BKCM LLC

Digital Asset Fund

April 2017

Upcoming Events

Consensus 2017

May 24, 2017 - New York

Brian will be participating on this panel:

"Digital Currencies an Emerging Asset Class – Are Institutional Investors Ready to Buy?"

Token Summit

May 25, 2017 – New York

Brian will be participating on an investment panel.

FOMO and MOMO

While the rest of the financial markets meandered into May, the new asset class on the block was a peacock. Bitcoin strutted in full plumage to rise +24.84% in April. The BK Capital Digital Asset Fund continued to outperform with a +68.01% return for the month. Our year-to-date return is +172.73% compared with bitcoin's +39.21% return.

Fear of missing out (FOMO) and significant price momentum (MOMO) combined to create a unique investment environment. Unique is an understatement; it was not unusual for digital assets to climb 30%+ in a single day. The price action in these markets reminded me of the euphoria that surrounded dot-com growth, reminiscent of a period that I thought long gone. I have lamented that I was too young and inexperienced to understand the internet boom, but that experience did teach me that disruptive technologies create booms that exceed our wildest projections.

Our thesis is that digital assets and blockchain technology have the potential to be even more disruptive than the internet, and as a result, are a once in a generation investment opportunity. Digital assets are a new investment class with superior returns and are uncorrelated to traditional investments. In April, this thesis continued to be supported.

The objective of the BK Capital Digital Asset Fund is to provide exposure to the high-growth digital asset sector by actively managing a portfolio of bitcoin and other digital currencies. Our goal is to beat the performance of bitcoin while providing an investment vehicle that is uncorrelated to all other asset classes.

	March	April	YTD
BKCM Digital Asset Fund	**+62.33%**	**+68.01%**	**+172.73%**
Bitcoin	-9.33%	+24,84%	+39.21%
S&P 500	-0.30%	+0.99%	+6.42%
US Aggregate Bond Index	-0.26%	+0.70%	+1.08%
US Dollar Index	-0.79%	-1.51%	-4.20%
Gold	0.00%	+1.58%	+6.60%
Oil	-5.91%	-3.17%	-14.75%

BIG IN JAPAN

On April 1, 2017, a new law came into effect in Japan that recognized bitcoin as a legal method of payment. This is a significant step forward for bitcoin, especially when we recall that Mt Gox – one of the biggest exchange collapses – was domiciled in Japan.

The new law puts in place capital requirements, cybersecurity regulations, employee training, and annual audits. Further, the Accounting Standards Board of Japan has begun to develop standards for digital currencies, like bitcoin. This follows Japanese mega-banks' investments in a digital currency exchange, fueling speculation that these banks will begin trading bitcoin as a currency just like the yen, dollar and euro.

These developments have made Japan the dominate player in the bitcoin trading market. According to data compiled by CryptoCompare, the Japanese Yen is the most popular fiat currency used to buy bitcoin. Over 50% of the daily fiat to bitcoin trading volume is in Japanese Yen.

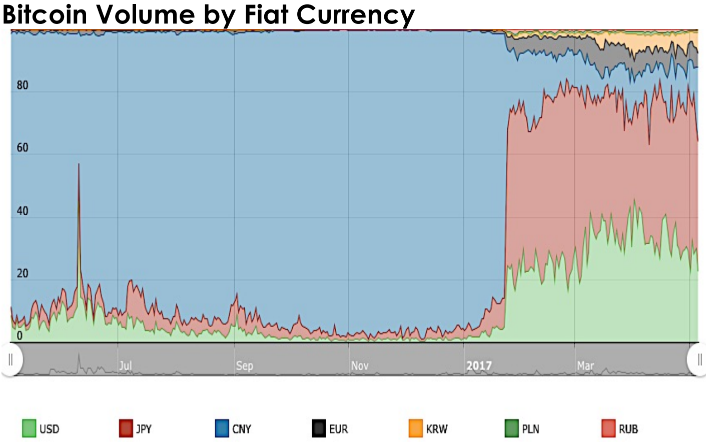
Bitcoin Volume by Currency

Month	USD	JPY	CNY	EUR
Dec-16	0.99%	3.43%	95.29%	0.20%
Jan-17	21.56%	52.18%	18.92%	4.89%
Feb-17	27.66%	53.78%	10.39%	5.92%
Mar-17	30.82%	39.28%	17.27%	6.21%
Apr-17	29.27%	52.87%	7.90%	5.03%

Source: CryptoCompare

Since the beginning of 2017, the Japanese Yen has surpassed the Chinese Yuan in bitcoin trading. This is likely the direct result of Chinese exchanges being forced to charge fees and much of the volume moving to lower-cost Japanese exchanges.

