



Introduction to Digital Assets

FOR INSTITUTIONAL INVESTORS

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Introduction

Digital assets have seen a steady uptick in popularity in recent years, particularly among institutional investors. This clear and distinct growth in interest in digital assets has driven many to consider what an allocation for their business or clients could look like. Investors come to Fidelity Digital AssetsSM with varying knowledge levels and experience, and it is our job at Fidelity Digital AssetsSM to help guide them through every stage of their investment journey.

In this piece, we will introduce the most popular digital asset concepts and provide a road map for those looking to understand the market and evaluate making an allocation to digital assets.

What are Digital Assets?

Let's start with Bitcoin

We believe it is useful for investors to begin their digital asset education by first understanding Bitcoin and the impact of its technology. Bitcoin was created in 2009 by Satoshi Nakamoto, a pseudonymous person or group of people. The Bitcoin white paper describes a decentralized payment system powered by a network of “miners” running an algorithm. It also defines a fixed supply of 21 million bitcoin and a deflationary “halving” mechanism. In this halving, the reward for creating new bitcoin is cut in half every 210,000 blocks, or approximately every four years.

On the Bitcoin network, transactions are recorded on a transparent and open database, or ledger. Instead of keeping a centralized copy of the database under one person’s control, thousands of people and computers all update their own copy. These computers are called verifiers, nodes, or, sometimes, verifying nodes, and they are responsible for tracking all previous transactions on the ledger and verifying new transactions.



Bitcoin uses a consensus mechanism, a program for blockchain systems that allows distributed, anonymous validators to agree about the network's state, to confirm the accuracy of its database. In a decentralized network, such as Bitcoin, there cannot be a typical voting system of one vote per person (because one could not identify the person or prevent people from voting multiple times), nor can there be one vote per computer or IP address (because someone could use a lot of machines to overtake the voting process). Instead, Bitcoin uses one vote per unit of computing power and electricity expended, referred to as "proof-of-work."

To successfully mine a block of transactions, a randomly generated number must be guessed. The computer guesses repeatedly until the correct number is submitted, which is essentially trial-and-error guessing. More computer energy used means more attempts can be made by miners to guess the correct number. The first computer to accurately guess this number wins write access to the ledger—temporarily gaining authority to include pending transactions for that block on everyone's ledger. For this service, they receive a reward in the form of new bitcoin, also known as a block reward.

This mechanism allows the decentralized network to come to an agreement and solves the problem of double spending, in which malicious users try to spend the same bitcoin token twice. Since the network's transaction history is publicly available, dishonest actors will have their transactions rejected by the rest of the network's honest users. The mining process requires a lot of guesswork and computing power so bad actors are disincentivized from attempting any dishonest activity because that energy would be wasted and their transactions would be rejected. As the network grows, more energy is required to mine new blocks. As more miners compete to guess the randomly generated number, the network becomes more expensive to participate in dishonestly, further securing the network. Additionally, as the amount of mining power fluctuates, the network algorithmically self-corrects through a concept called the difficulty adjustment, which adjusts the work required to guess the right number. This mechanism helps to keep a schedule of when blocks are added and ensures that there is a state of competition from miners trying to guess the number. This also keeps the supply of newly minted bitcoin on schedule, thereby holding bitcoin's inflation rate in check.



First of Its Kind

The technology that powers the Bitcoin network was the first of its kind. Previous attempts at decentralized digital networks failed to fix the double-spend problem described above. With Bitcoin, a secure, peer-to-peer electronic cash system was born, and, over a decade after its inception, more than 250 million people own bitcoin as of Q1 2023.¹ Bitcoin has proven to be durable and scalable with the help of its layer 2 Lightning Network protocol (more on this later), and blockchain technology has touched nearly every commercial sector, including finance, business, real estate, art, gaming, and more.

Interested in advancing your knowledge about Bitcoin and the importance of understanding it as the “first of its kind”?

