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Crypto hedge funds: The big thaw

Posted By *Ludovica Brignola* On July 3, 2019 @ 7:01 am In Analysis | Comments Disabled

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The latest cryptocurrency surge has sparked frenzy among emerging and established digital currency hedge fund managers, who are gearing up to reap the potential rewards from an evolved, more mature asset-class.

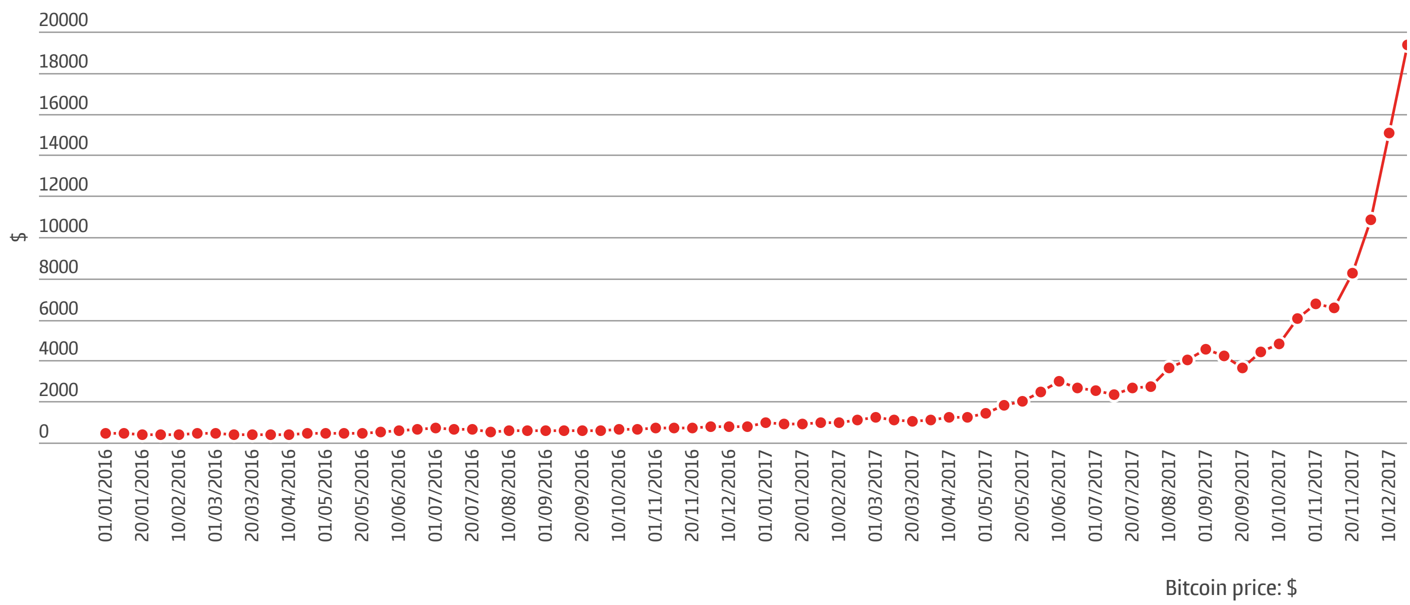
After plummeting an eye-popping 72% in 2018, bitcoin has surged 70% year-to-date, according to Coinbase.

While still significantly below its 2017 record price of $20,000, the climb has had a positive impact on an industry which, according to a recent report by PwC and Elwood Asset Management, is on the cusp of an institutional take-off.

The study, by the global auditor and Alan Howard-owned digital asset manager, found some 150 crypto hedge funds survived the 2018 big freeze, with the majority outperforming their benchmark by falling 'only' 46%.

And a number are now readying new launches.

Bitcoin price: past three years



Source: Yahoo Finance

Aaro Capital, a London-based company incorporated in June 2018, is currently prepping the launch of a digital coin fund of funds, looking to profit from direct exposure to digital assets such as bitcoin and ether.

"We believe the market is becoming very sophisticated," said Ankush Jain, Aaro's CEO. "The volatility in the space is decreasing: liquidity has improved since the opportunity to short exploded in the last year and a half. And most importantly, big names and market makers are now gearing up to get involved in the sector".

Futures exchange Bakkt, a platform created by Intercontinental Exchange – the owner of the New York Stock Exchange – is currently awaiting for CFTC's final green light before launching.

