

*diffusetap*  
Virtual Event Series

# Shorting Crypto

*Guest Speaker:*

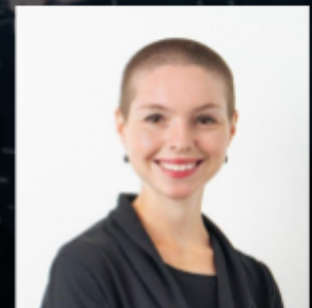


**Andrew Woodruff**  
Chief Investment Officer  
Black Lotus Capital

*Hosts:*



**Kenny Estes**  
CEO & Founder  
Diffuse



**Ayla Kremb**  
COO & Co-Founder  
Diffuse



## DiffuseTap: Shorting Crypto

Last time on DiffuseTap, Andrew Woodruff, Chief Investment Officer of Black Lotus Capital, talked to us about how to short crypto and why you probably should, why most tokens are bound to go to zero, and gimmicks not to fall for in the crypto space.

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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 WOODRUFF is a crypto and equity investment research analyst with more than 10 years of investment research experience in macro, commodities, and a variety of sectors and asset classes. Andrew is currently the Chief Investment Officer at [Black Lotus Capital](#), an institutional grade long / short fundamental-oriented hedge fund focused on digital assets.

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**KENNY ESTES:** Mr. Andrew, would you mind telling the folks a little bit about your background and what you're up to over at Black Lotus?

**ANDREW WOODRUFF:** Sure. Hey, everyone, thanks for joining. Feel free to ask any questions in the chat if you have anything to ask. For my background, I spent most of the last decade in a multibillion dollar long-short, predominantly equities hedge fund. It just happened to be probably at an early stage of the liquid token space.

I've been in crypto since 2017. I ended up helping people build out parts of their crypto investment research processes, data analytics, and networking. That was before I decided to leave about a year and a half ago to go off on my own. The goal was to help figure out how to create what I believe to be something closer to a true institutional grade, long-short hedge fund purely focused on digital assets that's adapted from the traditional institutional grade hedge funds that I've worked in for most of my career, and to focus on deep research.

A big part of that is shorting for the hedging side, and really figuring that out. We have four general partners. Three of us are based out of Puerto Rico. Three of us generally have a lot of experience bridging the crypto world and the traditional finance world professionally. Black Lotus launched a couple of weeks ago officially after building and testing all with our own capital for almost a year and a half. That's a little bit about us, and I'm happy to get into anything deeper from there.

**AYLA KREMB:** Awesome. Thanks so much for hopping on. Maybe we'll start with some of the fundamentals. How did you get started shorting crypto? How did that get going?

**ANDREW:** From the equities world, I had a background in investment research and in looking at shorts of all different types based on certain frameworks. From spending a lot of time researching the crypto space and trying to apply fundamental research to this space, as you get into a lot of these tokens, the deeper you go, you see that most of them fall apart in some way.

As far as sustainability, in the end, things need to produce profits or breakeven to be sustainable in the long term. And in crypto, it's even a lot more confusing when you factor in tokenomics, and all the complexities of blockchain mechanics and everything. The question that we were trying to answer is, okay, we felt good based on our personal experience that we're able to discover great long's that have that 10x to 100x type of upside potential. But who cares if you can capture those if you don't know when to get out and you can't actually realize those gains without being good at timing, for example, which is very difficult, especially in a volatile space like this.

So, the hedging part with the shorts really evolved out of a need for us to figure out how we can get exposure to these very high convexity digital assets without taking the massive drawdown volatility and crypto market risks, like what we saw in 2022. Then it also helped us figure out how to build a strategy that's more hedged. Generally, we believe that most tokens, probably more than 95% of them, are going to be priced losers over time.



If you zoom out on the data and look down over the last six years, back to 2017 when I personally first came in, the top 100 by market cap looks very different today than it did back then. If you zoom out even more, the top 500 digital assets in market cap look extremely different than they did back then.

So, if we believe that most of these tokens are trending to zero over time, we could build a strategy that allows you to get exposure to the the best longs and then use a basket of shorts to hedge that out, where you can not only hedge out the majority of the price drawdown, volatility and other risks in the crypto market, but you can also produce alpha on that short portfolio side.

