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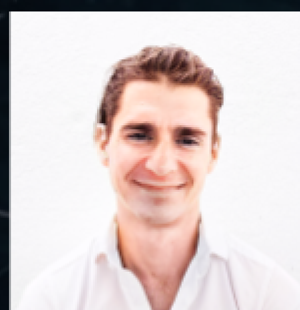
Virtual Event Series

DeFi Funds Strategy Trends

Guest Speakers:

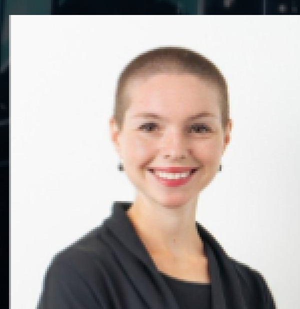
Taylor Engstrom
Product Marketing Manager
ConsenSys



Johann Bornman
Group Product Lead
ConsenSys

Hosts:

Kenny Estes
CEO & Founder
Diffuse



Ayla Kremb
COO & Co-Founder
Diffuse

DiffuseTap: DeFi Funds Strategy Trends

Last time on DiffuseTap, Taylor Engstrom and Johann Bornman of ConsenSys talked to us about DeFi fund strategies beyond basic yield farming, how DeFi fund managers have had to shift their strategy in less than a year, and what went wrong with Genesis' lending platform.

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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 Speakers

TAYLOR ENGSTROM is the Product Marketing Manager of ConsenSys, an Ethereum software company. One of their main offerings is MetaMask Institutional, which enables funds to swap tokens, borrow, lend, invest, and interact with DeFi protocols and apps using the MetaMask interface.

Linkedin: @taylorsengstrom

JOHANN BORNMAN is the Product Lead for MetaMask Institutional, launched in 2021. Since then, Johann has managed the product strategy and roadmap, design and operations, as well as crypto custodian integrations.

Linkedin: @johann-bornman

About Diffuse

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.

KENNY ESTES: Taylor Engstrom and Johann Bornman, would you mind telling us a little bit about your backgrounds and what you guys are up to over at Consensys?

TAYLOR ENGSTROM: Hi, everyone. Honored to be here and really excited. This is a super cool community that Diffuse has enabled, and we were excited to be invited to come on stage. I can't promise any alpha in the current environment, but I think we can share a lot about what we're currently working on, and what we're excited about within DeFi and in terms of Metamask Institutional.

As Kenny said, my name is Taylor Engstrom. I'm the product marketing manager here at Metamask institutional. I don't have anything remotely close to a finance background. I come from tech, largely software-as-a-service. I'm just here to help enable the conversation, hopefully do some networking, and to answer some burning questions you all have. I will pass it over to our expert in fintech and the head of our product, Johan.

JOHANN BORNMAN: That's a very tough act to follow. Pleasure to meet you all. My name is Johann Bornman. I am the product lead for Metamask Institutional. I've been with Consensys now for 19 months. My background is in TradFi. I helped start and build an investor base in London about 15 years ago now. I ran a global macro portfolio management desk, and did for about eight years. I realized software was eating the world in around 2013 or 2014. So, I decided to combine technology and finance.

I moved my way over to a robo-advisor as director of product and helped build the company's investment engine. I helped it scale across Europe before I ran my own fintech business for about three years. And then, I joined Consensys to build, start, and lead Metamask Institutional. We focus specifically on providing a web3 institutional platform, providing unrivaled access to web3, along with institutional key management, as well as all the things that its users need to think about when accessing web3, like reporting, monitoring, custody, risk management, etc.

AYLA KREMB: Awesome. I will drop you right in the deep end for the first round of questions. How would you define a DeFi fund manager? What are the skill sets that they need? Maybe we could do a comparison of the skill sets required for a DeFi fund manager nine months ago, and the skill sets required today. What do you think has changed?

JOHANN: Thoughtful question. I think that risk management is always top of mind in any capital allocation process. I think with DeFi, the first principles stay the same. You're talking about the financial primitives that have been part and parcel of finance since the beginning of time, like lending, borrowing, saving, investing, and swapping. DeFi takes those first principles and adds code to it. It allows for new ways of settlement, and allows for the manufacturing of new financial services that are fundamentally better than what exists in TradFi today. But with those opportunities come a whole new set of risk management that is required.

Coming from a TradFi background, we learn things like how to put money into trades, how to do risk management, how to do position sizing, etc. The infrastructure is fairly standardized and institutionalized. But given the fragmentation of DeFi, and given that the industry and the structure of the markets are still very nascent, risk management becomes very technical by nature.

We often see that DeFi fund managers have not just TradFi backgrounds, but have had to grow their technical expertise instead. That requires understanding not just blockchain from the first principles, but also very importantly, all the nuances that go into running a DeFi fund. This entails understanding infrastructure, understanding wallet providers, RPC endpoints, MeV extraction, and all the technical nuances that go around when it comes to managing a DeFi fund.

To answer your question, I think what we've seen over the last nine months or so is that there is a deeper focus on risk management in all regards. The conversations we've had over the last six to three months are very much focused on institutions once you understand the counterparty risks, understand their smart contract risk, how they decode transaction parameters, and whether they know what they're signing.

