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Rise Of The Machines In The Hedge Fund Industry III: Beaten Down Bitcoin And The Coming Catalyst



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Events in bitcoin always move quickly and never more so than this week. As has been widely covered in the news, Bitfinex, the leading bitcoin exchange outside China in terms of liquidity suffered a major hack. Some 120,000 bitcoin were stolen, equating \$72m USD in value at the time. Such attacks were common place in the early evolution of bitcoin, however it has been several years since one of this magnitude has occurred, made more significant by the fact that security generally in the space has been upgraded on all fronts over this period. The genesis of the attack is somewhat ironic. Bitfinex had been successfully using a cold storage protocol to secure its bitcoin, leaving only actively moving coins in its more exposed hot wallet. As part of a settlement with the CFTC, who fined Bitfinex for not allocating bitcoin directly to clients but rather pooling them in the cold wallet vault, Bitfinex moved to an allocated system. This allocated system relied on a well reputed third party, Bitgo, to provide multi-signature support to the new, account-specific, wallet. However, these wallets were not cold stored but visible online. The unknown hacker found a vulnerability in this arrangement, and it looks currently as though they obtained the API key or keys that Bitfinex used to access the Bitgo platform. Once this vector was identified the hacker bypassed all security, including delays to withdrawal, two-factor authentication and passwords, and accessed the accounts. Over a period of a few hours, thousands of individual wallets were emptied. The hack is worrying. That said the nature of bitcoin is that it is always by definition going to have an online interface at times when it is being used to trade or for transactions. Bitcoin is a work in progress and while attacks will be ever-present the lessons learned have always produced a more robust product. This however was an expensive and painful one for a large number of participants. What eight years of bitcoin history has also shown, is that bitcoin is resilient and recovers from these events. It's hard to imagine for example, that values are several multiples higher than post the MtGox attack in 2013, after which many people declared the death of bitcoin. I am sure the ecosystem will once again adapt and go forward. In some way, with a longer term view, the events have provided an appealing entry point at the new, lower price levels.

A rare price catalyst is in sight.

Contrary to appearances and some public commentary, I'm not a bitcoin evangelist. It's true that, to date, I have never written a structurally bearish analysis on bitcoin. That's been a winning strategy. I've also been challenged many times by investors who think a long-only approach lacks imagination and skill. I look forward to the day when I can arbitrage bitcoin options strike prices or generate strong returns using high frequency algorithms - I'm quite familiar with those strategies. But sometimes the very best strategy is to be long, and sit on your hands.

The two watershed moments in bitcoin in my experience were at prices levels of \$250 and again at \$450. At the lower level there had been a wholesale abandonment of bitcoin as an investable asset, and a near unanimous shift that "blockchain is great but bitcoin is bad". That made no sense to me. Validation of blockchain was not only a validation of bitcoin, but blockchain could not reach its potential without a stronger bitcoin price (Read More). Later, at the higher level, it seemed to me that the bitcoin-halving episode, an effective cut in real time supply of 50%, was an undiscounted catalyst. That also proved accurate. (Read More)

So after almost a year of strong gains, what happens next?

Commodity investing can be viewed at one, very basic level. A commodity responds first and foremost to net inflows of capital. Before capital can move however it needs a pathway. In our business we have two high-quality vehicles by which investment can be made indirectly into bitcoin. Our Global Advisors Bitcoin Investment (GABI) strategy, targeting institutional and HNW investors is a best-in-class product with full transparency and robust oversight. Our recently acquired XBT Provider business is aimed at retail, stock market investors using electronic brokerage platforms such as Interactive Brokers. Both of these have their respective merits and between them have garnered \$20 million in assets.

Other vehicles are available including Barry Silbert's Bitcoin Investment Trust, Pantera's bitcoin fund and more recently we've seen new entrants including Revolutura's Gibraltar based Exchange Traded Instrument and also a new listing from Vontobel, a well-reputed Swiss-based asset structurer. The universe of investors is splintered by geographic location and regulatory mandates - each of the above mentioned products addresses part of this universe, in some cases with little overlap.

What is coming next, the Winklevoss, SEC registered, US based ETF will change the game.

Before looking at the impact such ETF's have had in the past on other commodities let's consider why the packaging of bitcoin, which can be readily accessed directly on numerous bitcoin exchanges, might be enhanced when offered in such collective investment pools as Funds or ETFs. Bitcoin exchanges are still not integrated with other stock and commodity markets. This means that in order to invest capital, it has to be removed from a central clearing account, such as an investment bank or brokerage account, and placed with an exchange. This has a number of disadvantages. Exchanges are still rudimentary. Experience has shown that such exchanges rise and fall, and sometimes disappear altogether. So investors face challenges as to which one to choose. A collective scheme has the economy of scale both to spend time on initial and ongoing due diligence and also can spread risk among good candidates - an administrative burden that few investors will want to bear.

- Many exchanges do not offer good quality cold storage of the coins that are owned by investors. This would lead investors to think about moving coins, once purchased, off exchange to more secure venues for long-term custody. This is another area where experience, know-how and personal knowledge of the venues and players is key.
- Exchanges offer little in the way of insurance. Whether it is insurance against theft of coin, against errors or to cover the missteps of the Directors of such companies, there is little or no cover.
- Because bitcoin exchanges are ring-fenced, there is no cross margining capability - so unlike a traditional account holding stocks, bonds and commodities, there is no ability to use one's other assets to support bitcoin positions.
- Direct investment in bitcoin can have complex tax implications and is highly jurisdiction dependent. Bitcoin in an ETF or Fund form would usually be treated in line with traditional ETF and Fund investments, independent of the underlying asset, bitcoin.

