November 19, 2018

Product Development for Crypto Funds

Introduction

Product development is defined as "the creation of products with new or different characteristics that offer new or additional benefits to the customer."[1] During my days as a hedge fund allocator, I observed that hedge funds generally do a poor job of product development. There are many ways to package a manager's skill into an investable product, and different investors have different objectives and constraints. Yet, it's rare to find a manager that proactively engages with its investors and then creates a product that achieves maximum alignment. Rather, most managers offer one form of access: a commingled hedge fund with market-standard terms. Suboptimal alignment can lead to bad economic outcomes and soured relationships. As perhaps the most obvious example, the amount of capital that is paying performance fees on equity beta is astounding.

The cryptocurrency asset class offers incredible opportunity for skilled managers and their investors. Simply participating could be considered a once-in-a-generation opportunity. The market inefficiencies and dislocations offer additional opportunities for active strategies. However, some of the characteristics that give this asset class such investment appeal can also exacerbate the negative effects of misalignment. Consider this: Many crypto managers launched funds charging performance fees with no hurdle and that crystallized annually each December 31. The market was hot in 2017, and so even the worst managers were paid large performance fees. The market decline during 2018 (through today) means that unless there is a sizable recovery, many of the best managers will not get paid performance fees this year. They will also start 2019 far underwater, so those managers are now incentivized to erase their high-water marks by closing their funds and starting new ones, as has often been done in the hedge fund world.

These seemingly minor product structuring flaws have created major problems. Beyond misaligned economics, these bad outcomes also include investor lawsuits, distrust, confusion of luck for skill, inflated manager egos, and worst of all, investor distaste for the entire crypto asset class. Product development is critical for crypto fund managers to get right, and so we offer the following four tips:

1: Describe your strategy in terms of passive exposure and active management.

Your strategy likely delivers passive returns (passive exposure to some investable subset of the crypto asset class), active returns (alpha), or both. Investors will assess these two components differently and will understand that they should carry different economics. This is basic for most fund managers, but sometimes we overlook the obvious.

[1] http://www.businessdictionary.com/definition/product-development.html

2: Don't charge performance fees for beta.
In bull markets, when investors realize they are paying performance fees for beta, they redeem. Conversely, in down markets, an excellent manager that significantly outperforms her benchmark may not earn any performance fees. The most sophisticated investors will be more than happy to pay for true alpha even when the strategy overall is down. How you hedge or how you use a hurdle should be very specific to your strategy. Getting this one aspect right is perhaps the most powerful way we crypto fund managers can demonstrate to sophisticated investors that we understand how they look at the world.

3: Determine a crystallization methodology that maximizes alignment with investors.
Consider different frequencies, tranches across the calendar, various loss recovery methodologies, and other levers at your disposal. If you model various hypothetical return streams using different combinations of those levers, then you can determine your points of indifference in terms of fee percentages. Investors will likely have strong preferences if given a choice. However you get there, the outcome you want is a methodology that maximizes aggregate value and maximizes alignment. Your investors want you to be economically motivated to generate excess net returns for them.

4: Identify and solve problems caused by crypto's illiquidity and price volatility.
Price vol alone creates problems in crypto that aren't even considered in the traditional world because they are immaterial. For example, using traditional fund accounting, normal fund activities like subscriptions and redemptions can result in material transfers of value between sets of investors. You cannot let accounting drive the economics. New problems require new solutions, and these new solutions require work. Another example is side pocket mechanics. Depending on your strategy, you may need to spend a good deal of time working through each variable to arrive at the right solution. Make sure your investors understand how your fund's side pockets operate in various scenarios, and actively listen to their feedback.

Conclusion
The crypto asset class offers exposure to ideas that are truly revolutionary, and the opportunity set is incredibly rich. The crypto markets are getting stronger and stronger in terms of legal clarity, regulatory oversight, infrastructure, and transparency. As we crypto managers each improve our product structures, then this demonstrated desire for alignment will have a network effect on our reputation in the investor community. We will only attract capital and succeed if investors know that we are aligned with them.

Contact:
Brice Wilson, CPA, CFA
Global Head of Asset Management
brice.wilson@xbto.com