Comparison of Blockchain & Crypto Fund Strategies for Institutional Investors

January 9, 2019

Prior to starting Hutt Capital, a blockchain venture capital fund of funds and direct investment firm, I spearheaded the blockchain/crypto efforts at Greenspring Associates, a VC platform with over $7 billion under management across fund, secondary and direct investment strategies. In my research at Greenspring, and more recently with Hutt Capital, I have been dismayed that despite the breadth of high-quality market content produced, and the eagerness to see institutional investors allocate capital to blockchain/crypto strategies, very little effort has been made to help these institutions sort through the noise and determine a smart investment approach.

For institutional Limited Partners (LPs), blockchain and crypto are a whole new world and it is difficult to make sense of the wide range of investment strategies which have emerged. This post will attempt to cut through the noise and help investors forming a blockchain/crypto strategy to understand their options and determine what type of fund is best aligned with their goals.

Historically, most large institutional investors — groups such as family offices, endowments, foundations, pensions, sovereign wealth funds, etc. — have not managed their assets directly. While there are exceptions, these entities primarily invest in funds instead of picking and directly holding individual stocks, bonds, commodities, etc., I have seen no compelling evidence to suggest the crypto market will be any different.

Outside of some ambitious family offices, I expect institutional investors making initial investments in the blockchain/crypto market to gain exposure by investing in dedicated funds. We have seen examples of this with top endowments such as Yale, Harvard, Stanford and MIT reported to have recently committed to dedicated hedge and/or venture funds. Based on my conversations, I believe other similar organizations are approaching this market in a similar fashion.

So for investors who utilize externally managed funds to access this market, the next question is what are the options to consider?

What Fund Options are Available?

In my view, there are three main categories of funds for investors to consider who want exposure to this market:

1) Index Funds

2) Hedge Funds

3) Venture Capital Funds

Even though these funds may all operate in the same sector, the strategies and underlying exposure can vary greatly. In order to help investors think through what the right approach is for their specific organization, I have outlined below what is the strategy and some of the pros/cons for each of the three core fund types (index, hedge, venture).

[writer's note: since bitcoin ETFs have not yet been approved by the SEC I have not included them for consideration in this writing]

Index Funds

Strategy — Passive public crypto index. Typically offer exposure to the top ten or more public tokens, often weighted by market cap. These funds are passively managed but those that are market cap weighted will rebalance on regular intervals to maintain appropriate weightings and will have outsized exposure to bitcoin.

Pros

Simple and Inexpensive — An index is a simple way to gain crypto exposure at a low-cost relative to hedge and venture funds. Attractive for those who want passive long exposure to the market without paying for active management.

No Custody Required — For investors who want passive crypto exposure but don't want to have to worry about holding assets directly and either doing self-custody or using a third-party custody solution, an index can provide an easy solution.

Low Investment Minimum — Index products typically accept lower investment minimums relative to alternative investment funds. For example, the Bitwise 10 Index has a stated minimum investment of $25k whereas hedge and venture funds often will have minimums for individuals of at least $100k (higher for institutions).

Low Selection Risk — Unlike hedge and venture funds, the selection risk is relatively low. Proper diligence is still required but variance of returns between funds should be much lower.

Cons

Long-Only and Fully Invested in a Highly Volatile Market — Indices are long only in a highly volatile market and don't move into cash (or USD-pegged stablecoins) when markets are overvalued, which increases downside risk and volatility during bear markets like we have seen in 2018.

Investor Makes Timing Decisions — Crypto indices offer a passive strategy, so the decision around when to buy and sell the index is left to the investor who may be more prone to buy and sell at inopportune times vs. a professional fund manager.

Limited Diversification — Index products provide minimal diversification for two reasons. First, the correlation of crypto assets is very high, meaning they tend to move together rather than based on unique fundamentals of each underlying asset (details available in this recent article from The Block). Second, the market cap weighted indices are very heavily weighted to bitcoin (>50% of total crypto market cap) and the top three assets (BTC, XRP, ETH) which combined represent 74% of total crypto market cap as of the time of this writing. So even if an index has exposure to 10 or 50 or 100 crypto assets, the traditional benefit of lowering risk through diversification has minimal application for market cap weighted crypto indices.

No Exposure to Private Tokens or Equity — Crypto index products offer exposure only to public crypto assets. They do not provide exposure to 1) crypto networks which have only sold tokens in private transactions and do not yet trade on exchanges or 2) equity in crypto and blockchain businesses. As such, crypto index products do not provide exposure to large and important parts of the market such as crypto financial services, tokenization, or non-crypto use cases of blockchain.

