diffusetap
Virtual Event Series

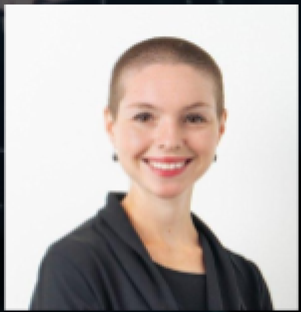
Evolution of Product Design in Crypto

Guest Speaker:

Bob Guzman
Web3 Executive at Large

Hosts:

Kenny Estes
CEO & Founder
Diffuse



Ayla Kremb
COO & Co-Founder
Diffuse

DiffuseTap: Evolution of Product Design in Crypto

Last time on DiffuseTap, Bob Guzman, Web3 executive and business innovator, talked to us about how crypto products are maturing alongside the market, how the crypto market's evolution is mirroring that of traditional finance's early days, and why the risks are different this time around.

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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

BOB GUZMAN is an expert Web3 business strategist and innovator with a solid background in traditional finance. Most recently, Bob led the development of a cloud-based portfolio risk platform for digital asset hedge funds, prop trading firms, OTC desks, and individual entities managing a diverse portfolio of digital assets.

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KENNY ESTES: Mr. Guzman, would you mind telling everybody about your background and what you're up to?

BOB GUZMAN: Sure. Thank you, Kenny. My name is Bob Guzman. I've been in the financial markets for a long time, roughly 30 years. All but the last three years have been in the traditional space. I come at the markets from the buy side perspective. The first 10 years of my career was on the sell side. But for the last 20 odd years, we're on the buy side.

I come at it from the perspective of institutional asset management focus. Think of pension plans, insurance companies, sovereign wealth funds, endowments, and foundations. That type of investor with the perspective and focus of a disciplined investment approach. I became very interested in blockchain technology and all of the things that I thought would change the world that I knew, the traditional investment world. And after 20 odd years in the traditional space, it became a little boring. I wanted a new challenge.

I was looking to have a marriage of my financial experience and background with the right technology to enter into this new new world. In the last couple of years, that's what I've been focusing on. Most recently, I was at a brand new startup with a focus on digital asset risk management.

I left the firm at the beginning of July and I'm in the process of starting up my own project with my two co-founders. Hopefully, we will launch before the year ends, maybe as soon as the beginning of December. And again, it’s also in the portfolio asset management realm.

AYLA KREMB: Thank you so much for sharing some details on your background. We're going to talk to you right in the deep end here. What has been the evolution of crypto products specifically over the last two to three years? Evidently, there has been this surge of greed followed by an immense level of fear within the last six to nine months. What has been the evolution of crypto products recently?

BOB: Great question. I think the evolution of the products is beginning to follow the evolution of the market. The market has been dominated by individuals that caught the market at the right time. Yes, there has been a crypto winter. There have been periods of great volatility where the markets have dropped meaningfully. But for the most part, it has been a retail marketplace.

If you were early enough, you had great gains that you could weather a lot of pain, because your entry levels you got in at afforded you market losses, but not real losses. That was fine. It all came down to your timing and your risk appetite. In the last 12 to 18 months, as the drum has begun beating more loudly for institutional participation, I think that's forcing a natural change in the market dynamics.

Much of 2022, from April to date, has not been very favorable. You've had a lot of new participants that are suffering significant losses. You've had a lot of hiccups along the way with various protocols failing. It really casts into doubt the viability of certain types of borrowing, and lending certain types of stablecoins.

We're not meaning to digress into any of that, but I think all of it has provided a backdrop. The institutional players have not really entered. Yes, folks are starting hedge funds. And yes, they will be getting to dip their toes, but it's really nothing to really talk about yet. I think most of the products have consisted of systems like Coinbase. These are really centralized exchanges where a user can see their portfolio and see their holdings, and the profit and loss of their holdings.

It really has not evolved much from that. You can go on various borrowing and lending protocols where you can stake or do whatever it is that you want to do, and get a sense of the P&L and price dynamics of your various positions. The lay of the land hasn't evolved yet to where the marketplace is thinking about "well, what is the risk of my portfolio?" But people are beginning to think about that. It's not a natural thought process for most individuals.

