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Virtual Event Series

How to Structure a Killer Arb Trade

Guest Speaker:

Jiho Kang
Partner
Antler

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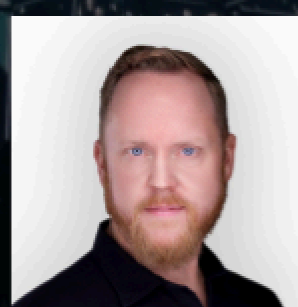

Kenny Estes
CEO & Founder
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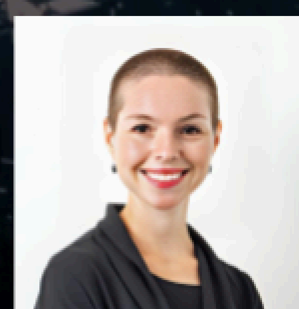

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DiffuseTap: How to Structure a Killer Arb Trade

Last time on DiffuseTap, Jiho Kang, Partner at Antler, talked to us about the Kimchi Premium and why it exists, how inefficiencies in TradFi are creating big opportunities for crypto traders all over the world, and how crypto regulation in South Korea works differently.

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DiffuseTap: Where Crypto and Technology Shape Finance

DiffuseTap takes you to the heart of finance and digital assets. See how changes in crypto and tech are transforming the industry, with insights from top leaders and experts.

Meet the Speaker

JIHO KANG is an investor, full stack hacker, and product designer with experience across Seoul and Silicon Valley. With 20+ years in consumer web, mobile, and web3, Jiho is a six-time startup founder who has raised funds from Y Combinator and 500 Startups. He is a Partner at Antler, a global startup generator and early-stage VC firm based in South Korea.

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KENNY ESTES: Jiho, Do you want to give the good folks a little bit of your background? Maybe talk about Antler briefly, and then your experience with arbitrage trading. Oh, and also, thank you for coming.

JIHO KANG: Thanks for having me. A brief introduction. I built my career as an entrepreneur in consumer tech and e-commerce. I am a six-time founder, four of which I have failed miserably. I have two small exits under my belt, one of which is a web3 startup where I was building a fiat-based stable token based on the South Korean Won.

That sold to Binance in 2019, if I remember correctly. Afterwards, I was the head of Binance in Korea for about two years before I came over to Antler, which is where I'm at right now. We not only invest in web3, but also in AI and all sorts of stuff. The key thing is we invest super-early.

KENNY: Okay, that makes sense. The topic of the day is arbitrage trading. What's your experience there? And actually, maybe start with what is arbitrage?

JIHO: Arbitrage is basically where you discover the price of some commodity or product is much more expensive in one location versus another. It can be whatever, like fish or beer. If you discover the same type of beer is cheaper in one location, you can just buy it, move it over, and sell it for a profit.

I got into crypto in maybe 2013 or 2014 when Bitcoin had just popped $100, which was news at the time. I started mining Litecoin in the office. Fast forward to 2017, a friend in California called me while I was still living in Seoul, Korea. He called me saying, "Hey, why is the price of Bitcoin 10% higher than the price of Bitcoin anywhere else in the world?"

I looked at the price and was like, "Wow, the price is actually really high. Why would that be?" But at the time, I didn't put too much thought into it since I had been mining Litecoin. "Oh, the price is higher. So, can you send me Bitcoin? I would sell it for a 10% profit in Korea. And then I would split the proceeds with you." That was how it started in 2017.

KENNY: Okay, so you're boots on the ground. Somebody else noticed the opportunity, price differential, and you're sitting there thinking "Yeah, this seems like free money." That makes sense. Why exactly was that the case?

JIHO: It took me a while to actually understand what was happening. Crypto trades 24 hours a day, seven days a week. Apparently, this is different for different currencies. I think the USD trades 24/7 as well in different markets. I believe the Euro also trades 24/7 in different markets. The Japanese Yen probably trades a lot. The Korean Won is only tradable in the Seoul Forex market.

The Seoul Forex market opens from 9 AM KST, which is Korea Standard Time, until 3:30 PM KST. If you are trading with South Korea and you want to trade South Korean Won, you can only trade it during those hours. If you need to trade it off hours, you need to trade it in non-deliverable forwards or NDFs. NDFs are basically a contract where you sign a contract with your counterparty saying you will only split the difference in the FX rate at a future date without actually exchanging the fiat Korean Won. That is the number one hurdle.

