diffusetap
Virtual Event Series

Battle of Crypto Index Funds

Guest Speaker

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DiffuseTap: Battle of Crypto Index Funds

Last time on DiffuseTap, Max Sherwood, Business Development Analyst at Finoa, talked to us about why the U.S. still does not have a crypto ETF, what types of investors are crypto index funds designed for, and the problem with DeFi funds.

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DiffuseTap

This networking session is part of our weekly virtual events series. Networking (you'll bump into at least a dozen high caliber fund managers) meets purposeful (you'll tap into brand-new sources of ideas) … straight from your armchair like a boss.

Meet the Speaker

Max Sherwood is a bitcoin believer, user, and investor for over 5 years. In 2019, he created Wholegrain Crypto, a platform where aspiring Bitcoin investors can learn about and enter the space with confidence. Fully realizing the massive potential for cryptocurrency, in 2021 he doubled down on the crypto market and took on a business development role at Finoa, Europe's leading digital asset custodian.

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We are an alternative fund platform offering differentiated investment products. From digital assets to VC funds and beyond, we identify green field investment opportunities we feel will have market beating returns and turn them into professionally managed funds. For more information, visit www.diffusefunds.com.

AYLA KREMB: Welcome, everybody. I think we may have just lost Kenny for a second, but we'll kick off the session just as usual. Max, do you want to hop right in and share a little bit about yourself and what you’re working on?

MAX SHERWOOD: Sure. Hello, everybody. I'm Max, calling in from the offices of Finoa in Berlin. I guess I'm what you'd call a crypto native. I first came across Bitcoin in 2013 and became a believer in 2016. I made my first investment in late 2016 actually in an index manner, which we'll get to in a second.

Recently, I've been doing a lot of research on the intersection between traditional finance, or traditional capital, and the crypto space. I see funds and exchange-traded products as critical to that. Diffuse came across my radar, and I did a holistic review of all the exchange-traded products in the space. They all still fit into a reasonably sized Excel spreadsheet. I also did a review of all the index funds in the space. There really aren't too many that I would call true index funds. I think Diffuse is one of the few that actually has a pretty broad market coverage, but we can get into that in a second.

Just to explain what Finoa does, we are a digital asset custodian in Berlin with a preliminary crypto custody license from the German BaFin. We serve institutional investors, such as VCs, crypto funds, etc. We also do infrastructure for crypto businesses, CoinList being the biggest one on that front. They are an exchange that also does a lot of token listings and token sales.

I guess you could say that our claim to fame is that we have done a few integrations. From the Mainnet launch, we’ve supported protocols such as Mina, Skale, ROSE, NEAR, and Flow from Dapper Labs. We've done custody and staking for those investors from the moment that the blockchains have gone live, and we have cut our teeth on those partnerships. I'll leave it there for now. We can fire into the questions.

AYLA: Sounds good. So, first question. What is the value of index funds specifically in the crypto universe? Obviously, we’ve seen them in traditional finance for years, but what does it mean for the crypto world to actually have access to index funds?

MAX: Yeah. I guess there are similarities to traditional finance. And I think it has to do with what narrative you're buying into, or the “whether you want to stay agnostic” narrative. Crypto is a very dynamic place. We’re constantly hearing success stories that no one has ever heard of 12 months ago. Conversely, we have coins that haven't done much in years that are falling down the rankings of size by market capitalization. I think access to an index fund just lets you express the narrative that you think the space is going to grow and keep it at that.

That's actually what I did when I first invested in crypto. I just bought the top five in 2016. And that gave me exposure to 95% of the market capitalization of crypto, which is pretty much everything. These days, to get exposure to 95% of the market, you need between the top 30 and 50, probably around top 40.

I think it's important to speak to the fact that in crypto, everything is pretty much unpredictable. For example, the biggest thing right now is probably DeFi, but most of us probably had not heard of DeFi over a year ago. At least I know I hadn’t. Last year’s DeFi summer was the first time that most people have heard of DeFi, and now it's the dominant narrative in crypto. However, I don't think it's impossible to spot these trends before they happen. Sometimes the technology just hasn't been invented yet. We're still doing a lot of R&D in this space.

Index funds are a good way to hop into a long-term investment narrative, where you're coming from a place where you're not super keyed into the technical, granular level of the space. I know I'm certainly not. But I think index funds let you express that things are changing in the crypto space, and everything is continuously growing as a whole.