An individual tends to think, "I'm invested in crypto and I'm invested in stocks. What's the P&L? How much money would I have if I suffered a loss today?" They tend to not think about their exposures to different sectors, in the case of digital assets to different protocols to two different exchanges. Not even smart contract risk. Individuals haven't yet started to think in that way.

There has not been significant institutional participation to breathe life into this way of thinking about this new space, but it's beginning to happen. Hopefully, the one I'm going to be starting is focused squarely in that space. The evolution from a product perspective is really just beginning.

I think that's quite normal. If you look at the world of hedge funds, back in the early '90s, hedge funds really weren't in the institutional space. You mainly had wealthy individuals invest in hedge funds. When they started, there weren't any portfolio management systems to really understand what was happening in these funds. And as that market matured with more institutional participation, the market forced more analysis, more risk management, more transparency. I think we're seeing the same thing in digital assets now.

KENNY: We quote Matt Levine a lot around here, and one of his lines is that crypto is really just taking all the lessons of financial services and relearning them in about a 10 to 20 year period, and reinventing a lot of what is already out there. Do you share that line of reasoning? Do you share that thought process? Because with some of these products like derivatives, it just seems like we're doing all of the same steps that traditional finance did.

BOB: This is going to sound a little heretical, especially given my background. While I don't disagree with any of that, I disagree with the pace. The way I look at it is that some of the biggest improvements and enhancements that blockchain technology can bring is to the middle and back office infrastructure and less on asset types. One of the greatest risks to the traditional financial system is settlement. It's the time and the delay in settlement that can pose real systemic risk.

I'm sending you money, but I'm not me, Bob, and you're not you, Kenny. We're two institutional players. You're a bank or an asset management firm, and I'm waiting for my several million dollars, and I hope you're going to pay me and you hope I'm going to deliver what you just bought. But I'm going to have to wait maybe two or three days, or in the old days, five days. And during that interim, there's risk. What if you default? That's just one example of risk.

So I really think that it's the plumbing. It's the infrastructure where the biggest gains are with blockchain. It's like building a house from scratch. As you can tell from my background, I'm in a room that's being renovated, so I think it's quite apt. It's infrastructure where the greatest improvements are going to be made. It's the foundation that we're going to build upon. That was what attracted me to it originally, and what caused me to want to get into this space. I'm a bit surprised at the speed of the evolution of things.

When you look at some of the spectacular failures over the spring and early summer, they weren't due to the complexity of the assets being traded. I mean, they're quite trivial. In my view, it was because people weren't asking basic questions that anyone who's done this before would have asked. People didn't do the proper stress tests, and didn't try to see what would happen. Anybody that has spent 10 years in the field would have naturally asked these questions of any exchange.

For example, what does it mean to be a stablecoin? How does it work? What are the ins and outs of an algorithmic stablecoin? Not so much from the fact of " wow, this is really cool. The coding is really neat and the mathematics are robust." It really hasn't been properly tested in periods of dislocation. If I were designing the digital asset space from a blank sheet of paper, I would have bedded down spot assets. I would have said, "I need to have a functioning spot marketplace." By that, I mean Bitcoin and Ether tokens.

I wouldn't have begun concerning myself about derivatives because until I have my foundation working seamlessly, adding levels of derivatives and complexity is just compounding the problem. I would have a proper functioning, the equivalent of a repo market where I can go long and short, and I can borrow and lend. I would have spent time developing an interest rate market. Right now, there really isn't the concept of a fixed income market, there is not a risk-free rate. There's only a concept of a fluctuating-by-the-minute type of floating rate market.

It doesn't allow for the underpinnings of a proper debt market. Without a proper debt market, you have nothing that would get unbiased, like the fixed income market. Without that, I, as a lender or borrower, don't know my exposures if I want to be fixed. I don't know my borrowing costs until I have that. How can I build derivatives on that? I can't. I don't really know how to price them. Again, I think the marketplace got ahead of itself because let's be honest, it's just a lot cooler and more exciting to be talking about derivatives than it is to be talking about some of the boring stuff I just spent five minutes highlighting.

AYLA: Very good. That was a nice little overview. We have some phenomenal questions here in the chat, and I'm just going to toss them right at you. Why do you think the digital finance providers like Bach, Phi, Celsius, and Voyager are quite not required to possess any form of risk management collateral, the same way that a TradFi firm is? There are no minimum or collateral requirements. Why do you think that is? Why do you think it took a whole collapse for them to get to this?