Because if you can't produce alpha on the short portfolio side, what's the point? You might as well just use a long-only mixed with cash strategy. We built out those frameworks, procedures, and IP over the last year testing, shorting in all sorts of different circumstances that were adapted from my experience in that world. Personally speaking, I think that it's actually easier to create alpha in shorts over the long term in the digital asset class than it is in the equity side, given the dynamics of crypto. That was the whole basis for it. Let me know if you want me to add any context to that.

**KENNY:** I like the approach of “hey, the reality is most these tokens are going to zero. So we might as well try to find the ones that are going to go there a little bit faster and get some alpha rather than trying to ride crypto to the moon.”

Let's talk about super practical nuts and bolts. How do you short? What are the options? Do you do it on-chain or on an exchange? What are the pros and cons of each and what are some of the complexities involved?

**ANDREW:** In order to build a truly hedged strategy, we've tried a lot of different tools and products to see which ones had the best correlation to our longs. You can manage the correlation risks, beta risks, sector risks, all that stuff. We tried equities, put options, so on and so forth. But when those correlations break down, like we've seen in the last two days, that's generally not the best way to hedge a long portfolio of digital assets.

For crypto-specific product hedges, you can do put options. You can do traditional borrow and shorting through a prime broker like Falcon X or the other ones. But generally speaking, liquidity on those is limited for around the top 25 in market cap. There's just not enough liquidity there for most tokens that are probably the most attractive shorts in this space. This leads us to perpetual swaps. For anyone who's not in crypto, it's kind of a unique invention.

Think of it as like a perpetual rolling-over futures contract where people can go on exchanges like Binance and get long or short exposure indefinitely using whatever amount of leverage they want.

And the way those work is basically, there's a funding fee rate. Whereas, if the perpetual contract is trading at a mark price that's higher than the spot price of that asset, the funding fee will be a positive. That incentivizes traders and arbitrageurs to come in and short the perp contract price which would



bring it closer to the spot price. And basically, the longs are paying the shorts in that example. The funding fee is dynamic and usually rolls over every eight hours, during which the funding fee rate is realized. If it's the opposite and the perpetual contract mark price is below the spot price, the funding fee rate will be negative, and therefore the shorts will be paying the longs in order to be short that contract.

In those types of contracts, there are about 350 to 400 names of digital assets that you can trade, depending on the exchanges that you have access to. But liquidity varies widely based on what tokens you are looking at. And obviously, the Binances of the world have the most liquidity out there. So as you scale up beyond 100 million, that shortable universe as we call it starts to shrink significantly if you're looking to short things that are outside the top 100.

And then, what we've also seen is because most of the market is long biased, especially in bull markets, those funding fees can be a source of yield for your shorts. That can potentially be quite attractive over time especially in bull markets. There's that extra element there, because everyone asks me about borrowing costs. I think that perpetual swaps are just a more dynamic way of being able to manage that without actually having to generally pay borrowing costs, as long as you can balance it out across the shorts.

**AYLA:** Awesome, super practical. I'll pick up some questions from the audience. Are you using any AI tool to help you find the shorts that you want to deal with? Or is this all traditional, good ol' research that you're doing?

**ANDREW:** Our goal is to, as Warren Buffett would say, start with A and work your way to Z. Our goal is to have breadth in our research to really understand the universe of investable assets in the digital assets class. How do I know if something is a good investment or a good short if I don't know that 20 to 30 other competitors are all trying to do the same exact thing? There is a lot of oversaturation for different types of assets or projects in this space, and you have to understand the competitors just as much as you understand a specific project, whether it has sustainability or competitive moats, and so on and so forth.

We have four GPs and two Columbia Business School MBA students, and our GPs work around the clock and it's still a lot trying to manage all of this. So, we've tried to automate as much as we can to build something we call the map of the world, which is basically pulling in data through API's from most of the major data sources out there. That could be blockchain data, user transaction, volume, fees, so on and so forth. It could be market data from exchanges, but it could also be developer data, social metrics data, etc.

We do this for the top 2,000 tokens, but only the top 500 are generally liquid enough for us to really play in that sandbox, depending on the size of AUM.

We try to automate as much as we possibly can because really, our primary goal to do our jobs well is to segregate this universe out between having a more concentrated basket of longs that we think are the best of the best, and that check the box of having a clear path to widespread adoption, sustainable



competitive moats, and value capture for the token. These are ones that we want to hold three to five plus years out. We want to own the future Amazons of the world for this space, and things that we think can compound 100x plus over that time.

