The Equus Report

—BY BARNABY LEVIN

What's Going On with the World of "Crypto"?

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A Client recently asked: What's ***happening*** with the "Crypto" market? And, has our outlook on Bitcoin investments, over the next 1-3 years, changed as a result?

Well, it's a long story – in what has been a ***very*** bad, couple of weeks for "Crypto" overall.

But first, as a reminder: *This is not an offer to buy or sell securities. No investment process is free of risk and there is no guarantee the process or investment opportunities referenced herein will be profitable. They may not be suitable for all investors. This document was created for informational purposes only and the opinions expressed are solely those of LK Wealth & Asset Management.*

That said, surely by now, ***everyone*** has seen or heard at least ***some*** of the news on 30-year-old, **Sam Bankman-Fried** ("SBF" to "friends") and his company, **FTX**, going bankrupt? It's (**arguably**) the single biggest test the industry has faced since "Satoshi Nakamoto" anonymously authored a white paper on "Bitcoin" in 2008, launching bitcoin's **original** reference implementation along with the ***first***, "blockchain" database.

Because 'ol Sam was so "admired" by so many, however – by some of the *smartest*, "Smart Money" people throughout the Investment Community; the most in-depth, "crack" Interviewers and Journalists; ***and*** our illustrious Congress, before which he testified on more than a few occasions (though I'm not sure if that was ***before*** or ***after*** the $40 million he made in campaign contributions)[1] – the tremors resulting from his collapse will extend far beyond whatever money is, ultimately, lost. But it's pretty safe to say, it will be in the ***Billions***.

And yet, what's even ***more*** ironic is how, in recent months, "SBF" had been something of a "White Knight" himself, bailing out everyone ***else***, from crypto lenders BlockFi and Voyager, to a "personal" investment he made in Robinhood, when "retail" trading dried up and the latter's stock collapsed.[2] But the question (belatedly) arose: **with *what* *money***? Well (it turns out) he was a) raising cash based on the issuance of (not one, but ***two***) of his ***own***, proprietary tokens (known as "FTT" and "Serum"); b) borrowing funds from one company (his Crypto Exchange, FTX) to fund another (his Hedge-Fund-slash-Trading-firm, Alameda Research, run by former girl-friend, Caroline Edison); and

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[1] "Politicians are regifting Sam Bankman-Fried's donations to distance themselves from the disgraced FTX founder," by Marco Quiroz-Gutierrez, Fortune, November 15, 2022

[2] "Sam Bankman-Fried's crypto firms had deep ties to Voyager Digital and its banruptcy wipeout," by MacKenzie Sigalos and Rohan Goswami, CNBC Tech, August 9, 2022

c) ***allegedly*** (through an ***illegal*** act known as "**comminglin**g") using customer assets as collateral. According to the ***law***, "commingling" is a breach of trust in which a fiduciary mixes funds held in care for a client with one's own funds, making it difficult to determine which funds belong to the fiduciary and which to the clients, which (in part) is what this week's announced bankruptcy proceedings will attempt to unravel.

But consequently, it seems a lot of people were "tricked" – from Third Point and Mayfield Partners to Sequoia Capital and Softbank (who just announced they're writing off their respective $210 million and $100 million investments). But this is just a start. Other Investors include Chase Coleman's Tiger Global; Anthony Scaramucci's Skybridge Capital; the Ontario Teachers' ***Pension*** Fund; and Mike Novogratz (a frequent guest and "Contributor" on Bloomberg ***and*** CNBC) at Galaxy Digital. Novogratz, by the way, ***only*** lost $76 Million, in comparison. The point is, there's going to be a ***lot*** of collateral damage in the days, weeks and months ahead.

That said – again with the ***Caveat***, *anything* having to do with "Crypto" is still considered ***Speculative*** – a ***lot*** of what's going on has (in my ***opinion***) been a result of stupidity and all I can say is, ***shame on them***.

Let's start with ***Binance*** (the ***largest*** Crypto Exchange ***and*** one of the **earliest *investors*** in **FTX**). This whole "run" on FTX was ***triggered*** by Binance which, over the prior weekend, announced they were **selling *all*** $**580 million** of their **"FTT" tokens** (issued to them, as a reminder, by FT**X**) because of an article they read in **Coindesk**.[3] And yet, it was Binance *themselves* who, some time ago, accepted – as ***payment*** – FT**T** tokens which (again) FT**X created** (or, better, "***made up***") when they sold their investment ***in*** *FTX* ***back*** to ***FTX***.

