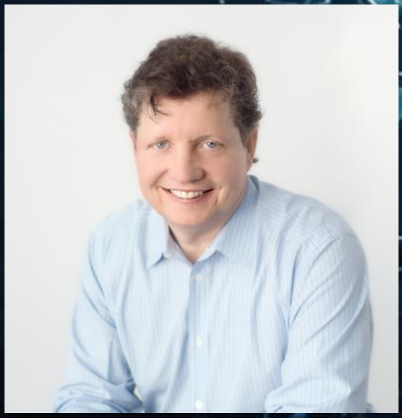
DiffuseLaunch
virtual fund pitch session

Launching a Crypto Index Fund

Guest Speaker:



Brian Walls
Managing Partner
Bridge Alternatives

Hosts:

Kenny Estes
CEO and Founder
Diffuse

Ayla Kremb
COO
Diffuse

DiffuseLaunch: Launching a Crypto Index Fund

In our very first DiffuseLaunch session, we were joined by Brian Walls, Managing Partner at Bridge Alternatives, to talk about Diffuse's exciting new fund, Diffuse Digital 30 – a market weighted, institutional grade index fund of the top 30 hottest tokens in the market.

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

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.

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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 to today's session. This is actually our very first DiffuseLaunch. As opposed to DiffuseTap, which is all about networking and insights, DiffuseLaunch is all about new alternative funds that are coming to market. To give you a quick overview of the agenda today, we started with a tiny bit of networking. So thank you for entertaining us. If you meet someone interesting, let us know. We'll be happy to connect you later on.

Then, we follow this up with an overview of Diffuse Digital 30, our brand-new fund. Diffuse Digital 30 is a market cap weighted index fund that's going live as we speak. We will give you an overview of this at the moment, and then we will follow that up with a spin-the-wheel, which is something we're doing for the first time. We will spin the wheel, and Kenny and I will get grilled by Brian Walls. I'm quite excited about that because it's a new experience. Feel free to ask us tough questions in chat. And then, we will close as usual by inviting you all to our telegram group to ask more questions, or you can also ping us directly for more information.

Now, about Diffuse. We're an alternative fund platform that seeks to identify interesting investment opportunities and spin up funds around those. Diffuse Digital is our proprietary fund family that focuses on digital assets and gives exposure to that as an asset class in a variety of ways. I'll give it over to Kenny to kick us off and share a little bit more about Diffuse Digital 30.

KENNY ESTES: All right, sounds good. Welcome everybody. Diffuse Digital 30 was technically launched June first. We just did some guinea pig money just to make sure that it's all fully functional. But before we get started, a legal notice (not a solicitation): you have to be an accredited investor to invest. We will be sending a private placement memorandum and things of that nature, so please treat that as such. I did not read the whole thing out, but you can see there for your purposes.

So, what's the idea? For those of you who aren't really active in digital assets, or even for the ones who are, alternative coins are the new rage. Bitcoin and Ethereum are no longer the hottest coins around, and honestly, Bitcoin is now being referred to as the boomer coin, which I find absolutely hilarious. The reality is that there is just so much innovation going on right now in DeFi that the story is less and less about Bitcoin and Etherum. Ethereum is trying to catch up, but they have some pretty serious throughput issues.

This chart here tells the story. This is the market cap of Bitcoin and Ethereum, versus the field. With this yellow line being the field, you can see that from the beginning of this year to now, there has been a pretty meteoric shift in the relative value of Bitcoin and Ethereum compared to the other ones. We fully expect that to continue as we see these alternative chains, and as DeFi continues to grow.

That is the landscape of digital assets, which creates an issue for investors. The first one being that the products that are in the market, the Grayscales of the world, they're pretty much just focused on Bitcoin and Ethereum. There're not really any good indexes that are investable out there, which creates a problem for custody if you injure yourself, or if any of these funds want to. Also, if you're looking for exposure to the larger market, you need to get past Bitcoin and Ethereum. But that just doesn't really exist in an efficient manner today, until now.

