DiffuseLaunch
virtual fund pitch session

# Attractive Yields from Stablecoin DeFi Investments

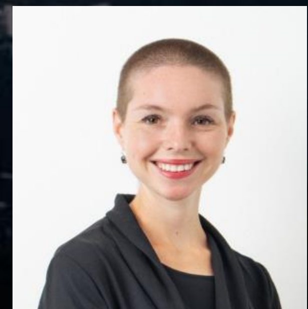
Guest Moderator:

Brian Walls

Managing Partner
Bridge Alternatives

Hosts:

Kenny Estes
CEO and Founder
Diffuse



Ayla Kremb
COO
Diffuse

# DiffuseLaunch: Attractive Yields from Stablecoin DeFi Investments

In our latest DiffuseLaunch session, we were joined by Brian Walls, Managing Partner at Bridge Alternatives, to talk about Diffuse's exciting new fund, StableFi, which aims to generate strong yields in a market-neutral manner (i.e., minimal exposure to overall digital asset volatility) by investing stablecoins in innovative DeFi products.

If you want to make new friends from the Diffuse Ecosystem, email contact@diffuse.com.

## DiffuseLaunch

This session is part of a virtual events series where we talk about brand new innovative and alternative funds in the market with none other than the masterminds behind the funds.

## Guest Speaker

Brian Walls is a passionate advocate of DeFi with over three decades of experience in the alternative assets space. He is currently Co-Founder and Managing Partner of Bridge Alternatives, an independent brokerage firm that focuses on providing advisory, capital introduction, index development, and research events within the alternative investments industry.

Linkedin: @briangwalls

## Diffuse®

We are an alternative fund platform offering differentiated investment products.

## Diffuse® Digital

A family of fund products for investors who want exposure to the potentially attractive returns in digital assets. We partner with service providers respected by Wall Street and adhere to tight compliance, risk management, and investing processes.

## Diffuse® Digital 30

Our institutional digital asset index fund that provides exposure to a diversified basket of crypto currencies by investing in the top 30 coins, weighted by market capitalization.

AYLA KREMB: Welcome, everybody, to our second Diffuse Launch session. This is where we actually bring in brand new funds — in this case, our own fund — and a large group community to give you guys an opportunity to ask all the tough questions and also get a sneak peek at how we actually create our funds from scratch.

The purpose of today is a few things. We want you to have a chance to do a little bit of networking, which is a lot of fun. Then, we'll introduce the Diffuse Digital stablecoin, StableFi, which is our brand new DeFi fund. The main premise is these provide high yields and low volatility. Then, we'll then go into a live Q&A with Brian Walls, who is a very avid crypto investor. He will be grilling us, and then we'll close up right on the half hour.

Now, a bit about Diffuse. Our main mission is to identify attractive alternative passive investment opportunities, and then spin up funds around them. Diffuse StableFi is obviously one of those funds. Diffuse Digital came out of that mission to give more access for investors to invest in digital assets, so this is one fund. Number two is our little fund family of digital asset funds, which gives you an opportunity to get access to something that's institutional grade, while having a cutting-edge strategy behind it. Now, I'm passing it on to Kenny because we are tight on time today.

KENNY ESTES: Sure. So, Diffuse Digital StableFi is the newest fund that we've launched. Here's a legal notice. This is not a presentation. This is not a solicitation. This is solely for informational purposes. If you're interested in investing, we're going to have that conversation but please do reach out for a PPM.

Moving on, this is a DeFi fund. What is a DeFi fund? DeFi is decentralized finance. In a nutshell, it's taking tasks and services traditionally done by financial institutions and finding a way to do them in a decentralized, permissionless way. Think of it as doing what a bank does, or what a financial institution does, without all the bureaucracy and golden parachutes, and just the general overhead. The yields are created by staking assets into DeFi products. Currently, the most lucrative (and maybe we can go into detail a bit later) are actually market making services. It's converting between one digital asset and another digital asset.

The way it works is you provide liquidity by staking your digital assets into these pools. And then, every time they facilitate the conversion from one asset to another, you earn a share based on your investment size of the transaction fee that the pool itself charges. Now, this chart shows you the rise of DeFi. It has just absolutely exploded since last year, in what they called the summer of DeFi. But it's only gotten bigger since then (this current affair is just a general market sell off).

