ASSET MANAGEMENT

market notes: Leverage Lesson...Again...And Again

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11 November 2022
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1. Every true test is rewarded by some growth in knowledge, strengthening of character, or intuition into higher consciousness. Paul Brunton, a masterful philosopher, postulated that the pains of growth were evident through intuition and character, and most readily discovered in crisis. Growth centered on experiences gives a strong sense of conviction around knowledge. Digital asset markets are providing that experiential learning, from financial crisis to calm to confidence crunch in a matter of months.

2. FTX represents another shock to the centralized digital nervous system. It is unlikely to cause a systemic downfall, but the timing was most certainly a surprise. After all, digital assets had just gone through four months of deflecting volatility from traditional markets. Industry leaders massively deleveraged loan books, with active loans for Genesis down nearly 80% from the first quarter. Now, what matters most is the timely recovery rate of customer funds. Investors are de-risking with liquid-market hedges against frozen funds, adding volatility to the downside while funds are locked; the reverse will be true when hedges are unwound.

3. Leverage is the lesson. Leverage does not play well with a 50-150% volatility asset class, its range in the past year, that is limited in supply and without a lender of last resort. One River Digital did not have exposure to FTX directly or indirectly. The concentration of ownership of FTX Token is one of several factors that did not meet our fundamental screens for entry into our benchmark indices (Figures 1 & 2). The circulating supply for the FTX Token was running less than 40% at our latest Index reconstitution, well below our required threshold for entry. The risks of concentrated FTX Token holdings were exposed with a large, public seller of the asset.

4. Onshore regulation is the pathway forward. And it should come with a greater sense of urgency. One can be reasonably surprised by the slow speed of change on that side. After all, the rules on customer protection, re-hypothecation, financial reporting, and custody are all sitting in traditional finance, ready to be imported into the digital ecosystem. Constructive ambiguity has exported innovation to weaker regulatory

regions and imported risks to investors. By accident or design, FTX gives US regulators a much stronger narrative to push forward.

5. Senator Lummis offered that sense of urgency in a statement, arguing that recent events "are the clearest example yet of why we need clear rules of the road for digital asset exchanges in the United States." Lummis-Gillibrand Responsible Financial Innovation Act spells out various practical regulations that will encourage onshore innovation with, among other things, clear rules around digital assets at exchanges being definitively shielded from bankruptcy. It's time.

6. It is important to emphasize – emphatically – that the failure here is not the technology. It is the human behavior around it. There are more than 170 million active users in our Index constituents. Bitcoin is averaging more than $31 billion in daily transaction settlement, 7 days a week, without downtime or third-party oversight. On November 9, amidst volatile markets, Ethereum managed more than one million transactions with a 6% turnover in its market cap. And stablecoin is working. If the political calculus is that the deficiencies in centralized finance will drive digital assets into oblivion, it is flawed logic. Innovation will simply migrate where it is wanted.

7. Stablecoin legislation is the regulatory unlock on the immediate horizon. McHenry and Waters have been in extensive negotiations in the House Financial Services Committee – a definition of stablecoin will be provided and precedent will be set on which government agencies are in charge of oversight. Clarity around stablecoin will also converge to the Federal Reserve guidance on novel institutions, and how stablecoin enter the banking system. This will also be relevant in the context of custody, given SAB 121 required digital assets to be brought on balance sheet, a severe impendent for banks to provide the service given the high capital charges and limited return potential.

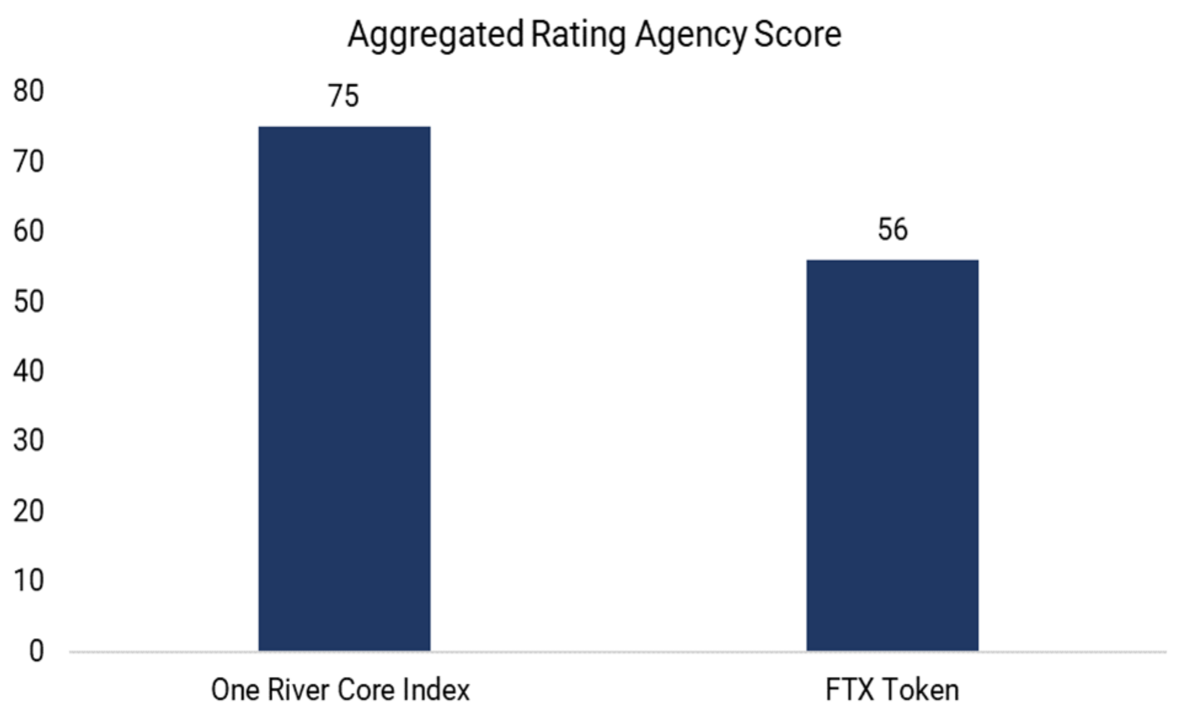
8. Separation of fiat and digital banking is a natural pathway forward, and guidance strongly points in that direction. Policy is rightly concerned that small digital asset markets could pose material unintended risk to fiat banking in its early stages of innovation. After all, the technology stacks are not natural fits. SAB 121 is that separation tool – it takes banks out of the digital custody business. Of course, the Fed, the super-regulator of the banks, could see it differently. Yet, their guidance points strongly in the same direction – it shows a strong desire to integrate stablecoin into the formal banking system.