Hedge Funds

Strategy — Strategies vary by fund but, in general, crypto hedge funds are providing exposure primarily to publicly listed tokens on an actively managed basis. Strategies vary from algorithmic-based trading strategies with high turnover and short holds to those investing with low turnover and a longer-term hold strategy who in legacy terms are actively "stock picking". The top handful of tokens are the most commonly held but exposure may include a much broader range of tokens.

Hedge funds can use leverage and provide exposure beyond long-only public tokens by taking short positions or via illiquid investments. Hedge funds may short certain tokens to create long/short strategies though its hard to do this, especially with any scale, as the infrastructure is very immature relative to traditional asset markets. Some hedge funds will also invest in private tokens (via SAFTs, pre-sales, etc.) or even VC-style early stage equity though are restricted as to how active they can be in illiquid assets given they have to hold them via side pockets. Hedge funds are liquid vehicles, though typically have one-to-three-year lockups and custom redemption schedules.

Pros

Active Management — Hedge funds can reduce the fund's long bias by going adding short positions or moving into cash or a stablecoin when markets seem overheated. Hedge funds can also impart their view of which crypto assets are most attractive (i.e. "stock picking") rather than being forced into an index approach. In an environment where crypto assets move in a highly correlated fashion, active management and the ability to reduce long-bias and, if executed well, can help to manage downside risk during bear markets.

More Creative Strategies — Actively managed hedge funds are open-ended liquid vehicles (though many have substantial lockups of one-to-three years and redemption restrictions) and can be more flexible and creative vs. passive crypto strategies, such investing in private token and equity deals or using algorithms to take advantage of short-term inefficiencies. Hedge funds can also deploy other opportunistic approaches such as pair trading or event-driven strategies.

Structural Inefficiencies — Some hedge funds utilize algorithmic trading strategies to take advantage of inherent and unique inefficiencies of the early crypto markets such as price arbitrage between exchanges. These inefficiencies may diminish partly or entirely over time as the market matures and becomes more institutional but can be profitable given the current nascent market structure.

Exposure Outside the Top Three Public Tokens — As mentioned earlier, the top three tokens (BTC, ETH, XRP) represent 74% of the total crypto market cap. As such, any market cap weighted index will offer minimal exposure to other promising tokens, not to mention those that are outside the top 10 or top 25. While portfolio composition across firms varies greatly, hedge funds offer the ability to gain more meaningful exposure to high conviction tokens outside of the top three and even much smaller crypto assets.

Cons

Primarily Investing in Public Tokens Leads to High Volatility and Business Risk — Despite having more tools vs a passive index, hedge funds are primarily investing in public tokens (vs private tokens and/or equity) and therefore subject to the inherently high level of risk and volatility inherent in the crypto markets. This may lead to extreme returns like we saw in 2017 (for good) and 2018 (for bad). It also leads to business risk, as hedge funds who are down 50%+ in a year (many were down significantly more in 2018) may have a difficult time staying in business if they are not at sufficient scale.

Fundamental Analysis is Difficult — The ability for hedge funds to perform fundamental analysis is somewhat limited due to the lack of consumer adoption, user metrics and financials that would typically support such an analysis. There are very smart individuals and teams doing good work to quantify fundamentals and build more standard valuation methodologies, but it will take time for widely accepted valuation frameworks to emerge.

Public Token Markets are Not Yet Rational — In addition to the difficulty of performing fundamental analysis, crypto assets regularly see large price swings based on no news or fundamental change, and crypto assets tend to move together. As such, hedge fund investors might make sound investment decisions based on their diligence and research but could underperform the benchmark or have the market move significantly against them for extended periods of time. This dynamic suggests an environment in which it is hard to reliably provide positive performance in excess of the benchmark.

Limited or No Exposure to Private Tokens or Equity — Hedge funds offer exposure primarily or solely to public crypto assets. They provide little to no exposure to 1) crypto networks which have only sold tokens in private transactions and do not yet trade on exchanges or 2) equity in crypto and blockchain businesses. As such, hedge funds typically provide minimal exposure to large and important parts of the market such as crypto financial services, tokenization, or non-crypto use cases of blockchain. For tokenization (security tokens), while hedge funds could buy these tokens, the underlying assets will have nothing to do with crypto (could be real estate, a private equity LP interest, art, or anything else) and thus wouldn't make sense for them to own. The tokenization market is more appropriately played by owning equity in the tokenization infrastructure.

