ELEMENT

Our Weekly Thoughts

ELEMENT DIGITAL ASSET MANAGEMENT

JUNE 28, 2018

At press time, the price of bitcoin is hovering around the $6k level, flat in the past 24 hours but roughly 9% weaker than prices a week ago. The entire market is trending in lockstep, with small cap names getting hit the most at -18% in the past week. There's little to no excess volumes on exchanges currently, which leads us to believe the recent weakness may be taking a bit of a breather for the time being. Social media, traditional media and well known influencers have all given their two cents for what's been causing this latest bout of weakness. The topics tend to revolve around the more sensible probable causes - exchange hacks and security measures, companies dumping ETH, etc. We however posit that the market is still in the correction phase from earlier this year, albeit the tail end. Enough said there. Here are some of our other thoughts for the week:

1. The price of bitcoin is experiencing a tremendous decay effect. The 'decay' we are talking about is similar to that experienced with a leveraged ETF - a short-term trading vehicle that can offer 2-3x returns in traditional asset classes. These products use derivatives to multiply the daily return of an underlying index or stock and are therefore a popular instrument for those that wish to make very confined short term bets. The single biggest drawback to a leveraged ETF however is decay. Since these ETFs attempt to maintain a daily leverage of some multiple (usually 2x), the math behind the rebalancing of the assets tend to erode the value of the fund unless markets follow a strong trend. In other words, it pays to hold a leveraged bullish ETF in an uptrending market or a leveraged bearish ETF in a downtrending market. But in a trendless market, there's little drift in the price movement of the underlying assets and therefore the daily rebalancing creates a bit of a leveraged trap in returns. This trap is otherwise known as decay and it manifests itself as a real monetary cost on a daily basis. This cost tends to eat into returns over a long time horizon. Bringing this back to cryptocurrencies, we've noticed that the market tends to respond negatively to bad news a fair amount and not with necessarily the same vigor in the event of good news. This happens fairly consistently as of late. As a result, just like with leveraged ETFs, there's now a bit of decay effect when holding on to digital asset exposure.

2. We're moving in a questionable direction with market microstructure. At a recent crypto conference, some of us had the pleasure of interacting with a number of senior financial executives that have newly entered the crypto space. Most are seasoned veterans that have found a second career for themselves by building out tools and products within the trading and microstructure landscape. This conference gave us pause to think for a few reasons. One, it was unlike previous crypto conferences in that the average age of the audience was likely in the late 40s. The demographic was somewhat homogenous too (think black suits, pleated pants and wingtip shoes). It had the look and feel of a traditional Wall Street conference. Two, we had the chance to demo some trading platforms that will be released this summer. One platform for instance provided a way for market makers to send out automated request-for-quotes in an efficient manner. It was something that looked and felt like those used in traditional markets. We found this interesting but at the same time a little odd. While it's great to see some innovation happening in the crypto trading landscape, we're not entirely sure this is the right type of innovation that's needed right now. If we analogize the development of digital asset space to the development of an apartment complex, what we need right now are basic utilities that work well. We need running water, plumbing, central air, etc. We then need families to move into the apartments using these utilities every single day. We need them to build a community with their neighbors. What we DON'T need right now are state of the art temperature controls, smart appliances or robotic home assistants. Yet what is being built out in the market microstructure space currently are exactly that. This stuff is cool and there will be a use case for it at some point in the future. But we don't need it right now. What we need are basic utilities - qualified custodians, regulatory oversight, security. Then we need a network of people actually using blockchain technology in their daily lives and realizing value from it. We need these people to use tokens seamlessly in their daily lives. Only when crypto breaks into the mainstream in a meaningful way will there be real network effects to portend new all time highs in prices.

3. The speed at which the digital asset marketplace evolves needs to be a consideration. Bloomberg recently ran a story about how many quant hedge funds are struggling to make money this year. Although they didn't get into the reasons behind their underperformance, here is one theory: All quant funds at a fundamental level look for some sort of relationship between an asset's price and some other thing, and their models are trained on historical data. This could be an asset's previous returns for some momentum-based model or some macroeconomic indicators for a macro-based model or some other financial information. Quants make money in the long-run when these relationships that have existed in the past persist in the future. And generally this is how human investors make decisions too — humans have a natural instinct to look for patterns, it's just that quant hedge funds find some way to quantify the patterns. When the market is instead being primarily impacted by other things like a tweet, political drama, or the impact of a trade war, the relationships that once held in the past are no longer the primary drivers of markets and markets may perform differently than what a quant' model predicts. I think there are interesting parallels for cryptocurrency markets. The absence of any token valuation framework that has achieved widespread adoption makes it difficult to determine a token's intrinsic value. The speed at which cryptocurrency markets evolve suggest that looking at historical data and patterns may be of limited use. And the market is extremely susceptible to news and events and the timing of these things are almost random. It becomes very hard to be on the right side of markets when the main things that impact markets are the timing of when a hack is disclosed, a tweet by a public figure, or a speech by a regulator.

Thanks for reading everyone. Questions or comments, just let us know.

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