Sankala Group

Cryptocurrency Distress

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Back in 2016 it was becoming evident that Bitcoin was an enduring concept, and I needed to learn more for myself and to address increasing client interest. I quickly found a “Bitcoin Meetup” in Boulder, a social group that gathered once a month to discuss cryptocurrency.

After sitting through a few meetings, it became clear one individual, a senior in high school, understood far more than anyone else in the group. He was mining bitcoin in his spare time, and I decided to ask him to consult for our firm. He was keen to add some U.S. dollar income to his bitcoin income, and he soon began helping me understand the cryptocurrency landscape.

He pointed me to a short, beautiful document colloquially called the “Bitcoin Whitepaper” formally titled “Bitcoin: A Peer-to-Peer Electronic Cash System”**.** The whitepaper, written by the pseudonymous inventor of Bitcoin, Satoshi Nakamoto, deeply impressed me. It was clear that extremely innovative and remarkable conceptual math/computer science was contained in this paper which defined the "blockchain" as we know it.

Our initial work with this consultant focused on understanding wallet options, nascent brokers coming into existence, and how to securely store bitcoin (BTC). We discussed many options, including "cold storage", a practice that involves storing private keys to BTC wallets generated on computer equipment (and often then paper files) never connected to the internet.

My first purchase was nerve wracking. I went with my consultant to a Wells Fargo branch and deposited actual $100 dollar bills into a third person's USD checking account whom I never met (trusted consultant beside me) and waited until my phone chimed and my first bitcoins (BTC) were deposited to my digital wallet. In 2016, the market was far less developed, and this risky approach was common. Using my own money, I justified the unusual transaction in the name of investment research.

My initial purchase was priced around $700 per BTC. By the summer of 2017 the price had risen ~3x and I decided to exit my investment to fund another project. In retrospect, it was one of the worst investment timing decisions I ever made. By December BTC traded up to $20,000, well more than 20 times higher than my initial investment!

Through this process, it became clear our firm was limited to consulting uniquely technology savvy clients on how to purchase BTC directly themselves (or via brokers) as they became interested. No easy or intelligent way existed to add the asset to managed client portfolios.

During that period, one client asked a very intelligent question, "Hal, how are we going to know when to sell bitcoin?" In their case, no other projects/investments needed funding, so the time horizon was potentially much longer. Since BTC doesn't generate cash-flows organically, it is impossible to value through comparison to other cash-flowing assets. I acknowledged the challenge and asked for more time to ponder the question.

After a couple days, the old Wall Street adage "buy the rumor, sell the news" popped into my mind. It dawned on me there was indeed a clear rumor in BTC. The rumor was that cryptocurrency would eventually outmode traditional fiat currency, and completely revolutionize payments and commerce. So, I told our client, given the rumor, the "news" would therefore be a sovereign government announcing the issuance of a nationally backed cryptocurrency.

Incredibly, we did not need to wait long. In December 2017, Nicolas Maduro, president of Venezuela, announced the issuance of the *Petro* (PTR), a cryptocurrency designed to end-run international sanctions on their country. I called the client, and said "There it is right in the headlines today. This is the first nationally backed cryptocurrency.” They replied “I thought it would be Iceland or Japan. Let’s not sell all of it, let's sell half.” I said fine, and we did just that.

