FCAM
Decentralised Digital Investing

Monthly Commentary

JULY 2022 PERFORMANCE

TOTAL NET RETURN

PERIOD	FUND RETURN
1 Month	+6.61%*
Life to date	+2.37%*

*Post management, performance and entry fees. Past performance is not indicative of future performance.

The Fort Stable Fund generated a return of +6.61% for the month of July 2022. We added to our long ETH position over the month via derivative strategies as the dust began to clear from the various insolvencies and declared bankruptcies in the Centralised Finance space (CeFi). We were able to capture about 630 bp of value from the execution of our strategies.

ETH traded a wide range over the month ending higher at $1700, but trading as low as $1026.

Our yield-based strategies earned 0.27% for the month. Life to date the Fund has returned +2.37%

Market

The macro environment remained volatile with Central Banks across the globe hiking rates. The RBA, ECB and FED all hiked in larger increments than has historically been the case (50, 50 and 75 bp respectively). This is in response to inflationary pressures that continue to remain elevated and, in some sectors outside of energy, build. The narrative that pervades markets is that rates will continue higher until inflation eases and that this will happen when activity slows, likely a global recession. This has participants looking to labour data and forward indicators of growth some of which are turning down. The US recorded its GDP during the month, and while backward looking it showed that the economy has spent the past six months shrinking. Other data, like gross domestic income which is rising (GDI), tell a different story— as does the employment rate that shows low levels of unemployment, high levels of unfilled jobs and a low participation rate. The strong dollar remained a theme for most of the month but has perhaps topped in the near term as has rate hiking expectations into 2023 which gave risk assets a boost over latter part the month.

We want to focus attention on the lessons learnt over the month from the various collapses and failures that started in June and concluded we think largely in July - Defi worked, CeFi didn't.

The institutions that fully collapsed over the month had points of failure that are found in traditional financing activities, the difference there however being the fact that Traditional Finance (TradFI) is inevitably regulated. The points of failure that were present over all these instances in CeFI failures.

1. **Borrow short Lend long** – Picking up the spread between paying an interest rate on a borrowing activity that requires instantaneous repayment (low cost) versus lending assets for significant duration (high return) works if you can manage the inflows and outflows. When these inflows and outflows become unpredictable (ie everyone wants their money back at once, you run into trouble)

2. **Leverage ratio's** – A lack of transparency saw many in the space take far too much leverage investing in highly volatile assets and equally many it seems have been assets that were already pledged elsewhere. There was also a significant lack of Due Diligence done when lending capital with little to no checking of what was backing what.

3. **Misrepresentation** – many were investing in CeFI products under the illusion that they were invested in liquid strategies where the mark to market process was transparent. What became apparent was that the funds were being deployed into extremely speculative projects and assets which in turn were, due to limited mark to market events, able to be re-leveraged into other schemes and projects.

The above is a complete oversimplification of the problems but hopefully gives you an idea of the type of behaviours and actions that came to light as asset prices collapsed. The real issue was a complete lack of transparency, no one had any true idea of which assets had already been promised as collateral elsewhere, and a lack of regulatory oversight. The issues regarding who owns what assets and what is left in the wash up will be resolved in global bankruptcy proceedings and likely criminal charges for some of the proponents.

So how did DeFi do?

Resilient financial systems need a few attributes.

1. How effectively does a system expel bad debts or over levered positions when discovered?

2.Does this system disincentivize unprofitable and unsustainable business models and activities?

3. Can it do both before the risks become systemic?

DeFI's key attributes that help address the above the issues are as follows.

Transparency – With everything "on-chain" positions and exposures are there for everyone to see and on which they can do their own risk analysis. Or more simply put the entire market prices this risk in real time. This transparency is the key, understanding which assets are promised where and to whom and under what conditions means that the system clears positions that become vulnerable. In fact, there is a "liquidation bounty" that became a feature of the last month with some actively pushing markets to clear positions.

Code is law – Unlike the CeFI space, where there was clearly ego driven lending and borrowing going on to be perceived as a "player", in DeFI who you are, or your reputation doesn't matter. The code determines the conditions of the financial activity and the terms and costs under which it will be initiated and closed or ended. There are no backroom handshakes to buy more time and there is no costly or time-consuming process through the courts to rectify the ownership of assets. Smart Contracts that are verifiable and immutable take care of transactions from implementation until conclusion.

The community - When systemic risks however unlikely are identified there are guardrails put in place to address them. As an example, over the last months a concentration risk was identified with regards to a counterpart managing staked ETH. The issue was with LIDO Finance which has a commanding position in managing ETH that is staked for PoS blockchain once Ethereum migrate from Proof of Work to Proof of Stake. LIDO currently controls 1/3 of all staked ETH that is deposited by investors and owners of ETH.

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LIDO manages the staking process for a fee. Once identified as an issue the community attempted first to limit the amount of ETH deposits into liquid staking and while that proposal failed the issue was resolved by the creation of 8 new validators. When decentralization is your guiding principle, you are preconditioned to root out any point of weakness introduced by centralization.

Concluding the analysis of DeFi over the last 30 days, DeFI was the canary in the coal mine that alerted participants to problem at Celsius. Celsius were forced to liquidate loans in DeFI to try and repay loans elsewhere. This happened again with Three Arrows Capital and any of the other CeFI counterparts who suffered stress. It would be arguable that in terms of priority DeFI has ranked the highest in the Capital stack, loans made in DeFi have been repaid and the participants in the protocols remain free from the likely lengthy and expensive process of liquidation and litigation.

The last point to address this month is the likely regulatory response. Regulators inevitably are amazing archaeologists as they will forensically dissect the events and set in place rules to address those deficiencies. CeFI platforms will likely exist but they will be regulated as banks in terms of capital adequacy and insurance, which will likely be a good thing offering surety and protection for investors. There are some interesting investigations going as well in The US with the SEC laying charges against Coinbase for insider trading. By the SEC acting and the fact that they have purview over securities the charges contain a loaded premise, namely that these handful of Coinbase-listed tokens are indeed securities. Should the insider traders be convicted, it indirectly puts Coinbase and those token-issuers on trial for violating U.S. securities law.

The lack of law established by Washington is seeing the regulators trying to force the agenda and have the courts make rulings. It is an interesting turn of events.

Regulation, by nature, tends to concentrate on minimizing harm rather than maximizing capital formation. Right now, the harm caused by crypto is more visible than ever, even if it is concentrated in a set of bad actors. The response is likely to be swift and hopefully not that hasty that it restricts the innovation that blockchains and digital assets bring. We have long advocated regulation is needed and we hoped it would be thoughtful and created with the medium term in mind. Right now it looks likely to be created in a negative environment which clearly is a risk to be navigated.

The macro backdrop continues to pose substantial risks to all assets. A rate hiking environment isn't one that is generally good for investing. The central banks of the world have indicated that while inflation remains a theme, they will look to normalise rates. What "normal" or neutral rates looks like given the unprecedented money printing and intervention by authorities over the preceding 2 years remains to be seen. In the near term the market seems more optimistic that we may be closer to an end to the hiking cycle than the beginning which would be caused by an oncoming recession. We intend remain nimble is the near-term maintaining exposure through limited loss strategies.

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