

Investing in Blockchain: A Breadth of Unparalleled Opportunity [Part 1]

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The only certainty in life is that change will occur and the future will look different than the present. Its just a matter of time until blockchain technology renders our legacy financial system obsolete, as the Internet has done with so many other legacy industries. Those who don't innovate and accept the paradigm shift will be destined to fade into obscurity in the train graveyards of finance.

Introduction

Blockchain is such a transformative technology that the only modern analogy is to compare its potential for disruption to the Internet. But as a novel technology with wide-ranging applications, it can be difficult for investors to filter out the noise and synthesize what are the specific new markets and business models enabled by blockchain technology. And more importantly, why are they compelling investment opportunities which warrant inclusion in a diversified portfolio.

In this post, we will introduce some of the key themes and areas of investment related to blockchain which has Hutt Capital so excited about investing in blockchain technology opportunities. We will keep it high level in order to cover a wide range of topics.

There is too much to cover in a single post, so we have broken this up into parts with each covering five categories. This is part one, which covers certain finance and money-related investment areas. Additional categories will be covered in future posts as part of this series.

List of Covered Topics

- Global, Borderless, and State-Free Money
- Crypto as Digital Gold
- Crypto Financial Infrastructure
- Digital Securities / Security Tokens
- Decentralized Finance (“DeFi”)

Global, Borderless, and State-Free Money

What is it: Crypto offers a protocol for money just as the Internet does for data, representing the first time in history that it has been possible to create state-free money and seamlessly move value around the world. Crypto also allows for the global movement of money to be faster and cheaper than existing solutions.

No government or company controls monetary policy, printing money, or the access to and use of money. Instead, monetary policy is coded from day one into the system and open sourced to be public and transparent. Global citizens can discretely and securely hold digital assets without fear of having their life savings confiscated whether directly through force or indirectly through high inflation.

State-free monies such as bitcoin, like other currencies, have a market-driven price based on supply and demand. We believe crypto will lead to the emergence of one or more global currencies which are complementary to existing fiat monetary systems (not displacing them).

Another type of promising crypto asset is a stablecoin, a price-“stable” digital asset tied to the value of another underlying asset, such as the U.S. dollar or Euro (typically with 1-to-1 reserves held). Stablecoins allows existing fiat currencies to enjoy the benefits of being digital, globally accessible and borderless, but without the volatility exhibited today by other crypto assets, nor the transparent state-free monetary policy.

Why is it compelling for investment: The money supply (M2) for twelve of the major economies including the United States, China, the Euro Zone and Japan was [\\$72.6 trillion](#) at the end of January 2019, an increase of 25% from just five years ago. For comparison, bitcoin’s market cap is [\\$160 billion](#) and the total market cap of all crypto assets is just [\\$282 billion](#), or 0.2% and 0.4%, respectively, of M2 of the twelve largest global economies. The total market cap of all stablecoins is just [\\$5 billion](#). If a digital asset becomes wide accepted as a global, state-free money, the upside potential is asymmetric for being an early holder.

For those in countries where there is moderate-to-high inflation, uncertain access to one’s money, or questionable economic management, crypto represent a transformative opportunity for citizens to maintain the real value of their wealth. Stablecoins, in particular, are attractive in this manner because they are lower volatility and thus carry less price risk – effectively giving universal access to safe haven assets.

Stablecoins are also attractive for payments [which will be covered in a later section of this series] because they have the advantages of a digital asset (faster and cheaper), but absent the price fluctuations. They serve further as a “cash” asset for holders of digital assets.

Global state-free currencies and stablecoins both have potential market sizes in the many trillions of dollars. Investing in a global money with a fixed or limited supply before demand truly scales represents a significant opportunity, as does owning a stake in companies behind any stablecoin that is able to meaningfully scale.

Examples: Bitcoin is the most prominent crypto asset and is best positioned to serve as a global currency. Network effects and brand are powerful, and work heavily in bitcoin’s favor. There are other crypto assets competing, including some which believe they are more scalable or have superior functionality than bitcoin, while others such as Grin and Monero offer enhanced privacy. These features could enable other

crypto assets trying to serve as digital money could to become popular for specific use cases or within certain communities, but I don't believe any other crypto asset will ever overtake bitcoin as the primary global, state-free currency.

Notable stablecoins include Tether, True USD, USD Coin (from Coinbase and Circle), Dai (part of MakerDAO system which counts Andreessen Horowitz and Polychain Capital among its VC backers), and Gemini Dollar (from Gemini, the organization run by the Winklevoss twins).

