FCAM
Decentralised Digital Investing

Monthly Commentary

NOVEMBER 2022 PERFORMANCE

TOTAL NET RETURN

PERIOD	FUND RETURN
1 Month	-23.6%*
Life to date	-22.90%*

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

A traumatic month in the digital asset space saw prices under pressure and centralised finance dominoes continuing to fall. What became apparent was that the wholesale withdrawal of leverage post the May collapse of the Terra Luna ecosystem had not been truly reconciled and left a few the larger players vulnerable. The FTX / Alameda story dominated the narrative. As many readers will no doubt be aware, the FTX exchange filed for Chapter 11 bankruptcy in the US after a series of events led to its rapid collapse in early to mid-November. We also have seen the arrest and charging of Sam Bankman-Fried for Criminal Fraud and Money laundering.

The Fort Stable Fund generated a return of -23.5% for the month of November 2022. Unfortunately, FSF had recently deposited funds onto the FTX exchange and are now a creditor to the bankruptcy filing.

We have decided the best way forward is to write down the value of our deposit to zero by transferring the claim on the asset into a separate fund with existing investors owning a claim on any subsequent recovery.

In terms of month to date fund performance, this breaks down as follows: A loss of:c18.68% due to the write down of the FTX deposit, and additional losses of 4.82% due to market movements in the price of ETH (-23.5%) and other risk reduction activities due to the FTX collapse.

At the outset of the month, we maintained a long ETH exposure (at around 25% long ETH) which we had accumulated via our call options from the prior month's rally. We reduced our exposure down to 5% long ETH as the seriousness of the FTX situation became apparent and remain around this level.

Why FSF Decided to use FTX for Yield Generation

As a result of the various implosions in the crypto space this year, there has been a "flight to quality" into safer, fiat backed, centralized stable coins such as USDC and proven decentralized coins such as DAI. A consequence of this is that yields on these coins have declined to around 1-2% p.a. This situation has left us looking for alternatives where we can get higher yield without taking exposure on less proven protocols.

With low yields in DeFi, rising inflation, and rising Central Bank benchmark rates seeing US government debt generating higher rates than what was available in DeFi, we had been looking for ways to improve our stable coin yield. The FTX exchange provided a mechanism where depositors could lend their assets to other participants on the exchange with tight risk controls. These participants included market makers and hedge funds which had requirements for short term liquidity on the FTX exchange, this liquidity was provided without the funds ever leaving the exchange. For several months, the difference in yields between what was available on DeFi versus FTX was insignificant. However, with the improvement in risk sentiment in October and activity generally, yields became more attractive as market makers and arbitrageurs had more market opportunities available to them. With these circumstances in mind, we decided to make an allocation out of DeFi and into FTX of a little under 20% of AUM.

Why we chose to use FTX

To the best of our knowledge, we considered FTX to be a safe place to deposit our money;

- It was one of the largest crypto exchanges by trading volume.
- FTX had received investments from many prominent investors in the space.
- The founder, Sam Bankman Fried or SBF had been lobbying for crypto regulation in the US.
- FTX had been bailing out other troubled lenders in the space such as BlockFi.
- They had recently raised money and appeared to be well capitalized.
- The Terms of Service said that customer funds could not be rehypothecated

As more information is coming to light, it appears we, along with many others, made decisions based off false information. The legal system will establish responsibility, accountability and where required punish fraudulent behaviour.

Looking forward - Two things to discuss - The Macro and the collapse of FTX and its aftershocks.

Macro – We seem to have, in many parts of the West, reached an inflection point for the rate hiking cycle. We have seen an unprecedented speed of hiking over the last 12 months that, in the US, that has now slowed from 75bp increments back to 50bp increments at the December meeting. Changing the trajectory, however, probably doesn't alter the terminal rate as while inflation has eased it remains a threat. The markets rejoiced the speculation and subsequent confirmation of this change in trajectory of rate hikes and we have seen risk perform well and prices rally over the month. As we have mentioned previously the fear that has prevailed most pundits was that the FED and central banks would hike rates too much or too fast and cause stress such that we would have "credit events" or a significant collapse in growth that would have broader impacts, slowing the speed of hikes has perhaps reduced that tail risk.