That's the idea behind Diffuse Digital 30. This is a true institutional grade index fund to really give the investors that exposure to the larger market. We really tried to make this institutional grade (you're going to hear that term a lot) and we do that in three ways: asset selection, product design, and infrastructure. First, asset selection. This is a beta product, so the fee structure is set up as such. It's largely just a flat management fee. We want to give easy and simple one-stop access to the entire digital asset space, which, after the sell off a couple of weeks ago, is probably at a pretty good discount.

In terms of monthly rebalance, it is fully redeemable on a monthly basis. There's only a monthly lockup, which means you can really get money in and out pretty easily. We want to make this a one-stop shop. With the product design, again, we went with tier one service providers, some of whom are even on call, including our lawyer. We really wanted to focus on folks that are well respected by Wall Street to allow institutional allocators to get more comfortable. Now, that's not where we are today, but we figured we wanted to put the right foot forward out of the gate.

As an index fund, we will be publishing an index and tracking against that. That's not happening yet, and I'll talk a little bit more about what the roadmap looks like there. That's product design. In terms of Infrastructure, as I mentioned before, we are a qualified custodian throughout. We're working with top tier service providers with reasonable governance, regulation, all those things, so that when we get to that stage, institutions can really invest the way that they want to, and we can get through their due diligence.

I've alluded to this a couple of times — what's the plan, and where are we now. We just launched, so we're in phase one that's up to 10 million. We feel like this phase is going to largely involve high net worth individuals and family office investors. The advantage for phase one investors is they also get a profit share, which I'll talk about in more detail, for the lifetime of the fund. It's a pretty interesting opportunity because if this thing gets anything close to the AUM that its competitors have, that profit share would be very valuable.

Once we get past 10, which is where we're about breakeven operationally, we move into phase two. Diffuse spends a lot of time networking and building a broker dealer network, so once we get into phase two, we're primarily going to do broker dealer and distribution, pay success fees, and scale that thing up rapidly to get to around that 100 million level.

Once we get past the 100 million level, we get a serious look at what happens for phase three. There are a number of ways that it can go, and we don't entirely know. Option one is, we can turn it into an institutional only vehicle and continue to raise money. If the SEC has figured out ETFs and we have custodians that they're happy with, we can potentially turn it into an ETF and go public. We've already had conversations with folks about listing in Canada, or we can do a master feeder, there's any number of potential things. But really, the goal now is to get phase one up and operational, and make sure all the infrastructure is built. Phase two, we really scale. And then in phase three, we do any kind of based reasoning when it goes through.

The Investment Committee will ultimately be five people. For phase one, it's just two. It's me and our technologist, who again, some of them are on the phone here. We have a shortlist of pretty high caliber folks filling out the remaining three seats. But again, that's one of those things we'll do right when we're preparing to go out for that phase two, larger distribution push.

So, those were the terms, just to get things going. Until we get to 5 million AUM, it's 250k minimum. Unfortunately, we do have an investor count issue, so I don't think we're going to be able to accept SPVs and multiple investors to get to that 250k.

Like I said before, the fee is pretty straightforward. 2% per annum management fee, and 20% lending staking. That ladder is pretty minimal, it's the same with BlackRock, when they have their ETFs. They lend out those assets and get a little bit of interest revenue, in which they do an 80-20 split on that interest. It's the exact same concept for what we're doing here. There's no performance fee — this is not an actively managed fund. And because it is an index fund, we want to keep the slippage to the index as minimal as possible.

The advisors, the general partner, actually pays pretty much all of the service providers. That includes the custodian fee and the accounting audit. All of that gets covered by the GP advisor. So, it's not coming out of the LPs. It's a pretty expense-efficient vehicle for you. In terms of redemption, we touched on it before, but there are really no lock ups, monthly redemptions, 30-day notices, or any of those things.

We went live on June 1st, 2021. I mentioned this before, but the profit share scheme we're going with is, we're calling it, a jump ball. The way that it works is, the earlier an investor invests, the more profit they get. For the first million in total, investors get 2.25% profit share for the lifetime of the fund. And then as you can see, the second million in the door drops a little bit, and it keeps decreasing until we get to that eight to 10 million. And then, once we get the full 10 million in the door, that's really the beginning of the phase two distribution.