- ▶ Check out our most popular research paper, “[Bitcoin First Revisited.](#)”

Beyond Bitcoin

Enter Ethereum

In the years following Bitcoin’s invention and launch, digital assets largely represented a single value proposition. Most non-bitcoin tokens launched in the years following offered what many industry analysts have characterized as an inferior and undifferentiated version of bitcoin’s value proposition.

That perception in the marketplace changed in 2015 with the release of the Ethereum protocol. For the first time, a truly differentiated digital asset emerged, ether (ETH), exhibiting alternative value propositions and a wide array of potential use cases. This launch spawned a new era in digital assets, featuring increased innovation and competition.

Ethereum was created to provide an infrastructure for smart contracts, the key layer behind decentralized applications (dApps). People can build dApps on the Ethereum blockchain using a variety of accessible programming languages, just as smartphone apps are built on Apple’s iOS and Google’s Android operating systems. Unlike traditional protocols, the applications built on Ethereum are meant to be decentralized and run based on the logic and authority programmed into the smart contracts. Smart contract platforms, such as Ethereum, facilitate the existence of decentralized finance (DeFi) applications, non-fungible tokens (NFTs), and decentralized autonomous organizations (DAOs).

¹ <https://crypto.com/research/crypto-market-sizing-report-h1-2023>



Smart contracts are like legal contracts, or even just casual agreements, in that if a certain condition is met, then there is a predetermined output or transaction enforced by code. However, there are some interesting differences between digital smart contracts and traditional financial agreements:

Traditional Contracts or Agreement	Smart Contracts
Need to trust the other party to fulfill obligation.	No need to trust the other party because the contractual obligation automatically executes when certain conditions are met. However, this also introduces the risk of automatic execution of unintended action (e.g., misprogrammed code).
Risk of unpredictable outcome, such as human judges interpreting contracts differently.	Only one interpretation by the computer reading the code.
May not be public or verifiable.	Reside on the blockchain, making them auditable and transparent, but, as a result, may sacrifice privacy in some cases.
May have lower privacy (contracts tied to individual identity).	Transactions tied to a unique address, but not necessarily a person's identity, due to pseudonymity.
Risk of fraud, unauthorized contract alterations, or misrepresentation of parties in contracts.	Risk of bugs in smart contract code and, therefore, potential exploits or hacks of the code.

Proof-of-Work vs. Proof-of-Stake

Following the long-awaited network update, The Merge, Ethereum's consensus mechanism transitioned from proof-of-work to proof-of-stake. This update was unrelated to transaction speed, capacity, or throughput, but rather was simply a matter of how the network chose to order and validate incoming transactions.

Unlike proof-of-work, proof-of-stake validates new transactions into blocks via a wealth-staking mechanism. In this system, instead of expending electricity and computing power that can be lost if a user does not follow the rules or acts maliciously, users lock up their tokens or wealth, which is then subject to being lost ("slashed") if they do not follow the rules. Since Ethereum's successful transition to proof-of-stake, its users can now stake their ether tokens to help secure the network while earning a yield for their efforts. Under proof-of-stake, miners have been replaced with these staking validators and competition for each block is replaced with randomness via an algorithm.



The Next Frontier

Ethereum laid the foundation for a robust decentralized ecosystem that includes ether, its native token, and thousands of non-native tokens and dApps. The visual below helps to illustrate the various functions and parts of the Ethereum network and how they build on top of each other.



The core value proposition for ether grows as the number of tokens, smart contracts, and developers choosing to interact with the Ethereum network increases.

Decentralized Applications

While there has been an explosion in decentralized applications (dApps) with all kinds of use cases, there are a few main categories that the most popular dApps fall under, which are detailed below. However, much like the Internet, it should be noted that there will likely be entirely new dApp categories within the next few years. It is also important to note that Ethereum was the first of its kind of cryptocurrency network, but not the last. Many blockchain networks have emerged with similar value propositions (and trade-offs) that enable decentralized applications.

DeFi

Decentralized finance (DeFi) applications replicate many of the traditional finance functions, such as payments, lending, borrowing, saving, trading, and insurance. However, given smart contracts' programmability and how different things can be built upon each other, new financial services have emerged that can only be performed through dApps. Therefore, DeFi has come to represent a kind of catch-all for anything that is finance-related, but done on a blockchain through dApps.