DeFi is super high volatility. Each pool has its own token. No yields are really strong on Ethereum anymore. You have to get off Ethereum and really find something more interesting. It's kind of uncharted territory. It's a bit Wild West-y, with the high volatility. The way we tried to solve this is with stablecoins. What is a stablecoin? The easiest way to explain it is that it is a digital asset pegged to fiat currency. In all cases right now it's the US dollar, but that's not exclusive.

At a very high level, to explain what a stablecoin is, there is a bank account with some money in it, and they put a digital asset wrapper around the bank account so that at any point, the money is 100% backed by the dollars in the bank account.

Now, that's not actually how anything works in practice. One of the big risks you'll see throughout is that that peg can break. It has broken, not on the ones we've dealt with, but you see new stablecoins come up all the time and block. Avoiding those is the name of the game, so our strategy is only using the more established stablecoins in general, big market, north of 100 billion, and no volatility, because they've pegged their buck. That's what we do. We only invest with stablecoins.

The solution, Diffuse Digital StableFi, is a portmanteau stablecoin of DeFi. The name is not very clever. It just means that we're investing stablecoins in Defi. The yield comes from the DeFi bit, where we stake them. And the low volatility comes by only using stablecoins which are paid to US dollars. Theoretically, this is a market neutral strategy, which means that if crypto goes up or crypto goes down, our principal balance doesn't change.

Now, the only way that you can have the principal balance lost is if a peg breaks, in which case, we just diversify across different stablecoins, or if one of these pools that we invested in becomes fraudulent to such a degree that the developers are able to steal the funds.

We have four pillars. We'll talk about them each in turn here. First one is the team. I'm the portfolio manager. My background is what we talked about. I was a high frequency trader for a decade, and I actually started when I was 18. I was very early in that sense. Ayla is our COO at Diffuse, making sure all the trains run on time. And then, we have two technologists that, combined, have about 50 years of traditional finance infrastructure development, and they spent the last six or seven developing crypto trading infrastructures. We're quite an experienced team, for lack of a better term.

The investing process, as we've mentioned before, is that we only invest with stablecoins. However, the highest yielding DeFi pools are the brand-new ones, for reasons that we can explain if somebody's so inclined to learn. So what we do is, we continually find new pools as they come online. For most pools, we've been in on day one. We're aggressive because that's where the highest yields are.

We get in there first, and we buy a lot of them. And each pool, before we go into it, we do an underwriting around it. We look at things such as, do we know the developers' identities? Is there a backdoor that the developers have put in to steal the principal, steal the investments? How much AUM or TVI does that particular pool have? We have 15 or so different things that we look at when determining which pools we go into. Even then, we do diversify across them. Because for us, at the end of the day, the game is all about principal protection.

With regards to infrastructure, it's the same thing. We want to have a strong infrastructure. We currently are doing things manually. We are compounding every day. And what that means is going out and taking all the interest, rewards, tokens we've received, selling them, converting them into stablecoins and reinvesting them again. Because each of these reward tokens that we receive are very volatile assets, and we want this to be a market neutral strategy. So, as quick as we can we get out, we sell it and move it to stablecoins. We're actually in the process of automating that to increase our yield, increase our compounding, and decrease our risk. We'll probably be running when that's done on about an hourly basis.

Moving on to service providers, as I mentioned, our general goal is to be an institutional fiat on ramp. So, we use good service writers to allow more sophisticated allocators to invest. Kleinberg Kaplan was our

fund formation attorney. We wanted to use a signature bank because this is an audited product. This is a fund admin who has a very slick onboarding and great DeFi integrations.

With the terms, like we said, we like to keep it simple. It's a Delaware Limited Partnership, Reg D fund. The minimum investment is 250K, standard 2-20. But the key thing here is the redemption. This is monthly redeemable. It's a liquid product, where we don't have any long lockups or anything like that. If you want to put money in on month one and take all of it out in month two, that is completely fine. You'll get high yields without having the types of long lockup that you would see in a more traditional private equity style investment vehicle.