FED speakers during the month indicated that while there are signs that inflation is easing, financial conditions remain too loose. FED member Bullard indicated that "the policy rate is not yet in a zone that may be considered sufficiently restrictive." He suggested the proper zone for the fed funds rate could be in the 5%-7% range, we are just about priced at the bottom of that range this cycle. FED Head Powell also indicated that he remained committed to the path that they were on. Given all this the fact remains that the FED have not deviated from their objective of hiking rates to the point that it impacts growth and employment and in turn inflation. We are nowhere near that point now.

Most pundits are braced for recession in 2023. Many indicators, such as inverted yield curves, are pointing to that occurring however as we can see from the weekly series below (Fig1.) financial conditions during recessions are often much tighter, particularly in more significant recessions. Tighter conditions are driven either by higher rates, which we know we are getting even if at a slower pace, or by a deterioration in asset prices.

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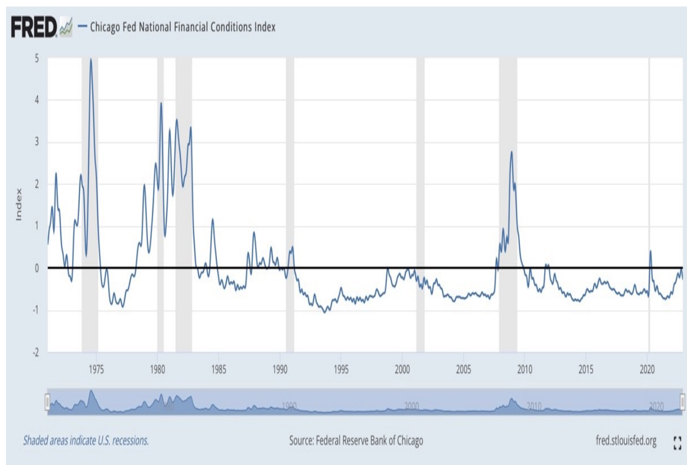
Central Banks do not want to create instability and many of the reforms post 2008 have created better stability in the finance sector. There will however likely be pockets where regulation has been light, or leverage has been excessive that we need to continue watch for stress.

Fig.1



The FTX and associated fallout.

FTX - The information we have is clearly partial at this point. Clarity will be created through the legal and bankruptcy process. What, it appears, was the crux of the problem however with FTX is in essence quite simple. They ran an exchange where they stated that customer deposits were protected. That appears not to have been the case. These assets were lent to a related business, Alameda Research, a hedge fund which was majority owned by SBF. This was against the terms of service that they offered to clients. Explaining the roles of these two parties simply;

FTX (A Crypto Exchange): You go onto FTX and wire in currency (US dollars, Euros etc.). After this you get to take those funds and buy and sell crypto currencies (BTC, ETH Etc.) Alameda Research (A highly leveraged and associated Hedge Fund): Investors consciously and knowingly give Alameda Research money to try and buy and sell crypto currencies for a profit. This was a supposedly unrelated entity that dealt with FTX on an arm's length basis.

The chain of events that has led us to this point it seems is as follows;

- Alameda (the hedge fund) starts losing money, most likely around the May / June time frame. This is where the story should end, however it doesn't.
- At this point FTX is still fine since they collect fees just like Coinbase would on every transaction.
- This is the point where cognitive dissonance kicks in. Alameda and FTX would rather double down than take a hit to their self-esteem by admitting fault. "Dissonance makes people feel uncomfortable and for a lot of people pivoting and admitting fault only adds to that discomfort."
- It appears that in order to try and stop Alameda Research from failing and declaring bankruptcy, they increase the transfer assets to Alameda from FTX.
- The model that FTX had set up for their balance sheet had a significant point of weakness was that they were backed by illiquid and self-created (FTT) tokens that were in turn used as collateral for many investments.
- The waterfall or cascade of redemptions saw the FTX exchange fail as it no longer had the assets it professed, rather Alameda had lost them through trading or they were posted as collateral against other investments that were speculative and illiquid. The liquidity crisis moved quickly to a solvency issue.

