De-Coding Crypto

Enigma Weekly

24th March 2021

Written by Joseph Edwards, Head of Research at Enigma Securities.

Our Market View

May you live in interesting times. Once again: slowly grinding upwards, but with plenty of bumps along the way. On BTC: less extreme ups and downs compared to the last few weeks as we finally approach expiry and the end of the March/early April doldrums, but still a fair bit of movement; currently struggling to consolidate back above support at $56,000 after a brief drop back towards $50,000. Usual refrain: we're still in a bull trend ultimately, that trend has shown no signs of breaking, and while we don't expect anything explosive short-term (though expiry could of course always be interesting), default tilt is still towards slowly up.

Alts for the most part not doing much against the backdrop of BTC drop. ETHBTC continues to grind closer and closer again support at 0.030; as we've mentioned, while this mark has held out in the past, we do not feel a great deal of confidence in it right now, and there seems to be a very good chance that we see support and severe short-term ETH underperformance on the next BTC leg up (though we also find it hard to see the sky falling in USD terms any time soon).

Biggest gains on the alts side generally to be found in microcaps at the moment. ADA down 9% on the week as it moves back towards $1; expecting it to continue to fall in BTC terms.

Please direct all enquiries about this week's research to jedwards@enigma-securities.io.

Major						
Ticker	Price	7D	1M	6M	12M	Cap
BTC	55730	0.9%	3.4%	421.8%	853.1%	1.040T
ETH	1700.77	-4.5%	-4.0%	382.8%	1274.0%	195.9B
LTC	192.31	-2.9%	-7.4%	318.3%	419.1%	12.83B
BCH	519.48	-0.5%	-17.3%	135.0%	153.2%	9.71B
EOS	4.255	7.7%	-8.7%	67.1%	102.6%	4.06B
Selected						
Ticker	Price	7D	1M	6M	12M	Cap
ADA	1.130	-8.5%	3.2%	1085.0%	3910.0%	36.11B
DOT	34.94	0.1%	-7.0%	708.9%	1104.0%	32.25B
LINK	27.23	-10.7%	-13.3%	164.6%	1259.0%	11.29B

The death of the Grayscale trade: a primer

What is Grayscale/GBTC?

Grayscale Investments are one of the elders of the crypto space at this point - founded in 2013, it was one of the first big crypto asset management firms (and certainly one of the few from that time that have managed to stick around long-term), and is defined primarily by its flagship product: GBTC.

The concept behind GBTC, the Grayscale Bitcoin Trust, is very simple: a fund that holds near-100% of its holdings in Bitcoin, takes a passive approach within that (i.e. all new inflows go straight into BTC and stay there), thereby creating an investment vehicle where the NAV tracks perfectly with the price of Bitcoin (minus an annual 2% fee).

At the time - and to an extent, still today - this was a significant step forward in terms of allowing a certain class of investors to gain access to BTC exposure. We should note here that, despite what we're going to talk about across the rest of the piece, we actually don't mean institutionals here in any meaningful sense; of course, the only people on that side who were interested in such exposure were the proverbial (and actual) 'junior guy at Fidelity who not only will just hold it directly anyway but also will build mining rigs instead of actually buying it', but even if interest had been there, GBTC would have been a flawed solution to that.

Why? The key is in the term 'ETP' - exchange-traded product, specifically with reference to the exchange-traded part. GBTC is generally not considered as an 'US ETP', because it isn't listed on any major US exchange, and can hence only be purchased over-the-counter (OTC). That exchange access, and lack therefore, is extremely significant; in contrast to Europe (where it matters significantly less), the nature of most mandates in the US means that moving up the 'ladder' in terms of where a stock is listed (from OTC, to minor/local stock exchanges, to national ones) makes a significant difference in terms of whether or not an institution can ultimately handle a product.