That's where we are now. I think this is really about seeding the fund, getting into that breakeven, and getting into that critical mass where it can get going. We do have a new website, so if you want to check this out, go to diffusefunds.com. And that is everything that I wanted to speak about. Ayla, over to you.

AYLA: Awesome. Well, I'm going to pass that bucket right off to Brian Walls. Brian, do you want to give us a moment to just introduce yourself? We know that you're part of Bridge Alternatives, and we also know that you do a lot of work within the alternative asset space and are passionate about crypto. But please, do the details about you. And then you're welcome to just run away.

BRIAN WALLS: Okay. While I'm talking, if people have questions, you can start putting them in the chat so we can go directly to them. So, for myself, I've been in the alternative investment world since it was created. I got involved back in ‘85, wherein I was doing stock index arbitrage in ‘85 and ‘86. That kind of blew up in ‘87, where I was providing services to places like Tudor and Caxton in the late ‘80s to the early ‘90s. I had a career there and managed futures and hedge funds, working for Dean Witter, Calyon Financial, and Newedge for about 25 years. In 2017, I got really excited about Bitcoin. I started deploying more capital into it in the last few years. Although I still act as an advisor on many of the other things, I'm primarily focused on crypto.

So, that's me and my background. I'm an investor in Kenny's other project, West Loop Ventures, as well as a few others, so we're kind of a tight crowd. Where I want to start with the Q&A, Kenny, is I know from my personal experience that if I go and buy THORChain, or RUNE, which is an exciting new project that I've been hearing about and reading about, I have to use a VPN and go to Binance to purchase THORChain.

It's sitting there in my Binance account, and I don't even know if I can get it out, to be honest with you. One of the first things I want to think about is, if I wanted to do this myself, if I said, I believe in the ecosystem, versus, the boomer coin concept, could I even do it? Could I do it with what you guys are doing with this fund?

KENNY: Could you do it? (laughs) Well, anything's possible.

AYLA: We believe in you, Brian.

KENNY: It's a pain. There's a couple things. One, if you did it, and you wanted to get that access, it's like if you're connecting through a VPN to Binance, Trade B&B, Ripple, or something like that, that's a whole different area of risk. One of the things you need to worry about is private keys. You need to worry about whether that exchange might shut down, or all sorts of fraud, and things like that.

Having said that, the way we went about designing the vehicle was really to focus, first and foremost, on that custody. Custody is big for us. We will only deal with it if we have a respected registered entity holding those private keys, so that there's no risk of Kenny and Ayla disappearing to the Bahamas with the cash or sending it to the wrong place. There's really clear fiscal and governance controls around how and where and when that money can move. That gives people an extra sense of security.

We launched with one custodian that gives us 17 out of the 30 coins, and we have others that we're talking to that can give us more. The thing is that the custodians are still playing catch up on these alternative coins, so we deliberately launched this vehicle early. We want you to get out there as soon as possible. We know that we don't have all 30 coverage, and we know that it's coming quickly because every custodian on the planet is trying to add them as we speak.

So, the idea is to get out there, get in the market, start building that track record, start tracking, and make it just so much easier. So you, Brian, while you're trying to connect to a VPN to the Netherlands to do a trade, you don't have to deal with that.

AYLA: One thing to add to that is the velocity in which custodians are adding new coins is picking up massively. We started the project in February and I think we spoke to 40 custodians in total. Every month, they're launching new coins and we're at the point where we see them coming pretty close to the top 30 within the next two to three months. The velocity is picking up. And I think it's mainly because there's so much redistribution of capital from your Bitcoins and Ethereums into the alternative assets. That's an interesting tailwind that we're getting from the progress of the asset class itself.

BRIAN: Okay, cool. I have one more question, then I'm going to go to the group questions. Solana traded at $1 for a year and then went to $40, and then got listed on Coinbase. Polkadot was at $2, and then it suddenly went up to $25, and then got listed on Coinbase. At the management of what you're doing, is it going to be strictly indexing, “let the market determine it”, kind of approach? Or are you putting any discretion into the choice of the tokens and whether or not you're in them? Maybe there's regulatory news or XRP. What type of discipline is going to be used on this?

