DiffuseLaunch
virtual fund pitch session

Market Long Crypto Exposure Meets DeFi Yields

Guest Speaker:

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Managing Partner
Bridge Alternatives

Hosted by:

Kenny Estes
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DiffuseLaunch: Diffuse® Digital MaxFi

Market Long Crypto Exposure meets DeFi Yields

In our previous DiffuseLaunch session, we were joined by Brian Walls, Managing Partner at Bridge Alternatives, to talk about Diffuse's exciting new fund, MaxFi, a fund that invests blue-chip coins in DeFi projects for strong yields and exposure to the top coins on the market.

Want to make new friends from the Diffuse Ecosystem? Email contact@diffusefunds.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.

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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 MaxFi

Market-long fund that generates attractive yields by investing BTC, ETH, Matic in DeFi products.

KENNY ESTES: Hello, everybody. This is not DiffuseTap, contrary to popular belief, but it's nice to see you all this morning. We're going to do it a little bit differently. Just briefly, here's a legal notice. I'm going to leave it up for about two seconds.

The agenda for today, as you might expect, is similar to DiffuseTap. We'll have networking, which you had a little bit of earlier, and then we're going to briefly talk about the fund we just launched: Diffuse Digital MaxFi. Our lovely Mr. Brian Walls, who many of you may have run into multiple times at this point because he is a true Diffuse friend. He will grill Ayla and myself all about what's going on, as well as emcee some questions from the audience. And then, we're going to do a quick wrap. We'll try to wrap things up in half an hour.

Briefly, what is Diffuse? Ayla and I are the co-founders of Diffuse. I work for Ayla, but I also talk more so it's okay. We are an alternative fund incubator. We try to find more high-alpha, non-correlated investment strategies, and we turn them into institutional funds. We're primarily focused on digital assets especially this year, but not exclusively. We now have three funds, including the one we're about to talk to you about.

Our team is getting bigger. I'm the CEO, Ayla is the COO. Jens Jorgensen and Eric Long are our tech leads, and they have a lot of technology trading infrastructure experience. And then, we have Ren, who's in the room now, and Yves. Ren is just amazing at finding new opportunities, and Yves is great at making it all run smoothly.

Quickly, to provide some context for those of you who weren't on the last one, the ambition of decentralized finance or DeFi is to take everything that financial institutions do, and do them without the institution bit. That means you get a lot of the same efficiencies, but in theory, a lot better. It's a very lofty ambition, but that market is exploding. If they can deliver on 5% of their vision, then there is a huge, huge market in this.

This chart here shows the market growth. At the beginning of last year, it was practically zero, but now, there's 228 billion invested into various DeFi protocols. The one that we focus on is market making. We provide liquidity into decentralized market making pools to receive transaction revenue. We do that in a specific way that we call pool hunting. As a general rule, when a new market making protocol launches, the yields are silly high because they're determined by the size of the pool. And when it's a small pool, we're basically the only participant in there. We collect the lion's share of the transaction revenue for facilitating the conversion between two currencies.

When we say pool hunting, or pool surfing (depending on when you catch us), basically we're coming in on day one and getting these really high yields that decays over time as more people follow us into the pool. And then, at any point in time, we'll have 10, 15, to 20 pools we're in and ride the decay down, and then reallocate into a new pool. That creates this concept of continually redeploying into the most pools and "hunting" or "surfing" the yield.

That's the core strategy we do both for this and for our other fund, MaxFi. The difference is the assets we invest in. If you think of the principle we're investing into these pools, it's the blue-chip cryptos. In all cases, they are the gas tokens. That includes Bitcoin, Ethereum, Fantom, Avax's Avalanche, and Matic's Polygon. We have an overall crypto exposure, but we juice that with the yield from investing into these market making pools. This is what we do. We're looking to maximize DeFi returns. So, if you want to be long crypto (or long beta, to use the traditional finance term), but juice that with the yield, that's what we're about. We do that with these four pillars: the team, the process, the infrastructure, and the service providers.

My background involves a lot of high frequency trading. Ayla is really good at commercialization operations. We've seen tech folks who are up and coming and hungry, like our favorite, Ren Yu. The process is all about finding these pools, and it's a very manual process. It involves going on Discord and finding them, underwriting them, making sure they're reasonably safe, diversifying them, and managing risk. All those pieces go into our investing process to create relatively consistent returns.

The infrastructure right now is largely manual. We're in the process of automating the whole tech stack to minimize our exposure at any particular point in time to pay the interest in each of these pools, or in a particular coin. We try to minimize our exposure, with the only risk profile being on the beta that is the blue-chip cryptos.