We launched on July 15 with internal money, and this is really the first time we've spoken to outside investors about investing. The next close will be on September 1, and that is that. I'm sure I missed a lot of points there, but we'll call it because that's the end of our slide. Ayla, back over to you.

AYLA: Beautiful. So now, we're going to have our favorite moderator Brian Walsh, who has kind of become our staple host for the Q&A section of Diffuse Launch. Brian, do you want to give a quick introduction to yourself?

BRIAN WALLS: All right. I come from traditional finance. I spent many years at places like Dean Witter, Calyon Financial, Newedge, and then SocGen and the prime services, futures brokerage, commodity trading advisors, and hedge funds. About four years ago, I got really interested in crypto.

I invest in a lot of different funds, and I've done some of my own investing as well. I've tried doing DeFi investing myself. It is cumbersome and detail orientated, which is not one of the things I'm good at. So, I am happy to make my investments through groups like Diffuse and others. And in this case, I am actually one of the first investors in StableFi, is that right?

KENNY: That is right. Yeah. Brian is an investor in Diffuse. He's got the right of first refusal there, and we're part of the internal money. So thanks for that.

BRIAN: There we go. We have a couple of questions about how you look for high yield pools. I'm going to table on technical questions for a second, but I wanted to get to the big question to me, which is, what type of yields are we talking about here that you've seen? And why would they exist?

KENNY: The yields are very high, especially for this type of product. Because again, this is market neutral. It's principal-protected. Right now, I think the net of fees is 50% APR. It's not small. That will come down as you see more capital come into this space, but we would be pretty surprised and a little disappointed if we don't hit that 30% net of fees in year one. And the reason for that is the way the market maker model works is, you get a transaction fee and that's paid out to all liquidity providers.

So if you think about the yield, it's the number of transactions divided by the size of the pool. New pools are small, but they're also exciting. There's a lot of transactions. You will see that the highest yield by far is on day one for pretty much every pool, and then that decays very rapidly, as you see capital moving over into newer pools.

BRIAN: Okay, so part of the strategy then is to be early. Let's go to the question I saw in the Q&A, which is specifically around how you look for back doors. Let's talk about that due diligence around the tech. Since you're getting involved in early-stage tech protocols, and you want to be a first mover, how do you protect against a big loss of somebody taking the money, or maybe the peg was not maintained in a reasonable way and so we have a big drawdown?

KENNY: There are two major factors with how a new project can break. The first one is what's called a soft rug pull. This is where the developers don't have a back door and they can't get the principal that you've invested into their pool. But the developers are given these reward tokens which they hold while they're maintaining the projects as an incentive for them to do that. If that reward token goes up, everybody's happy. In a soft rug pull, the developers say, “I'm done with this”, and they just sell all of the reward tokens, and they abandon the project.

Now, the principal is sitting in the blockchain and there's no back door for them to get it, but that’s fine. The way we mitigate that risk is by selling, at least daily, all the reward tokens that we receive. We almost have no exposure to soft rug pull scenarios. We’re selling every day, and we're split across 10 different pools. If a soft rug pull happens, then we lose only one day’s worth of returns for one pool out of 10. This way, it's a pretty small risk.

The bigger one is a hard rug pull. And that's where usually the developers are malicious, and they’ve written back door code. To mitigate those, we look at audits, we look at third party services like RugDoc who specifically seek these out and make them put risk warnings around them. We'll even look at odd source code here and there to see if we can find them. However, we're not going to find them all. Nobody's ever going to find them all. That's why the key element of this is diversification across a bunch of different things.

BRIAN: That leads me to the next question. If you were going to characterize the investments that you're making, or the process, how do you budget that risk? How do you look for stability, but also seek the yield? How would you break it down?

KENNY: Generally, what we do (I've started using this term and I don't know if it's going to stick) is pool surfing, where you have this high yield on day one, and then it comes down. You just continually want to diversify across the high yields, so it feels a little bit like surfing. Diversification is by far our biggest thing. It’s the easiest thing and cleanest way to do risk management.