If you have a surge in demand for, say, Bitcoin in South Korea, what naturally happens is there is already a higher demand, and you need to supply the amount of Bitcoin that the South Korean market wants. If there is not enough Bitcoin in the domestic exchanges, someone has to buy some in other markets to sell on the Korean exchanges.

But how do you do that when the markets are only open for South Korean Won from nine to three? Also, when there are stringent Forex regulations, it's really hard to get around. It's not impossible, but there is a lot of red tape to go through. There is a lot of paperwork to get through to do that.

Basically, the demand for Bitcoin or any crypto just surges. There are people that will arbitrage, but the arbitrage traders are not fast enough to keep up with the demand. And so, you end up with a 10%, or even a 30% price spread in the price of Bitcoin in South Korean Won versus USD, for instance.

KENNY: Okay, that makes sense. So basically, there is some FX inefficiency and some cash movement inefficiency that regulators in traditional finance put in place for all sorts of historical reasons. I can't help noticing that you are using the present tense. You're talking about this premium. Is that still the case? Are opportunities still in the market today?

JIHO: I think there are more arbitrage traders now than six years ago, which is why I think the spreads are still, I guess, not outrageous. If you Google "kimchi premium", the spreads will be about 1.5%. That means the price of crypto in South Korea is 1.5% more expensive than the price of crypto in any other exchange trading in USD.

And 1.5% is pretty consistent with the maximum spread that the banks will take on FX when you are trading USD to Korean Won. The maximum spread that the banks will charge you when you are trading your USD for Korean Won, vice versa, is 1.5%. I think it's on par.

So, if you are an arbitrage trader, you are going to look at what FX rate your bank is going to give you. Again, they can give you lower rates, 1.5% being the maximum. You are basically looking at what the banks are going to give you versus timing when the price is going to fluctuate when I'm making these trades.

KENNY: So obviously, the kimchi trade is an example. Are there any other examples of these arbitrage opportunities? And is it really just driven by this disconnect between financial regulations in different areas?

JIHO: There are a couple of African countries that I knew had outrageous spreads in terms of FX and the price of crypto. And again, I think it all comes from the inefficiencies in the traditional financial markets. Crypto is super efficient. It's 24/7 and fast, compared to traditional finance. If there are wild price swings in crypto and the traders cannot follow the fluctuations, that is when you see spreads.

You will see this less in currencies that are traded universally. For instance, the USD versus the yen or the USD versus the euro. You will see very little spreads there. However, if you were trading against the Korean Won or the Thai Baht, or even the Aussie Dollar, the spreads are bigger. I haven't actually looked at the prices, but the less it's traded, then there are inefficiencies that are layered in. That's where the opportunities lie.

If you have a huge price swing, what needs to happen is the arbitrage traders need to come in and make sure that the prices are leveled out across the market. However, if there are artificial walls set up by the existing financial system or by governments, that's when the arbitrage traders cannot trade fast enough to keep up with the fluctuations in the prices.

KENNY: And then they go a little bit crazy.

JIHO: Exactly.

KENNY: So, I get the regulations. I get that the arbitrage traders cannot keep up because there are only so many of them floating around...

JIHO: Exactly. To do these trades, you also have to know how the financial system of the market you are trading in works. For instance, in South Korea, to move money in or out of the country, the bank actually just has a list. It's a list of reasons that you are sending money in or money is coming out.

If your reason does not fit into this list, the banks are basically scratching their heads saying, "How do I do this?" If you are sending money abroad, you are either selling something. If you're selling something, that means that something needs to come into South Korea, which the customs office will check. If money is coming in, it means that you have sold something abroad, and they will also check.

I've heard some really funny stories where some amateur arbitrage traders, whose original job is, for example, a fish importer, would send money abroad to import fish into the country. He saw this opportunity and thought, "Why don't I just put a markup on the fish I'm importing?"

Let's say each fish is importing for $10. He would say, "I'm importing it now for $15," and the $5 would go to buying crypto. He would do this trade, but later get into a lot of trouble with the customs office, saying, "Why are you importing fish at a higher price when everyone else is importing the same fish?"

KENNY: Honestly, that sounds a lot like money laundering.

