

Episode 25

A conversation for the crypto-curious

Cryptocurrency is not going away. So where is it going? The team discusses Bitcoin, blockchain, and the future of internet business.

Kara O'Halloran (00:07):

Welcome back to Fireside, a podcast from FS Investments. My name is Kara O'Halloran. I'm a director on our investment research team here. And today, we are talking about crypto, which is not something we've covered a ton on the podcast before, so I'm really excited to dive in. Just like broader risk assets, a lot of the well-known cryptocurrencies have had kind of a rocky start to the year. So we will discuss what is driving these moves, the outlook we have for the space going forward, portfolio implications, and much more. Joining me today is Dan Wilk, a client portfolio manager here at FS and a digital asset specialist. Dan, welcome to the show. Thanks for joining me.

Dan Wilk (00:46):

Big-time listener of the show, so you can say a long-time listener, first-time caller.

Kara O'Halloran (00:50):

Awesome. We're really excited you're here. So Dan, I really want to get right into it because I have literally so many questions, and so we have a lot to cover. But I will start out by saying I think this will be our first conversation of many. There is obviously so much to talk about in the crypto and digital asset space, but today I want to focus mainly on Bitcoin. But I guarantee we will have you back on to keep us posted on all things crypto. I think the first and really kind of obvious question is what has been going on since November? We're recording on January 25th. When I checked Bitcoin right before coming into this room, it was at about 37,000. It started the year at about 47,000, but that's also down from its peak of close to 70,000 in November. So walk us through this recent decline and what you think is driving it.

Dan Wilk (01:46):

Yeah, it's a fair question. I think we've really seen markets all around be more challenged broadly. The entire investment landscape has been struggling here through the course of January. Roughly 40% of NASDAQ stocks are down 50% from their 52-week highs. The ratio of stocks hitting one-year lows is at the highest level since March of 2020. And while the indices themselves were supported by a handful of names, now those handful of names are kind of showing cracks, which is continuing to spark this more broad risk-off move. And in crypto, it's really been no different. I've always said crypto in its current form is really just a proxy for risk sentiment, being that it is so far out there on the risk curve. And per usual, you now have a major drawdown. You're seeing a lot of folks call for complete collapse. They're saying, "Hey, I told you so."

Dan Wilk (02:34):

But if you look at current positioning, blockchain and crypto assets, they're really not going anywhere, and the metrics don't point to that in any sense. Blockchain in itself is simply just an

evolution in ledger-based accounting. It's probably the biggest advancement in ledger-based accounting or accounting overall since the Medici family used double-entry bookkeeping to create modern banking in Italy during the 15th century. The beauty of a system that's run on public ledgers means we have ultimate transparency at a business level. It's pretty easy to tell when money is leaving the ecosystem or it's just a temporary flee of different assets. And right now, it's just the latter.

Dan Wilk (03:11):

So what we can look at right now is stablecoin supply or the market cap of stablecoins overall, and we've continued to see that number increasing, right? Digital dollars running on crypto rails. As that continues to increase, the balances on exchanges also has increased. So what that is is quite literally money sitting there in cash, not withdrawing from the system. They're waiting for better entry points. And in previous cycles, most notably probably 2017, 2018, we had a much longer bear market. We didn't really have value investors. We didn't really have sophisticated clientele or institutional clients valuing different protocols, different ways. Well, right now we just have participants basically sitting on the sideline, trying to figure out when is the most appropriate time to buy back. And I think that's really supported the asset prices overall, Bitcoin specifically.

Dan Wilk (04:00):

If you look at Bitcoin's Relative Strength Index, its RSI, it's at its lowest level since the COVID crash in March of 2020. We can certainly go lower, right? Bitcoin digital assets, we are no stranger to a 20%, 30% drawdown. But if you think about broader risk sentiment and you listen to our team at Chiron, they do tremendous quant work alongside Brian Cho and their team, we don't think the global economy is really late cycle yet, but here we are in January pricing in late-cycle outcomes, right? Investors have continued to have to grapple with the speed at which markets are willing to price in outcomes wildly before it's even clear that it's a possibility. And yes, the market's a discounting mechanism, but markets are pricing in extreme things faster than we've ever seen. And from an economic view, the base scenario we're looking at is markets feel the Fed is hiking into a slowdown, and that's why we're seeing this big risk-off move.