KENNY: You mentioned DeFi, so we'll go there first. We've seen a couple of DeFi index funds come online. What do you think about those products, especially as it pertains to staking, in which a lot of the yield comes from DeFi in itself?

MAX: Yeah. Staking is another core business model here at Finoa as well. Finoa supports custody, so we're aware of how key that is to the space. Staking is how you're validating the blockchain. Someone's going to be doing it, and you're rewarded in kind for that. The DeFi funds in the space right now — or at least the ones I'm aware of — are usually around 10 coins, and they don't usually have staking as part of the yield. They don't offer a yield.

The whole point of DeFi is participating in the networks and offering some kind of service or participation. Whether that be lending out your assets to other people, or verifying transactions on a proof of stake blockchain, and then collecting the yield on that. Without trying to step on anyone in particular, when I see a DeFi index fund, where you're paying 2% but you're not getting any yield, I think it goes against the original point of DeFi in the first place. I hope that's not too negative of an answer.

AYLA: There is also an interesting bit here around the meaning of these kinds of products, especially beta products, in terms of the investor profile that it's suited for. I think maybe a year or two ago, people were really gung-ho about getting into crypto. And now, it's become a staple allocation even in tiny family offices, and it's moving into the institutional realm. What kinds of investors do you think are best suited for these index products, given the fees and how they're designed, etc.?

MAX: Yeah. An index fund is passively managed, so I guess it's suitable for the investor who is conservative for crypto, but forward thinking enough to try to get a crypto allocation. It's best for an institutional investor who doesn't want to own crypto directly, but they want to own shares in a regulated fund. And yet, they might want to go out on the curve a little bit, and own more than just Bitcoin. These kinds of investors understand that there are intricacies in the space and there are shifting dynamics.

I'm going to reference December 2016 when I got in. I could have just bought Bitcoin, and I would have owned 87% of the market. But now, if you're buying Bitcoin, you're at about 45% market coverage. So, for you to get coverage on the crypto space as a whole, it's no longer just about Bitcoin. I personally hold

Bitcoin, and I'm pretty diehard in that regard. But there's no denying that the crypto space is about more than just Bitcoin at this point.

So I guess to wrap up the answer to your question, this is typically suitable for the institutional investor who wants to go long on crypto, they know that they don't know what the future holds, and they just want to have exposure to the changing dynamics.

KENNY: Makes sense. One thing one of our former speakers said is that the U.S. is in a real risk of becoming a digital backwater for just the way the regulators are dealing with this. We have ETFs in Canada; we have some mutual funds coming online. When do you think is the U.S. going to have an ETF? And just at a high level, why is this important when it comes to index funds to have an ETF structure in place?

MAX: Yeah. Do I have an opinion as to whether a U.S. ETF is on the way? I mean, it's purely speculation at this point. Without any inside information on how the SEC is working, I think Gary Gensler, the head of the SEC, understands crypto, and he seems to make sense. He doesn't seem to think that Bitcoin is a security, but that doesn't apply to, for example, stable coins, and a lot of the coins in the top 30.

We've been waiting on a Bitcoin ETF for forever, for over five years now. I think there's more than 10 that are on his desk right now. So I can't really say with a clear conscience that we're going to have an ETF next year or the year after. But in the meantime, we do have ETFs in Canada. Here in Europe, we have plenty of ETPs, or exchange-traded products, which are one-to-one physically backed with crypto. They're trading in Switzerland, Germany, and Amsterdam. That puts into question whether we need a U.S. ETF.

I'm sure a lot of major, large institutional investors in the U.S. have regulatory requirements that they need to get long via a U.S.-based ETF. So I'm sure when that gets approved, it will bring a real sense of momentum with it. But I think in the meantime, we've been doing pretty okay. Grayscale filled in the gap with their trusts, but they've had a bit of an issue with the premium or discount fluctuating quite heavily because there's no redemption mechanism for those. But I guess we'll have to wait and see on an ETF.

AYLA: That begs another question. What is the fundamental difference in how traditional finance ETFs or index products are structured versus ETFs in the crypto universe? How do they differ from the number of service providers you have to engage, to expenses, and etc.? What's the difference?

MAX: You guys will know this better than me. If you're going to do it yourself and get the top 30 tokens, I imagine that you probably will have to go to at least three or four custodians. You're probably going to need to go to more than one exchange. You're going to need to do things like exclude stable coins.

