How the Industry's Top Crypto Funds Are Trading and Investing in Cryptocurrency | Ari Paul

January 31, 2018

Never try to sell at the top. It isn't wise. Sell after a reaction if there is no rally. – Jesse Livermore

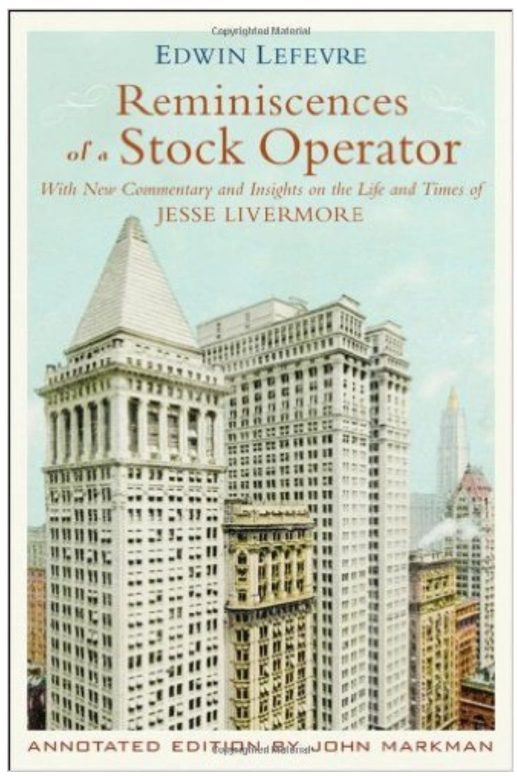
INTRODUCTION

What's up everybody? Welcome to this week's crypto forces segment of the Hidden Forces Podcast, with me, Demetri Kofinas. My guest for this segment is Ari Paul. Ari is co-founder and CIO of BlockTower Capital. He was previously a portfolio manager for the University of Chicago's $8 billion endowment, and a derivatives market maker and proprietary trader for Susquehanna International Group (SIG). Ari earned a BA in political science from the University of Pennsylvania, and an MBA from the University of Chicago with concentrations in economics, entrepreneurship, strategic management, and econometrics & statistics. Ari is a CFA charterholder.

WHY DO I CARE?

It's one thing to be bullish on cryptocurrencies – or to say you are bullish – and it's another thing to make money trading them. So far, it has been easy. Buying and "hodling" has been a good strategy, but that won't last. At some point, the market will settle and timing will become much more important. That said, the early days of any market with the potential of cryptocurrencies offers tremendous opportunities for experienced traders and speculators to exploit risk/reward arbitrage and capitalize on trends before the herd can follow. Today's conversation will help you learn how this new market is changing as institutional capital flocks in and interest grows. It also offers an opportunity to learn techniques and strategies for making short and long-term gains in cryptomarkets.

WAYS TO BUY



1. Exchanges – Coinbase, Bittrex, Gemini, and Poloniex (BTC, ETH, and LTC).
2. Bitcoin Options – LedgerX
3. Bitcoin ETF/ETN – ?
4. Bitcoin Futures – CME & CBOE
5. Equities – dApps

"It would not be so difficult to make money if a trader always stuck to his speculative guns – that is, waited for the line of least resistance to define itself and began buying only when the tape said up or selling only when it said down" – Jesse Livermore

FRAMING THE FUND

1. Background – What's your background? How would you describe what you are doing now? How would you describe this fund that you have started (Blocktower)? How many partners are there? ***according to CrunchBase, the firm officially closed $140mln in funding from Andreesen Horowitz and Union Square ventures in January 4th, 2018. Where does this rank you among other crypto funds?
2. Returns – What type of returns are you looking to generate? What is your time-horizon? These assets exhibit higher levels of volatility. How does this factor in to how you value your portfolio at any moment in time? Do you need longer lock-up provisions? How do you communicate the risks to your investors?
3. Performance Measures – How do you measure performance? What other funds do you compare yourself with? What type of exposure are your clients looking for when they come to you?
4. Capital Raise – How do you manage taking in new money? For example, if you own ¥500 million, you know what it's worth because the market is liquid and there isn't any real opportunity for arbitrage across exchanges. But, if you own some alt coin with a market cap of $500 million or $5 billion, how can you feel confident that someone who is giving you $1 million to invest is going to get his/her fair allocation of the fund's assets when fair market value is unclear?