Are you following this? ***Binance*** was selling their ***Equity*** stake in a company (FTX) because they wanted to "cash ***out***" of that investment. But in so doing, they were willing to accept a means of exchange (an "IOU," really) that was backed by nothing more than the "faith and credit" of the very company they no longer wanted to have anything to do with. Now, I'm sure they had their "reasons" – like (perhaps) "wanting to support the industry and its development" (blah, blah, blah) – but who ***does*** that?!

But (and this is **important**) ***none*** of this has ***anything*** to do with ***BITCOIN itself***. In fact – despite the impact it has and will continue to have on prices overall, as people are forced to liquidate ***whatever*** they can to meet Margin Requirements – ***I*** believe Bitcoin will

[3] "Coindesk" is a news site, specializing in bitcoin and other digital currencies, that is owned by Digital Currency Group, owner of Grayscale Investments.

emerge stronger than ever – not in ***spite***, but ***because*** of – everything that's happening.

This, again, is the ***premise*** I ***personally*** subscribe to and that I've written ***and*** spoken about (at length) in my articles and podcasts – and (of course) only time will tell if I'm "right" or "wrong," understanding there are ***many*** who (vehemently) disagree and argue otherwise (including Warren Buffett and Charlie Munger).

But, while Bitcoin ***might*** be a consideration for many people for many reasons, the ***primary*** justification should ***always*** have been that ***Bitcoin*** – and the entire ***concept*** of **"*De*-Centralized Finance"** – were **created *precisely*** to ***avoid*** this kind of thing in the ***first*** place! If not, then ***neither one*** should ***ever*** have been a consideration. As Jack Mallers, CEO of Strike (quite passionately) said on CNBC, the way to think of "Bitcoin" and "Blockchain" is as an Arbitrage. "Money," he said, "is the most valuable good we have in any market. It's the nucleus of a functioning Society. We simply *engineered* the best *version* of it – so if you want to commit fraud, you don't use Bitcoin. And FTX, by the way, had ***Zero*** Bitcoin on its Balance Sheet. Because Bitcoin alone gives ***everyone*** **Property Rights**, accessible to all on an equal basis, secured by mathematics. "[4]

From the beginning, Bitcoin was based on an immutable, mathematical equation in which there was to be a fixed number of units (21 million) that could ***ever*** be minted (each one more difficult and costly to "mine" than the one before) so, as a "**Store of Value**," it couldn't be devalued, as ***all*** "Fiat" currencies ultimately are, when central bankers print a virtually unlimited amount, over time, in what often seems an arbitrary fashion over which we, as taxpayers (i.e. the ones footing the bill) seem to have little or no (meaningful) control.

The premise of "***De***-Centralized" Finance is that ***no individual, company, institution or country*** is ***ever*** "in charge" and it isn't ***necessary*** for us to have "**faith**" that ***any*** of them will "stand behind" their currency, when push comes to shove (because, when "push" ***truly*** comes to "shove," the only way they can is by printing even ***more***, which only makes matters ***worse***). Instead, based on the Bitcoin Block Chain, every transaction and change of ownership is transparent, in the "open" and fully ***disclosed***, so ***everyone*** can see ***exactly*** what's going on ("on-Chain"), at any time, indisputably – and (again), based on the principles and protocols of ***De***-Centralized Finance, "trust" is rendered unnecessary and irrelevant.

This is different than many (if not all) other "tokens" or "coins" – and while I admit I have

[4] Power Lunch, CNBC, November 16, 2022

very little knowledge about ***most*** of them (because I had no interest)[5] – they were ***all*** created with rules and objectives very different than those for Bitcoin. I had no interest in anything other than a "Gold Standard" which (I hoped and believe) would ultimately prove a better "store of value" than gold itself.

The point is, ***everything*** going wrong today (and earlier this year with companies like BlockFi and Voyager) has had to do with ***proprietary*** tokens, issued and backed by individual, ***private*** companies, not subject to oversight by anyone or anything.

