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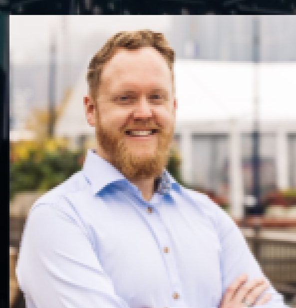
Virtual Event Series

The $100M Metaverse Fund

Guest Speaker:

Andrew Steinwold
Managing Partner
Sfermion

Hosts:



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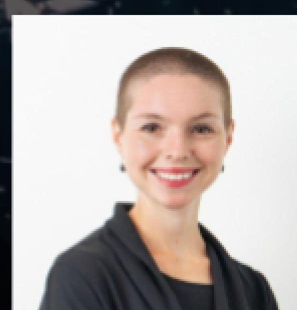

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Diffuse

DiffuseTap: The $100M Metaverse Fund

Last time on DiffuseTap, Andrew Steinwold, Managing Partner of Sfermion, talked to us about raising a $100 million NFT-metaverse fund, what happens when big companies like Disney start to enter the NFT space, and what the recent major Ronin hack means for the crypto industry.

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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

Andrew Steinwold is the founder and managing partner of Sfermion, an investment firm that invests in NFTs and companies building out the open metaverse infrastructure. Andrew also publishes the Zima Red newsletter and podcast, both essential resources on all things NFT for metaverse enthusiasts. Currently, he is a partner at Polynexus Capital, a multi-strategy digital asset fund that invests in distributed ledger technologies.
LinkedIn: @andrew-steinwold

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KENNY ESTES: Today's speaker is Andrew Steinwold. Andrew, do you want to do a brief introduction on your background and what Sfermion is up to?

ANDREW STEINWOLD: Yeah, Kenny. Thank you so much for having me on. I'm super excited for this chat. To briefly give my background, I got involved in Bitcoin in 2013. Throughout 2014 to 2016, I attempted two different blockchain related startups, both of which failed completely. In 2017, I launched a crypto fund. We were doing well, but we were underperforming compared to our peers. We realized that in order to really build something impactful, we needed to specialize and focus on a certain subsector of the market.

In 2018, we were looking at different subsectors, and we realized that DeFi was not really our skill set. It's a very quantitative, technical skill set that didn't really suit us. But then, we dove deeper into NFTs, and we realized that it was going to be the world's largest market. And so, we decided that we needed to set up a fund entirely focused on the sector. That was in September of 2019.

AYLA KREMB: Amazing. I'll hop right in there and ask the big questions. In September 2019, most people were not talking about NFTs, and the metaverse was still a fluffy thing that nobody knew what actually meant. How did you come up with the idea of raising a $100 million fund? And who were the first investors in that fund? Who were the initial LPs that believed in this early on?

ANDREW: I will say that in September 2019, we funded it with personal capital. We were unable to raise back then. We were talking about an NFT-focused fund, and we were directly buying NFTs, not investing in venture companies that were involved in the NFT space. It was a very esoteric strategy. And on top of that, we tried to raise capital for this vehicle. It wasn't successful in 2019, nor in summer 2020, even though our returns were very healthy. It was just too weird.

It's funny because we were pitching to crypto people. We were pitching to Bitcoin OGs and people who have been in this space forever. And our thought process was, "Oh, they will definitely understand because they believed in this nascent space when no one else believed in it." But they were the harshest critics. They would say, "Are you telling me that you're buying crypto kitties?" and I would say "Well, not exactly crypto kitties." That was a tough conversation to have.

It wasn't until the narrative shift in September of 2020, after the DeFi Summer, where the general yield that you can generate from a lot of those applications was trending downward. And so, that crowd was looking at what the next DeFi was going to be or what the next big market was going to be. And luckily, that crowd wanted to enter NFTs. That was in September 2020. They quickly realized that this is a different market with different value drivers, different cultures, and different communities.

What it did was it brought interest to us, because we were already operating. We were able to cobble together $5.3 million for our first vehicle. We ended up launching in January of 2021. That was without the raised capital, just personal capital. And at that time, the demand for the fund was extremely high.

People were telling us to raise 50 or 60. But we wanted to raise a small fund because we wanted this first fund to perform very, very well so we could move on and raise fund two.

Fund Two was the $100 million venture fund. When we were raising the $5.3 million fund, all of our LPs were saying that it was way too big. The total NFT trade volume in 2019 was $8.3 million. That was for the whole year. But in 2020, it grew to $82 million. And so, we realized that there was definitely some incredible growth here.

With the $100 million fund, we were having similar questions as we did before. When you're raising a $100 million fund for this nascent asset class, it's kind of insane. But we thought of it as the same process as the first fund. We were thinking, "No, it's not insane. It's extremely small for where this market is going to go."

