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Virtual Event Series

Crypto Adoption from The Institutional Investor's View

Guest Speaker:

James Lavish
Co-Founder
The Looking Glass

Hosts:

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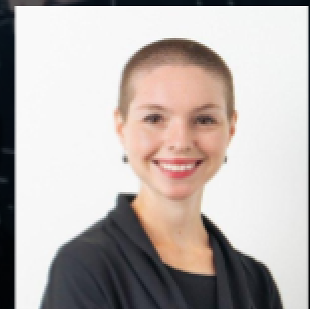

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DiffuseTap: Crypto Adoption from The Institutional Investor's View

Last time on DiffuseTap, James Lavish, Managing Partner of The Bitcoin Opportunity Fund and Co-Founder of The Looking Glass, talked to us about why hedge funds aren't "real" institutional investors when it comes to investing in DeFi, how they differ from pension funds and endowments in their approach to adding alternative assets to their portfolio, and the problem with hedge funds touching the retail-driven space that is crypto.

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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

James Lavish, CFA, has over 25 years of experience in institutional investing and risk management. He is Managing Partner of The Bitcoin Opportunity Fund, as well as Co-Founder of The Looking Glass, a crypto education platform. Prior to this, James was COO at Alternative Investments at LKCM, a $26B asset management firm, and worked with hedge funds like Carlson Capital, Tribeca Investments, and Ranger Arbitrage, which he also co-founded.

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KENNY ESTES: You're here to hear from this good man, Mr. James Lavish. James, would you mind telling us all about your background and what you're up to over at The Looking Glass?

JAMES LAVISH: My name is James Lavish. I come from the institutional investing space. I've been in hedge funds or private equity for almost 30 years now. I started on the floor of the New York Stock Exchange trading something called ADR arbitrage, which some of you may know. It involves trading American Depository Receipts for international or US clients, depending on their portfolios.

It's basically translating foreign securities into US Securities by putting them together in a basket, and then converting with the FX currency and the stamp taxes, etc. Back then, we didn't have Excel spreadsheets. All we had was a little calculator. And so, whoever could do it quickest got the trade. I happened to be pretty good at math. And if you've seen my background, some of you may also know that I was a hockey player. I was a hockey player on my way to the professional circuit. I was drafted by the Boston Bruins. But in my senior year of college at Yale, I blew out my knee. That was the end of it. So, in an instant, I had to figure out what I wanted to do.

Back to work. Because I was pretty good at math, I got a spot on the floor of the New York Stock Exchange, trying to pay some bills. That was between 1993 and 1994, but it quickly got me into the institutional hedge fund space. Back then, hedge funds weren't really a big thing. They were looked down upon because we had just come out of the Ivan Boesky, Michael Milken world, as many of you may remember.

And so, we were the weirdos trading these long-short strategies. I got into that side. My experience brought me down to Texas where I worked at a hedge fund called Carlson Capital for about five years, where I traded their arbitrage book. And then I opened my own hedge fund. I learned about macroeconomics pretty quickly. When you're in the arbitrage world, you don't really care about much but that one trade, because everything in the markets can happen around you. You're isolating your alpha on an arbitrage, and you don't care about the rest of the world.

I got my lesson in macro when interest rates went to zero that first time, and I had to shut down my hedge fund. That's because if there is no interest rate on fed funds and you don't have a benchmark to key off of, all arbitrage collapses. Flash forward, I went into private equity and another hedge fund, which was more of a micro cap strategy that invested long, long durations.

It was long duration investing with public micro cap and private equity. I did that for the last 15 years. I was the chief operating officer of a hedge fund unit within a larger office called Luther King Capital Management down in Fort Worth, Texas. And so, my wife and I were going back and forth between two cities.

When the pandemic hit, we got locked down in separate cities for 100 days. I had enough of that in June 2020. I packed up, got in the car, and drove out to Las Vegas, where I am now. I soon came to an agreement over the last year to leave that firm. After that, I wasn't really sure what I was going to do.

Now, my son is over at Cornell and he has a bunch of intelligent friends. They were all getting into crypto in late 2020, early 2021. He implored me to take a second look at crypto, and I did. I started looking at

Ethereum, Cardano, and Solana, and eventually settled on Bitcoin. I've been Bitcoin-focused ever since then. If you want to hear about my first introduction to Bitcoin, I can go into that. But that was probably a longer answer than you expected.

AYLA KREMB: All good. So, you have touched on both sides of the coin, institutional and non-institutional. What's really the difference between them? If you segment just universal institutional investors in the first place, what does that really comprise? How would you bucket different institutional investors, and what are the needs of each of them when it comes to allocating capital to something like crypto?

