How Cryptocurrencies Can Diversify Your Investment Portfolio

By Allen Taylor

Serious investors are usually familiar with Modern Portfolio Theory. In a nutshell, the idea is to manage risk by diversifying one's assets within a specific asset class as well as allocating one's assets across multiple asset classes. On a practical level, this means moving some investments from traditional asset classes such as stocks, bonds, and money market accounts into other asset classes and spreading one's investment within each asset class among several investments within the class. This type of portfolio management allows an investor to put assets into vehicles that deliver a high return, vehicles that produce moderate returns, and other vehicles with lower returns based on the investor's individual risk tolerance.

A Look at Alternative Asset Classes

Investors differ in how they define the asset classes. Some investors consider stocks, bonds, and cash equivalents the three traditional asset classes and everything else an alternative asset class. Other investors include real estate and commodities among the traditional. Regardless of how you define the asset classes, there's more to portfolio optimization than allocating some assets into gold, some into real estate, and the rest into a few select hedge funds.

The key to investing in alternative asset classes is to manage risk in such a way that some parts of your investment portfolio balance other parts so that if one asset class takes a plunge, others in your portfolio performing strongly will keep your entire portfolio growing as markets tend to move in cycles.

For instance, in 2008, there was a sharp decline in the Dow Jones Industrial Average (DJIA) market index, but since the beginning of 2009 there has been a steady growth. On the other hand, real estate fell from grace from 2006 to 2008 didn't start to bounce back until late 2011. It still has a ways to go before it reaches the level of its 2006 high whereas the Dow Jones has significantly risen higher than it was in 2008. Therefore, if you had a significant portion of your portfolio in real estate from 2006 until now, you would have lost money while you would have seen signficant gains if the same investment was in the DJIA instead.

Since performance of any asset class is unpredictable, the best way to hedge against losses in any asset class is to constantly monitor your asset mix and adjust as necessary for long-term trends.

Now is the Right Time for Cryptocurrency Investing

The time to have invested in real estate was 2008, when the market was at its lowest. Investors who got in on the panic at that time would have done well. Prices were low and returns were promising. You could say the same for stocks. Investors who took advantage of the market hitting bottom in 2008 would have done well if that was their entry point.

While timing markets is a difficult and dangerous game, riding waves is much more profitable. But investors have to ensure that what they are seeing is a wave and not an aberration. Cryptocurrency investors who mined bitcoin in 2010 would be doing a lot better than investors in either real estate or stocks today. Even investing one year ago would have significantly increased your returns.

Predictions on the value of bitcoin range from $50,000 to $1 million (See "How High Can Bitcoin Go?"). While predictions can be wrong, there are plenty of indications that cryptocurrency investing is an idea whose time has come, and it's likely that the recent upswing is simply the first tick in an enormous stochastic wave.