And then, on the short side, this allows us to scour the universe and build a portfolio of diversified shorts that we think are the worst of the worst. We are generally always net long.

But this is where we've generally come out over the last year and a half of testing this and experiencing the good, bad, and ugly over the craziness of the crypto markets. But that's how we generally approach it. We *are* looking into AI already because we are trying to automate even more parts of this process as much as we can. We also have a catalyst calendar. I said this before but I wish I knew in advance when the top 2,000 tokens would have a certain catalyst or if an upgrade was going to happen like ETH 2.0 well in advance of the expected date.

For more obscure tokens that no one's ever heard of, these catalysts can shoot up the price 2 to 5x. We've seen it time and time again. If I was aware of those ahead of time, we could actually do bottom-up research a few months in advance to understand the significance of that for the fundamentals, for the price movement, etc. That also helps us optimize on timing and sizing across both our longs and shorts. But we are starting to look into AI to see how much of that we can automate through there.

Outside of automation, there's no other way to do it. You really have to put bottom-up fundamental research to it to really understand something. And a lot of times, you also have to understand the real world, which I think for us is probably another plus given our past traditional asset class experience. That's because we spent most of our careers researching equities and companies in the offchain world.

We were generalist investors from the equities world, understanding the social media space, understanding Google, Facebook, and all the Amazon-type companies for example. A lot of these things that blockchain wants to disrupt, we already have experience in those. You have to understand that side as well to understand whether a blockchain project is a truly a good product market fit, and whether it's sustainable long term.

**KENNY:** So it's really all elbow grease, and getting in there and doing the research for the fundamentals. Not to give away too much alpha, and for the audience, this is not financial advice. But what are some of the things that really distinguish a more garbage token, or something that you can signal that you find super bearish?

**ANDREW:** Some of these are pretty obvious especially to traders in this market. But obviously, one thing that's very unique about digital assets that's uncommon in other traditional asset classes that we have experience in like equities and fixed income, commodities, etc. is that these tokens usually have some form of inflation. They're diluting themselves over time.



Based on the inflation schedule that they usually set out at the beginning, a lot of that inflation comes in the form of early investors or founding developers vesting over time, but also from these liquidity mining programs. We've seen a lot of gimmicks in this space where if you go play on their application, you can generate yield in the form of the token of the application, which is usually dilutive.

And usually what yield farmers and mercenary capital does is they just come in, they try to generate as much yield as possible, and then they dump it on the market as soon as possible, creating a yield market-neutral arbitrage strategy. Generally speaking, if you have two tokens that are exactly the same and one is inflating at 100% a year versus the other inflating at less than 5%, all else being equal, the token that's inflating at 100% should have a lower price over time.

If you zoom out on the data analytics and you look back over time from 2017, you'll see this play out but it's hard to notice in the short term because this asset class is so volatile. But in the long term, those mathematical properties do play out, generally speaking. You do have to be careful, of course. There are outliers. You could have a token inflating 100% but it's still going up 5x or 10x on some narrative. But maybe it's also a good product market fit.

It's not just as simple as building a strategy around inflation. You do need to understand what you're shorting and what you own. Tokenomics is one thing, and also token value capture. A lot of these things make revenues, but they don't go to token holders. They go to equity holders or some treasury, etc. So you have to understand that.

I think one of the biggest things is competitive moats. Every day, there are probably hundreds of new tokens that are released, most of them are scams and have little to no competitive moats or user stickiness over the long-term.

The competitive moats that we look for are very similar to what we look for in companies in traditional equities. It could be network effects that are very sticky. UX and UI are very important, which we know blockchain is not very good in that area. Branding matters. Once you cross the chasm for adoption and it works well enough, users like to stick with what they know. But it could be other things like talent, the quality of management, or the quality of developers. It could be IP or technical capabilities, like the programming language and the network effects on that side.

There are a lot of things that you can look at to see how sticky users are and how sticky developers are in a certain project. But we think that's a pretty important thing, because if they don't check any of those boxes, it's most likely a race to the bottom and going to be commoditized over time.



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Corporate Director, CME Group

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CEO & Founder, LionShare Media

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2022

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VP/Global Head of Tax, Binance.US

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Decoded with Binance.US

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