Outside of that, we do have a model that is surprisingly involved, to figure out the yield, how old the pool is, the various risk factors, the TVL, the AUM, the amount invested in the pool, and then putting those all into a model to show a really rapid decay over a period of time. And then, we just count that even further to take into account the probability of default. It's not perfect, but it is a very effective way of projecting the returns and minimizing the number of transactions, because every time you do a transaction in this space, it's expensive. It costs money. We try to minimize that by finding older, more mature pools, where a lot of our portfolio goes to get a solid income, and then the newer pools where they have really high yields. We do that pool survey more aggressively.

BRIAN: So then, if you could help me and help us all understand a little bit of what the percent is going into the less risky, and where you're stretching and taking a little more risk for yield. Give me a feeling for how risky overall the fund is allocating.

KENNY: We just launched, so we're still trying to optimize the portfolio. But the goal we're working towards is 70% in more mature pools. These are pools that are more than a month or two old. The other 30% is in brand new, wild west of the wild west pools with the highest yields. This way, you have the core engine creating solid returns, and then just pairing them with the smaller mountains, which are the newer stuff.

BRIAN: And then within that 30%, what would the diversification look like?

KENNY: Right now we're probably heavier on the new stuff versus the old and we're split across about 10 pools, where we don't put more than 15 or 20%. We will tweak it as we go in any one pool at any given platform.

BRIAN: Okay. So another question on there which is also on my mind is regulatory risk. We see the senate hearings, we see the infrastructure bill, we see comments from senators and Congress, in which people are talking about DeFi and stablecoins. I'm guessing to some extent, it's what's going to keep the yields available. The velvet steamroller isn't here yet. But on the flip side, what's the regulatory rug pull risk? Is there a risk of suddenly, the protocols you're working with are deemed to be exchanges and need to do KYC and everything else?

KENNY: It's definitely a risk. This is a whole can of worms, so the first thing for us, the way we structured it is to be compliant on day one. We are only accepting accredited investors. We are just a Reg D fund, which gives us a lot of flexibility. And as long as we stay within those conditions we have, we can really invest in quite a spectrum of things.

You'll see that companies like BlockFi, if anybody's following that saga, are being sought after pretty hard by regulators lately. They've got cease and desist, because they're offering something that looks a heck of a lot like a bank account, but they're not properly licensed to offer that type of product. We don't have

that issue. We're a Reg D fund from day one that only takes in accredited investors. We're doing it the right way. And this is pretty consistent with Diffuse Digital across the board.

The big regulatory change, the thing that has the industry in a tizzy right now is that there was a last minute slapped-on language to an infrastructure bill in Washington DC, that they were going to start forcing lots of different types of crypto projects to registered broker dealers. That's okay. But the language was sloppily put together and was originally going to include all miners and people that don't touch any customer money. It's like "no, you're a broker now."

This is what every single advocacy group in blockchain land is focused on right now. And even if that doesn't change, the net effect is it's going to push these pools offshore. Because they just won't want to be regulated. They'll just then go international, and we would still be able to invest in those as a default.

If anything, to your point, that would probably just increase yields, and we're going to keep seeing these funds come online. There might be a slight downtick, but honestly, the U.S. is not the most forward-thinking regulator when it comes to crypto. That's why a lot of it is already offshore. Ayla, did I miss anything in there on the regulatory? I know that's one of your favorite areas as well.

AYLA: No, I think you actually caught it. I think what's important is that it really depends on the structure that you've set up from day one, which Kenny definitely mentioned there. Not that we are not really invested. We're also watching as everything unfolds in front of our eyes. But I think the way that we have structured ourselves might actually be a good thing. The fact that other investment opportunities are disappearing with regulation kind of increases the interest in our product. For us, that might not be the worst thing in the world.

BRIAN: Gotcha. So basically, because this is a Delaware Reg D fund only for accredited investors, and you do all the KYC, all the AML, that if these restrictions come through, it doesn't really affect the StableFi fund.

KENNY: Anything can change. That might change. But it's our understanding right now that it would have a relatively small impact, if any.

BRIAN: I personally know this when I did the investment as well. The KYC and the AML was at a higher standard than it was for other stuff, even though I was invested in other products. But moving on, what about custody? These things are not Coinbase custody-friendly, right? So what's the custody and the security around that?

AYLA: Maybe I'll just give you an overview. Out of the top 100 coins at the moment that are actually in the market, Coinbase will manage about 15 to 20 of those on any given month. The turnover within those coins will be about 20% month-on-month. But we also include all of the new DeFi pools that are being launched, and their individual rewards tokens.

