MARKETWATCH

Do bitcoin ETFs have a place in retirement portfolios?

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By Mark Hulbert

The SEC's decision opens up 401(k)s and IRAs to investing in bitcoin

The SEC's approval of bitcoin ETFs arguably is the occasion to sell, not buy.

This is especially important for retirement investors to consider, since this week's SEC decision will make bitcoin ETFs eligible for inclusion in 401(k)s and self-directed IRAs.

Perhaps the most compelling reason to be skeptical of bitcoin in the wake of the SEC's decision is that the existence of a bitcoin ETF should not change the cryptocurrency's underlying value, according to Itzhak Ben-David, a finance professor at The Ohio State University.

In an email, he pointed out that "the price of bitcoin should be based on its intrinsic value, not on whether there is an ETF. The fact that bitcoin's price depends on an ETF indicates how much the price depends on the size of the crowd that speculates and likely indicates that the price doesn't indicate the intrinsic value."

The upshot, he continued, is that it's "very likely" that both the new ETFs and bitcoin itself will fall in coming days and weeks.

Read: How to trade the new bitcoin ETFs in your 401(k) or IRA

Ben-David bases his prediction on a study he co-authored last year that was published in the Review of Financial Studies. The study was titled "Competition for Attention in the ETF Space," and was co-authored with Byungwook Kim of The Ohio State University, Francesco Franzoni of the University of Lugano in Switzerland, and Rabih Moussawi of Villanova.

The researchers' argument is based on the nearly universal tendency of providers of specialized ETFs to focus new offerings on themes that are riding a wave of investor enthusiasm. This is hardly surprising, since it wouldn't make business sense for them to bring an ETF to market in which few investors were interested. Nevertheless, this tendency makes it likely that specialized ETFs at launch are invested in overvalued securities.

This is illustrated in the accompanying chart. Notice that the average specialized ETF performs significantly worse than the average broad-based ETF, and worse still relative to the market. This period of underperformance lasts for at least five years after launch.

These precedents already constitute strong headwinds to the new bitcoin ETFs. But there's another reason as well: Bitcoin's rally in wake of the SEC's decision suggests that investor sentiment about bitcoin is especially frothy. Ben-David refers to this as a "reverse-causality channel": In addition to these new ETFs responding to investor interest in bitcoin that is already inflated, bitcoin is itself responding to the creation of these ETFs by rising even more. Such feedback loops often end in big drops.

Bitcoin's fair value

Assessing the likely direction of any asset is difficult, but especially so in the case of bitcoin since there is nothing analogous to a company's earnings or dividends on which an analyst could base an estimate of fair value. In previous columns, I have relied on a bitcoin fair-value model that is based on Metcalfe's Law. Please refer to an October 2023 column for a fuller description of the model.

This model has a creditable record, successfully identifying periods in which bitcoin is extremely over- or undervalued. Currently, according to this model, bitcoin's fair value is around a quarter less than its actual price.

For these and other reasons, there are good odds that the new bitcoin ETFs will lag a simple low-cost broad stock market index fund over the next five years.

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