Idiosyncratic Risk – can be thought of as the factors that affect an asset such as a stock and its underlying company at the microeconomic level. Idiosyncratic risk has little or no correlation with market risk, and can therefore be substantially mitigated or eliminated from a portfolio by using adequate diversification.

5. Benchmarks – It seems like you have 3 benchmarks here, whereas the traditional fund manager only has one. (1) You have the beat the market (absolute return), but (2) you also need to beat the cryptomarket as a whole, and (3) you need to outperform BTC and ETH, which are very easy to buy and hold for normal investors. In some ways, you are putting yourself in a position where, yes, you may perform really well, but there can still be naysayers, even if you return 2X over the next 5 years, because BTC may return 5X or 10X. How do you think about the perception of success in this case? How do you communicate that to your clients? Is it even important to you?
6. Boy Plunger – Talk to me about why you think there is a unique opportunity here for professional money managers in this space. Do you think that your expertise and know-how gives you an unusual edge in a market that is still in the early development process? Are we talking about Europe in the 17th century and America in the late 18th & 19th? Are we in a new age where the stock operators of old (a la Jesse Livermore) can really thrive?

INVESTMENT FRAMEWORK

7. Investment Approach – How does your approach differ from some of these other funds that invest earlier or take more of a value-driven approach to investing? How important is momentum and trend following for you? How often are you trading?

Systematic Risk – also known as "market risk" or "un-diversifiable risk", is the uncertainty inherent to the entire market or entire market segment. Also referred to as volatility, systematic risk consists of the day-to-day fluctuations in a stock's price. (Beta, Duration, & Illiquidity)

8. Alpha-Alpha – What % of your portfolio is in cryptoassets, and what % is invested in the rest of the market? Traditional hedge funds differentiate by beating the benchmark (seeking alpha). That means finding uncorrelated returns. It also means having exposure to assets that are negatively correlated with the market, so that if the markets drop, your entire portfolio doesn't go into the can. Some funds are using crypto for this. Are you just using crypto more for this, or are you actually using the market as your hedge? Walk me through your investment framework.
9. Bitcoin Beta – Within the cryptocurrency ecosystem, there are currencies and assets that exhibit higher or lower correlations to BTC or ETH than others, correct? How do your trading strategies take this

correlation into account. How does this help inform your approach to risk management? How are cryptocurrencies correlated?

10. A Changing Market – Is there going to be more money coming into this market? How long will this go on? How does the influx of the new money impact the dynamics of this market? How are trading patterns changing?
11. Bear Market – What signs are you looking for that will tell you when the next major bear trend will have set into this market? Do you think the consolidation has started?
12. The Short-Side – How are you preparing to take more short positions, and how do you apply shorts in such a new market? Do you need to get creative, and how do you do that? How will your toolbox expand with time?
13. Counterparty Risk – How do you manage counterparty risk, and where is that risk most prevalent? How do you factor in the risk of having your exchange hacked? What is that probability?
14. Arbitrage – What are the types of price discrepancies that exist between exchanges? How do you capitalize on these?
15. Futures Markets – Are you trading in futures? How do you think about/use cash-settled vs. physically-settled markets and exchanges? Are you able to get short exposure using some of these futures markets or not? What are the margin requirements, how do they differ from those of more established futures markets, and how does that difference impact your trading and risk mitigation strategies?
16. Knowledge Gap – How do you overcome the large knowledge gap here? How much do you rely on technical analysis in your trading and how much does knowledge of the market and the assets you are trading factor in?
17. Tectonic Shifts – You are in a unique place to provide comment on what some opportunities will be in the financial space, whether those are jobs at a wall street bank or at a fund like your own. In other words, we are getting to a place where the financial industry as a whole is going to view this as a knowledge set that they want to acquire. If you were 22 years old today, but still needed real-world experience, where would you go? What would you do?
18. Macro View – What's your macro perspective? Your outlook for global markets? You are on record saying that there is a risk of inflation and that the dollar could lose reserve status. Let's geek out here.
19. Existential Risk Factors – How do you factor in regulatory risk? How do you factor in the possibility that the US government will clamp down on bitcoin? What if there is eventually dollar flight from the US? What are the biggest risks that you see to these currencies or assets? How do you trade around forks? Do you think about geopolitical risk? Does the concentration of miners in China represent a risk?
20. Interesting Plays – What are some of the most interesting trades or opportunities that you are actively considering?