With regards to service providers, again, the whole mission of Diffuse is to be a more institutional fund vehicle or investment vehicle incubator. We work with pretty legitimate service providers to draw money for fund admin, such as Kleinberg Kaplan, which is a tier one or tier two Wall Street fund formation firm. This is an audited fund, and we also have Signature Bank as a partner.

In terms of investment terms, it's just a standard Delaware limited partnership with a $250,000 minimum, 2 and 20. We redeem every month, but it's a 90-day notice period because this is a very volatile fund. But it fits in nicely with our other funds, like StableFi, which is not volatile at all. That allows people to really tailor their risk profile. That is the end of my monologue, so over to you Mr. Brian Walls, partner at Bridge Alternatives.

BRIAN WALLS: Excellent. Thank you, Kenny. I have to say, we already have some questions in the queue, some of which are going to preempt my questions. I'm one of those people who almost don't have a short-term memory. So every time we do this, it's almost fresh, and I can ask the same questions again. But this time, we even have the questions coming right from the audience. I'm going to go to the first one.

This is from Henry, and it's almost always my first question too. Why do these yields exist? At the base level, StableFi has some yield, and then this has some yield. But then, 300% is quite a big number. When we're looking in traditional markets, the difference between treasuries and junk is at around 300 basis points. So, why would these yields exist in this space?

KENNY: Sure. So, it's super inefficient out there. My background was in high frequency trading. I started when I was 18, and I didn't know what I was doing. I still don't really know now, to be honest. But back then, traditional finance felt like it was held together by duct tape and barbed wire. It was just messy. The technical recession wasn't great as well.

In DeFi, we have 20 new pools launching every single day. They're practically copy and paste. For one of the pools, for some reason I had to add seven zeros at the beginning of it. I manually had to punch in seven zeros for some reason. It's just really inefficient. There's no custodian that can actually support this. Nobody has a trust license. They're relatively small pools. That's why we have so many of them at any particular point in time.

That creates an opportunity because institutional allocators can't be in there. They can't go in there without a qualified custodian to start with, more so one that doesn't exist. And you definitely can't go in there with the check sizes that they need.

This is really what Diffuse is about. We like to go where it's messy, where it's not fully developed, and just get our hands dirty by understanding it and finding a strategy. We are one of the few people on the planet who can actually develop and create that strategy.

These yields are silly and legitimate, especially when you compare it to traditional finance, but it's as retail as retail can get. We're the first and one of the few institutional players out here playing in this field like this. And to your point about that 300 plus percent APR on day one, that definitely decays. But even in the decayed state, the baseline is at 25 to 30% APR. it's just bananas out there, and there's so much opportunity.

However, it is so manual. Ren's primary focus is just continually scouring Telegram, RugDoc, Discord, and Twitter to find these pools so that we can be there on day one to take advantage of these opportunities.

BRIAN: Gotcha. Now, obviously it's decentralized and I could do it myself in theory. So when I think about the fees that we pay for this, this is one of those true retail situations. Unlike an equity hedge fund, the actual work of doing it is laborious and takes expertise.

KENNY: Yeah. Just to execute the trades takes two hours every morning, once we've done the research and figured out what we want to do. For better or worse, these tools are so new. By the time you get a technical integration to automate the whole thing, the yields are gone. By the time the WiFis of the world and the yield farming aggregators get to it, it's already a mature pool.

BRIAN: That leads us to another question that Adam had put in. Do you leverage, and are you yield farming, at all?

KENNY: These terms are ambiguous, but I would say what we do would definitely be considered as farming.

BRIAN: Okay. Do you use leverage?

KENNY: Right now, we don't, but at some point, we probably will put some pretty conservative leverage on, but that's subject to collateralization and things like that. But right now, we're at no leverage.

BRIAN: Tomo asked a question. Do you participate in pools only, or in farms? I don't really know what that distinction is.

KENNY: Again, it's a little bit ambiguous. Pools in general are just one asset. It's just a big one. You put an asset in there, and then behind the scenes they take that out and invest it into their various farms based on whatever algorithm they have. Farms directly facilitate the conversion between Bitcoin and Ethereum. We do both, but in either event, it's just one asset in the pool. That means it only has half capacity on one of those blue-chips.

In the farm scenario, both sides have to be a blue-chip. So, we wouldn't do something like Bitcoin and a stablecoin. That would just never be something we invest in directly. There's some ways you could potentially get exposure, but it would have to be Bitcoin and Ethereum, or Bitcoin and Avax, or something like that.

