings.

Sizing bitcoin in portfolios
Estimated contribution to risk in a 60/40 portfo



A risk-based approach
Share of hypothetical portfolio risk, 2014-2024



Source: BlackRock. Data from Bloomberg, as of December 2024. Past performance is not a reliable indicator of current or future results. This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise – or even estimate – of future performance.

Bitcoin's growing legitimacy, institutional adoption, and distinct risk-return profile have made it an increasingly relevant, if unconventional, tool in modern portfolio construction. It doesn't behave like traditional assets, and that's exactly why it matters. When used thoughtfully and in moderation, Bitcoin can complement a diversified portfolio much like other high-risk, high-reward exposures. Still, its role is far from static. As adoption expands and trading deepens, Bitcoin's volatility and correlation dynamics may shift potentially allowing for higher allocations while simultaneously reducing its outsized impact on portfolio risk. Yet broader adoption could also dampen its upside potential, weakening the case for a permanent allocation.

For now, we believe a small, intentional exposure can offer both diversification and an attractive risk-reward profile. But like the asset itself, the decision to hold Bitcoin should remain dynamic, guided by ongoing evaluation rather than set-and-forget conviction.

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