Comparing traditional finance with DeFi can help to illustrate some DeFi value propositions:

Traditional Finance (TradFi)	Decentralized Finance (DeFi)
May be closed to customers due to geography, lack of identity verification, or credit metrics	Open to anyone with an internet connection
Trust in central authority or intermediary, such as a bank	Decentralized, no single intermediary to trust (but one must trust the protocol or code)
High transaction friction—can have high costs or take days to complete	Usually lower costs, with transactions happening in minutes to a few hours
Low transparency (i.e., do not know exactly how loans are approved)	High transparency; most code is open-source, auditable, and verifiable
Funds held by intermediaries	Ability to control funds directly
Ability to censor (e.g., freeze accounts, block transactions)	Censorship-resistant
All activity linked to real identity	Pseudonymous
Limited hours, in which institutions are open	Always open and running

Stablecoins

Stablecoins are digital assets pegged to the price of fiat currencies, equities, or other digital assets. The need for stablecoins emerged in the early days of digital assets when traditional banking and payment providers refused to work with exchanges. Users needed a way to convert their fiat currency into bitcoin and other digital assets, and stablecoins offered a solution. Most stablecoins claim to be backed 1:1 by fiat currencies, such as the U.S. dollar or the euro. This allows for the stablecoin price to remain at \$1 or €1, enabling users to get in and out of the market without delays or price volatility.

Additionally, some countries have already launched Central Bank Digital Currency (CBDC) pilot programs. China released [the digital yuan](#) in 2020, followed by progressions by [Nigeria and several Eastern Caribbean countries](#), while the U.S., [U.K.](#), [India](#), Russia, and others have announced research efforts.



NFTs

Non-fungible tokens (NFTs) have become wildly popular in recent years, and some have made headlines for their outrageous price tags. For example, a single work of digital art by Beeple sold for \$69.3 million in ETH in 2021.²



To begin to understand NFTs and why some consider them valuable, it is helpful to first define fungibility. If something is fungible, it can replace or be replaced by another identical item. For example, the U.S. dollar is fungible because each dollar has the same value. The same is true for gold, silver, bonds, barrels of oil, rewards points, bitcoin, and ether.

For something to be non-fungible, it must be one of a kind and irreplaceable. By this definition, many of the items in one's home or life are non-fungible, like a piece of original art on one's wall, a personal collection of seashells, or one's identity.

In the simplest terms, NFTs are unique identifiers that are minted on networks, such as Ethereum, and assigned to non-fungible assets that may be digital or physical. One popular application of NFT technology is digital art. Instead of selling their work at a brick-and-mortar gallery, issuing a certificate of authenticity, and adding their unique written signature, an artist can issue an NFT of the artwork on a public blockchain, creating a unique digital signature to prove its legitimacy. When the artist sells their work, they initiate an on-chain transfer of the NFT to the new owner, providing verifiable proof of authenticity and ownership.

Just as public blockchains allow for peer-to-peer transfers of digital assets, such as bitcoin, they do the same for NFTs. When buying and selling an NFT, there is no need for an intermediary, which allows creators to transact directly with fans and collectors.

Scaling Solutions

While many digital assets, such as bitcoin and ether, serve as digital mediums of exchange, their initial iterations were primarily designed for decentralization, not speed. As digital assets became more popular and received more network requests, users complained of high transaction fees and long wait times. This posed the problem of scalability.

2 <https://www.nytimes.com/2021/03/11/arts/design/nft-auction-christies-beeple.html>



Fortunately, some networks are developing or have already launched **layer 2 (L2) scaling solutions**, or software enhancements built on top of the original blockchain base layer, to make transactions faster and cheaper. For example, Bitcoin's blockchain base layer can only process up to seven transactions per second (TPS). This was the only option until its layer 2 solution was released, dubbed the "Lightning Network," which can theoretically process up to 1 million TPS for as little as a few cents. Numerous bitcoin wallets, mobile apps, and users have quickly embraced Bitcoin's Lightning Network, making Bitcoin not only a viable digital payments method, but also a superior one from a cost-efficiency standpoint.