Dan Wilk (04:56):

Well, the Fed hiking us off a cliff is really very unlikely for one of two reasons. One, the growth underneath the economy is likely to be more durable than markets currently think once you normalize for things like COVID or the inconsistencies of reopening. Or two, demand really is going to be a lot softer, which that means the Fed just has a lot less work to do when it comes to fighting inflation. So when markets tend to price in these outcomes of gross slowdown, false aggressive Fed, we saw this in December of 2018, you get a major risk-off move. Crypto being the most risk asset is certainly experiencing its drawdown. But moving forward, I think the global asset class has a lot more to work through outside of just the macro, right? There's regulatory risks. There's institutional adoption and on ramps, the expansion of SEC guidance, et cetera. So, over time, I think the digital asset space will be more nuanced in how it gets built out.

Kara O'Halloran (05:51):

Yeah. There's a lot to unpack there. That was a really helpful overview and good context. You started going down ledger-based accounting, and I'm a former CPA, so my ears perked right up. I want to touch on one thing that you said. You said a lot of money is waiting on the sidelines waiting for a better entry point. I mean, do you have any thoughts on what that is? I'm

not looking for a dollar amount, but kind of what shifts sentiment? What could really turn around here, and what comes next?

Kara O'Halloran (06:24):

I actually, side note, wish that... I wish that we could have recorded a conversation that I had with you back in... I don't know if you even remember this. But back in the fall, we were kind of talking about the podcast and different topics we could talk about, and you were like, "Oh, yeah, well, I think crypto's probably going to have a big pullback coming here soon, so there'll be plenty to talk about." I wish we had recorded it so that everyone could know how right you were. So I'm wondering if you have any thoughts on the other side now.

Dan Wilk (06:48):

Yeah. I appreciate the credit, and I think... Yeah, it's tough, right? If you look at the short-term, medium-term, long-term outlooks, all of these boom-bust cycles within the digital asset space tend to stem from what's called the Bitcoin halving cycle. So it's when the supply growth of Bitcoin is cut in half forever, and moving forward, miners continue to pull out supply at a rate much less than what they could currently do. So once that supply shock happens within the Bitcoin network, it tends to cause this wild set of volatility, where Bitcoin as a price has to find its equilibrium of profitability for miners, as well as the supply-demand equilibrium from the expansion of on-ramps.

Dan Wilk (07:31):

So basing off previous cycles, we've been pretty late, right? We've shown a lot of late-cycle behavior. You've seen the meme stocks or the meme tokens of DOGE and SHIB with no real fundamental value and highly speculative behavior cascading across the space. You've seen a lot of protocols with relatively no cash flows, no user growth, very little development, gaining hundreds of millions in valuations for a market cap of their token. And it's usually that type of behavior that's the perfect signal of we are very late cycle, right? Bitcoin and the rising tide lifts all ships. Well, as you move down the market, all that speculation was happening. Meanwhile, Bitcoin wasn't really trading anywhere, which kind of showed that everyone who was already in was in. We need a lot more regulatory clarity for a lot of those other projects to continue to grow. But for Bitcoin and its short-term outlook, the writing was kind of on the wall.

Kara O'Halloran (08:29):

Yeah. And I think we'll actually get, it seems like, some regulatory clarity in the next... possibly in the next few months. So we'll definitely have to touch back on that. I want to touch back on one point that you brought up, which is just Bitcoin really trading alongside broader risk assets. And right now, markets seem to be reacting pretty strongly to the Fed and the impending rate hikes that we're likely to get in the next few months. And I'm thinking through it. And at one point, Bitcoin was viewed as an inflation hedge, so it's kind of like, all right, well, if the Fed's going to come in and combat inflation, then maybe Bitcoin's a little less valuable in that environment. But now the narrative is shifting, and Bitcoin's just a risk asset. So walk me through what you're thinking there. Why does the narrative keep shifting? Where do you land on that too? I'm a little bit confused. Maybe I can't keep up. But what are your thoughts there?