Facebook released the white paper and other details for [its own stablecoin](#) called Libra to facilitate payments for its 2.4 billion monthly active users, with a [strong list of partners](#) as members of the foundation that oversees the network and each run a node. Libra is not expected to launch until 2020 but if successful could quickly become a major force given its massive distribution channel. *[More broadly, we believe that Facebook's entrance into blockchain will lead to accelerated and broader adoption of digital assets and represents a positive development for the industry as a whole]*

Crypto as Digital Gold

What is it: Bitcoin has the potential to serve as digital gold, a digitally native store of value and hedge against inflation and other financial system mismanagement (whether extreme situations like hyperinflation in emerging economies or even in the U.K. with Brexit or the U.S. if QE-forever becomes permanent policy). Because of its digital scarcity, fixed supply (capped at 21 million bitcoin), and permanent and transparent monetary policy, bitcoin is an inherently non-inflationary asset which offers an unmatched level of supply-side stability and predictability.

When priced in any inflationary fiat currency, even in a mature steady state post broad adoption, bitcoin should naturally increase in value over time and at least maintain real purchasing power.

Why is it compelling for investment: The current market cap of bitcoin is \$160 billion. The market cap of all gold historically mined is \$8.2 trillion. If Bitcoin becomes a widely accepted "digital gold" there is outsized upside potential and a compelling risk/return profile based on this value proposition alone.

As younger digitally native generations become older, I believe the mindset of a digital asset being a store of value vs. a physical asset will continue to move in bitcoin's favor. Further, bitcoin is a digital asset which does not need to be physically stored or moved, can be transferred quickly and cheaply around the world, and can be bought in small amounts (you don't have to buy a whole bitcoin). It will thus be readily accessible to more people which should lead to a higher level of potential marketability and demand vs any physical store of value such as gold.

Examples: Bitcoin is the clear leader trying to capture the "digital gold" status and no other asset is even close. I believe this dynamic, driven by network effects as first-mover, brand, and the fixed supply, will continue and that for this value proposition bitcoin will never have serious competition.

Crypto Financial Infrastructure

What is it: Crypto assets are a new asset class which are not served the legacy banking and financial services infrastructure. Holders of crypto assets want the same type of financial services as those holding fiat currency, i.e. an account to hold assets, custody, lending, borrowing, sending money to others, brokerage/trading abilities, etc. Institutions and crypto funds require even more sophisticated services.

Because the existing system is not setup to handle this new digital asset class, the entire financial infrastructure for crypto assets is instead being built from scratch. Adjacent markets are also currently being built from the ground up, such as digital asset market data and analytics, media, research tools, etc. As other types of digital assets such as stablecoins and eventually government-issued digital fiat coins become more prevalent, they will utilize the same infrastructure being built for crypto assets, not the legacy financial system. They will also serve to vastly grow the market opportunity.

Why is it compelling for investment: The global financial services market is expected to grow to [\\$26.5 trillion by 2022](#). We believe the crypto financial services market will over time capture a material and consistently growing share of the global financial services market, implying that building the crypto financial infrastructure is at least a multi trillion-dollar long-term opportunity.

In the future, we are going to have large financial organizations focused on digital assets, and who are going to be the JPM Chase (\$359B market cap), Wells Fargo (\$208B market cap) and Bank of America (\$269B market cap) of digital assets. With no incumbent competition in crypto, the financial infrastructure is a high priority in order to drive broad use and adoption, and an outsized share of future value creation is going to be captured by startups.

The future pillars of this industry are being built now and we believe there is a highly attractive opportunity to be an investor at the ground floor.

Examples: Broadly speaking, the crypto financial infrastructure has been the most active area of equity investment by venture capital firms of all blockchain-related categories. It's a very broad category and several crypto financial infrastructure startups are already worth billions, such as Coinbase, Binance, BitMEX, Circle, Kraken, Blockchain and others. Large financial institutions such as Fidelity, CME and ICE (NYSE parent company) are also building offerings backed by significant resources with plans to become meaningful players in this space.

Other startups such as Chainalysis, Coin Metrics and Messari are well on their way to being crucial infrastructure for trusted market data and information. There are additional venture-backed companies like BitGo, Anchorage, Staked and Bison Trails which provide other financial services specific to crypto assets, like specialized custody, or outsourcing the technical work to earn a yield on certain crypto assets by participating in network security.

Despite the significant value created to date, it's still early days and we expect to see a steady stream of early-stage startups be funded by blockchain VCs and scale into future pillars of this industry.

Digital Securities / Security Tokens

What is it: Digital securities, or security tokens as they are sometimes called, are digitally native securities which reside with all related information on a blockchain ledger. Digital securities are not cryptocurrencies. Digital securities are SEC compliant and can represent ownership of any type of asset, whether a stock, bond, real estate, private fund, commodity, or otherwise. The main difference is that the securities are issued digitally and utilize a blockchain ledger for storing and tracking ownership and other data about the security (which is coded into the security).

Security tokens allow ownership of a fractional interest of an asset which can then be traded on an exchange. Additionally, Digital securities are programmable and able to interact with smart contracts, so

they enable increased or full automation of many manual processes around things like KYC/AML, accredited investor rules, cap table management and ownership transfers.