But does this mean ***everyone*** and ***everything*** is a fraud? Of course not. There is (of course) Bitcoin itself, which can be bought, sold and stored at a number of respectable institutions, including Coinbase and Fidelity. And (without naming names) there are ***proxies*** for the "commodity" known as "Bitcoin," that can (themselves) be bought, sold and held in most brokerage accounts. Some file quarterly and annual reports – and issue audited, financial statements (including 10-Qs and 10-Ks) with the SEC, in compliance with the Exchange Act. And (of those) some are backed 100% by Bitcoin alone, which they clearly state they will never "hypothecate" (or lend against) nor apply leverage when investing and which they hold in "cold storage," at a third-party Custodian, which is their only "counterparty," so there's no liability issue with anyone else.

In ***other*** words, it ***is*** possible for one to **actually** do "**Due Diligence**" and to eliminate as many variables and "known unknowns" as possible before making an investment – which those who say they were "tricked" ***clearly*** didn't do.

So, the answer to the ***question*** is (in my ***opinion***) this is nothing more than a classic "**shakeout**" – no different than all those Internet "companies" (like "Webvan" and "Pets.com") went through in the Dot-Com Bubble and Bust. Many of them (you may recall) were ***pre***-profit and (in ***more*** than a few cases) pre-***revenue*** when they first went public. In like fashion, in recent years, there have been literally ***thousands*** of "Crypto" companies created – many of them creating and issuing ***thousands*** of their own, proprietary tokens – and (like FTX) many of them are so ***leveraged***, they too will go out of business, resulting in disruption across the industry. But if we ***always*** start with the **Balance Sheet** (whether our own or that of a company in which we're thinking to invest), it's pretty simple and (as Michael Levine of Bloomberg said) straightforward:

[5] even in people like Vitalik Buterin and Ethereum, which he created as a platform to "facilitate immutable, programmatic contracts and applications in a global, virtual machine."

Liabilities = Money customers give you, which you owe back to them
Assets = Stuff you buy with that money
Assets - **Liabilities** = **Net Worth**

Net Worth must be greater than **Zero**

But when it comes to the ***real*** "Blow Ups," it's always ***leverage*** that's the **problem**, isn't it? Whether it was the Dot-com Crash; Long-Term Capital Management in 1998; or the 2008 Financial Crisis. It's ***always*** **leverage** that (ultimately) gets everyone in trouble and creates a crisis and – as far as I'm concerned – it's the ***only*** thing on which Congress and our Agencies (whether the SEC, CFTC or *both*) should focus: on **Disclosure** and **Limits to Leverage**, like they do with our federally chartered banks. Otherwise, it's simply Human Nature: all too often, when someone comes up with an idea – and that idea gains traction – people ***will*** start to get greedy and, before everything's said and done, leverage it (often to the hilt) because (they think to themselves), if a little something is or works out well, why not make or do it a little ***more***. And it that works out okay, do it a little ***more***, until something (finally) breaks! Well the answer is: it's when the music stops (and at some point, it always ***does***). At some point, ***everything*** comes crashing down, "overnight," like Ernest Hemingway said in "The Sun Also Rises"[6] – and it's just too bad that, in the process, it typically takes the **good** ***with*** the bad, like Buffett talks about when he refers to the "tide going out" and you see who has clothes.

So ***that*** is what I believe this is. But out of the rubble, the strong ***will*** survive and (ultimately) prosper, like they always have – and, after a time of consolidation, the survivors will go on to become the Amazons, Googles (and "Bitcoin") of the world, at which point we'll return to the rules of **Supply & Demand**. As a reminder, the Law of Supply & Demand reflects the relationship, in that a change in one causes a change in the other. When there is higher demand for a commodity, for example, there tends to be a rise in the supply as producers step in to take advantage of the imbalance (and vice versa). The Law of Supply & Demand, then, explains the interaction between the desire for a product and the supply of that product. If the supply is low and demand is high, it means that product is scarce and insufficient for the number of people who want it and, in a Free and Open Market/Society, it will lead to an increase in the price of the product until supply ultimately catches up (or not). If not, price will (simply) continue to rise until demand subsides (and, then, falls) in what we call "Demand Destruction" (which is precisely what the ***Fed*** is ***hoping*** will happen as ***they*** continue to raise rates, to "vanquish" inflation).[7]

[6] When asked how he went bankrupt, Hemingway's character, Mike, says "Gradually, then suddenly."
[7] "The Law of Supply and Demand Explained," by Jason Gordon, The Business Professor, April 24, 2022

The Bottom Line – given the fact Bitcoin is ***mathematically*** limited to 21 million "coins" – once that number is reached, if anyone ***else*** wants one and nobody's willing to sell, the price has (at least at ***that*** point) no "choice" but to rise.

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