9. How stablecoin integrates into the banking system matters. It isn't through conventional banks, but through native digital ones. A novel institution is guided to reserve 100% of all fiat deposits. That is, a digital bank cannot compete with a traditional one for credit services. A stablecoin issuer under the strictest guidance will have access to Fed services and, thus, any stablecoin issued will have an offsetting

asset as a deposit at the Fed. A digital bank in that world is a stablecoin issuer that offers broader services to digital asset markets – all under the watchful eye of the Fed and other regulators.

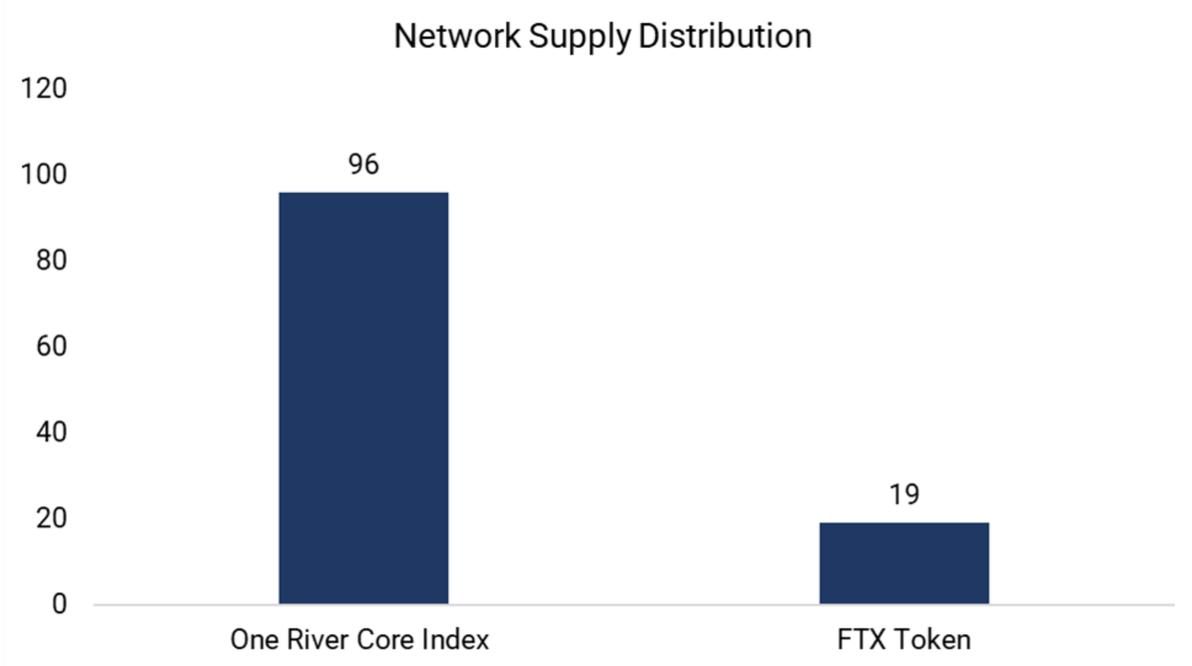
10. Digital assets need to enter the regulatory mainstream to harness their potential as a positive gateway to innovation. Their potential is no longer an abstraction – NFT integration into Web2 platforms like Reddit as well as Instagram and Twitter's focus on turning its social network into a payment vessel is all done with the digital ecosystem in mind. Weakness in prices from poor choices in centralized financial exchanges won't derail the progress.

Figure 1: FTX Token Rated Poorly by Agencies (Range 0 -100)



Source: Blocknomy, TokenInsight, Flipside Crypto, Baserank, (October 2022)

Figure 2: Supply in FTX Token Narrowly Distributed on Digital Pulse (Range 0-100)



Source: Coin Metrics, One River Digital Pulse.

Disclaimer

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