To give you some growth figures, in 2019, the total trade volume in OpenSea, which is the largest marketplace in the space, was $8.3 million. That was very tiny. In 2020, there was an 893% increase to $82 million. In 2021, we're at $17.7 billion in trade volume. That's a 21,000% increase. And just in January or February of this year alone, we're at $10.6 billion in trade volume.

That growth is similar to the growth of early Internet back in the 1990s or early 2000s. We decided on the $100 million figure because we wanted to do a small fund that we knew that we would be able to easily generate great returns from.

KENNY: That's great. You mentioned January and February volumes being great. Just from the mainstream press, it seems that a lot of the fervor around NFTs and a related concept, the metaverse, has died down a little bit, which is fair. So, what has transpired over the last 30 to 60 days? What are you seeing happening in the NFT space? Obviously, we also have to talk a little about Ronin and the recent exploits, because that's a pretty significant change.

ANDREW: Definitely. I would say that 2021 was just like 2017. If 2017 had the ICO bubble, in 2021, we had the NFT bubble. We saw a lot of new people entering quickly, and speculating on random pictures of monkeys and other silly things, which is completely normal in a new and exciting market with low barriers to entry. Speculation is a completely normal thing.

Obviously, it did get a little out of hand. There were times where people were raising $20 million on pictures of cats or whatever. And so, luckily, what's happening now is that interest or that type of market participation is leaving the space. Because as easy gains are no longer to be had, we now have more "professionals".

What's great about it is it brought a ton of capital, a ton of attention, and a massive influx of talent into the space between 2019 to 2020. I don't want to bash anyone that was building back then, but we previously had only a very small number of people with incredible backgrounds who were building stuff. In 2021, we saw a night and day difference. People who are experts in gaming were entering, experts in art were entering, experts in collectibles, and so on. That was the biggest change, in terms of the talent. These people who were entering were missionaries, not mercenaries. They're really motivated to build things for the long term. What's happening now is a flush out. That happens naturally after crazy price appreciation. Overall, NFT search volume is down massively. NFT trading volume is also down significantly.

But we look forward to having a slower period, because what's happening now is the people that are serious and have been building for the past 6 to 12 months are getting ready to launch their projects. And that's good. It's similar to how crypto has expanded, where in 2018, you had to have that lull period, which extended to 2019. And then, here we are today. I think NFTs will mirror that growth.

KENNY: Makes sense. We skipped the Ronin bit. For the people who aren't aware, what happened there? And how do you think that's going to affect the overall industry?

ANDREW: Ronin is a blockchain made by Sky Mavis. Sky Mavis is the maker of Axie Infinity, which is the most popular blockchain game. They have around 2 to 3 million users, and they've generated a ridiculous amount of money. It's very, very popular. However, their token economy was designed in a way that is not entirely sustainable. They're working towards fixing that now into a more sustainable model.

They built their own blockchain, and essentially they have a bridge to this blockchain. Now, bridges have some inherent security flaws. People would have to port their Ethereum or USDC over to their own blockchain, and they would do activities there, such as buying these creatures, buying land, etc.

What happened was a hacker was able to break into that bridge and steal all the Ethereum and USDC that was locked up in Ronin. I don't know the technical specifics of the hack, but they were able to steal a total of $650 million worth of assets, which is obviously ridiculous. It's one of the largest hacks known to date, in terms of current dollar value.

I think that it's very unfortunate. Bridges are still in their infancy, and all of this is still very early, and very immature. I don't know what the situation is with the actual assets. I don't know if they're going to be able to get those back. It's definitely going to be jarring for a lot of people. But overall, for us it's just another day. There's always some sort of hack. There are always risks.

AYLA: It took them six days for the public to get wind of it. They did a neat job hiding it. I guess they were trying desperately to get their money back somehow in one way, shape, or form.

As a follow-up question to that, what are the kinds of trends that are sustaining and the ones that are dying off? What happened to play-to-earn? Do you think that that's going to be something that sticks around? Or is that whole space going to need a little bit of an overhaul to actually make these games interesting and sustainable in the long run? What do you think?

ANDREW: I think broadly, gaming is essentially the Trojan horse to crypto mass adoption. That's because games are designed to be fun. Granted, there's always some learning curve to playing a game. In this case, you have to learn how to download this wallet, buy cryptocurrency, etc. Some people will do that, and they'll get red-pilled into the broader crypto ecosystem. I think it's a great way to onboard people to crypto.

I think that Axie is actually the most successful game, and has far exceeded every other game so far. But keep in mind that Axie launched in early 2018. They've been grinding nonstop since, and they're iterating multiple times. It's going to take some time to get these game economies right, because gaming is all about having a balanced economy, and balanced gameplay.