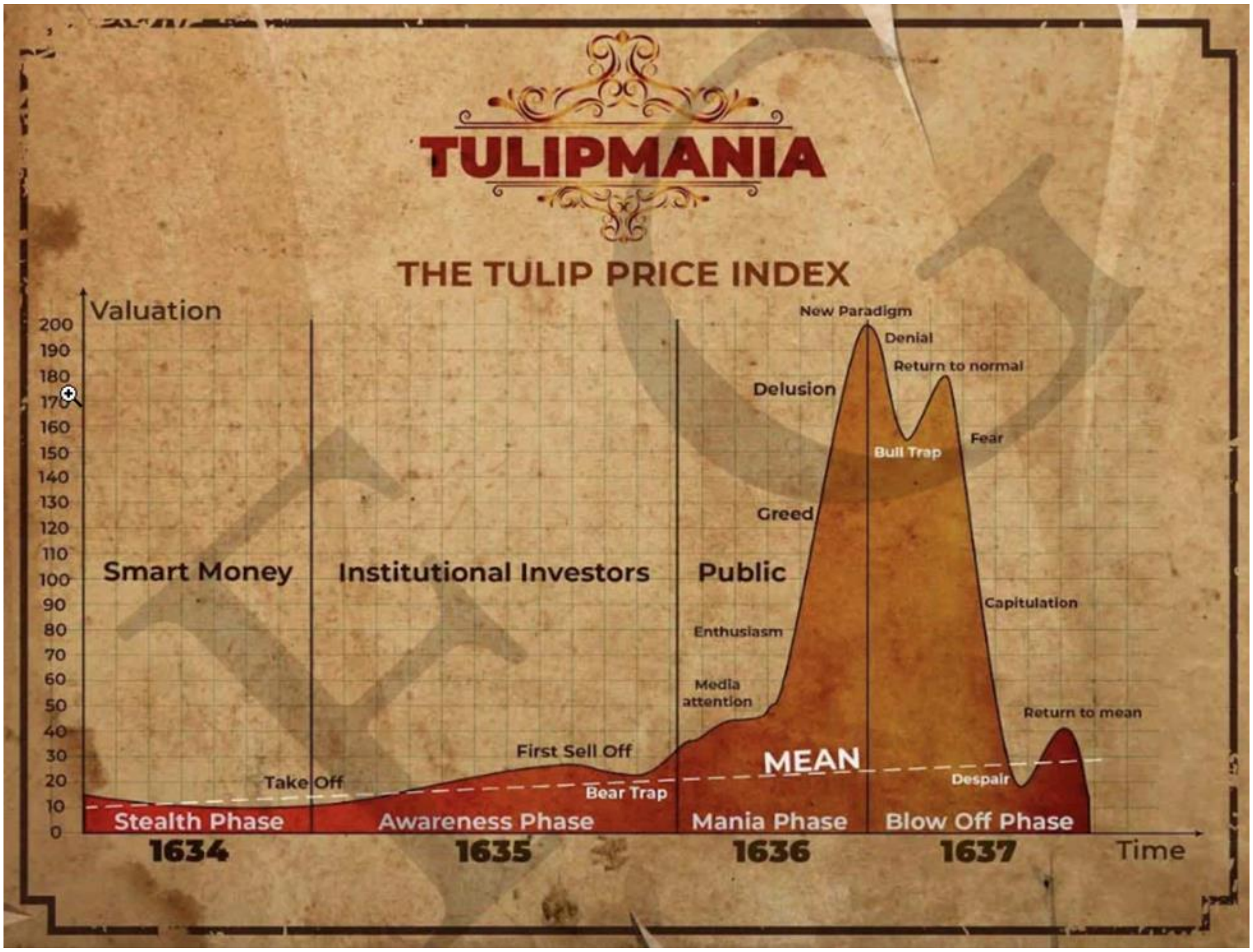
I should have stuck to my hypothetical guns. Within 48 hours, BTC had peaked around $20,000 in mid-December 2017 and it didn’t recover that price level for 3 years, until December 2020.

By 2021 far more people were tracking Bitcoin, but by this time there were also thousands of other speculative “coins” which felt impossible to follow the development and ultimate purpose of. While Ethereum made a strong case for itself and was being accumulated by many early BTC adopters, it was a bit harder to understand the supply of, and how it was “mined.” In short, computer programmers developing applications which functioned in the Ethereum ecosystem were rewarded with new Ethereum coinage, rather than by virtue of simply providing transaction verification computing power, which is how BTC is mined.

All of this hype combined with plunging interest rates (which added to speculation in all asset classes) and extensive time at home on computers during the COVID pandemic created a massive bubble in all kinds of cryptocurrency, including BTC and Ethereum. BTC topped out around $68,000 and Ethereum topped out around $4,800.

Needless to say, when the Fed began to raise interest rates, the bubble burst. Initial selling as people sought to exit their positions knocked on into generalized pressure on all technology/venture investors, which then culminated in a full-blown liquidity crisis (and fraud) as FTX Trading Ltd., a major broker of cryptocurrency failed. Contagion is currently ripping through markets with once mighty names like Coinbase, Silvergate Bank, Signature Bank, and the Grayscale Bitcoin and Ethereum Trusts all trading with serious distressed characteristics.

The best comparison I can think of is the great Tulip Bubble in the Netherlands in 1637, which is aptly described in this wonderful graphic on the next page.



Humor aside, the real purpose of this letter is to make a case for why re-entry into this space actually makes some sense (unlike into tulips), and to offer some ideas on how we can do so thoughtfully and conservatively.

First, I want to offer a list of characteristics of BTC which make it quite different from tulips (and gold):

1. BTC has a limited finite supply, unlike tulips which multiply, and gold which has vast unmined reserves on this planet and likely elsewhere in the universe.

2. BTC has a potentially infinite and low cost shelf-life, unlike tulips which need watering and eventually die, and gold which requires constant physical security.

3. Trade in BTC cannot effectively be blocked by governments without blocking the internet (and electrons) entirely since it is fundamentally a multinational distributed network.

Governments were able to block trade in tulips using traditional port-of-entry means, and history contains many examples of government orchestrated gold trade blockages. No government has yet succeeded in blocking BTC trade.