JAMES: Sure. The institutions can be things like pension funds, endowments, family offices, and hedge funds. Hedge funds trade. They chase alpha. Endowments and pensions chase growth and yield. They absolutely must grow to keep up with the costs of running their universities or the underlying foundations. And then, pension funds need to have yield in order to pay out those liabilities, and many of them are unfunded.

The difference between them is, if you put pension funds and endowments in one bucket, and then you put hedge funds and family offices in another bucket, you have a completely different set of rules that they can play by. The pension funds and endowments have a very strict set of rules that they have to follow. They have investment mandates that they have to work very closely to.

Whereas on the other side with hedge funds and with family offices, they may or may not have a mandate or have a mandate that's wide open. And typically, hedge funds do. Even in the arbitrage space, we had a mandate. But in the investment profile of our PPM, we could basically trade anything we wanted. That's typical of hedge funds. You keep that door open.

And so, what you've seen over the last few years is when you hear about institutions coming into the crypto and Bitcoin space, what you're seeing is a lot of hedge funds. The reason is it's far easier for them to just start buying Bitcoin or Ethereum and then figure out what to do with it or what it is later. Whereas on the other side, endowments and pension funds have this whole process they have to go through.

If I'm a hedge fund trader, I can just wake up one day and say “You know what, I'm going to check out this Bitcoin. I'm going to buy a little bit and then figure out what it really is.” I can then open up a Coinbase pro account and buy some Bitcoin in one of my portfolios, settle it with a wire from Morgan Stanley or JP Morgan, whatever my prime broker is, and then I've got it in my portfolio. I can just mark it as a little separate investment. No big deal.

If you're a family office, you can essentially do the same thing. Just buy it in your bank and keep it there, or custody it yourself. You're not worried about it. But in a pension fund or an endowment, there's a whole process that you have to go through. If you're a portfolio manager, you can't just say “Well, I'm going to check it out and buy a little bit.” Many of you may know the expression “leg into a trade”, where you just buy a little bit and then you do your research. Well, you can't do that at a pension fund or an endowment.

When we talk about institutions, that's what I'm talking about. I don't really consider hedge funds a part of that. When I'm talking about institutions today, I'm talking about pension funds and endowments.

So, if you're a portfolio manager in an institution and you decide "okay, I understand Bitcoin and how it's a separate asset class. I get it. I want to buy some", well, you have to first go to your Chief Investment Officer and convince him or her that this is the right thing to do for your portfolios, which is to create a separate asset class in order to get exposure to this new asset.

Once you convince him or her, the next thing you'd have to do is go to the Investment Committee, sit around the board, and talk about it. You've got to explain it to them. They've got to go home and do the research. You've got to get a majority of them to understand it and get comfortable with it. Once you go through that, which could take weeks or months depending on your board, you have to then go to your Compliance Committee.

The first person you're going to talk to is your Chief Counsel, and he or she is going to tell you whether or not you can actually take on this risk and create a new asset class. Once you get that Chief Counsel's buy-in, you have to then talk to the Compliance Officer or another person. Once you get their buy-in, you have to then sit down with a Compliance Committee and get their buy-in.

Once you get their buy-in, then you've got to think about all the structural things you have to do in order to actually buy and create this new asset class. First of all, who's going to trade it? You're going to use JP Morgan or Coinbase, or you're going to use a trader that has access to one of the platforms that is approved by the committee. You can't just go into Binance if it's not approved by the committee. You've got to get one of the platforms approved.

Then, once you trade it, you have to decide where you're going to mark it. Do you mark it at the close of London time? Do you mark it at the close of the New York Stock Exchange? I mean, it trades 24/7? What is your close? Are you going to use Coinbase's close, Bloomberg's close? Then once you do that, you have to figure out who's going to settle it. Are you going to settle it at your prime broker, Morgan Stanley, Merrill Lynch, or JP Morgan? Who's going to actually settle it?

And then, who's going to custody it? Are we going to take custody ourselves and hold those key phrases? Are we going to use NYDIG? Are we going to use new institutions like Coinbase or Gemini? And once we do that, are we going to use simple custody, or are we going to use a multi-SIG custody? You have to go through all of those things just to get it into a portfolio at a pension fund or an endowment.

Whereas, a person like me or any one of us can go out, open up an account at one of the brokers like Kraken or Coinbase, wire some money in from our bank, and we can own it in minutes. It's a completely different world. And right now, it is absolutely being driven by retail interest. It's not being driven by institutions yet. The only institutions that are in there in earnest are hedge funds, and that in itself is problematic for a number of reasons. I hope that answers your question.