KENNY: It's largely formulaic. We're going to watch the market cap. There have been many a Nobel prize that show that's actually the right way to do it. The more discretion you put into it, the more those charts look like an actively managed fund. At least historically in Trad Fi (or traditional finance), that active discretionary selection process underperforms just doing the formula and not even thinking about it.

With that said, there is the reality of certain regulatory issues. Ripple is a good example. It's hard to get people that can actually custody that, so it's a pure functional issue. It's the same thing with Monero. No custodians are ever going to get that covered. So, we choose to approach it as formulaic as humanly possible. We're not passing judgment on the coin itself, just whether we can effectively hold it.

BRIAN: So, you're not reading white papers to determine which tokens to add, you're letting the market determine what the largest cap tokens are?

KENNY: Exactly.

BRIAN: Okay, we have a question here. Are there any similar products to this? Do you have peers? Who would they be? If I was going to look at this Diffuse 30, who would I compare it to in terms of peers? And why is this a better fit?

KENNY: Yeah. The 400-pound gorilla in the room is Grayscale. That's just the reality. I think the last time I looked at them, they had one single product there: Bitcoin Trust. I think they have 430 billion under management at the moment. But the way that is set up is that there is no redemption. That's a big knock against the people who are actively trading in Grayscale.

Two months ago, the traded price for the secondary was 30 to 40% above what the actual book value was. That's a pretty significant discount. Which means that if you're an institution looking at this, it's very difficult to touch it. And some do, right? But then, they have to be comfortable with being subject to the whim of the crowd to figure out what the discount or the premium is on any particular day.

On the other hand, ours is a monthly redeemable product. We're still doing that same 2%. Grayscale, for what it's worth, has a whopping four-coin index that they charge two and a half percent for. This is pretty reasonably priced.

Outside of that, the only other main competitor would be Bitwise 10. However, Bitwise doesn't have great solutions for the custody. They're not putting that effort in as far as you can tell. Of the top six coins by market cap, they have two in the index. That's just not a very good way to track.

BRIAN: Okay. What custodian did you pick for the fund?

KENNY: We started with Coinbase, and we continue to talk to other people too, as we grow our symbol coverage. Actually, two reps are on the call right now, Kevin and Nathan. They're like a parent custodian, but they just got their trust license a couple days ago. That's how fast this space is moving, which is pretty cool to see. We keep an ear to the ground to see who has a license, an infrastructure, and fiscal control that we're comfortable with. And then we're just going to continue to increase the coverage over time.

BRIAN: I think you've kind of answered this, but I think it's worth repeating. Is it equally weighted or cap weighted?

KENNY: It's cap weighted. That chart that we showed in the beginning showing the relative market caps comes directly from our weighting chart.

AYLA: And that's an automatically generated list by our tech team. We'll do the rebalancing once a month, and we'll tie both redemptions and new investments to that same rebalance on that monthly cutoff date. What we do is we eliminate wrapped coins and stable coins from that list, because that will be repetitive. But that's the only edit that we're necessarily making. And of course, any coins that we cannot custody at the moment will be admitted. But besides that, we try to keep very tightly to that top priority list.

BRIAN: Okay, so there's a question about who is the committee technologist. You mentioned them but it's vague — “they’re in the deck. They’re on the call.” Can you give us some background and some transparency?

KENNY: I think I might have glossed over the team slide too quickly. My background is high frequency trading. I used to do that in a pretty decent size, and really focused on taking trading algorithms and scaling them a lot. In 2008, on some days I think I was about 5%, personally, of the US equity market, which is just bananas. But those were the days.

The firm I was at was a company called Getco. They were really good at technology. They actually build themselves as a technology firm, not a trading firm. We have two of the technologists from there, Jans and Eric. I think Jans is on the call. At a minimum, at Getco, they were senior and very respected technologists. Now, for about five or six years, they've been building out a crypto trading infrastructure. We partnered up with them on this fund to deliver sufficient execution and management.