JIHO: Exactly. Because the guy couldn't figure out a way to send money abroad to buy crypto to bring into the country. So, he got into a lot of trouble for wire fraud. The only way for you to wire money abroad properly is to write an invoice that you submit to the bank saying, "Hey, I am going to send a million bucks to the US or Singapore or whatever, because I want to buy Bitcoin. And this is the price of the Bitcoin I'm buying; this is how much of it I'm buying." The bank needs to say, "Okay," and then send you the money.

You used to be able to do this in Korea in 2017 because the banks were like, "What is Bitcoin?" and I would have to explain to them what it is. The funny thing is, the banker would look at the list of reasons they're sending money abroad and say, "Alright, this seems similar to digital content. Is this similar to what you're talking about?". And I would go, "Yeah, you can say that. It's a type of digital content."

So that's the checkbox they marked off when they were wiring money for me, early on. But later down the road, the regulators started clamping down on this, saying, "Alright, there is too much money laundering going on. No more wires for Bitcoin." Previously, there was no law forbidding banks from wiring money for the purchase of Bitcoin.

And so, the regulators started threatening the banks, saying, "Don't do it, or I will make your life miserable." After 2019, that's when it got really hard for people to do it. The only way to do it now is to actually send money abroad for some other legitimate reason, do another trade onshore in the other country that you are trying to buy Bitcoin or whatever crypto from, and then bring it in.

For instance, you say "I want to buy gold". So basically, you buy gold. You are sending money abroad to buy gold, except the gold is not actually being imported into the country. It's just being stored someplace else. So then, you sell the gold to some other dude, he gives you cash in some offshore account, you use the cash to buy crypto again, and that money comes in.

KENNY: But it's worth noting that financial regulations exist for a reason. Ultimately, they are protecting the consumer.

JIHO: Correct. I'm not angry that the regulators are doing this. I think they're trying their best. It's just that they literally do not know how to handle this. They know there are a lot of legitimate trades going on, but there are also a lot of illegitimate trades going on. If you are a conservative regulator, you do not want to cut off legitimate trades. But the illegitimate trades are causing too much damage, so you just have a blanket ban. That is kind of what happened post-2019.

KENNY: Picking up a question from the chat, with this arbitrage trading strategy, how important are things like volatility, slippage, gas fees, and the actual nuts and bolts of a more traditional trading platform?

JIHO: I mean, it is risky. I did trading the old-fashioned way at first, where I would send money abroad, I would trade Korean won for USD, the USD would be sent to Singapore or the US, and that USD would again be used to buy crypto.

Once the crypto was bought, my counterpart would send that to me immediately, which would take about 30 minutes. You have to take into account FX. As long as the spread is high enough that the FX fluctuation is of no consequence, you're fine. So, if the FX does not move more than 50 basis points in a couple of days, you're okay.

If the spread is like 5%, the money hits, FX is good, then that's when you start buying Bitcoin or Ether or whatever. If there is a very high price swing within the 30-minute window that you're waiting for the block confirmations, then you might lose. But it has been my experience that if the spread is over 5%, you would break even on maybe two out of ten trades and profit on at least eight. If the spread is like 3%, you might lose in one or two, but still profit out of the gate.

KENNY: There is definitely a volatility risk that you have to take into account here for sure.

JIHO: Yeah, when you're actually moving the crypto. But an upgraded version of that is if you already have a stash of crypto, let's say on your counterpart's side, let's say you are always going to have a stash of Bitcoin that you're going to hold on to for 10 years or whatever. Then, you do the trade instantaneously.

So, you already have crypto on the sell side and I receive the crypto in Korea. So basically, as soon as I buy three Bitcoin in Korea, then usually the original trade would be, I would buy three Bitcoin and send it to the US. And then, they would sell the three crypto for a profit. But if you are already holding three crypto, then I would buy as soon as my counterparty would sell. That way, you would have no loss and be a market maker. You always hold on to three Bitcoin and have no loss in the transfer.

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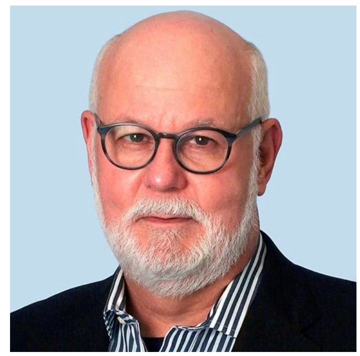

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