Dan Wilk (09:23):

No. And I think you even factor in this concept of quote-unquote "cryptocurrency." Right? Cryptocurrency, I think, is extremely poor branding. It implies that Bitcoin is ever going to replace the dollar in some sense. I think that's a straw-man argument because if you talk to the broader subset of the crypto community, nobody thinks that, right? But as Bitcoin has become more widely adopted and understood, I think that narrative as an investment has continued to

evolve over time. It essentially moved from this fringe use-case as a quote-unquote "dark web currency," all the way to an institutional-grade store-of-value asset in the span of a decade without a central authority that was able to guide it along the way.

Dan Wilk (10:06):

And I think over the longer term, Bitcoin is really finding its place or potentially will find its place as it grows in market cap and it is more widely adopted by institutions as the greatest hedge against government profligacy, this reckless abundance or wastefulness in resources that continued to happen over time with the expansion of M2. So I think inflation is one narrative that's important, but fiat debasement is ultimately what's most important or relevant to Bitcoin's longer-term thesis. And if we just break that down conceptually, 40% of all US dollars in existence were created over the past two years.

Dan Wilk (10:45):

If we look at Bitcoin during that same time period, well, Bitcoin saw its local bottom in March of 2020 at around 5,300. And now at current levels, even with the massive drawdown, we're up a little over 560%, I think you mentioned we're settling in around 36,000, 37,000. So it obviously hasn't come without massive bouts of volatility. Bitcoin isn't highly volatile. It's hyper volatile. It has a standard deviation of 89, yet it still has a Sharpe ratio of 1.3. So as further on-ramps to invest in the space get built out over time, combined with this infinite expansion of global M2, I think Bitcoin is really going to serve as the hardest asset in existence, with its supply growth ultimately trending towards zero, and it'll greatly benefit from a lot of those outcomes.

Kara O'Halloran (11:31):

I want to talk more about the institutionalization of Bitcoin that you brought up or that you've just been talking about. As the asset class becomes more mainstream, more institutionalized, it definitely has pros and cons, right? I think more adoption of something is definitely good. It's inherently good for the asset class, but it also means, as we said, that Bitcoin and other crypto assets are trading alongside broader risk assets, less diversification that they used to promise and whatnot. But I imagine that as... We talked basically about Bitcoin really being just one application of the blockchain technology, and there really is an entire crypto ecosystem. So do you think that this heightened correlation with broader markets is just kind of a lack of widespread knowledge or understanding of the full space?

Kara O'Halloran (12:22):

For instance, in traditional markets, we obviously see different sectors or factors or asset classes performing differently at different times and in different market environments and reacting to different events and whatnot. So I wonder if, with this increased adoption and increased attention on the space, we'll start to be able to see investors kind of discern some performance drivers a little bit. So if we're in traditional markets talking about value versus growth or equities versus fixed income or even on a sector basis, in crypto maybe we need to talk in terms of DeFi in currency and gaming and whatever it is. And maybe that's not the right way to look at it. But almost that instead of just, oh, all of crypto's going to trade in one way, as it becomes more institutionalized, we can kind of discern what should be performing in different environments. Does that make sense?

Dan Wilk (13:08):

I think it makes perfect sense.

Kara O'Halloran (13:09):

My long-winded question.

Dan Wilk (13:10):

No, I think it's really insightful because it's bringing us to the space where it's showing folks that these are all different things, right? I mentioned cryptocurrency is just poor branding. You've now seen, over this last cycle, the entire space really build out and bifurcate into different sub-sectors. Each sub-sector is simply an application of ledger-based accounting running on an internet protocol, right? You're infusing programmable money into that business model, and you're creating an entirely new business model to structure on top of the internet, whether that be across Layer Ones, right? Think about Layer Ones as operating systems, global operating systems that allow you to build things on top using blockchain technology. You build apps on top of the iOS store or iOS system on your iPhone. You build apps on top of the Android system on your Samsung phone, apps on top of a website. You can build globalized accessible applications on top of Layer One networks.