The issue is that NFTs and tokens are released to the wild, to the community and to the participants, and they act like real mini-economies. And so, you have to be very in tune with the issuance of these assets, and the supply of these assets. It's almost like a whole central bank issue. Axie was the first one to hit it, but their model, as we know now, was not very sustainable.

They also knew that a lot of people were telling them that. So now, they're working on a new update which will hopefully turn it into a more sustainable economy. I would say that we're not even in the first inning for play-to-earn. This is just the very first iteration of one single game.

We are extremely excited about the gaming ecosystem, and how it's going to be played more broadly. I think it's really about creating balanced economies. What's great is that these assets and these worlds are programmable. You launch v.1, and if you find that v.1 doesn't quite work, you launch with v.2 and update it, or v.3, or v.4, etc.

In a real economy, you can't just hit the reset button or restart things quite easily. It's very, very difficult. That's why we are extremely bullish on crypto gaming, Web 3.0 gaming, and play-to-earn. Sure, there was one model and it didn't quite work out as expected. But there's going to be thousands of different models, and there's going to be real sustainable economies that generate billions of dollars, without a doubt.

KENNY: That makes sense. Although I will say that in TradFi, if inflation keeps going this way, you might have to figure out what that reset button actually looks like. It's going to be a little painful. Jumping to a question from Aga, let's talk about insurance in digital assets. We talked about the exploit of Ronin. Are you seeing a proliferation of insurance products against hacks and theft? Do you expect that to continue? What are your thoughts on that space?

ANDREW: I think you probably have a better view on this, because you're deeper into DeFi than I am. I know that there are some DeFi protocols that offer insurance, like on-chain insurance. And there are some institutions like service providers that offer insurance. In the NFT space specifically, there are a few insurance providers, but it's very, very expensive, and it doesn't make sense even for us.

We have to have insurance, but it's a much smaller policy. We're doing it almost just to check that box off for the SEC. But our LPs understand, and practically everyone understands that getting big insurance policies doesn't really make sense right now. Again, I'd say 99.9% of the population didn't know about NFTs 15 months ago. So it's a really, really new market for most people.

For us, for example, there's so much baseline infrastructure that needs to get built out. So there's no effective NFT portfolio tracker. There's no coin market cap for NFTs. There are some marketplaces like OpenSea, but we're still so incredibly early that this baseline infrastructure still needs to get built out. And so, It doesn't make much sense to get insurance, which I know sounds goofy, because insurance is something that you desperately need. But again, we're still incredibly early. These types of products will arrive, but they just haven't quite yet.

AYLA: One of the tough questions asked in the chat is, what do you think will happen when all the big players start entering the space? What happens when Disney comes online, and all the other big boys follow? Is that going to change the ecosystem fundamentally? Is that going to speed up adoption? What do you think is going to happen?

ANDREW: It's tough to say. I think that broadly, if Disney comes in, that would add value to the space. Right now, the space is very, very tiny. On OpenSea, the most popular NFT exchange which has 80 to 85% of the total trade volume, the total number of participants that have ever made a trade is just 1.49 million people. It's just incredibly small. Axie Infinity, which is the most popular game, has only 2 to 3 million people on the platform. The NFT space in total has around 4 million. It's just an incredibly small population.

If Disney decided to enter right now, they'd be catering to the crypto native audience. But right now, the crypto native audience wants metaverse native IP. They don't want some Disney-branded asset. They want Bored Ape Yacht Club, which is those monkeys, or they want CryptoPunks. They want these things that are native to the space.

And also, if you look at tech paradigms in general, in the ‘90s, the top 10 companies in America were oil and gas and media companies. Those companies were native to the paradigm of newspapers, and oil and gas, etc. They were the dominant players in that period of time. But now, there's a new technology paradigm called the tech boom. In 2010, all but three of the top companies were tech companies. They were all new companies that didn't exist before.

It wasn't like media companies just jumped on board and were now suddenly tech companies. The top companies were these new companies like Apple, Google, and Amazon, not these oil and gas companies that just adopted the technology. I think similar things are going to play out in the NFT space or the metaverse space, where the future big participants will be native to the space and this paradigm, as opposed to companies like Disney just adopting this technology and becoming huge players.

KENNY: That makes sense. I’m going to ask a nuanced question, which I'm sure I'm going to butcher. Back in the 80s and 90s, Teenage Mutant Ninja Turtles were toys first and foremost. And then, it turned into a television show to promote the toy. There also was the collectible element to it. Ultimately, a lot of the value of that franchise was derived from blending the various mediums.

Are you seeing a similar thing happening with NFTs, where things like Bored Ape Yacht Club are going to be turned into TV shows, and are going to form partnerships with more traditional media outlets to drive the growth?

