

Aug 21 - Written By Drew

Q2 '23 LP Letter



Performance

In the second quarter, the fund was down -3.1%, Bitcoin was up 7.1% and the S&P was up 7.9%. Since inception, the fund is up 6.5%, Bitcoin is down -24.5% and the S&P is up 1.3%.

Ethereum and Bitcoin were the top performers for the fund and crypto markets broadly. The Defi Pulse index, which tracks the market caps of the largest decentralized finance protocols, was down -17%. The largest NFT collection, Bored Ape Yacht Club, was down -39% (the fund does not own any).

The performance reflects our concentration in Ethereum and Bitcoin, and smaller exposure to a longer tail of digital assets. As of Q2 it's a roughly 75/25% split between Bitcoin / Ethereum and other digital assets. The smaller, concentrated bets, were a drag on performance this quarter but they have the potential to significantly outperform Ethereum and Bitcoin. However, the weighting reflects the odds.

While we're in the depths of the bear market, I expect the portfolio to slightly underperform Bitcoin. However, as we leave the bear market and on chain activity returns, I expect assets further out on the risk spectrum to outperform.

Our Top Secret Edge (shh, don't tell anyone)

TLDR:

- Analytical advantages come from using blockchains, observing economic activity and understanding value accrual
- Behavioral advantages are magnified in crypto because it's an always open, global market that quotes prices 4x more frequently than the stock market.

When making an investment decision, one must evaluate the assets' competitive advantage. Fund managers often forget to ask that of themselves, so I thought I'd lay it out as it stands for Crypto Native Capital. What is the competitive advantage of this investment manager, if any? It's pretty simple: **we do the analytical work and we understand that Mr. Crypto Market is even more manic depressive than Mr. Market.** How much more emotional? **In the last 10 years alone, Bitcoin has experienced two Great Depressions and four separate Great Financial Crises** (80%+ and 50%+ drawdowns respectively).

Sources of Edge

Bill Miller [explains](#) that there are three competitive advantages in investing:

- Informational (you know something others don't)
- Analytical (you process publicly available information better than others)
- Behavioral (you behave differently than others)

Informational advantages are weakest. They are weak in traditional markets because financial regulators make it illegal to invest with insider information and information moves instantaneously online.

Analytical competitive advantages come from processing public information differently than others. Market participants can look at Amazon annual reports and come to different views if the business is under or overvalued. Warren Buffet is famous for making a fortune reading annual reports from Omaha that the broader market has access to. He simply analyzed them differently.

Bill Miller continues:

"Behavioral advantages are the most interesting because they are the most durable. The field of behavioral finance is still in its infancy yet has already yielded results that can be incorporated profitably into a sound investment process. **The best part is that such results are likely to be systematically exploitable and not able to be arbitrated away as they become more widely known.** That is because they represent broad findings about how large groups of people are likely to behave under well-defined circumstances. Until large numbers of people are able to alter their psychology (don't hold your breath), there is money to be made"

Bezos put it more succinctly: *"The secret is to focus on things that don't change".*

Sustainable competitive advantages in investing tend to be a mix of analytical and behavioral.

Edge in Crypto

How are the competitive advantages similar or different in crypto? The global, always open and emerging nature of crypto markets provide opportunity and shake out all but the true believers.

Informational advantages are also weak in crypto. Blockchains are public databases. Market participants have access to the same information at the same time. There are advantages to being online 24/7 and being the first to react to news but these advantages are unsustainable and will continue to be competed away as the industry matures.

Analytical advantages in crypto primarily come from simply using blockchains and new products, analyzing network activity, understanding value accrual, and staying up to date on developments in token economics and cryptography. Side note: using blockchains may sound like table stake but it is not. I'm constantly surprised how few crypto investors get their hands dirty and try new applications.

For example, the vast majority of blockchains economic activity is happening on Ethereum and most "Ethereum killers" have near a mere fraction of comparable activity. Yet, the prices of these "alternative layer 1s" do not reflect this reality, which is a real head scratcher. Ethereum also has superior monetary policy (a helpful analogy is stock issuance) that is mispriced by the market. In the depths of a bear market, the Ethereum supply is decreasing as fees are burned (taken out of circulation). As holders of Ethereum, you are owning a larger percentage of the ethereum protocol each day.

A final example: most funds investing in NFTs buy "grails" or the rarest items of a collection. The data shows that "floors", or the cheapest of the collections, are a better investment. Another side note: it's on my long to-do list to publish the data and why I believe this happens.

Behavioral advantages are even more pronounced in crypto than traditional markets because it's an emerging, always open and global market. What is the effect of an always open market? Crypto is available to trade 4x more per year than the stock market (252 [days](#) per year for 8 hours per day). Market participants experience the same emotions, but it's more extreme. Some examples:

*"People get more bullish as prices go up, and more bearish as prices go down. They overweight recent trends relative to their long-term significance, and their emotions give greater weight to events the more dramatic they are, often out of all proportion to the probability of their occurrence. **All of these features of how our beliefs affect our behavior are actionable if they are systematically incorporated into an investment process"***

There are more fancy terms for these biases but above are the basics in layman's terms.

Conclusion

So, there it is. The Crypto Native Capital competitive advantage laid bare. We're doing honest, simple, long term investing adapted for the idiosyncrasies of crypto.

We use blockchains and try new products. We sift through the firehose of blockchain activity and try to reason about value accrual. We do our best to understand human psychology and counteract biases to avoid the mistakes we are susceptible to. Easy, right? Far from it. It is excruciatingly difficult to keep a level head while the markets turn from manic to euphoric, often multiples times per day.

The good news is: there isn't much competition for honest, simple, long term investing. It's damn hard. It's more fun and comfortable to react to headlines and follow the crowd. To jump on the latest trends so you don't get FOMO, buy the shiny new toy and get impatient when a position isn't moving how you'd like it to.

Let me be clear. I make many mistakes, but I hope that each day I get a little better than the last. Over time, patient, high quality decision making should result in a satisfactory return for the fund.



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