Dan Wilk (14:09):

Well, that value proposition as a Layer One operating system is completely different than Bitcoin as this finite asset and this hedge against government profligacy, right? And as the marketplace continues to understand these concepts... They're very new, right? The first Layer One network came out in 2015 with the Ethereum network, and it couldn't really do anything in the sense that you didn't really have a lot of applications being built on top. It was very akin to the protocol wars going back to the late '80s and early '90s with TCP/IP and the OSI model. You had two different models that were engaged in debates at what was going to be the protocol layer for data connectivity moving forward.

Dan Wilk (14:49):

Well, TCP/IP is quite literally the protocol layer that runs the internet. You fast forward through the mid '90s to late '90s. You have applications of TCP/IP, and then that takes us into the dot-com era with the boom-bust cycle. And just because we went through that boom-bust cycle, it doesn't mean TCP/IP was any more or less valuable. 40 years later, it's basically been one of the greatest innovations that we've seen. And I think blockchain tech is really plugging into that protocol to allow businesses to do different things.

Dan Wilk (15:18):

You mentioned DeFi protocols, right? Peer-to-peer lending systems without intermediaries in between. You can have Web3 applications, like cloud storage or video streaming, wireless networks, et cetera. It's always entertaining to me when folks tell me, "I don't like crypto. I don't believe in crypto, or I hate crypto." Normally, you would say, "Okay, well, what aspect of crypto do you not like? Which sub-sector?" It would be akin to what you mentioned in traditional finance. Simply saying, "I don't like equities," you wouldn't really say that because it's broad stroke. You would say, "I don't invest in energy, but I invest in large-cap tech. I don't like EM right now, but I do like developed markets."

Dan Wilk (15:57):

Within crypto, you're seeing institutions really begin to understand the individual sub-sectors, and you're seeing the venture community really pour capital into the space. Venture funds raised about 33 billion in crypto projects in 2021. That was larger than any year in crypto combined. So you're now seeing the space grow up in a sense, where you can track protocol-layer cash flows. You can understand if there is any value that accrues at the token level. Some do. Some do not. Right? And then Bitcoin continues to be its own thing as this institutional asset, this kind of North Star guiding light that's bringing people to the space. And over time, you need a ton of regulation to wash over in order to make sure that we have things like KYC and AML and best execution standards, but it's going to take a little time to get there.

Dan Wilk (16:49):

And I think it's worth noting, at this point, Bitcoin is the only asset in the digital asset space, across the thousands of digital assets, that has regulatory clarity, right? The SEC deemed it not a security. The IRS taxes it as a property level. And it has a regulated futures market by the CFTC. So when you factor that in, when institutions come to the space as a fiduciary, it's really the only asset that they can look at more seriously. And they're certainly educating themselves more broadly, but we're kind of at that capacity issue where everybody who's in is really in, and we need new things to develop and innovate in order to continue to push forward.

Kara O'Halloran (17:27):

Yeah. I think that's interesting. So, Dan, we talked about institutions looking at the space, and there's been increased retail adoption too. And I know a large part of your day job is to talk to advisors about Bitcoin. So how do you see crypto fitting into traditional portfolios? Where are advisors kind of allocating it, and what do you see there?

Dan Wilk (17:50):

Yeah, it's a really good question. Right now, we're seeing folks pull from their equity exposure, that long-term growth component. If you look more broadly, a roughly 2.5 to 3% weighting to Bitcoin in a 60-40 portfolio would increase your annualized return by about 3% while only skewing the volatility profile by about 25 basis points. And we're being told time and time again that that's a very asymmetric benefit for portfolio inclusion.

Dan Wilk (18:19):

Clients have to be comfortable with the volatility profile. They have to be comfortable with the longer-term thesis of it. I always try to educate clients. "This isn't a volatility or momentum play. This is something you should view as an asset to hold over the next three to five to seven to 10 years." And different clients are going to have different levels of comfortability with that thesis over the long term. I think you continue to need structures to access the space. And that's why, as an alternative asset manager ourselves, if this does become a qualified asset class more broadly, it makes sense that we have a pretty educated opinion on it.