Why is it compelling for investment: Digital securities are the natural next step in asset management as financial services increasingly move toward automated, technology-centric solutions and require better tracking of data and information. We believe all traditional asset classes will eventually transition to being digital securities.

Digital securities also increase the access to and liquidity of traditionally less liquid assets by fractionalizing ownership and enabling ownership interests to be traded on exchanges like stocks are today. Greater access and liquidity will lead to innovative new financial products being built and highly customized investment strategies created around digital securities.

Digital securities are an enormous market opportunity — the global equity and commercial real estate markets are by themselves worth over \$100 trillion. However, like with crypto assets, there is no legacy infrastructure to support the issuance, holding, research, trading and monitoring of digital securities — it is all being built from scratch. This creates a massive opportunity to build the infrastructure for digital securities, and we believe the early investors who have the vision to make investments in this space now, before it has become widespread, will be well-rewarded.

Examples: There are many players trying to establish themselves in the early days of this market, but some of the better-known companies who have platforms which facilitate the issuance and management of digital securities include Securitize, Harbor, TokenSoft and Polymath. Other players are targeting specific markets, creating marketplaces around the fractional ownership in assets such as real estate, art and classic sports cars. There are also a wide range of companies who have or are building exchanges tailored to digital securities, as well as blockchain protocols such as Ownera which are designed specifically for digital securities.

Existing players are looking to get in on this market as well — NASDAQ has been actively working towards facilitating exchange activity for security tokens, while crypto exchanges such as Coinbase and Binance are also expected to facilitate the trading of digital securities.

Decentralized Finance (“DeFi”)

What is it: Crypto has enabled the creation of digitally native money and peer-to-peer transfer of value without a third-party intermediary. But if you hold assets or trade with centralized crypto financial services companies (like Coinbase or Binance), it detracts from this lack of reliance on third party intermediaries (who could be hacked, charge outrageous fees, engage in fraudulent behavior, and dictate access to credit and to your money).

Countering this, DeFi offers crypto-based digital financial services, such as saving, trading, lending, borrowing, etc., with no third-party intermediary. DeFi services are attractive in that they tend to be more flexible, inexpensive, quick and transparent than traditional banking services. It is an ambitious vision to build a better and more automated, open banking system.

In addition to providing better traditional banking services, DeFi and its open protocols enable the potential for novel financial instruments to be built, including an endless array of synthetic securities with

significantly lower counterparty risk. For example, there are products today which offer exposure to U.S. financial markets for those abroad who would not otherwise be able to access our financial market.

The legacy financial services sector has proven inept at serving a global population, with [1.7 billion people](#) unbanked entirely, and many more underbanked. Access to financial markets has been determined by wealth and geographic borders. Due to the open nature of crypto protocols, anyone can build financial applications and custom products on top of them, whether for the mass market, or a given region or local community. This dynamic will lead to a financial system which is more accessible to everyone globally and better serves its users.

Why is it compelling for investment: As mentioned earlier, the global financial services market is expected to grow to \$26.5 trillion by 2022. It is still early days in the world of DeFi, with just [\\$578 million locked up in DeFi contracts](#), but growth to date has been strong and consistent. DeFi has potential to both steal market share from existing financial services businesses, but also to expand the market by increasing global access to financial services and markets.

Fintech has allowed financial services companies to put a better interface on our existing system by moving online, and to lower fees in some cases by making money off selling data, ads, etc., like a band-aid on a gunshot wound. DeFi aims instead for a more permanent fix by building a new, superior financial system. DeFi fully leverages blockchain's fundamental advantages to enable disruptive new business models which over time we believe could especially threaten the retail and small business banking and lending markets.

We have seen similar patterns in other markets, like music for example — iTunes brought music online with a legacy model and was initially dominant. Spotify (among others), which launched five years after iTunes, used an innovative streaming business model enabled by rapidly increasing Internet speeds to put iTunes out of business.

Consumers won't use DeFi services because they care about crypto or disintermediation, but because they are cheaper, faster, more accessible and more transparent.

Examples: There are a wide range of promising DeFi companies and applications despite being in the early stages of the market's development, with the most activity so far seen in lending and borrowing. Some of the more notable DeFi startups to date include MakerDAO, UMA, Compound, Dharma, BlockFi, Nexo, dYdX, Radar Relay, and Airswap. As a group, their investors include Andreessen Horowitz, Polychain Capital, Blockchain Capital, Bain Capital Ventures, 1confirmation, Morgan Creek, Breyer Capital, and SV Angel, among others.

Most DeFi applications to date have been built on top of Ethereum, meaning continued success for DeFi could also be positive for ETH, Ethereum's native crypto asset.

Conclusion

The Internet has brought industries once thought to be untouchable to obscurity. It is only a matter of time until blockchain-based technologies do the same to the financial sector. The financial systems of the future are being built today, and may represent the greatest opportunity for value creation of this generation, for those that are willing to see it.