Ethereum, the second-largest digital asset by market cap, also stands to benefit from layer 2 scaling solutions. Top Ethereum layer 2s by number of users, such as Polygon, Arbitrum, and Optimism, all aim to drastically help improve Ethereum transaction speeds and decrease fees while preserving Ethereum's decentralization.

Of course, these transaction efficiencies are not without trade-offs. For example, with Bitcoin's Lightning Network, instead of sending transactions to every node on the network (on-chain), transactions are only sent between the parties involved in the transactions (off-chain). This circumvents Bitcoin's seven TPS limit by allowing transactions to happen between individuals, reducing settlement time from 10 minutes to a few seconds because the transaction no longer requires layer 1 network consensus.

Digital Assets in a Portfolio

Bitcoin within a Portfolio

The investment case for bitcoin typically contains one or some combination of the following three unique elements: bitcoin as digital gold, a portfolio diversifier, or a venture-like investment. These characteristics show the important role that bitcoin, deemed by many as an alternative asset, could potentially play in traditional portfolios over time. The investment case for bitcoin should be viewed from the context of a broader portfolio, rather than simply as a standalone asset. The unique characteristics inherent in bitcoin could potentially help to drive more robust overall portfolio outcomes.

Bitcoin often receives the title "digital gold" from many of its proponents because of its hard supply cap of 21 million coins, giving the asset absolute scarcity. Physical gold has long been considered



to be a safe way to store value over time and a hedge against inflation. The reality for gold is that it functions less as a direct consumer inflation hedge and more as a hedge against overall financial repression. As expectations of real interest rates are driven lower, fixed income becomes less attractive relative to a scarce asset, like gold or, potentially, bitcoin. As bitcoin finds its way into more hands, external macroeconomic variables will probably become more important. Given enough time, bitcoin may also be seen as an alternative store of value hedge against financial repression, especially considering that over almost any long period of time, bitcoin has outpaced the expansion of the Federal Reserve's balance sheet and investment returns from broad market indices.

Regarding its role in a portfolio, one of the most recognized characteristics of bitcoin is the extremely skewed and asymmetric return profile that it has historically offered to investors. Many say bitcoin's investment opportunity is similar in nature to that of a venture capital investment. It is highly volatile, but it has a large total addressable market and presents plenty of potential upside for investors because of the companies, technology, and infrastructure that continue to develop on or around Bitcoin. All that being said, investing in Bitcoin and digital assets remains highly speculative, is subject to market manipulation and liquidity constraints, and investors should be well aware that they may lose their entire investment.

Alternative investments with heavily skewed return profiles can create excellent investment opportunities because one does not need to hold a large position to receive meaningful portfolio benefits. The monthly returns of bitcoin and shares in an S&P 500 investment fund show Bitcoin has been noticeably more volatile and positively skewed in its returns on a monthly basis. We believe that its current size is no impediment to the potential continuation of large, positively skewed returns either. Of course, past performance is no guarantee of future results. As of the end of Q3 2023, Bitcoin has a market capitalization of just over \$500 billion.³ Meanwhile, other store of value assets, such as gold and global fixed income, boast market sizes of roughly \$12 trillion⁴ and \$130 trillion,⁵ respectively.

Another potential reason for including bitcoin in investment portfolios is its ability to provide noncorrelated returns when placed alongside traditional assets. In recent years, bitcoin has been noted as becoming more correlated to traditional risk assets, such as equities, but it is not yet clear whether this trend will continue or if it will revert to its historically uncorrelated nature. Its supply

3 <https://studio.glassnode.com/metrics?a=BTC&category=Market&m=market.MarketcapUsd>

4 <https://www.gold.org/goldhub/research/market-primer/gold-market-primer-market-size-and-structure>

5 <https://www.sifma.org/resources/research/fact-book/#:~:text=Section%201>



scarcity and network effects probably drive medium- and long-term returns that swerve from those of the broad equity and credit markets. This has led to reduced correlations to other assets and has, over the duration of its existence, created a historically complimentary asset for many traditional portfolios. Portfolio allocators are constantly looking for assets with positive expected returns and low or no correlation to their portfolio. Bitcoin has historically fit the bill, exhibiting no meaningful correlation to any major asset class over the long term, and produced extremely advantageous returns for investors. While Bitcoin's investment prospect may seem advantageous, past performance is no guarantee of future results.