BRIAN: Okay. There's another general question that I think is interesting, and it has been asked a few different ways. You mentioned that you were long on the blue-chips, the Bitcoin, the Ethereum, MATIC, and all these big, well-established protocols, and that you participate in the AMMs. Do you hedge them at all? Do you say, "Listen, we're going to hedge out the beta of these blue-chips, and we're just going to provide you with a net yield."

KENNY: This is just a thing that goes with our theory. It's a Diffuse thing. I don't know that it's the right thing, but it's what we're doing. Our idea is that with every single one of these funds we launch, we want to have a very tight risk profile. You know exactly what you're underwriting, and you can come over the top and create a portfolio according to your desires. This is a pure beta vehicle. There's no hedging at all. You will have the beta exposure, plus the yield, and that's okay.

We have other funds like StableFi, which is market neutral. The idea is, if you want to have a blend, you choose how you want to do the allocations according to your risk profile. You can do 20% in MaxFi with the super long beta exposure, and 80% in the market neutral fund. That way, because it's such a clear profile and you're not relying on us to minimize the volatility, you know what you're in for, and you're not going to be subject to our hedging. You can decide how you want to allocate across the funds. So, the short answer is no, we don't do any hedging.

BRIAN: Okay. I think that is an interesting question because I could see that some might want a strategy where they're long Bitcoin and Ethereum, and they want perpetual futures on it, and they want to take out the beta to just have a net absolute return strategy. And so, how much of the return do you think is going to be the beta versus the farming?

KENNY: I mean, we're at all-time highs. That's a lot of beta. But the long-term interest will definitely juice that. If you're asking me to predict where we think the crypto markets are going to go, obviously I can't give you an answer. My crystal ball is notoriously not very good at these sorts of things.

BRIAN: Okay. So I'm going to ask you a question about the investment process because there are a couple of questions in here that I have to really think about before I express them. They're good ones. Could you walk us through how you scan the universe of pools? How do you evaluate them for risk versus return?

I understand, and I think most people understand that the reason why they're paying the high awards in the first few days is because it's a customer acquisition strategy. "We need to get this pool big as fast as possible. We're distributing a fixed amount of tokens per day. The smaller this pool is, the bigger your return on an investment is."

I think that we get that, but I think it would be helpful because you're talking about different tokens. How do you allocate that out? Is it all in Bitcoin? Is it all in those big tokens? What are your limits? And then, how do you investigate the pools? How do you assess them? How do you allocate?

KENNY: Okay, this is going to be a long answer, but I'll try to keep it as brief as humanly possible. Ren is really good at finding pools. Like I said, it's all manual. He does a great job of knowing what the yield is today, what's the size of the pool, and calculating what happens to the yield if we drop in here (or splash the pot, to use the poker term), because if we triple the AUM, we're going to third the APR. All that goes into an optimization engine that I wrote. When he's doing his underwriting, he's looking at things like what's the yield, or what's the TVL.

We also always do a test transaction, which is something that catches so many people out, like wrong contractors or fraud. This usually involves us putting in 10 bucks, and then taking out the 10 bucks. It's super simple, but it also takes a lot of the risk off the table.

And then, we do the audits. We use services like RugDoc and Paladin, which have these folks that go through and look at the code of the smart contracts to see if the principal is at risk of a hack or a hard rug pull, where somebody can get in there and steal the actual principal you invested in the pools. We will not invest in anything if there's even a hint of risk of our principal getting stolen. There's just no way we're doing that.

I do think eventually we're going to get it wrong, but that's where the diversification comes in. This way, if one of the 10, 15, or 20 pools we have experiences a 10 or 20% hack, the actual principle that's going to be lost isn't enormous relative to the type of returns we're talking about here. So, we do the underwriting first, we look at the yield and the TVL, and we do it every day. We're looking to automate that to go about every hour, running through the optimization engine to figure out how to maximize our income over a particular period of time.

As part of that optimization engine, we have a heuristic distribution that we fit around the decay. If we get 300% on day one, we want to know what it's going to be on day four. I know it's all guesswork. It's futuristic, and it's not clean. It's not 100% right by any stretch, but at least it gives us a reasonable approach to it.

The principle we invest is these blue-chips. The interest is always paid in tokens by the protocol or pool that we're investing in. I call those tokens “crappy little tokens.” I really shouldn't, but I do because they almost always go to zero. What we do every day is, we go out, we harvest all of the interests that we received, and we convert them back into the blue-chip tokens and compound them into the pools. That way, even if one of these tokens goes to zero overnight, we'll only lose one day's worth of interest in one of the pools we’re invested in. Again, that just adds more to the manual element we're doing, but we think it's the key part of our strategy.

BRIAN: That's interesting. And again, that's a lot of work. But what about the concentration risk? Do you go, “Oh, that's too much MATIC and not enough Bitcoin” or are you just letting the opportunities generally dictate what the positions are?