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Other potential failures

Genesis hasn't failed, yet, but it remains in a precarious position. Genesis is a lending business owned by the relatively well capitalized DCG group. They have multiple and stable revenue lines in diverse businesses from media in coindesk.com to the Greyscale BTC trust. They are unrelated businesses but the failure of Genesis would impact the credibility of the entire groups assets so there is a, not unwarranted, belief that the liquidity issue that they face will not morph into a solvency issue.

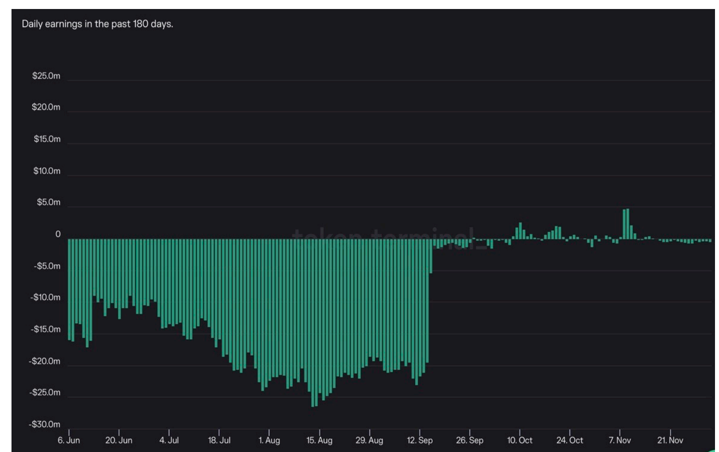
Binance, like FTX, is a centralised exchange that has also been in the spotlight. There is talk of them being targeted by regulators and equally while they have attested to having customer funds safe through what's called a Proof of Reserves there does remain some questions over liabilities. There are many opinions however,there seems to be a groundswell of evidence from independent analysts that indicate that the assets are accounted for.

Going Forward

The hype around the industry had certainly got ahead of the reality, however the builders and developers haven't gone anywhere and much of the progress, particularly in the Ethereum network, is moving towards improved scalability and improved economics. Looking through an optimistic lens make us comfortable with the longer-term outlook for ETH over alternatives. Rival unproven Layer 1 chains are likely to see an exodus of development talent. The performance of the DeFI network and applications during this period of stress validated the first two features of a quality blockchain. The network remained decentralized and secure; the issue of scalability remains a challenge to be addressed. There is much to be optimistic on this last point also as there is work being done on roll-ups and Zero Knowledge proofs that we will address in our next note.

The other aspect that has gone largely unmentioned is the profitability of the Ethereum, post the upgrades to the network, Ethereum has become profitable for small windows (green bars above the line)- Fig 2. Earnings = Revenue minus token incentives (eth issuance paid to miners/validators).

Fig 2.



When the cycle turns owning an asset that is profitable, battle tested and generates a yield we think will be attractive to investors and developers.

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While the events of this last month have been a setback to the performance of FSF and to the crypto space in general, the failings have occurred have been in of CeFi. At the onramp of fiat money moving to crypto and back. Clearly, the space requires and will undoubtedly receive greater scrutiny and much needed regulation. Our commitment to the Ethereum ecosystem hasn't changed as a result of the FTX event. We continue to believe it can provide a platform for real world use cases in DeFi and potentially beyond. We intend to be closely aligned with the development in the crypto space more broadly and deliver positive returns as ETH becomes a more valuable asset over time.

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