There's really no custodian that can manage this on their own or have any appetite to race after all these tokens as they get launched. But what we're looking to do at the moment, is we will partner with a company that actually does self-custody and allows us to do that in a safe manner. That's one option, where we can increase the security of how we manage our own assets, but also have that level of transparency for admins and auditors.

BRIAN: Okay. Another question I'm going to paraphrase from the chat is, if you are part of the market maker, and you're contributing to the stablecoin side, what's the risk of participating in the market making pools? Because it's not the same as just lending and getting a yield. You are actually participating in a pool, and there's a token on the other side of it. What's the risk then of market making? What if that thing gets away from you really quickly? Do you have an impermanent loss that goes permanent?

KENNY: If you have a pool (and again, we don't want to get too far into details here), which is half one asset and half the other, and then the prices change, they call it an impermanent loss when there's a shift in the portfolio allocation relative to the true value of the market. For us, we're using stablecoins. So even if the composition of the fund changes, they're all still worth a buck, so we have virtually no impermanent loss. Some days they may be equal to a buck, some days they may be 99.5 or something like that, but it's pretty small.

Now, we've already talked about the pool risks, the pool being the counterparty, where there's the soft rug pull and the hard rug pull. We've already kind of beaten that horse to death. The other one we haven't talked about much is the peg. That is probably the biggest risk to the fund. Right now we're only using three stable ones, so if the peg breaks on any of those, we're going to feel it now.

However, it's not going to go to zero. If you looked at it, Tether, for example, has an absolutely terrifying interview out there about how maybe they're not as collateralized as everybody else thinks. This is not new information. The peg is maintaining Tether, and we make sure that we keep about under 20% of our portfolio exposure on Tether, so we want to tread lightly with them. If that breaks, it will go to zero. It will go to what the perceived collateral level is. We watched IRON Finance happen, and it dropped to about 70 cents on the dollar instead of a buck. So if we have 20% of our portfolio drop 30%, okay, fine. But I think that's much more likely to happen in the next year in, say, the stock market. Although we view it as a very real risk. It's something we try to diversify around as best we can, but it's not solvable. That's for sure.

BRIAN: Okay, one last question. Are there any other products like this out there? I'm not aware of any, but what can we compare StableFi to?

KENNY: This may not be a great analogy, so don't go away thinking of this, but it does look a little bit like a money market fund, where it's relatively low principal volatility, but with focus on yield. It looks a bit like a fixed income product. We've not seen anybody come out with a specific strategy. There's plenty of people that invest in DeFi that have this weird antagonism between pools, and that don't want us to do this type of strategy because they want to keep the money there forever.

We know there are other people who are doing the same strategy as we are. But the thing is, a lot of crypto strategies you see start with trading, where they want to raise outside money to see the strategy. And so, they make a security token pool and migrate —huge cough— 95% of your capital base. No institutional investors are ever going to touch that, so we went the other way. We're definitely the first one with the strategy that's actually doing things in a regulatory compliant manner.

Thank you for downloading this DiffuseTap event transcript.

Sign up for upcoming sessions and check out past features and event transcripts.

**Dennis Chookaszian**
Corporate Director, CME Group

DiffuseTap: Institutional Grade Governance

Sharing his decades-long expertise on corporate governance, Dennis discussed how to avoid a co-partnership going sour, the problem with overly idealistic CEOs, and the importance of keeping your board in check. Read on

**Susan Brazer**
CEO & Founder, LionShare Media

DiffuseTap: Media Metaverse 2022

Susan talked about the 2020 digital media landscape; the evolution of media distribution; how converging, emerging technology points to the metaverse; and the prospect of having an open, decentralized, and free Web 3.0 marketplace. Read on

**Raj Mukherjee J.D.**
VP/Global Head of Tax, Binance.US

DiffuseTap: Crypto Taxes Decoded with Binance.US

Raj explained the complexities of the US crypto tax landscape, how he built a dynamic tax information system for Coinbase and Binance from scratch, and how investors can profit from crypto without getting caught in a taxation mess. Read on

JOIN US

© 2021 Diffuse Inc