Hence, over the first few years, GBTC inflows and interest largely came from spheres that would ultimately be described as 'retail'. To be clear, with regards to inflows in particular, we aren't exactly talking tiny fish; the bulk of new share creation was actually done by miners looking for somewhere to place their production throughout the 2013-2017 supercycle. Still: a retail product. In terms of BTC holdings, GBTC enjoyed fairly steady growth from 2015 to 2019:

	AUM $m	BTC price	BTC	Growth ($)	Growth (BTC)
29/12/2015	60	422	142119		
27/12/2016	157	898	175004	162%	23%
27/12/2017	2741	12532	218728	1643%	25%
28/12/2018	765	3797	201482	-72%	-8%
31/12/2019	1881	7316	257100	146%	28%

Data via Ycharts.

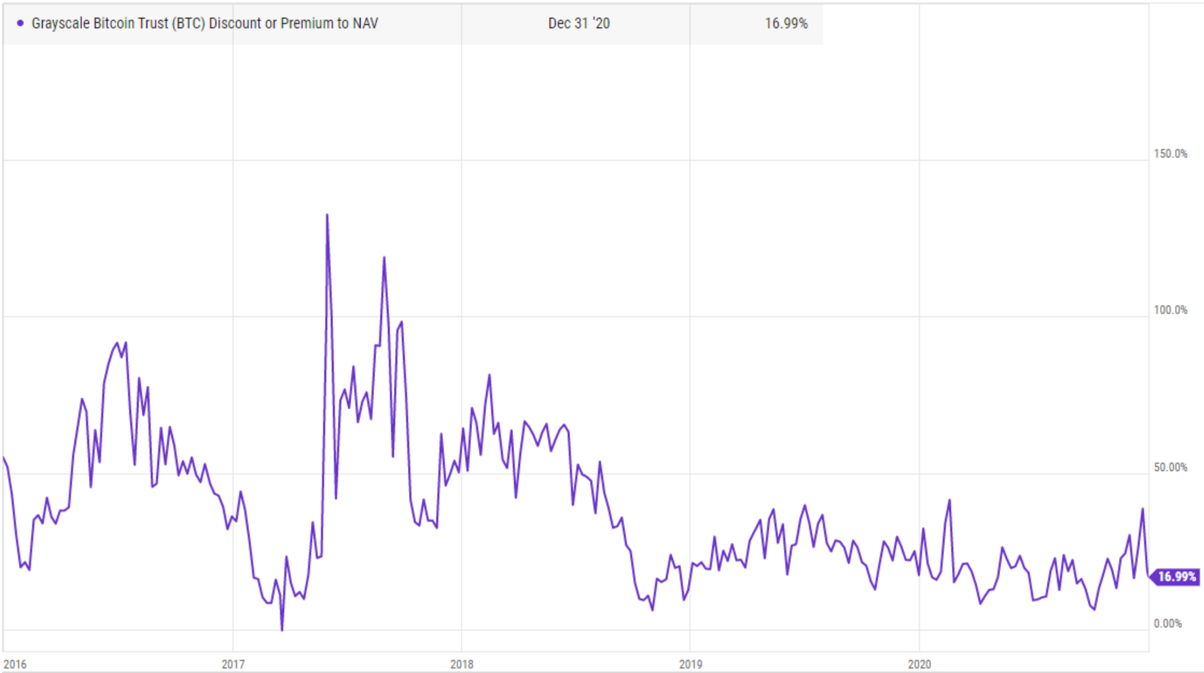
AUM value of course skyrocketed in 2017 (and came back to Earth again in 2018), but as we can see, there was a steady flow of new share creation throughout those few years - good for an additional 25% or so in three of the four, with a slight contraction in 2017.

Let's go back for a second, however. As we mentioned, most inflows were coming from miners, and, in most cases, it was in-kind creation - miners handed Grayscale X amount of BTC, Grayscale handed them an equivalent amount in shares (Grayscale do explicitly publish how much BTC a given share represents; it was originally in the region of 0.01 BTC, but fee erosion and a stock split place it at 0.00094586 BTC as of the close on 23rd March for instance.

Miners, ultimately, are about as crypto-native as it comes; they should be the last people who want to relinquish 'physical' BTC, especially if it's not even for dollars or any other fiat that pays the bills. So, why?

What is the GBTC premium?