KENNY: Thorough. I love it, that was great. We have our index fund, and we get compared to Grayscale a lot. However, the investors at Grayscale are very much like JP Morgan, but they're on the trading desk. They're not allocating for yield or capital appreciation. They just want to take advantage of this inefficient market, whatever the case may be.

JAMES: Right. And because it's traded on the New York Stock Exchange, it's really easy for them to settle because you can get around all those examinations. But we all know that Grayscale has its own issues, because buyers don't really have Bitcoin liquidity.

KENNY: Exactly. There are massive inefficiencies there. So, if we were to analyze this ridiculously complex process in a pension fund, which could be good or bad, the first step in that is asking whether we want to go in this direction. That's the first step. Step two seems to be compliance. And step three, for lack of a better term, is technical implementation, like how we actually do the trade. Where do you think most pension funds and endowments are in that process right now?

JAMES: They don't yet understand the space. That's where most of them are, which is the first step. First, you have to have enough people to just understand it. That's one of the problems, and we can go into the reasons for that. But quite honestly, it's pretty simple. The current system has greatly benefited all of them, for the most part. They're not incentivized to learn about this whole new system.

They hear about this and they see on Bloomberg or CNBC that this token is up or down a certain percentage, or that Bitcoin is dragging down the whole crypto space, and that's all they hear. It demands them to dig deeper, but part of the problem is there's not an incentive to do that. That's one part of the problem.

The second part of the problem is what happened to me back in 2018. I had some discretionary capital that I wanted to invest. I wanted to go out on the risk curve and do something different than public or private equity, or even venture capital or real estate. I wanted to go out on the risk curve, and I heard about this thing called Bitcoin. And I thought, "this sounds interesting, I want to check this out."

So, the first thing I did was what any institutional investor would do. I talked to the so-called experts in institutional investing, because they're supposed to be some of the smartest people in the world. I went and talked to the technology analysts in my space. They were out at different banks or within my own firm. And the problem is, when you talk to them, they're stuck in that legacy system.

This was 2018, and the technology had been around for almost a decade at that point. And the answer that I heard from everyone across the board, bar none, was to avoid it. It's a Ponzi scheme. There's no underlying value. Do not put money in it because it's going to zero at some point. It's just a tulip. It's a digital tulip, is what people told me.

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And so, I avoided it. I didn't invest in it. It was the worst investment decision in my career, to not invest in Bitcoin back when it was under $3,000. But that's what we do in the institutional world. We try to understand it, and then we talk to people about it. Sometimes you're getting your information from mainstream media, but they don't understand it.

AYLA: This next question is related to one of the things you said earlier, which is that hedge funds that have a high level of participation in digital assets might not be the best thing for everybody. What do you think is the potentially negative outcome of hedge funds being the main institutional player?

JAMES: Okay, let's talk about hedge funds. Everybody knows hedge funds are trying to isolate alpha. What they're trying to do is create alpha in a way that the pension funds endowments can't do, and they do that by hedging out certain risks. If you're trying to hedge out beta risk in your portfolio and you own a bunch of technology stocks, the easiest thing to do is to short the NASDAQ against your portfolio. You hedge out the total market risk of technology, and you own the alpha of your positions on top of it. So, if the market goes up or down, your positions will move according to their beta factor to that portfolio.

The problem is hedge funds are using Bitcoin as a sloppy or a quasi-hedge to their portfolios, and they're doing it in a way that creates this reality that Bitcoin and Ethereum, in particular, front run all of the risk assets. If they want extra alpha, they will go long in the crypto space. They'll go long on Bitcoin and Ethereum, which have a high beta to the market.

If they want to be long in the market, they could just as easily go out on a Saturday, at two o'clock in the morning, and say “you know what, I've been hearing some things today. I don't want to wait for the Monday morning opening to take some positions in technology stocks like the Apples, the Googles, and the Microsofts of the world. I want to front run that.” So, they go buy Bitcoin and Ethereum and grab some alpha over the weekend if they want to. That's one problem. They're using it just as a trade. They're not using it as a long term investment.

The second thing, and this is a major deal, is that we don't have a spot-settled Bitcoin ETF. All we have is a futures-settled ETF. The way that futures are created is that you can borrow and short as many futures as you want to hedge out your portfolio the way you want to. They can hedge out hundreds of millions or even billions of dollars worth of these coins in a futures market in a snap.

That just serves to drive the price lower. It's problematic. They’re using it as a sloppy hedge because they can. You just can't do that at a pension fund or an endowment. In a pension fund or endowment, if you're going to get into the space, you will have to understand it and use it as a separate asset class. You can’t just use it to drive short term alpha.

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