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FTX meltdown: collapse, but no contagion to traditional markets.

FTX, once the world's third largest cryptocurrency exchange valued at $32 billion, declared bankruptcy in mid-November. A month later, its founder and former CEO was arrested and charged with fraud. The spectacular collapse of FTX has generated headlines and caused ripple effects elsewhere in the crypto sphere. Nevertheless, we do not expect financial contagion to reach traditional markets.

The latest crypto failure

FTX declared bankruptcy on November 11, 2022, falling suddenly from its onetime valuation of $32 billion. The troubled centralized cryptocurrency exchange collapsed in a scenario resembling a classic bank run, where too many investors tried to withdraw their funds at once, leaving one million creditors in its wake. While traditional banks are highly regulated with specific liquidity requirements, crypto firms are largely unregulated. Therefore, despite stating in its own terms of service that it would not lend out customer funds, FTX was essentially free to do just that. As a result, when crypto investors lost confidence and attempted to withdraw their money from the cryptocurrency exchange, they found it was not there—and had been replaced by FTX's own cryptocurrency. By mid-December, FTX founder and former CEO Sam Bankman-Fried was arrested and charged with fraud.

FTX's failure has led to the failure of other businesses within the crypto sphere, most recently BlockFi, a cryptocurrency lender. The collapse itself was triggered in part by previous failures within the industry (Terra Luna, 3AC, Celsius). While the collapse of FTX has the potential for further impacts within the world of cryptocurrencies, we do not expect it to spill over into traditional asset classes. The insulated nature of the crypto market keeps the potential for contagion low. While FTX's $32 billion in lost value may seem staggering, consider that the market capitalization of a single company like Apple is over $2 trillion.[1]

Billions of dollars in debt

As more details emerge about the misdeeds of FTX and its trading affiliate Alameda Research (also founded by Sam Bankman-Fried), the operation looks more and more like a classic Ponzi scheme. FTX loaned its customers' capital to Alameda as collateral in exchange for FTT, a cryptocurrency that FTX itself issues. When FTT began to fall in value amid volatility caused in part by other crypto failures (Terra Luna, 3AC, Celsius), Alameda was unable to meet its margin calls. Crypto investors subsequently lost confidence in FTX and began withdrawing their funds—leaving the cryptocurrency exchange out of cash and $8 billion in debt.

[1] https://finance.yahoo.com/quote/AAPL?p=AAPL&.tsrc=fin-srch

Our view: speculation, not investment

We understand the allure of cryptocurrency investing, which has been known to surge in value by over 1,000 percent in a single year.[2] However, such astronomical gains are hardly guaranteed for any type of investment, but even less so for digital assets. While the return potential of traditional assets such as stocks, bonds, and real estate can be evaluated based on the fundamental strength of an underlying business (looking at its forecasted earnings and asset levels), crypto assets have no such underlying businesses to evaluate; their return potential is anyone's guess. While these traditional investments may not be known to deliver quadruple-digit gains in a year, their return projections are typically grounded in relatively reasonable projections.

And, as the FTX scenario underscores, the crypto space is largely unregulated and volatile. Accordingly, SEI does not make any strategic allocations to cryptocurrencies or related businesses. While some of our alternative investment managers may have small positions in the space, those holdings are an insignificant portion of a diversified portfolio.

The real value of cryptocurrencies

The cryptocurrency market is just beginning to mature, and the supportive value of digital coins remains difficult to price. Cryptocurrencies and blockchains (the public digital ledgers that record cryptocurrency transactions) appear to have promise as technology disrupters. On the contrary, it is the underlying technologies driving cryptocurrencies that most seem to interest corporations, entrepreneurs, venture capitalists, and even central banks and government institutions. We have been and will continue to monitor the space as new ideas, potential benefits, and risks of crypto-currency related investments emerge.

[2] https://www.statista.com/statistics/326707/bitcoin-price-index/

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