GBTC has, for most of its lifespan, traded at a significant premium to NAV (net asset value, i.e. the value of BTC in the fund):

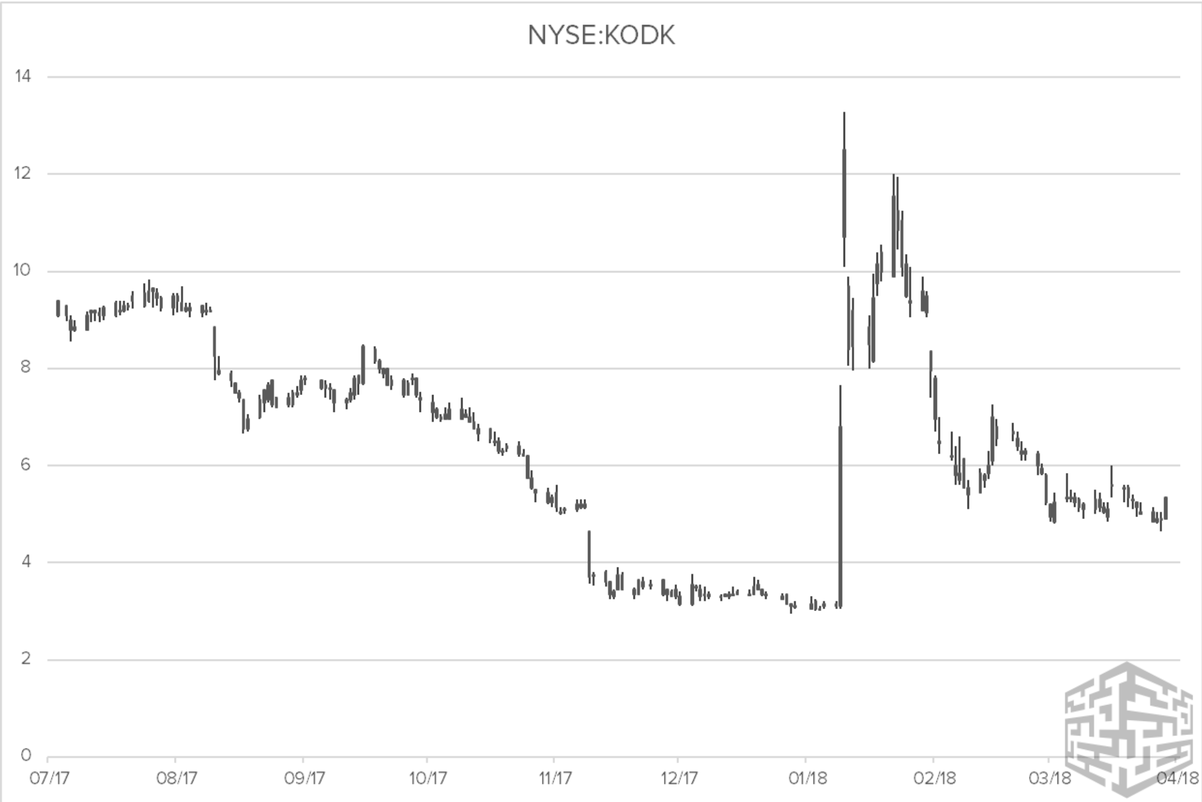


Credit: Ycharts.

Why? There are a few factors at play here, but the core one is excess demand. While GBTC's OTC listing wasn't up to the standard where true-blue institutionals were comfortable investing, there nonetheless was - and is - a significant market for whom GBTC remained the best option available.

It was accessible through their existing equity brokerages, could be held without all the risks and mysteries that came with holding physical BTC, and while it of course compared poorly to direct holdings in terms of pure efficiencies, the nature of it as a fund that held 100% of underlying meant that it could be expected to hold correlation far more aggressively than alternatives.

It's important to bear in mind here just how poor the landscape was in that regard in 2017/2018. When we talk about alternatives for equities exposure, we aren't talking about a Microstrategy-style treasury play. We aren't talking about something like Square or Tesla, where there's a real, significant hook into an existing established business. We largely aren't even talking about firms like Canaan or Argo Blockchain who are, in concrete terms, working on the crypto space. We are talking about firms like Kodak, who jumped 400% in a couple of days because they added "blockchain" to the company title (and never did anything concrete in crypto, ever):



Data via Tradingview.