More importantly, they're focusing on aspects of how keys are stored, the signing process, and governance rules. For example, what transactions are allowed during the signing process? Who are the entities that can sign transactions? All those risk management considerations have increased. I think the skill set that the DeFi fund manager needs and how it's evolved over the last six to nine months is largely risk management.

KENNY: Very good overview. Taylor, anything that you want to add to that?

TAYLOR: I think Johann covered a lot of the bases. I think one thing to keep in mind is that there are some large differences between DeFi and web3, and traditional capital markets. I think the cycles are definitely different. A lot of things can happen very quickly in DeFi. I think information dissemination within said markets is also different.

Things can pump in a very short amount of time. And obviously, we can see that the reverse is true as well. I think the importance of networking and the importance of doing your own research is extremely key to doing a great job within the industry. And keeping up. It's really about understanding what's a good project, who are the people behind the project, what is the institutional capital behind the project, and what is their roadmap.

For people coming from an equity research background, for example, there *are* a lot of similarities. It's just a little different. I think understanding the nuances is key as you begin to allocate into the space and invest more and more.

KENNY: Makes sense. There are a lot of threads there that all tie to a super topical question. I hope you guys checked your news feeds this morning. I'll start with you, Taylor, because your microphone is awesome.

Genesis, apparently, has some issues. There seems to be this blending or gray area between DeFi and TradFi with people in Genesis. What are your thoughts on what's going on? And then also, how does that work into the counterparty risk side of the DeFi yield investing?

TAYLOR: I'm going to go out on a limb here and look uneducated. Like I said, crypto moves extremely quickly. If things have changed with Genesis, this is an update to me. I would love to pass this over to Johann to talk about it, because this sort of thing has happened before. Johan, I'd love for you to help me out here.

JOHANN: I think there definitely have been some murmurs in the market for a while now about how Genesis was going to be impacted. I think everyone's very well aware that the 3AC fall out had a deep impact on Genesis and the group that stands behind them. Given what happened with Alameda, I think there were already murmurs in the market that many of the lenders would be deeply impacted. It's not surprising to see Genesis being halted.

I think we all know, especially for most of us who are running money, that the first, second, and third order effects are deeply, deeply painful. Last week took the market by surprise. We spoke with a lot of clients and users that are still very much in a state of shock, given how fast the FTX situation evolved, and how quickly the whole process unwound.

I think what we are expecting to see is second and third order effects impacting lending markets and different traders and books for the foreseeable future. I don't have deep insight in terms of what happens next. It's important to note that we're a software business. We don't trade risk. We don't run money. We're not a hedge fund.

We provide infrastructure and tooling. And so, we don't really have deep insight in terms of making market predictions. The only thing that I can say that is very understandable is that a lot of these lending DEXs are deeply impacted, given what has happened with Alameda. And I suspect we'll see more fall offs for the foreseeable future.

TAYLOR: Yeah. To expand on what Johan mentioned, I think that at the end of the day, whether it's FTX, BlockFi, Celsius, or whoever, these are not magical computer systems. These are just companies, and people, and brokers for specific types of assets. The true ethos of decentralized software lies outside of these legacy companies and ways of doing things. The fallout and the things that have been caused by these players is not at all a direct reflection on the promise of DeFi and the promise of the stuff that we work on.

I've done a lot of the research on the FTX fallout, and this is relevant to Genesis. FTX' initial 5% yield, in terms of users locking up their assets, was not yield that was coming from any specific coin or any specific yield strategy. That was just FTX paying it and then marketing it to make it seem like blockchain was somehow enabling that 5% return. It was really just the company paying it. I think it's really important to decouple some of these exchanges in the way those financial systems work versus actual blockchains and actual decentralized software, like Metamask Institutional.

AYLA: I can give you another Google question here. Let's talk more about the strategy side of things. It is obviously concerning when someone just hands you a check but it's not earned by doing anything. That's concerning.

What are some of the strategies you've seen over the last 10 months? There was a lot of vanilla yield farming. Apparently, Alameda was doing a lot of that. But then, there were also more complex strategies. What have you seen over the last few months that has been cropping up in terms of new strategies and what might be successful moving forward?

JOHANN: I think one can segment the market by some key consistent strategies we see. First and foremost is early-token. That's big mostly in VC investing. It involves going to protocols directly, and often going into investing contracts in early tokens at a time as they are distributed. Then, we see a lot of yield strategies, the most plain and vanilla there being staking. This is normally ETH staking or other layer one staking strategies. And then, that yield category expands into more complex strategies over time.

We start with stablecoin yield, which involves investing in stablecoins and then staking that in different DeFi protocols. That then expands into quite sophisticated strategies that are run by some of the larger players. And then, that coalesces on risk frameworks around how much they can allocate to a particular DeFi protocol, to layer one or layer two networks, and the smart contract risks. They can take an embodied and very focused risk-adjusted return and sizing into their portfolios.

