Reflecting on Cambridge Associates' Blockchain Investment Research Piece

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Cambridge Associates suggests that investors should "venture into the unknown" with its latest blockchain research piece

Last week, Cambridge Associates published a research note called "Cryptoassets: Venture into the Unknown", which discussed the state of the blockchain industry and encouraged clients to start considering investment opportunities in the blockchain space. We recommended reading the entire piece (which can be found here):

"…in looking across the investment landscape, we see an industry that is developing, not faltering…Although the crypto industry remains in its infancy, we think institutional investors should begin exploring it…Though these investments entail a high degree of risk, some may very well upend the digital world."

This was a big deal. Cambridge Associates is a bellwether in the advisory world for institutional investors, and reportedly has $389 billion of assets under advisement and $30 billion of AUM. Cambridge's influence is vast among institutional Limited Partners in private equity, and the firm is especially strong within the endowment and foundation world. Cambridge would not have released this research note without a lengthy process of careful research, consideration and scrutiny by its authors and management.

The piece, in Hutt Capital's opinion, is clear sign that Cambridge wanted to send a message to its client base saying the blockchain market is for real and should be taken seriously. Further, that institutional investors need to become educated in the near-term to ensure they don't miss out on a potentially massive long-term opportunity and technological shift.

We are excited to see Cambridge Associates take a leadership role within the investment consulting world by encouraging clients to take a forward-looking view of blockchain technology's significant potential for disruption and value creation. It would be easy to sit back and wait but instead they have been proactive to ensure their clients are well-informed and their beneficiaries are being well-served.

However, aside from broadly encouraging clients to take this market seriously and increase their knowledge base, there were several comments which specifically address how Cambridge believes investors should approach this market. At Hutt Capital, we found ourselves in agreement with Cambridge's recommendations and wanted to highlight some of the key comments which investors may find relevant in helping to form their own investment strategy.

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Cambridge Associates offered three categories of fund investments for investors can consider: Public Index, Public Active and Private. This framework looked very similar to Hutt Capital's own framework published last month which discussed Index, Hedge and Venture funds, respectively, and can be found here with further detail on each of the fund strategies.

After laying out the "Advantages" and "Consideration & Risk Factors" for each of the three strategies, Cambridge goes on to state its preference for private strategies, i.e. venture capital, over crypto hedge funds or index funds.

"Though investors should generally not exclude high-quality liquid assets from consideration, we generally see a dichotomy between what investors can currently access via a private approach and a public active approach. The former typically makes longer-term investments in pre-token distribution assets and company equity, and the latter tends to make shorter-term investments in post-token distribution assets and mainstream cryptoassets…We tend to prefer private approaches, as their patient long-term focuses better align with the opportunity set.

Private approaches may overlook short-term opportunities that public active approaches could capitalize on, but they typically don't suffer from the same structural challenges. For instance, the underlying liquidity of assets and liabilities of a public active approach are often mismatched, which could be a considerable hurdle in a crisis, such as the one experienced in 2018, and after lock ups expire. Furthermore, incentive fees that are annually crystallized do not align incentives well between the general partners (GPs) and limited partners (LPs) and may materially erode investor returns. The limited ability to short, the potential for short squeezes, and the high level of counterparty risk may also hinder public active approaches."

Hutt Capital's sole focus on blockchain venture capital strategies is a key tenet of our strategy. We agree wholeheartedly with Cambridge that venture capital offers the optimal way to approach the blockchain market and believe it provides the most attractive risk/return profile. Among other reasons, this is due to the focus on equity and private tokens, broad exposure across blockchain sub-sectors (not just crypto), long-term patient approach, lower risk and volatility profile, and strong LP/GP alignment.

We fundamentally believe at Hutt Capital that that investors are better off owning early-stage equity in the infrastructure, or picks and shovels, of the crypto industry and its burgeoning financial services ecosystem, as well as in companies pursuing the wide range of promising non-crypto uses of blockchain technology (supply chain, identity, security, etc.), rather than narrowly focusing on holding publicly-traded crypto assets. This is an approach focused on building real businesses instead of speculation, and it can only be achieved through a venture capital strategy.

"Although investors could rely on venture capital funds in their portfolio to determine their allocations to cryptoassets, there are strong reasons to consider a dedicated crypto fund investment…investors could miss out on investments with the most knowledgeable managers in an industry with large potential payoffs."

Cambridge, in this statement, and its supporting commentary in the research piece, is encouraging investors to consider gaining exposure through dedicated funds — those that invest solely in blockchain. This is consistent with another of our key beliefs at Hutt Capital, which is that investors need to utilize dedicated blockchain managers in order to access this market, rather than relying on exposure provided by generalist venture funds.

While there are some high-quality individuals investing in blockchain from generalist firms, they are broadly at a significant disadvantage vs those at dedicated funds. Dedicated funds have stronger reputations in the market, superior expertise, better relationships, higher quality and quantity of deal flow, the ability to focus resources on active network participation, and are a more desired partner for blockchain entrepreneurs.

Further, dedicated firms are structurally more likely to achieve strong results given their sole focus and buy-in from the full team, as well as their ability to develop fully built portfolios vs having to pick a smaller number of deals. The latter will often lead to a more risk-averse approach which is not consistent or best suited for investing at an early stage in an emerging category such as blockchain.

As Cambridge notes, many of the top blockchain-focused individuals at generalist funds are likely to eventually spin out to create dedicated funds anyways, with recent examples such as a16z crypto and Paradigm (from Sequoia), among others. Cambridge expects this trend to continue, which suggests that the top investment talent in the industry will continue to shift towards dedicated funds, to the detriment of their generalist peers.

"Like other asset classes, investors should seek to diversify across managers and assets to mitigate some of the risk involved. Diversification will also help investors capture the industry's upside, as returns are likely to be generated by a small subset of companies and projects. For smaller portfolios that cannot diversify across managers as easily, investors should consider allocating to a fund-of-funds or an index fund to gain exposure."

Cambridge, in the above statement, is recommending a diversified approach in order to mitigate risk and increase likelihood that investors gain exposure to the large individual outcomes that traditionally drive venture returns. For those investing through a blockchain venture capital approach, this means manager diversification. Specifically, Cambridge is suggesting investing in a handful of managers instead of choosing just one, or otherwise using a fund of funds (such as Hutt Capital) to gain access if making a handful of commitments is not appropriate for a given organization.

At Hutt Capital, we strongly agree that diversification in such a nascent market is important in its own right, and that a diversified approach provides the best risk-return profile for investors. However, funds of funds offer more than just diversification, but also domain-specific diligence expertise and market knowledge, the ability to access the top funds (often oversubscribed), alpha generation through the identification of best-in-breed emerging managers, late primary or secondary arbitrage opportunities, and the ability to follow managers into their best companies through direct investment at a later stage.

Conclusion

In addition to giving its clients the green light as it relates to considering blockchain investments, Cambridge Associates has suggested within its research notes three key strategy recommendations:

· Preference for venture capital strategies

· Preference for dedicated fund managers (vs generalists)

· Need for a diversified approach, either across managers or via fund of funds

We are excited to see that Cambridge's view are consistent with our own at Hutt Capital, which led to us creating the only institutional blockchain venture capital fund of funds. Hutt's focus is providing investors with long-term diversified access and exposure to blockchain innovation solely through venture capital strategies, and by only investing with dedicated managers. We strongly believe this approach offers the best risk-return profile for investors are glad to see we are not alone!