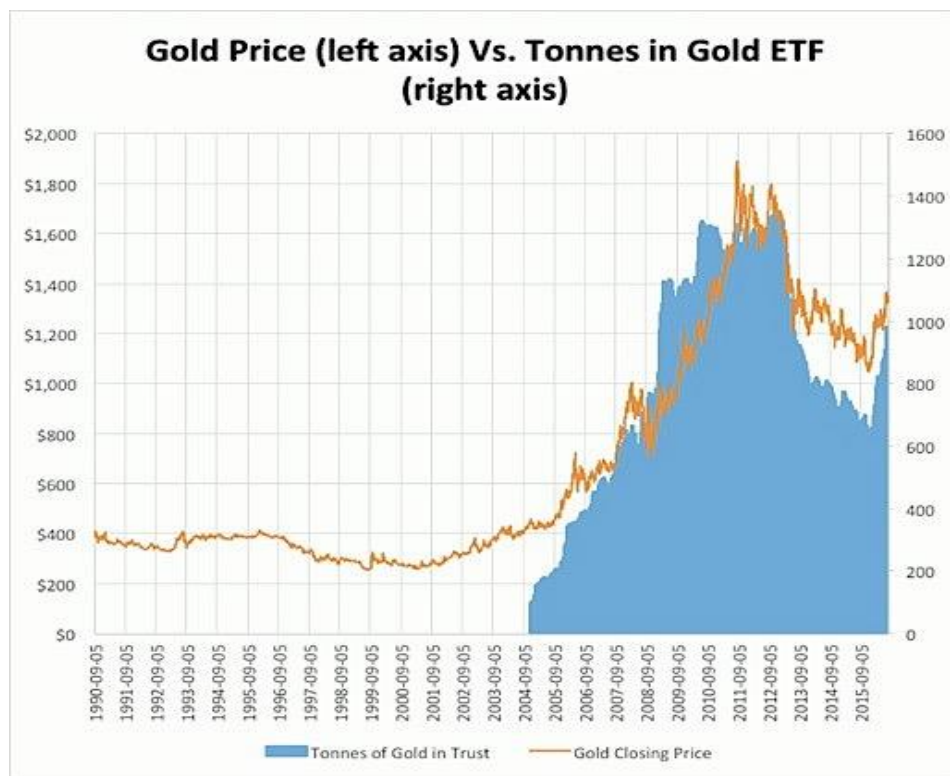
So in summary a collective investment scheme probably costs a little more than a direct investment but, just as in many commodity asset classes, a pooled investment of some kind like a Fund or ETF can carry a number of advantages.

Let us consider the potential impact of the soon to be released Winklevoss Bitcoin ETF. The documentation can be viewed here. This ETF reaches new heights compared with existing offerings. There is no doubt that bitcoin is a controversial asset class and that the SEC is the World's most demanding regulator – so in order to create this fund, the Winklevoss brothers have scaled difficult hurdles. Along with all pre-existing requirements for such instruments they have had to create entirely new solutions. One is the need for a regulated exchange, and the Gemini Exchange has a Trust license from the New York Department of Financial Services – no mean feat I can assure you. Also the product requires robust storage protocols which can be simultaneously secure as well as flexible. With personal experience I can attest to that standard.

So now comes the big question. Is it Chicken or Egg?

I've seen many instances of where a new, fully scalable ETF, accessible by the enormous pool of US retail capital, has had a dramatic effect on market prices of the underlying commodity. From the early 2000's onward there was a proliferation of ETF's covering all manner of commodity interests. In each and every case -- for Gold, Silver, Oil, Natural Gas, Platinum, Copper and even indices -- the advent of the ETF's led to higher prices, more trading volume of futures and cash exchanges and higher levels of commodity futures open interest.

Historical data is hard to come by in this space. However, we are fortunate that the grand-daddy of all commodity ETF's – the SPDR Gold ETF (“GLD”) does provide such data. We've also looked at some proprietary data we collected on other ETF's before that data was obscured by the providers. In each case, there is a clear pattern. An ETF, by opening a new and significant pathway to investment, has a meaningful impact on price. The charts below show this for GLD. The reason for the impact is simple. Retail and equity investors, who wouldn't or couldn't go direct to the commodity markets, were prepared to invest in these vehicles. That in turn sucked physical commodity, used to back the ETF's, out of the markets in question, leading to price appreciation. It has to be emphasized that the capital that flowed in was not doing so in some repackaging exercise, but was fresh, previously unseen capital.



Source: Global Advisors (Jersey) Limited Research, SPDR Gold ETF (“GLD”)

It is my strong belief that precisely the same effect, over the long term, will happen to bitcoin following the Winklevoss ETF.

I think that makes bitcoin, given the risk discount prompted by the hack, an attractive buy right now.

This perspective is neither an offer to sell nor a solicitation of an offer to buy an interest in any investment or advisory service by Stone Mountain Capital LTD. For queries please contact Oliver Fochler under email: oliver.fochler@stonemountain-capital.com and Tel.: +44 7922 436360.

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20/09	Liquid Alternatives - Investor Circle - Zurich (info)
26/09	Longevity Swaps and Life Settlements - CAIA – London (info)

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