The platform aims to offer physically-settled crypto-futures as well as custody services, and cater to institutional and retail players.

Similarly, Chicago-based futures exchange Eris X, also backed by a number of Wall Street behemoths such as retail brokerage TD Ameritrade and high-speed trader Virtu Financial, is expected to gain approval by the US regulator and launch in the second half of 2019.

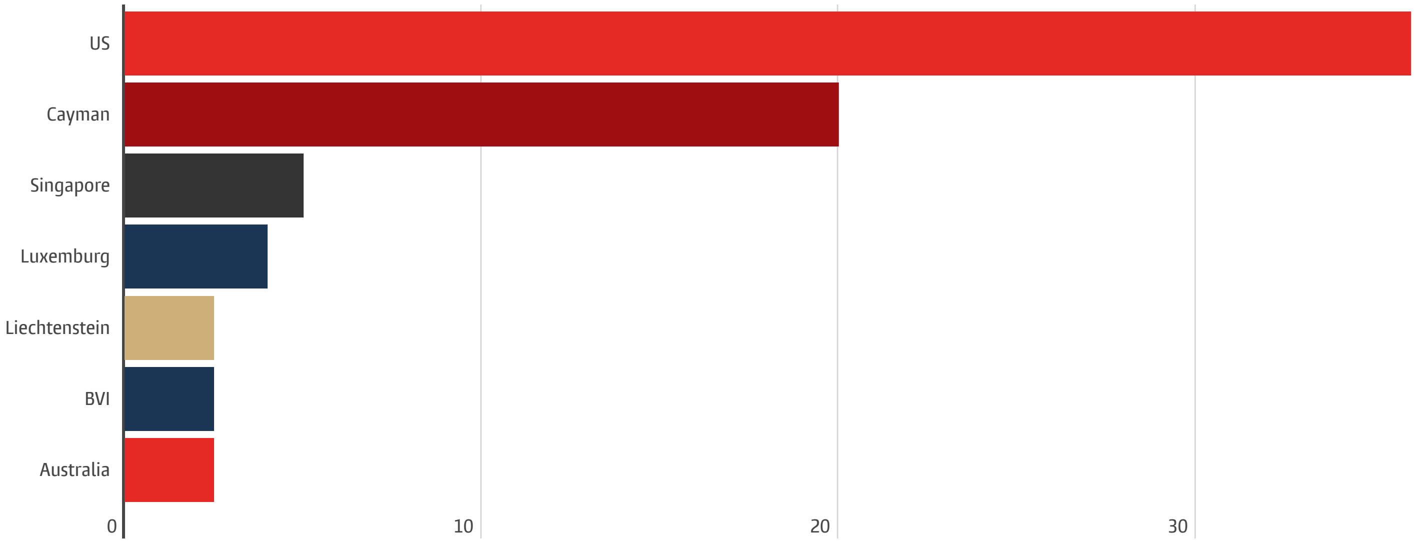
Investors hopes were boosted when two weeks ago LedgerX was the first crypto derivatives exchange to obtain clearance by the CFTC, and start trading bitcoin futures that are settled in the digital currency, a move supporters view as a step forward in building a derivatives market for the volatile asset.

London-based BitSpread, a blockchain asset research and advisory firm and one of the first movers in the space, agrees.

"Names such as Fidelity and ICE are bringing renewed trust to the sector, a quality that has notoriously lacked in the crypto's infancy stage".

The company is understood to be looking at quantitative crypto strategies, and created a blockchain asset management platform BlockBerry in May .

Where crypto hedge fund management companies are located



Source: PWC and Elwood Asset Management

"I believe that the newly launched crypto hedge fund vehicles will exploit more sophisticated crypto assets and derivatives, rather than merely make money on the arbitrage between various [crypto] exchanges," Lionel Fournier, BitSpread Financial Solutions' CEO, told HFM.

Traditional exchange giants CME and Cboe both launched cash-settled bitcoin futures in December 2017, although the latter pulled the plug on its offering last month due to low trading volumes.

The CEO of a $700m London-based hedge fund says his firm is pre-marketing a crypto fund but prefers to remain anonymous for regulatory reasons.

"I think there's an interesting opportunity given the growing appeal of the space to the big asset owners, even though the environment is still unregulated and the funds are mostly unregistered", he said.