Ether as an Investment

The primary value proposition and investment thesis for the Ethereum protocol is its unique programmability and resulting usefulness for building applications on the network. This includes the enablement of dApps with various use cases and abilities.

One of the primary cases for investing in the Ethereum protocol is based on yield-generating opportunities presented directly through ether staking or indirectly via any number of dApps. Specifically, one such opportunity is related to borrowing and lending capabilities. Users who hold assets, such as ether, can lock them into a smart contract as a saver or lender, while the protocol facilitates the borrowing of those assets for a specific period, automatically paying interest to the lender. What makes this different from a traditional borrowing/lending arrangement is that there is no bank or intermediary, no personal information needed, and automatic execution of all processes through code.

Another opportunity presented as a case for investment in the Ethereum ecosystem is integration with stablecoins. Because buying or selling digital assets with U.S. dollars requires an "on-ramp" (usually in the form of a regulated exchange and high fees), the ability to swap between a digital asset and a U.S. dollar-like token is appealing to many users, especially those engaging in DeFi transactions or frequent trading. As stablecoin demand and popularity continue to grow, the use of the Ethereum ecosystem in this space is expected to continue to grow alongside it.

Today, ETH's use case is to function both as the native currency for transactions on the Ethereum blockchain and as collateral for proof-of-stake validators. Once Ethereum changed to proof-of-stake, ETH became a vital part of the network's security and transformed into a yield-bearing asset. Under proof-of-stake, ETH offers the ability to function in a capacity similar to that of application-specific



miners on a proof-of-work blockchain, except that these ETH miners are nondepreciating and can be used or traded within the network. ETH's role as a consensus-validating asset means that overall network usage and the importance of maintaining adequate security will be a potential driving force for future asset price appreciation.

Read our [Ethereum Investment Thesis](#).

Additional Digital Asset Considerations

Decentralized assets like bitcoin can be transferred across the world in as little as seconds without the need for an intermediary. Bitcoin's decentralization brings great opportunity, but also a great responsibility for those using and storing it. Bitcoin ownership is determined by private keys, like a bank account password, that the owner must manage and custody. Digital assets' decentralized and connected nature sometimes subjects them to hacks, theft, and human error. Because of this, they require a unique set of requirements to ensure secure custody.

While not without its flaws, a familiar analogy for this public key cryptography is that the public key is like your email address, and the private key is like the password to your email account. You would never share your password with a friend, but you would freely share your email address. Just as your friends can send a message to your email address, they can send digital assets to a digital asset address that is computed from your public key and can be freely shared.

At the most basic level, digital assets can be stored using hot, cold, or multisignature wallets. Each wallet variation has potential trade-offs.

Hot wallets are software-based and connected to the Internet. This method makes accessing and transacting with digital assets easy and convenient by keeping the private key more accessible for the user, but it can also leave the wallet and its user vulnerable to security compromise. Generally, for security reasons, many people prefer to minimize storing their digital assets in a hot wallet as much as possible.

Cold storage wallets are not connected to the Internet. A cold storage wallet can be a USB or digital asset-specific hardware storage product for storing and/or controlling private keys or simply a paper



copy of private keys stored in a vault or other secure place. Many consider cold storage to be a preferred solution (some firms use cold storage exclusively). Cold storage adds a manual step to accessing digital assets, but provides an additional level of security.

Multisignature, or multisig, wallets require two or more participants to facilitate a transaction, adding an extra level of diligence and security. If a bad actor were to gain access to a private key, they would not be able to send bitcoin from the wallet without cooperation from another party.