By comparison, GBTC was hence manna from heaven for those trying to get access. We should say here, incidentally, that throughout this time, that demand wasn't exactly overwhelming compared to total fund size; as one point of comparison, GBTC volumes on each year as a proportion of total AUM were 162%, 114%, 58% and 104%, whereas on the SPDR gold ETF, the median from 2005 to 2015 was 255% (and only went below 200% once).

However, there was nonetheless enough of a surplus in demand over supply to maintain a premium that generally landed in the 40%-80% range in 2016, 2017, and 2018. Even at its lowest points (e.g. the Q4 2018 crash), that premium held, compressing to a low of 13% on December 8th.

'The Grayscale trade'

As mentioned, pre-2018 or so, inflows into GBTC were largely coming from Bitcoin miners. Why? It was because, if one were comfortable having directional exposure to BTC, there was a simple but great trade to be made:

1) Create shares in-kind of GBTC when allowed to (Grayscale can open and close placement windows at their discretion).
2) Hold those shares for the lockup period (originally 12 months, but now down to 6).
3) Sell those shares.

What was the point of this? Remember: when you create shares in this manner, you are not creating them at the current market price, but rather at NAV; as long as one is comfortable holding for those 6 months, they essentially pocket the premium at the end. Of course, during this period, one would still be exposed to fluctuations in said native price; still, for Bitcoin miners (who are obviously naturally and structurally bullish re: the price trajectory of BTC) who were going to do that anyway, this was a very attractive trade indeed, and essentially free yield.

Of course, as with anything in finance, if something can be turned from a directional trade to an arbitrage trade, it will be. With that in mind, consider the following:

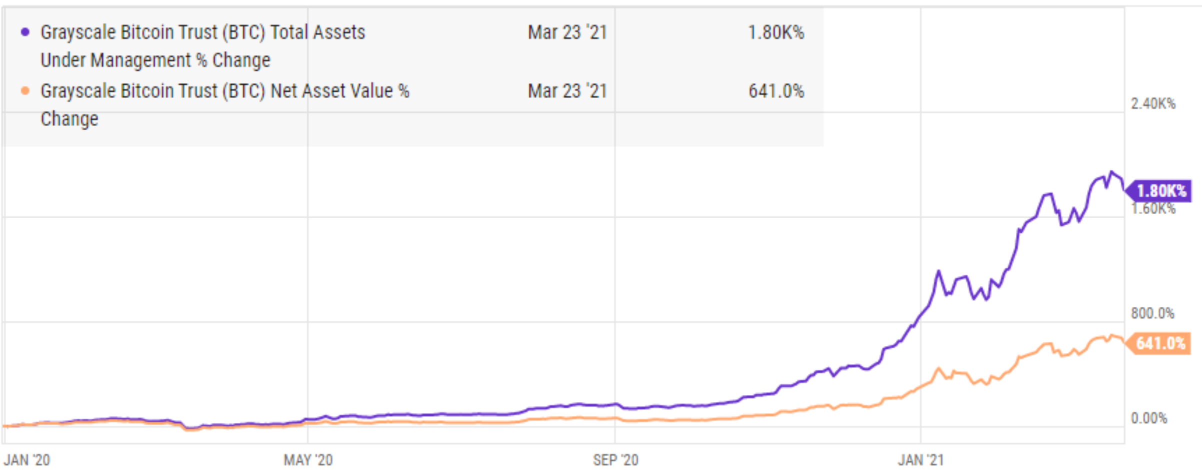
1) Borrow a set amount of BTC.
2) Create shares in-kind of GBTC with that BTC.
3) Hold those shares for the lockup period.
4) Simultaneously sell those shares, buy BTC equal to the amount borrowed, and repay the BTC loan.