KENNY: It's more driven by yield. As we get more sophisticated and bigger, we would probably put risk profiles around it and try to figure out if we wanted to minimize exposure. But again, my crystal ball isn’t that great. So, with regards to figuring out whether we want to have more Ethereum versus Bitcoin, I just don't want to make those bets.

BRIAN: Yeah, and I don’t want to make those bets either. Unlike investing in a hedge fund that says, “we know which crypto is going up,” you're taking a different approach. You actually want to go long on the beta of the highest yielding stuff instead.

KENNY: Right. And theoretically, because we're always adding new chains (we added Fantom maybe a week or two ago, so that’s a new gas token), this is going to be more of an alternative coin exposure than Bitcoin and Ethereum.

Paul just asked the question, and I need to give him a proper answer. He asked, of the five top tokens we’re in right now, what is the actual distribution between the three? It's certainly not market cap weighted to Bitcoin and Ethereum. It's a lot more heavily weighted to the smaller, more up and coming chains, which I think is the right exposure. You want to have more exposure to the lower stuff that hasn't really fully matured yet.

BRIAN: Okay, let's take a shift here. I want to ask about the regulatory framework. We see hearings, and we hear talk about banks and the Federal Reserve and the Treasury pushing back on DeFi. If I make an investment in the fund and they change the regulatory framework, how does that affect the returns? And how does that affect my standing?

KENNY: Yeah, well, we pay lawyers a lot [laughs], and a lot of it is exactly that. This is the great gray area. We're going to be as compliant as humanly possible. We're a reg D fund, and we're a 506c, which is the highest of reg D funds. That's the one where you have to have an accreditation check. And it's the most arduous in terms of onboarding investors and things like that. And we're also onshore, so we're not doing things in the Caymans, which theoretically means that we're going to have more compliance upkeep long term. I think that's going to be the right approach.

But that also gives us a ton of flexibility, as far as what we can actually invest in. It's our attorney's opinion that as we're doing these pools, we as a fund are not at risk for those regulatory changes. Some of these pools, if they're onshore and they're not doing AML or KYC the way they should have, the SEC might go after them. But they wouldn't be going after us.

The risk is not that we're going to get this massive fine because who knows what the biggest change is going to be. It's our lawyers' opinion that that's not a major risk at all. The risk is more about if this whole thing fizzles. If the SEC cracks down and no one will be able to trade in the U.S., then the fund fizzles. We'll return everybody's capital along with their loss.

BRIAN: Gotcha. What new chains out there do you think are interesting? Somebody mentioned Algorand, Polkadot, and Solana. As you look at the non-Ethereum stuff, which chains do you see more opportunities coming in? And if so, which teams do you expect them to be on?

KENNY: We're really driven by yield. That's not the same as far as which chain we think will be more successful long term. For instance, Solana is white hot right now. But we're not trading on Solana. And the reason for that is because it's so hot and DeFi is so large, we just haven't seen the type of yield opportunities you see on the likes of Polygon, which is older (or at least relatively old in this space). It's an older chain, like Binance Smart Chain, which we're not on anymore.

Right now, we're only on three but we're always looking for interesting opportunities on other chains. We use a fund administrator called Sudrania, who is super comfortable with being early adopters to new blockchains. As soon as we find a new chain and we need to go over there, it's pretty easy. We can instantly obtain a new explorer for the chain and a wallet address. We can trade over there and they'll do the actual accounting, which allows us to be super nimble.

BRIAN: Gotcha. Like you said, Solana is white hot, and there are tons of new projects launching. But you're still looking at it from the standpoint of "Yeah, but they seem to be really well-funded and there's no big yield opportunity. So I'm still going to be looking in the places where there are big yield opportunities."

KENNY: Right, exactly. And I like Solana a lot. I love the technology, and I like the vision that they have. I'm not saying that I think Solana is not going to be successful. It's just not worth it.

BRIAN: Alright. Are there any similar products to MaxFi out there? We just saw BITO get listed, so there's a Bitcoin ETF now. But is there anything that people could buy such as a public fund or an ETF that does this strategy?

KENNY: Definitely not. And that all boils down to the custody.

BRIAN: But we shouldn't hold our breaths either as well. Because the custody is not going to work.

KENNY: Yeah. Even if you have things like Grayscale who have a DeFi index fund, they're just buying tokens like Solana. They're not actually doing the staking that we're doing. So all of that 30 percent return you get on top of the beta appreciation, they're just leaving that on the table. And that's understandable because if you can't have a custodian, you can't have institutional money invested in there right now.

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