Venture Capital Funds

Strategy — Blockchain venture capital funds are primarily making early stage investments in blockchain/crypto companies and crypto networks, both through equity and token structures, with a long-term holding period. The mix of equity vs token varies by fund, but most have flexibility to do both and in the aggregate the industry is more weighted to equity investments. Venture funds, while each has their own strategy, generally provide exposure to three main areas: 1) private crypto assets (i.e. tokens which have yet to hold public sales or list on exchanges), 2) equity in crypto-related businesses and infrastructure (financial services and technical) and 3) equity in companies using blockchain or decentralized tech for non-crypto use cases. In other words, everything *except* public tokens (with exceptions). Venture funds are illiquid and most have standard ten-year terms like traditional venture funds.

Pros

Broader Exposure via Private Tokens and Equity — Venture capital, by investing in both token and equity instruments, provides exposure to a broader set of opportunities than just crypto tokens. Venture funds do invest in tokens, granted largely via private sales (instead of buying publicly once listed on exchanges), but more substantially offer exposure to equity in companies building both the financial and technical infrastructures and companies who utilize blockchain outside of purely crypto use cases.

Lower Volatility vs Public Token Centric Strategies — Venture funds invest in private token and equity assets, which are valued by funds quarterly and not subject to real-time public mark-to-market valuations like publicly traded token assets. Accordingly, venture capital funds should be expected to exhibit lower volatility vs public token centric index/hedge funds.

Long-Term Focused — Venture funds invest in early stage assets with expected hold periods of at least several years. While there may be attractive opportunities to liquidate certain holdings in shorter time frames, especially as token holdings become liquid, the long-term and hands-on approach is better suited to the blockchain/crypto market which is still early in its maturity.

Traditional Business Models Increase Ability to Perform Fundamental Analysis — By owning equity in companies building businesses which generate revenue and (potentially, whether now or in the future) profits, these assets held by venture funds have a clear and proven method for value creation and thus a return for investors. While crypto-centric companies will experience some level of impact on their business when prices move significantly, by building user bases and expanding product lines they are often able to maintain or grow value in down-markets and increase value in excess of crypto prices during up-markets. For example, Coinbase increased its private valuation by an estimated 381% (post-money to pre-money) between its Series D and Series E financing rounds, in August 2017 and October 2018, respectively. During this same period, Bitcoin was up 84%. This concept of business building naturally suggests a lower risk profile vs solely owning crypto assets and helps venture funds to perform well even in crypto bear markets, with 2018 being a perfect example. Pantera Capital Venture Fund II, for one, was reportedly up nearly 60% during the first three quarters of 2018 despite bitcoin being down 53%.

Enhanced Liquidity Profile vs Traditional Venture — Many venture funds invest in private token assets which may become liquid much earlier than their equity counterparts. While some funds will hold for longer than others, blockchain venture funds broadly offer an enhanced liquidity profile and potential for quicker return of capital relative to traditional venture, in some cases by a significant margin.

Cons

Illiquid — Venture capital is illiquid and not the best way to take advantage of short-term crypto price movements. While this is a purposeful feature of the strategy, for those who are looking for short-term profits based on crypto market pricing or just want exposure to public tokens this is not the appropriate vehicle.

Limited Number of Funds and Access Challenges — There are a limited number of venture funds who are dedicated to the blockchain and crypto markets, at least relative to the number of crypto hedge funds or traditional venture funds. The fund sizes are also small vs their traditional venture peers. As such, the ability to find, diligence and gain access to the top funds may be more difficult than with index or hedge funds.

High Selection Risk — Venture capital is well-known to have high selection risk, where the returns of the best funds are significantly greater than the returns of the median funds. I would expect standard deviation of returns between funds to be even higher in a nascent market such as crypto and blockchain. As such, to implement a venture strategy it is important that investors can assess and gain access to the top-performing funds. This is made more challenging given the limited track records of investors in this market.

Portfolio Management Challenges — Certain funds may be hesitant to sell quickly meaningful portions of their holdings when there are large increases in the value of publicly held tokens post-lockup, as there could be reputational damage for those who are not long-term supportive. Further, venture funds are not used to dealing with early stage public assets (as they will once their private token holdings become liquid) and need to determine best practices for how to manage reserves, public purchases and public sale processes [I will be publishing a separate full post soon on this topic].

Competition with Traditional VCs — Blockchain venture funds compete with certain traditional venture capital firms for deals. Some of the top generalist firms such as Lightspeed Venture Partners, True Ventures, and Union Square Ventures, have been active investors in crypto and blockchain related startups. While I believe dedicated blockchain venture funds are significantly better positioned for success in this market vs. their generalist peers, increased competition from traditional VC funds remains a potential risk.

So What Type of Fund is Best?

Which type of fund is best for your organization depends on your specific goals, preferences and risk tolerance. We have our own opinion at Hutt Capital, which we will share in a future post, but wanted to keep this informational and neutral. Hopefully this can help other investors to make more informed decisions as they approach the blockchain/crypto market.