As if by magic: the directional turns into arbitrage. However, for many years while the 'miner's trade' thrived, this idea was something of a footnote; the Venn diagram of 'comfortable enough in BTC's existence as an asset to transact', 'not comfortable enough in BTC's direction as an asset to favour this over a directional approach', and 'had access to appropriate infrastructure including BTC borrow-lend services' had so little overlap that one would need to pull out the microscope to find it.

However, things change, and a mixture of the rapid growth of the associated infrastructure and services required to make the trade work (see the buzz that started around the 'crypto prime brokerage race' from early 2020 onwards), and collective institutional confidence that at least Bitcoin as an asset wasn't going away any time soon (we again saw this turn on a dime coming into 2020 - as rough as 2018/2019 had been at times, they were proof enough for many on the institutional level of Bitcoin's resilience), meant that for the first time in 2020, risk management and compliance departments up and down the East Coast finally softened slightly.

In other words: they weren't going to invest in crypto, but they were at least willing to touch it, and over the course of the second half of 2020, billions and billions of dollars flooded into Grayscale in pursuit of that arbitrage dream.
As of the close on March 23rd, Grayscale has 692,370,100 shares outstanding, and holdings of 0.00094586 BTC per share, for a total of 654,885 BTC under management; this represents close to a 400,000 BTC increase compared to the end of 2019, or a 155% increase over the past 15 months (compared to that aforementioned annual growth of ~25% in both 2016 and 2017).

This is an important point to note. Grayscale went from $1.8bn AUM at the end of 2019 to $17.5bn AUM at the end of 2020, and far further since. In a year where BTC made the gains it did, it can be easy to mentally assign that as a function of that appreciation. It wasn't.

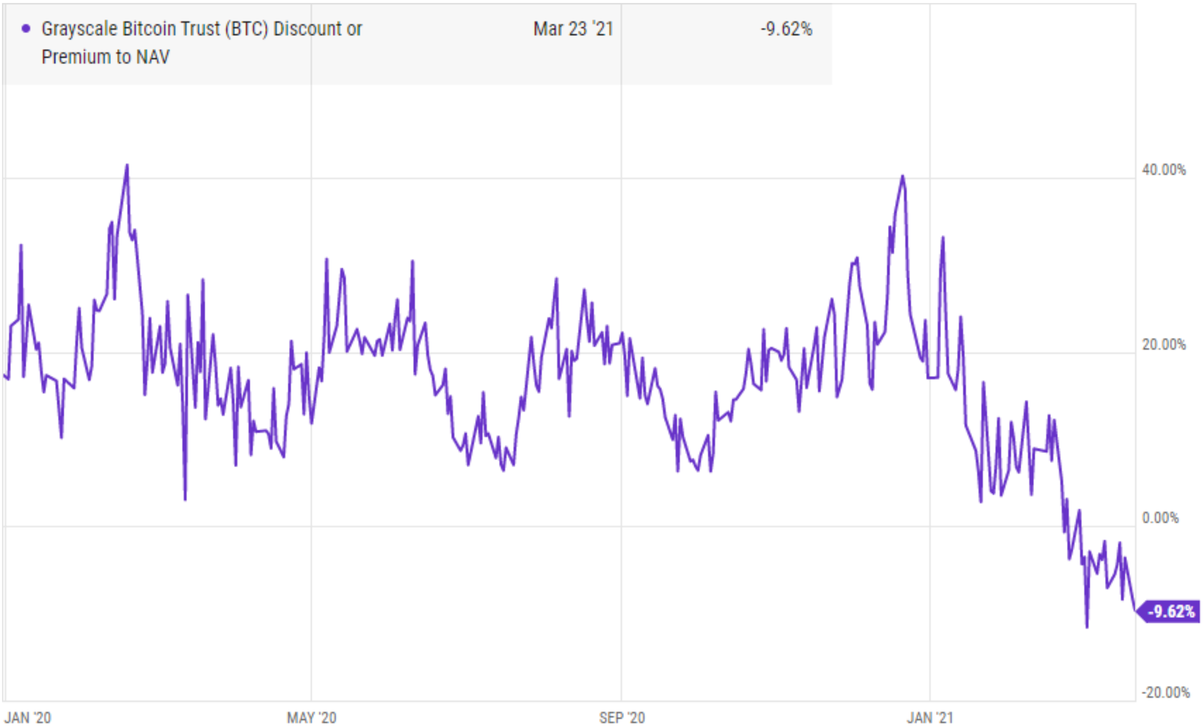


Credit: Ycharts.