4. BTC is expected over the long-term to have conceptual/statistical pricing similarities to gold, reacting to changes in fiat money supply growth and interest rates. However, BTC is theoretically superior to gold due to its near costless storage and security. Gold is very expensive and dangerous to transport and store. Tulips are obviously cumbersome to move and store.

5. So far, governments have struggled to seize BTC, while seizures of gold litter history and the bottoms of many oceans. Presumably, many tulips were also surreptitiously uprooted during the flower bloom!

Second, I want to offer a list of interesting ways this liquidity crisis can be invested in more conservatively, with some margins of safety beyond simply relying on the price of BTC and Ether to stabilize, or buying the common stock of crypto-related names. I will order them from the easiest to execute and understand to the most difficult:

1. **Buy BTC and/or Ether via a brokerage like Coinbase, and store it in your own digital wallet.**

   a. You own actual BTC/Ether directly.
   b. You're assured your assets are not lent as collateral.
   c. Less susceptible to corporate fraud than keeping it in broker custody.
   d. In the U.S. you suffer an additional 1099 form and material tax hassle.
   e. Purest exposure, but least distressed and lower return potential.
   f. 100% NOT RECOMMENDED to any client who ever forgets passwords!

2. **Buy Grayscale Bitcoin or Ethereum Trusts** (GBTC, ETHE)

   a. Own BTC/Ether at 43%/59% respective discount to the fund's net coin holdings. (1/3/23)
   b. Gain option on SEC approval of conversion to ETF – said discount closes to zero with a price appreciation of ~75%/144%
   c. Coinbase Cold Storage with anti-rehypothecation terms.
   d. Fees are paid for fund management.
   e. Can be held in all IRAs, taxable accounts etc.

3. **Buy Coinbase Convertible Debt** (ISIN: USU19328AB62)

   a. This 3.625% senior paper yields 7.4% at price $49, and is $100 par. (1/3/23)
   b. Duration around 7 means not very interest rate sensitive.
   c. Can double in value, paying high interest if environment stabilizes.

d. More secure than the common stock.
e. Can be held in all IRAs, taxable accounts etc.

4. **Buy Silvergate Non-Cumulative Preferred Stock** (CUSIP: 82837P507)

a. This 5.375% dividend non-cumulative paper yields ~10% at price ~$12, $25 par. (1/3/23)
b. Not very interest rate sensitive.
c. Can more than double in value while paying high dividends if the environment stabilizes.
d. More secure than the common stock, but still high risk.
e. Can be held in all IRAs, taxable accounts etc.
f. Attractive in taxable accounts (qualified dividend)

To date, our firm has taken action on every option, but focused most capital on Option #2, which strikes a good balance between asset purity, distressed return potential, risk, lower administrative cost, and ability to place inside IRAs.

Options 3 and 4 are only appropriate to certain clients given the harder liquidity conditions, complexity, and broker constraints in these names.

As far as our view on funding these trades, it makes the most conceptual sense to reduce gold holdings as GBTC has declined ~80% during a time when gold did quite well. That does not make a whole lot of sense as we expect the same macroeconomic/statistical forces to work on the valuation of both assets. That suggests funding BTC/Ether (especially via distressed fund holdings) using gold proceeds is a unique value trade.

To that end, I also want to highlight a paper titled Hedging Sanctions Risk: Cryptocurrency in Central Bank Reserves. Written by Harvard economist Matthew Ferranti, this paper shows how cryptocurrency is beginning to loom larger in discussions of central bank reserves globally, and particularly in similar ways to gold. It also underlines the unique advantages of BTC vs. gold in certain situations with sensitive intergovernmental considerations. While we don't appreciate or condone the use of cryptocurrency to skirt sanctions, we recognize as professionals that all material sources of supply and demand must be considered in any complete analysis.

Which leads me to another concern. Investors are rightly worried about the climate implications of blockchain technology, and the intensity of electricity use supporting these systems. Establishing a value judgment here can be challenging, especially in light of all the energy and atrocities committed in the name of gold (and fiat currency) over the centuries. What we are confident of is that BTC, which is built on a system known as "proof-of-work" is far more electricity intensive than Ether, which is built on a system known as "proof-of-stake." Harvard Business Review's paper titled "How Much Energy Does Bitcoin Actually Consume?"

begins to explore this issue more deeply. Fortunately for us, the distress and statistical properties of BTC and Ether are similar enough we can customize our approach in these investments given client concern about climate and carbon intensity. We have adjusted our models accordingly.

Finally, as we have discussed in our past letter Rebalancing Alpha, we are also pleased to use these assets within our wider portfolio diversification/optimization strategies. Even small positions in these more volatile crypto-related assets can be significantly beneficial with regard to risk management and our ability to generate value with periodic rebalancing. We are happy to be increasing exposure during this period of time characterized by distress, rather than at a time characterized by euphoria. We think that the element of timing in distressed investing is especially critical.

Best,

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