So far, crypto hedge funds have been largely outside the scope of regulators. But the tide is turning swiftly, as London-based Prime Factor Capital became the first crypto hedge fund to obtain the stamp of approval from the FCA.

Not only has the recent bull-run proven a boon to emerging crypto hedge fund managers, the space has also shown to be relatively resilient to unfavourable market conditions, with managers able to raise capital despite a year-long downward-spiral of the coin.

According to PwC, the median crypto firm AuM at fund launch stood at $1.2m in January 2018, a figure which has tripled on average, reaching $4.3m AuM as of Q1 2019.

The majority of crypto hedge funds still hold assets of less than $10m, which has in the past prompted questions about the long-term sustainability of their business model. But larger funds remain bullish over the long-term prospects of the nascent asset class.

Polychain Capital, a San-Francisco based cryptocurrency hedge fund backed by venture capitalists Andreessen Horowitz and Sequoia Capital, told *HFM* the asset class currently represents a big opportunity.

"We are not only looking at 2019: we have a very long-term approach, and we are more confident on the space as the underlying blockchain technology is quickly developing," says Polychain president Joe Eagan.

"This is year will be the biggest year in terms of the evolution of the crypto technology, as I am seeing managers looking to reap profits while enhancing their governance," he added.

One of the biggest hedge funds in the space, Polychain said it outperformed the market last year, but declined to disclose its performance or AuM.

Alongside the bitcoin's price rebound, another recent development in the digital assets space has helped galvanise the managers and put central banks and regulators on notice.

Last month, Facebook unveiled plans to launch Libra, a blockchain-based digital currency pegged to fiat currencies that could be used to send money around the world.

"We are considering Libra at the moment as it is a very interesting project which could provide significant synergies with our model," Gerald Brant, director of capital formation at San-Francisco based Pantera Capital Management, told HFM.

Pantera's Bitcoin Fund lost 76% in 2018, and its Digital Asset Fund did even worse, tumbling 87.3%, but the company stands ready to double down its investments in the sector.

Silver 8 Partners, a multi-strategy bitcoin fund managed by the US-based eponymous company, fell 63% in 2018, but has risen 70% this year.

Industry data shows that on average crypto hedge funds returned 82% YTD through May, with huge gains expected for the month of June.

Volatility in the asset-class is unprecedented: in 2017, the strategy returned a whopping 2907%, while the years before displayed milder figures – but still disproportionate when compared to industry standards, with crypto hedge funds rising 109% in 2016 and 47% in 2015.

Despite positive recent developments, the sector stands on shaky ground.

As the PwC and Elwood report found, most crypto funds do not have independent directors on their board, an alarm bell for institutional investors, who carefully monitor funds' corporate governance before committing capital.

Furthermore, only a limited number of fund administrators are currently servicing the space, although according to the report, this seems set to change as the industry matures.

Lastly, crypto hedge fund performance data has so far been self-reported, which represents a valuation conundrum for investors.

"I am currently not working with crypto hedge fund managers, but I am noticing a growing ferment in the market segment" said Ole Rollag, managing principal at Murano Connect, a bespoke capital introduction firm.

"Crypto managers differ widely than traditional portfolio managers: in most cases they have never managed money before and hence have never been through economic cycles. If they will become more sophisticated and come up with a real portfolio… I will surely start to take them into account."

A senior executive at a quant London-based hedge fund agrees: "We are not looking at the space. And Libra? It looks like a glorified ETF to me".

Bitcoin has divided opinion since its first inception.