With these considerations in mind, investors can gain exposure to digital assets in two main ways: 1) through a direct investment in the underlying asset, or 2) through a managed investment product. Both options have unique trade-offs depending on an investor's needs.

Direct Investment

To make a direct investment in bitcoin, ether, or another digital asset, many people make purchases through a regulated exchange or other execution provider and then choose a custody solution.

As described above, digital asset custody requires special considerations. One can choose to self-custody their assets, independently maintaining the security of their private keys by storing them in a personal hot or cold wallet or via a managed custody solution provided by a third party. Self-custody puts the onus on the individual to institute their own controls and independently store their private keys. While a managed custody solution may be a simpler option for some, not all providers are the same. It is important to evaluate the cyber and physical controls in place as well as the company's regulatory status, insurance policy, and reputation.

A potential advantage of direct exposure is that it may be one of the more cost-efficient ways to access the asset class, given the relatively low aggregate fees (trade execution and custody costs) compared with managed investment products. Another key advantage is capital efficiency. As bitcoin and other digital assets become more widely accepted as investable assets, borrowers may increasingly leverage them as collateral to access liquidity while maintaining their positions. Lenders may see value in bitcoin's use as collateral because it offers certain appealing characteristics, such as liquidity, borderlessness, and facilitation of fast, final settlement and real-time price discovery.

A potential challenge of a direct investment is the required technical due diligence. Given the relatively more technical nature of digital asset custody, investors may feel ill-equipped to appropriately perform due diligence on service providers. Thus, certain institutions may prefer to select vehicles that allow them to outsource evaluation of service providers due to technical



knowledge and experience gaps. Additionally, there is a lack of institutional solutions for direct digital asset exposure that are integrated with traditional equities providers, creating potential tax and reporting challenges.

Managed Investment Products

Today, there are various managed investment products on the market, including passive and active digital asset funds. These options may provide a more familiar and convenient experience for institutions seeking to gain exposure to digital assets through a traditional investment vehicle.

Private funds provide accredited and qualified institutional investors with another channel to obtain exposure to bitcoin. While funds exist to offer active strategies, many elect passive funds because they remove the complexities of bitcoin trading and custody and present the asset to investors in a familiar structure. The cost of convenience is the management fee that funds charge investors in addition to the trading and custody fees, which they pass along. These fees not only account for the fund managers and operations, but the costs the fund incurs via their elected custodian.

Investors may also find value in gaining exposure to bitcoin through an actively managed vehicle. As a transparent, liquid, and volatile asset that trades 24/7, bitcoin offers a compelling opportunity for active managers to generate alpha on top of regular price behavior. While bitcoin's inability to fit neatly within the framework associated with traditional active management has dissuaded institutional investors from adopting an actively managed strategy, bitcoin offers a unique set of tools that investors can leverage to assess its fundamentals. Specifically, market participants can source data to analyze bitcoin in more depth than is possible with any other traditional asset. In the same way that a government statistical agency publishes data about a country's population and economy, or a public company publishes quarterly financial statements disclosing growth rates and earnings, the Bitcoin network provides a real-time global ledger that publishes data about the network's activity and inner economics.

Interested in receiving the **latest proprietary research** on Bitcoin and digital assets from Fidelity Digital AssetsSM?

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Get Started with Fidelity Digital Assets

Fidelity Digital Assets offers a suite of digital asset services and investment solutions built to serve institutional investors' unique and varying needs.

Custody and Trading Platform

- Access multivenue liquidity from a single platform without moving assets from cold storage.
- Buy or transfer bitcoin or ether and securely store it on our industry-leading custody platform.
- Access credit from approved third-party lenders using digital assets secured with Fidelity Digital AssetsSM as collateral.

Global Coverage

Available across the United States* and many countries in Europe, Asia, and Latin America.

*State limitations may exist depending on client location.

Discover Your Options

Interested in learning how Fidelity Digital AssetsSM custody and execution services or investment products could be right for you?

Fill out [this form](#) and a member of the Fidelity Digital AssetsSM team will reach out to you.

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