Kara O'Halloran (18:54):

Yeah. No, no, that makes a lot of sense. All right. I want to wrap up with a couple of personal questions. They're not super personal. Don't get nervous. But I'm always curious to ask people, crypto people these questions because you just get different answers. So I'm curious, why did you get interested in the space initially? I will admit, and I think you know this, I was a... Ignored it as long as I could, until I, as someone who works in finance, could no longer ignore it a few years back. So I'm always curious, how did you get into it and your thoughts there?

Dan Wilk (19:31):

Yeah. It's been a fun ride, for sure. It started at my time at the University of Pennsylvania. I think being on the football team, I was in a locker room with a number of folks in the Engineering School, the Wharton School, College of Arts and Sciences, and it gave me a really diverse background of people studying a lot of different things. And I think that's when I was first introduced to this concept of crypto and blockchain technology, and folks were thinking about it a little more and more. I began to kind of explore the space, going back to '14 and '15. And I really started to understand, okay, when you peel back the onion, it's really just applications of the tech. It's less relevant to the actual token. It's more about the tech underpinning this, and I think that's what excited me most.

Dan Wilk (20:15):

And then in 2016, I came out here to Silicon Valley. I came out to San Francisco, and it was right in my face. It was everywhere. It was all people were talking about. I had a number of folks who had startups in the space. I've got now relationships with different protocol developers. They launched ICO projects. They partnered with different venture firms in order to try to scale their business. And I kind of had this aha moment like, "Wow, there's really something here."

Dan Wilk (20:42):

So now continuing to follow it and watch, I kind of haven't lost faith. It's just given more time for fundamentals to catch up to these overstretched valuations in a sense, but it's been a very fun ride to now see. We're talking to some of the most sophisticated alts platforms in wealth management, and they're talking about their opinions on Bitcoin, and they're talking about their opinions for broad-based regulation. Right? So I think it just excites me more than anything else now, because I'm not saying I'm right, but we're certainly getting to that point where it is accepted. And if you're a known skeptic, that means I've just got to convince you over the longer term. That means we're going to have to have a little, a quarterly check-in of what the stuff is, how it works, educational theories. You know?

Kara O'Halloran (21:25):

I don't think I said I was a skeptic. No, although that actually... I think that's a perfect way to end. Well, first of all, I can tell... I mean, you can tell just talking to you how excited you are about the space. It does get me super excited about it as well, so excellent job there. But I want to know, just to wrap up, last question, what would you tell a nonbeliever? What would you tell a skeptic? What's your elevator pitch?

Dan Wilk (21:51):

The elevator pitch would be to not focus on pricing and tokens and the outputs, but focus more on the inputs and educate yourself as to what is blockchain as a technology. Why is it significant in accounting? What are the parts that are coming together, right? The whole is greater than the sum of its parts. What are all the parts coming together across programmable money and decentralization and blockchain and the continued expansion of the internet to allow for new business models to be created on top of the internet, right? Web1 was an environment where we could only read on the internet, right? You'd go on the internet. There wasn't anything really we could do other than read. Web2 was the advent of reading and writing, right? You've got social media companies. You have publishers. They're monetizing data through centralized servers, and it allowed users to both read and write within the internet ecosystem.

Dan Wilk (22:45):

Well, Web3 is now the next iteration of internet businesses. It allows us to read, write, and own. And it's the ownership component in these networks and in these business models that I think is the most unique. And I think if more folks understood that, they'd understand what these applications are, why they have use-cases, why some do not, right? There are plenty of skeptics in the space that are skeptics rightfully so, but they probably have a fallacy as to why they're skeptics. And then again, Bitcoin as its own asset leading the way will certainly continue to push us forward.

Kara O'Halloran (23:20):

Awesome. That was great. I think we can leave it there. Dan, thank you so much for coming on. I think this was great. I learned a lot. I'm super excited to have you back on. I do think you're right. I think we need to make this a regular series, so we'll have you back very soon.

Dan Wilk (23:37):

Awesome. I appreciate it. Thank you very much for the time. This was great. First podcast under my belt.

Kara O'Halloran (23:41):

You were great. You were great. We'll have you back anytime. All right. Thanks, Dan. See you.

Dan Wilk (23:50):

There we go. Thanks a lot, Kara. Yeah, appreciate it.

Kara O'Halloran (24:01):

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