Where are we now?

So, back to the unit of account here - the premium. The GBTC premium never fully recovered from the depths of crypto winter (unlike the underlying), but it remained existent - landing in a range of 10% to 40% instead of its previous highs, but still consistently there.

Then, 2021 happened:

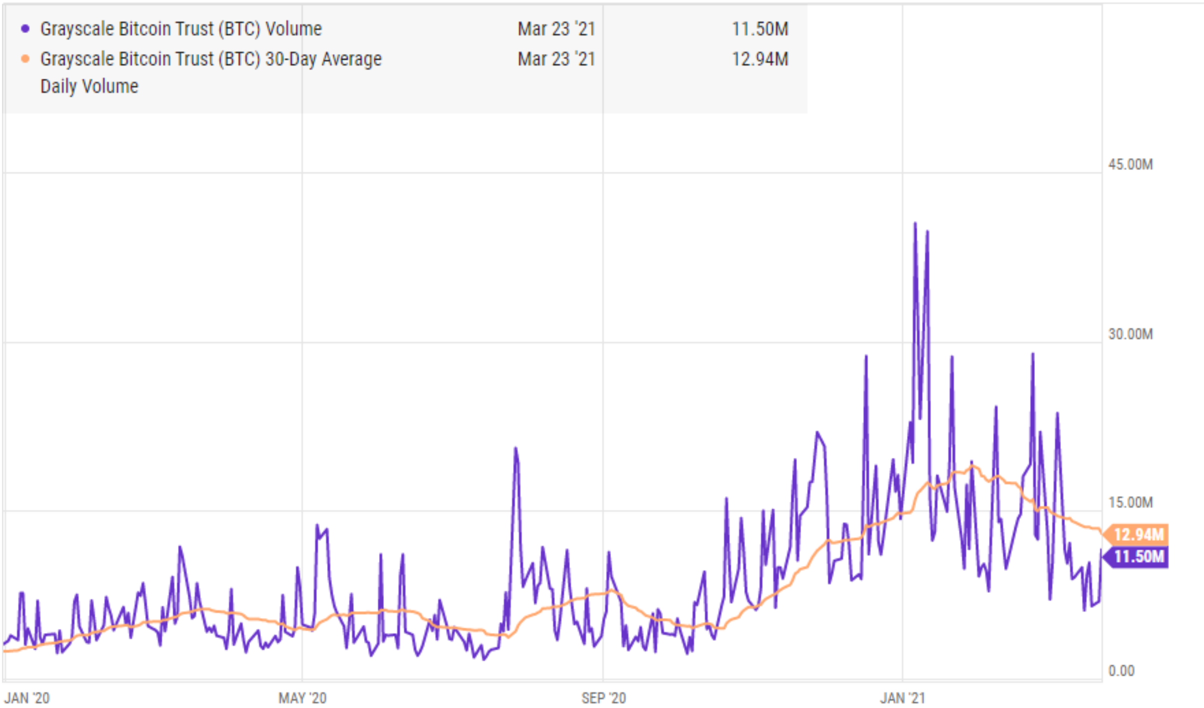


Credit: Ycharts.

The GBTC premium went negative one month and one day ago on 24th February, and has remained negative since. What on Earth happened?

As mentioned: the key to GBTC's massive appreciation was that arbitrage trade bringing price-agnostic money into the ecosystem. The problem? That money is eventually going to want to get back out. Remember that this trade ultimately works on the basis of borrowing BTC (rates on this have varied, but have rarely been lower than 6% annualised, and have been as high as 15-20% in extreme circumstances), and that there is natural erosion with regards to Grayscale's management fee; while one can technically liquidate and exit at their convenience, there is some pressure, and most firms involved in this sort of trade are looking to get out of it as soon as they reach the end of the lockup period.