BRIAN: Okay. Explain a little bit this idea that you're getting a percent of the staking revenue, but it's not two and 20. The thing is, you're not taking 20% if the market goes up 50%, so what are you taking a slice of?

KENNY: Yeah. Let's say we have 100 million under management. What we can do is we'll do very conservative lending, where it's either into a pool that's over collateralized, or we have an insurance product, because safety is key for us. Let's say we take 33, a third of that 100 million. We can then use that and lend it out to people. The prevailing rates are in that four to 5% range. All we do is we facilitate that. It's effectively prime lending.

Like I mentioned before, this is how BlackRock works. They lend out those assets, they do an 80-20 split, where they keep 20% of any lending interest. And that's it. So, if that 100 million turns into 200 million, all we get is the 20% of the interest on what we lent out. We would take no 20% of the upside or anything like that. This is a pure beta, index type model. And the reason we're doing that, frankly, is to help overcome any fee drags. We have really, really, really good tracking to the benchmark index we're using.

BRIAN: Okay. So then, I guess another question would be, is it an offshore fund with a US feeder, or a US fund with an offshore feeder?

KENNY: It's actually neither. We're starting this as a simple package. This is just a simple Reg D, US-based fund. Now, when we decide to scale, we might need to drop a feeder in there. Some people want to turn this into a public company, even. There are all sorts of options, but the objective now is just to get it out, get it to a critical mass, and then we can figure what direction we go once we're actually operational.

BRIAN: Alright, I'm gonna throw one other larger question at you. As you're addressing security issues and you're addressing custody issues, you have an investment philosophy. What about that wildcard of regulatory issues? Does this meet all the regulatory standards right now? And what happens if they come out and say, "you can't hold Bitcoin" or "banking is going to be more closely regulated in DeFi"? What do you think about that risk?

KENNY: It's a concern. As a private fund, we have a lot more flexibility, frankly, on how this all goes out. The big question, actually, for those of you who were on DiffuseTap yesterday with Matt Lisle, is whether ETFs are going to be allowed. And if so, when that plays into this in a big way, it won't sound super positive from the SEC's perspective anytime soon, which is a whole other can of worms.

The other thing to think about is when there's a cap at about 150 million, you need to become an RIA. That's also why we've phased things out the way we have. RIA stands for registered investment advisor, and for those of you who don't know, when you become an RIA, you have to hold everything with a qualified custodian. But then, we'll be registered, we'll have a qualified custodian like we are today (we're only dealing with qualified custodians). And then, that will just make us that much more respectable for scaling for institutional capital.

BRIAN: Cool. We're right at 11:29, and I know you and Ayla were firmly committed to this being 30 minutes. So I just want to check, do you guys have anything else that you wanted to bring up? Any questions I didn't ask?

AYLA: Well, I think one of the interesting bits which actually showed up in the chat is where we get our data from. That's interesting. And another bit is around the operational side of things. It's how do we actually use that data to then strike an app, and all those bits and pieces. I think Steve asked here, if we used CoinMarketCap for pricing. Yes, that's exactly what we do. We use CoinMarketCap with our fund admin.

KENNY: And all these top 30 coins that we're dealing with, at least last I checked, all have north of a billion. These are not brand-new projects that are spinning up the Titans, which famously blew up yesterday. It's not at that level of crazy. These are the more established players in this space.

All right. Well, that takes us right to the top of the top of the half hour. If there's any questions or comments, do not be shy. Again, we do have a new website, I think we drew attention to that, diffusefunds.com. We're actually in the middle of shifting everything onto the same domain, but there's more information out there. And as always, you can drop us an email to gather any information.

AYLA: You will also receive a follow up email with our contact details and a link to Brian in case you want to ask him some tough questions about us, so feel free to reach out directly and in other ways. If you want to have a look at the deck or any other information, just shoot us a quick email and we'll be happy to get a call or just to share the information with you. Thanks, everyone.

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Corporate Director, CME Group

DiffuseTap: Institutional Grade Governance

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CEO & Founder, LionShare Media

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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

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