ANDREW: For something like Board Apes, where it’s an IP first, game second, I think that that's similar to the play that they're going for. They're going for the LVMH of NFTs, because they're going out and acquiring great IP that already exists in the NFT space. They acquired CryptoPunks, which is the top collection. They have Meebits, which is another really popular collection. And they're just going to aggregate all these great collections. They’re going to take their IP and build different products off of them, whether it be movies, videos, stories, or T-shirts. Who knows?

Yuga Labs, which is the parent company of Bored Apes, is creating this virtual world. They're going to put all these different collections that they acquire into this virtual world, and you're going to be able to walk around with your characters there. It's really interesting.

If you look at the 1980s and 1990s, the Internet didn't really broadly exist. And so, people were spending most of their time buying physical toys or buying T-shirts or watching TV. But now, the Internet has basically allowed people to become way more engaged. Today, you can interact with your favorite brands by going on their YouTube channel or by buying their merch, etc. I think that's a really exciting prospect that is due to the Internet. And if you look at what NFTs do, they allow you to have ownership of part of that brand or a piece of that brand. And that makes people even more engaged.

Comparing the 1980s to what we have today, you’re way more engaged because of the constant interaction with that brand. And now that you have a piece of the ownership and potential upside or potential downside with that brand, it makes the most engaged users ever. Zooming out even more, if you look at screen time, the average American is spending 7 hours and 11 minutes per day staring at screens, whether it be TV, phone, or computer.

We're spending all of our time inside the digital world. And so, it makes sense that people are buying these digital goods and really engaging with them on that level, and actually putting skin in the game in these projects that they're so engaged and intertwined with.

AYLA: You've been investing since the beginning of NFTs. What are some of the success stories and failures where you ended up plunging your money into? You don't have to mention names, but it would just be interesting to hear about some of the things that you thought were going to work, but didn't end up working out for you.

ANDREW: Because we invest in different asset classes, it's hard to choose one. We invest in NFTs directly. There are certain NFTs that are very hard to determine whether or not they're going to appreciate in value, even if the reason for them increasing in value is obvious in hindsight. It's just like how most markets work.

But going forward, when you're initially making that investment, it's a venture-style investment. What we do is we just look at the core fundamentals, like the team, the product, the tokenomics, the community, the market, etc. We do that homework.

And then, when we determine that it's a great collectible or piece of virtual land or game asset, etc., we'll dive deeper. We'll have to figure out to which submarket the NFT belongs. That's because NFTs are a very broad category. Saying NFT is almost like saying Internet. There's virtual land, there's collectibles, gaming assets, arts, etc. You have to know that the value drivers for virtual land are location content parameters, and the value drivers for gaming assets is utility, and so on and so forth.

Once you figure that out, then you have to dive into that specific project, and essentially make an investment thesis based on that environment. A simple example would be, for instance, you were investing in two different virtual worlds. With one virtual world, you could say that you're going to invest in the land that is on the waterfront. And with the other virtual world, you could say you're going to invest in that land near the spawn point, because that has the most foot traffic.

It's all about doing your homework, digging deeper, and then making almost a venture-style investment, where you're not certain how it's going to play out. That's the kind of homework that we do. I'd say that the best successes are just doing our homework, and then making that play. The percent return on individual NFTs is pretty astonishing, because these are all micro economies.

They're very esoteric, and liquidity is low. They're also hard to understand and hard to get access to. The market participants are often gamers, collectors, and hobbyists, as opposed to people who are going after a certain ROI. Broadly speaking, I'd say we make NF T investments that are in the percentage return of a couple thousand percent to a couple hundred thousand percent. I know it sounds insane; the problem is scalability. You have to do that with a lot of different assets., but generally, the alpha that can be generated is just ridiculous right now.

That's the success part. On the failures, there's a lot of them. There are a lot of times that we make an investment and it doesn't play out. But luckily, the initial capital that you deploy into that collection or asset is so low compared to the winners, that the winners more than make up for it.

On the venture side, it's really exciting for us because there's so much baseline infrastructure that needs to get built out. There are so many things that just don't exist yet, and that we need in order to onboard more people.

We've made a lot of winning investments on the venture side, and some failures as well. It's hard not to name names and be specific. Sometimes we find something that doesn't exist yet that's backed by a great team and a great founder, and so, we invest in them. But then, they get distracted by new things, and they go in different directions.

We've learned that the number one thing we need to look for is mission-driven people that are really for the space, and who are into the metaverse, NFTs, and Web 3.0. They have to be mission-focused, and they need to be able to focus on one thing and dominate that arena. Then eventually, they will be able to expand. I don't want to get into the specifics, but those are the things we've learned.

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Corporate Director, CME Group

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CEO & Founder, LionShare Media

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VP/Global Head of Tax, Binance.US

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