The other problem? GBTC demand, in terms of the number of shares being traded, has been dropping off for the better part of the last two months.



Credit: Ycharts.

30-day average volume peaked at 18.98m shares for the period ending January 30th, 2021; it has decreased since. The daily peak was all the way back on January 6th, when 40.50m shares were traded.

Bear in mind here: since the start of October, 220m new shares have been created, and one has to presume that a very significant portion of those come onto the market with the intention of being liquidated at the end of lockup. For reference with regards to scale, the current issues appear to be stemming from the roughly 70m shares created from July to October.

Even with BTC demand being significant compared to historical levels, there just isn't enough demand to support profitable liquidation of these positions. Adding to these problems is the fact that there is no direct escape; unlike a lot of similar funds, there is no way for even accredited investors to redeem GBTC back for the underlying BTC. We should say here that some of those mentioned products have themselves run into similar issues - 3iQ's QBTC, which does have mechanisms for cashing out at NAV and/or at a slight discount to NAV, has also been running negative since February 17th - but it's still a particularly significant issue for GBTC.

Where next?

The truth is this: GBTC, and Grayscale, finds itself now in a genuine moment of crisis.

Our long-term view on GBTC has been, as we said all the way back in February 2020 (in the context of the idea of the premium as an active directional indicator):

> We would naturally expect GBTC premium to shrink as market infrastructure improves…it is a product that benefited dramatically from being first-to-market and being positioned to take advantage of direct exposure being too fraught with risk even for small investors. Premium did increase in the bull run in 2019 (and was a leading indicator of further upside), but nowhere near as dramatically as it had in the past.

The GBTC premium is, at its heart, a function of demand, and that demand is in turn the function of an immature market infrastructure. Remember: GBTC is not exchange-traded. Hence, the moment that an exchange-traded product with the same reach as GBTC comes along, in some senses, it immediately becomes obsolete; and while that doesn't mean value to 0 overnight, it does mark the beginning of the end.

This threat - that of an US BTC ETP making GBTC obsolete - has been on the horizon for years, but in 2019 and 2020 in particular, looked to be staying firmly on said horizon, rather than approaching any time soon; Jay Clayton was an implacable opponent of crypto ETPs as head of the SEC, with dozens of applications being rejected. In 2021, it suddenly went, Monty Python-esque, from on the horizon to at the gates with the replacement of Clayton by Biden nominee Gary Gensler, and in addition to a surge of new products in various markets, it does seem like a US Bitcoin ETP/ETF before the year is out is now at least possible, perhaps even likely.

Hence: in the context of that natural compression, this is a particularly unwelcome problem. To put it simply: what we essentially have here with these tens of millions of shares is a clog in the drain in the normal market structure of GBTC. Not pleasant, but something that can be worked through (maybe with some intervention from Grayscale themselves - there has already been authorisation on a buyback program).

The addition of the post-October shares is more akin to pouring fat down it. There is a serious, legitimate threat at this point that this doesn't go away without further action; and in a world where GBTC is already in for a rough ride against competitors, we can actually imagine a world in which without dramatic intervention on Grayscale's side, the premium remains inverted for even longer than it already has.

We would hence urge extreme caution when dealing with GBTC at this point, especially with respects to 'buying the dip' on said premium and similar ideas; if one is inclined (or required) to deal with ETPs with regards to their crypto exposure, there are far better options at this point.

Until next week – thank you for reading.

ABOUT US

Enigma Securities is a leading, regulated liquidity provider, offering its clients bespoke liquidity solutions through the use of a proprietary electronic trading platform and API access.

The firm was founded in 2017 as a subsidiary of Makor Partners Limited (UK), amid growing institutional demand for digital asset trading. Looking to seize the new, exciting opportunities presented by cryptocurrencies and blockchain technology, Enigma became one of the first regulated brokerage firms to set up banking relationships and custody solutions to meet institutional standards.

Since its launch, the firm has expanded its capabilities to the broader Fintech arena, leading innovation while working to bridge the gap between the traditional financial services industry and cryptocurrency markets.