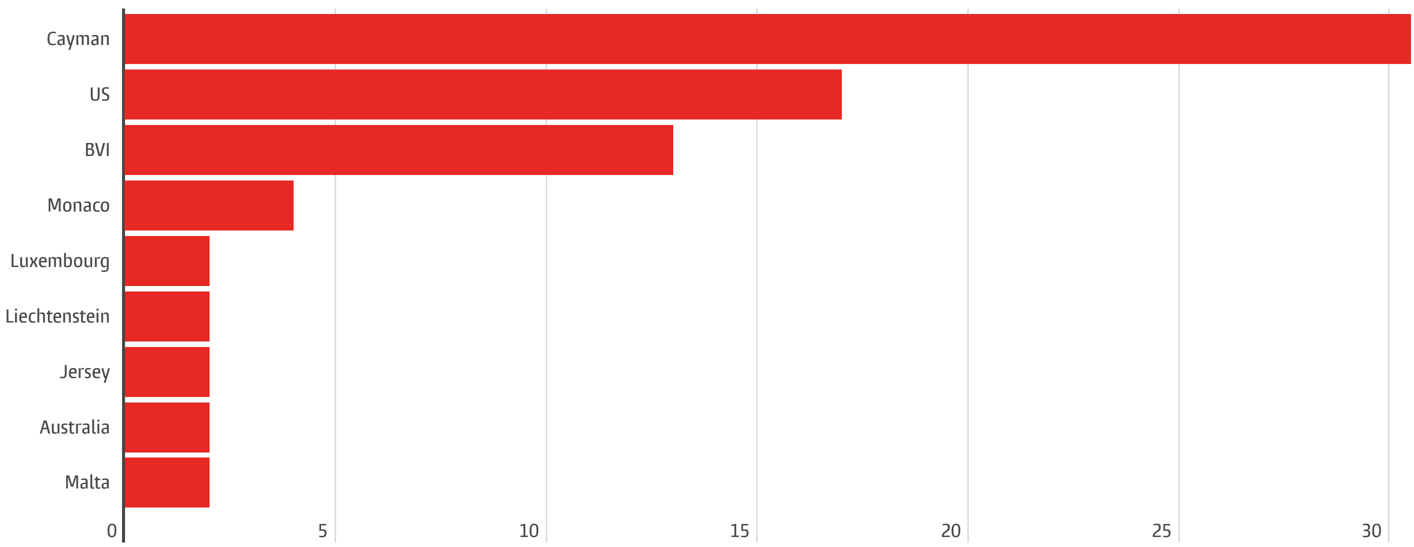
Benoît Cœuré, a member of the ECB's executive board, last year described bitcoin as "the evil spawn of the financial crisis". Mark Carney, governor of the Bank of England, said in March last year that bitcoin was "inherently risky" and needed tighter regulation.

And Jamie Dimon, JP Morgan's CEO, openly called the currency a fraud in 2017, albeit retreating a year after, when he announced in a televised interview that the "blockchain" was real.

As it is often the case in financial markets, only time – and market cycles – will be able to tell whether the asset class has real scope to grow.

But according to Henri Arslanian, global crypto manager at PWC, the regulators have never looked at the space with more interest than today, after the industry made it through "a crypto winter", a proof of resilience to economic shocks.

Where crypto hedge funds are domiciled



Source: PWC and Elwood Asset Management

A report published in December 2018 by Cambridge University shows only 5% of regulators across the world do not have a dedicated team for the cryptocurrency sector.

"The average regulator I speak with is more knowledgeable on the subject than the average financial services provider, which is a good sign. This is coupled with the recent entry of institutional players to a space that was previously led by retail investors," says Arslanian.

The change at the helm of the CFTC, which regulates virtual currencies as a commodity, will likely shed more light on the future direction of crypto markets.

On 15 July, Heath Tarbert will replace Chris Giancarlo as the US derivatives regulator's new chairman, a move that has stirred some anxiety among the crypto enthusiasts who regarded the incumbent leader as particularly crypto-friendly, dubbing him "crypto dad".

Tarbert, the second Trump-appointed official to lead the Commission, hasn't yet disclosed his opinion.

"Irrespective of the stance that the new chairman will have, no regulator can now ignore the asset class, given the amount of interest it is drawing from all directions," Arslanian says.

Dan Berkovitz, one of the CFTC's five commissioners and a former general counsel at the agency during the Obama administration, told HFM he believes the US regulator will continue to play a focal role in the supervision of the asset class.

"We have seen a lot of institutional interest, and we are acting expeditiously, having put in place a robust program in this area. The CFTC is doing a great job in putting the crypto-assets' word out."

According to some hedge fund managers, a continuation of Giancarlo's legacy is vital if the US hopes to remain central to the environment.

As Tushar Jain, Multicoin Capital's managing partner, a US-based crypto hedge fund, says: "The CFTC has been very level-headed so far: if they won't pass renewed regulation the bitcoin business will move offshore: the new centre of gravity is increasingly becoming Asia, currently fighting to win big chunks of US business".