BOB: I'm trying to think of a politically correct way of answering that. That's my problem. That always gets me in a bit of trouble. I can't think of a nice way. This is one man's view, and I am biased. You have to have first spent time in an exchange working in traditional exchange fixed income or equity. You have to understand margin. If you've watched the movie "Trading Places" and reflect upon it, you have to understand why it went so poorly for the two older gentlemen when there was a margin call. You have to understand how that can actually happen, and when it does, what it actually means.

If you're not intimate with all of that and if you don't really know what that means, you have absolutely no business starting an exchange. I don't care how clever you are. I don't care how well you code. You have to have that practical sense of how things can go wrong quickly in the blink of an eye. And once they do, it doesn't matter how clever the algorithm is. It's going to fail. I guarantee you that it will fail.

You have to have an intraday margin. You need the ability to do proper scenario analysis, and understand what is going to happen if the wheels come off this car. Just like in "Trading Places", they had margin, and eventually the losses exceeded the margin. It's what happened to the Bear Stearns. It's what happens when it goes wrong. These people didn't think of that because why would they? They had no experience in the space.

They were very clever. Right time, right place. Look at FTX. Not that they enjoyed any of the problems of some of the others, but they were in the right place at the right time. They noticed arbitrage opportunities and took advantage of that, and credibly made a lot of money from that. They spun out an exchange and managed to sidestep some of the mistakes. That's just one example. I think a lot of this was due to the fact that they started running before they learned how to crawl.

KENNY: What I'm hearing is that you need to get the crypto checked. There are a lot of these questions about risks and you've touched on some of them already. The risks are very different in crypto land versus TradFi, where you don't often have somebody who just absconds with a bunch of money that you can't find or track. How do you quantify these? If you put your investor side hat on, how do you actually figure out and quantify, and work these types of risks into your model?

BOB: I think that's a great and open question. Maybe by analogy, in the traditional space, if you had an equity portfolio or fixed income portfolio and you don't understand the volatility, you don't understand the risks of the assets, then we could do some scenario analysis. We could look at what it was like in 2008 or 1986, or any of the real highlights when the market was in stress. That way, we could get a good handle on how your portfolio would have behaved if we experienced something similar.

We never talked about what would happen if the New York Stock Exchange failed. It's a perfectly valid question. It could happen, even it would be extremely unlikely that that would happen. If it did happen, the Federal Reserve would come to the rescue, the Treasury would come to the rescue. It would never be allowed to fail. You have backstops that prevent such an outcome, but it certainly could happen. The Chicago Board of Trade could have failed back in the day. Any of these things could have happened.

But as a risk manager in the traditional space, I never even considered that as a possibility because it was unthinkable. And when it does happen like in ‘08, circuit breakers would be kicked off. People were rightly or wrongly provided liquidity, because enough liquidity gets you out of just about any problem short term. Ultimately, you pay the piper. But in the short term, you survive. In crypto, with the proliferation of different protocols, different AMMs, different smart contracts, this is all new.

The horses have escaped, They’re no longer in the barn. So now, you have this huge proliferation of ways that one can invest their money. You can stake, lend, and borrow in different types of exchanges. You have something called a smart contract, which I don't think most people really understand, and some very clever people find ways of hacking it and exploiting it.

Arguably, in the grand scheme, that's a healthy thing. The more exposures that are found and highlighted, holes will be filled, and people will do a better job next time. From a risk management perspective, you need to understand the protocol that you're engaging with to the extent that one can do due diligence on smart contracts, and to the extent that you have transparency in there and you can actually see the code.

I'm speaking beyond my area of expertise, but I think you need to really understand how that particular smart contract is working or supposed to work. How is that AMM working? What type of due diligence has been done? If we experienced some of the things that were experienced back in the spring and early summer of ‘22, what would be the knock on effect?

When something goes wrong, you don't sell what you want to sell, you sell what you can. I think we saw that play out over the spring and summer. I think those questions are important. It's very hard to say it's amenable to mathematical analysis. I don't think there's a grand theory one could apply that would help gain insight into some of these protocols or exchanges other than in the traditional world. You would have people come in and do operational due diligence.

This really falls into the area of operational due diligence. That area of risk management, again, is really premature for digital assets. But you're going to see the development and the birth of odd operational due diligence groups, and that's already starting to happen. I think that will become more commonplace.

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