Following that, we work with a lot of users that have conventional hedge fund strategies too, which could be delta or market neutral. We also see some directional trading strategies, and programmatic or systematic strategies as well. That's normally through LPing. And then, I think something that we've seen emerge over the last year, particularly over the last three months or so, is the far more sophisticated allocation towards NFTs.

This starts at work through some small allocation around NFTs and a DeFi portfolio. It was normally a "buy and hold" strategy, but that has now evolved. We're starting to see far more sophisticated NFT funds start to deploy capital. Many of these funds are building their own pricing models. They're running advanced programmatic strategies. It's a very interesting segment of the market. We've seen far more sophistication emerge, which spans the gamut from very plain vanilla to more complicated strategies.

KENNY: Taylor, you want to answer that?

TAYLOR: Yeah. This was one thing that Johann and I chatted about yesterday. A huge theme during "DeFi summer" and afterward was chasing the highest yield, and getting really sophisticated about how you approach that. But to quickly touch on "risk management" within DeFi is that it's not just about, and it's not just about how you custody your assets, who you trade with, and what blockchain you work with. One thing that goes into the risk management calculus beyond all that is yield strategies.

How do you think through the risk for your protocol, and the risk for the smart contract underlying within these protocols? What stablecoins do you add to your mix in terms of how you're farming this yield? I think there's a lot of things to be pursued in hopes of growth. It's really important to have a true POV and have your different areas for flexibility there, in terms of how you shift that, and in terms of which projects you truly believe in. Also in terms of the old school "buy and hold" strategy that came from early Bitcoin and early Ethereum adapters, to these more sophisticated farmers.

JOHANN: I think something amazing we've observed from a lot of our users is just how risk taking and being risk averse has evolved in the last 18 months. What we saw was a very popular layer one trade in 2020 and 2021. And then, that has culminated in a very risk-averse stance across many of our users. There are a lot of market neutral strategies being deployed at the moment. Big allocation to Ethereum and stablecoins, where that mix would have been allocated with far more diversity across layer ones. Also, Luna had a giant impact on how portfolios were positioned during and after that fallout.

KENNY: Love it. You guys touched on a few things that are near and dear to us. Our DD does require us to look at the actual code for smart contracts and things along those lines, and see where those rug pull risks are. But fundamentally, on-chain has very different risk profiles than tried by people who understand counterparty risk. That's a real thing with the implosion of FTX, and now, Genesis.

There are a lot of people guessing that we're going to see a lot of capital flow into decentralized platforms, and away from centralized platforms. Do you think that tools like MetaMask Institutional can actually do that? Can they go in on-chain? Do they have the risk framework to actually support that? Or do you see that not working out?

JOHANN: Yeah. Thank you for the softball question. Absolutely, would be our answer. We fundamentally believe in the decentralized future. We believe that web3 is building the new internet. DeFi is the financial system for the web3 economy. And invariably, we will all be transacting on the new decentralized web. Fundamentally, what DeFi offers is better infrastructure.

As I mentioned earlier, you can create risks. You can transfer or package risk better. And around that, you also have near-instant settlements. And with the way blockchains are structured, you have transparency and interoperability. As you just mentioned, with all the centralized entities, you do not have that. We truly believe that the future is on-chain. We are observing large institutional capital moving on-chain, both within Metamask institutional, and also with a lot of our on-chain custodial partners. They have also seen a lot of inflow.

And then, the second part of your question is very important. Whether the on-chain or decentralized web and DeFi protocols will take large institutional capital. I think what we've seen over the last few years is a flood of VC investing into all kinds of projects, protocols, tooling, and infrastructure services to build the bridges required for institutional capital to move into the space far more meaningfully.

And secondly, what we're seeing in terms of the scaling of Ethereum and other layer ones is the infrastructure that can take large institutional capital. Today, there are probably only a handful of DeFi protocols that can take allocation from some of the largest hedge funds in the world. But that is being built out, again, to provide the bridging so that institutional capital can deploy meaningfully within Web3.

Blockchain and crypto can be very volatile, as we've experienced over the last several years. But I think that this wave of innovation that is happening is the way by which more and more venture capital will be allocated to the space, and that’s something that we are very passionate about. It's very much our mission within Metamask Institutional. We are squarely focused on how we can bridge every single organization on planet earth into web3, and whether the things that we're building are ready to facilitate that.

KENNY: Love it. Taylor, do you want to add to that?

TAYLOR: Yeah. Related to what Johann was saying there, I think this moment can really be a watermark for our industry. We're seeing that now, with Metamask customers, some of them are draining most if not all of their funds from centralized exchanges. I think people are really realizing what the Wizard of Oz of someone like SBF could represent in terms of there being nothing behind the curtain.

I think when code is law and when everything is on-chain, a lot of individuals, let alone institutions, are very safe. I also think the space is still maturing at a very, very rapid pace. The "early days" of DeFi were less than five years ago. I think we have a lot of primitives and building blocks, and that's just going to make things a bit more safe and a bit more innovative. There's risk in innovation, of course. But I think as the space matures and as people realize more and more the true power and safety that can come with decentralization, I think the net is good for anyone looking to get into this space and invest more.

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Corporate Director, CME Group

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