If you go to CoinMarketCap and you look at the top 30, there's a few stable coins in there, which wouldn't really fit in an index fund. You're going to need to exclude wrapped tokens. I think Bitcoin wrapped on

Ethereum is in the top 30, so you need to exclude that. And then, you need to have a conversation around how rigorous of an index you are going to stick to. Are you going to include stuff like Dogecoin, which is a meme but is solidly in the top 30?

Thankfully, we don't have actual Ponzi schemes in the top 30 anymore. Back in 2017, we had Bitconnect, which was a straight up pyramid scheme. Thankfully, we don't have any of those in the top 30 today. Although they still exist. So you do need a level of savvy to put together an index fund, and you're going to need to put a lot of time into working with multiple service providers, which is what I'm sure Ayla and Kenny are doing all day. They're not sitting on their hands, that's for sure.

KENNY: Thank you for plugging us, it's always nice when the speakers do that. But I do sit on my hands. Ayla does the work, so it's okay. Question from Grant. What's your view on index-like products? Earlier you mentioned the DeFi Pulse index as an example.

MAX: Index-like products? Is that referring to non-physically backed, or…

KENNY: Basically, tokens that provide exposure to multiple tokens.

MAX: Oh, okay. There are some interesting developments going on. Let's say on Ethereum, you're basically relying on a smart contract on Ethereum, to go out and buy the different pieces for you. It's all been programmed ahead of time. You're just giving it your ether, and it buys the different pieces. Or at least that's how I understand it. I'm not an expert.

There are decentralized fund structures. DAOs may be the ones with the longest history. Those are decentralized, autonomous organizations, and they are really interesting because they give the shareholders voting power. You can have venture capital DAOs and things like that. But I don't think institutional investors can go out and explore these tokenized offerings. I am loosely following the developments in that space, because I think that's interesting as well.

AYLA: One of the questions that pops up quite frequently is the battle between the different index funds, from emerging players versus the big boys. Do you see institutions coming into this space and setting up their own index funds rapidly, and then eating up the entire market? Or do you think some of the emerging players that have created funds over the last two to three years are going to sustain and become market leaders?

MAX: Yeah, that's a good question. Time will tell. I've scratched my head plenty of times thinking why don't we have this type of product, or why don't we have that type of product? And whenever I get a chance to talk to an ETP provider, they tell me "Well, there's no demand for anything other than Bitcoin or Ethereum", or one-to-one backed products.

Also, institutional investors don't want yield-only products. They want appreciating assets. You probably have a better sense of demand than I do, but I think until there is an overwhelming demand from institutional investors for index funds, for staking yields, or for some of these more “off the beaten path” products, I don't see the behemoth of traditional finance crowding that space, if that makes sense.

KENNY: Yeah, it really does. One question we have ties into some of the items you touched on earlier, in terms of the level of complexity in doing it yourself. If you're going to go out, and if you're an institution that wants to spin this up, how expensive would it actually be to do this on your own balance sheet, versus doing it in a more scalable index fund type setup?

MAX: I think a lot of it is not even about expenses, but it’s also about risk. If you've got someone internally in your organization going out and working with multiple service providers and trying to physically replicate an index, that carries a lot of risks. The expenses might end up being operational mistakes that end up in loss transactions or things like that. But on the face of it, to answer your question, you're going to be using a custodian either way.

In my research, I did find that single asset ETPs have, on average, a 1.8%. annualized fee. Multi asset ETPs have 2.3% annualized fees. Custodians are obviously way lower than that. But, of course, these funds are built on top of custodians. I think some of those fees can be offset with access to staking, access to lending, and things like that. But of course, there is more that needs to happen behind the scenes to make those possible.

I'm familiar with how we price our service offering as a custodian, which is primarily just a percentage of the assets under custody. But I think the fact that you can go out and buy an S&P 500 ETF for 0.03%, and yet a single asset ETP might cost you 2% crypto, I don't think that's graft or negligence. I think that's really just speaking to how far we still have to go as service providers in the industry to bring down the cost benefit from economies of scale. You guys have probably done a huge amount of due diligence on the space and probably have a really good understanding of all of our competitors, and where the gaps are. But ever since I've been in this space, things have just gotten better year over year.

We're now talking about enabling multi-billion-dollar positions in the space. Michael Saylor comes to mind. Things like that just were not possible a few years ago. I know it only started two and a half years ago, and there weren't really any institutional grade custodians on the market back then. But now, there are a number of pretty decent ones. So what will fees do? In the short term, they will probably stay the same. In terms of what they will do in the longer term, I'm very certain, they'll come down to levels that we associate with index funds in equities, and in other spaces.

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