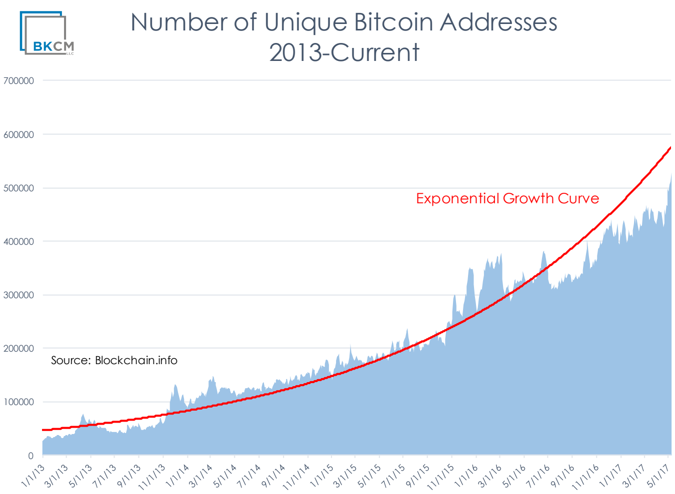
Bitcoin Volume by Fiat Currency



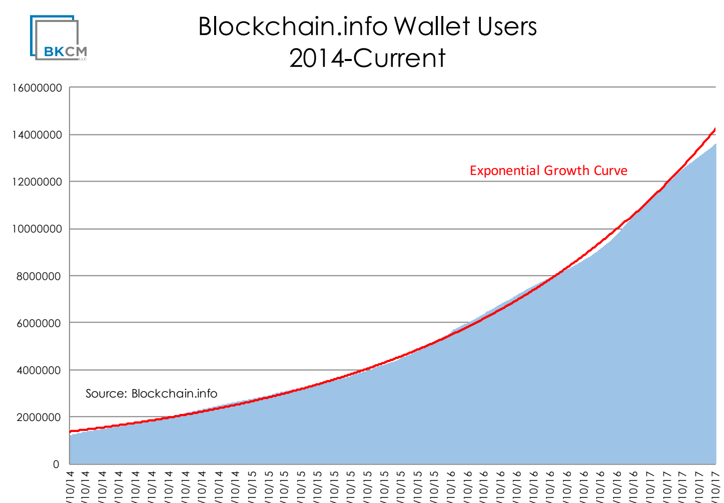
Source: CryptoCompare

The expansion of Japan's bitcoin ecosystem added to the already impressive trend in the underlying usage statistics. Since bitcoin is the onramp for all digital currencies, we continue to watch these figures closely.

At the end of April, there were over 600,000 unique addresses used on the bitcoin blockchain, which represents a 62% increase from April 2016 and a 140% increase from April 2015.



Even more impressive was the 92% YoY increase in wallet users from 7 million to 13.5 million.



Looking back to April 2015, there were only 3.3 million wallets, and the most recent data shows a 309% increase in just two years.

For perspective, in 1995 IDC estimated that there were 16 million internet users, and by 1996 that number had doubled to 36 million. The number of internet users doubled again in 1997 to 70 million, and the internet boom was moving in full force.

Bitcoin is experiencing the same rate of adoption as the internet and this suggests to us that this is simply the beginning of the boom.

BITCOIN NEARING FULL VALUE

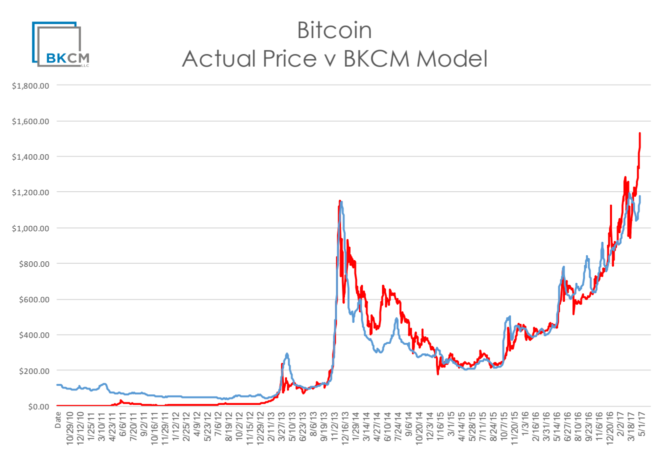
Despite our long-run confidence for bitcoin and other digital currencies, the shorter-term valuation dynamics for bitcoin have us cautious.

Our valuation model draws inspiration from Metcalf's Law and Susan Athey's (Stanford) pioneering valuation work. Inputs into our model include exchange volume, velocity, and transaction volume to name a few.

At the current level of network activity, our model computes a fair value for bitcoin of $1176, compared to the current price of $1850. It is not unusual for our model to diverge from the actual price as market participants continuously speculate about network growth. Nonetheless, this is one of the largest divergences we have seen.

The 30-day average transaction volume is growing by 278% on a year-over-year basis, while the 30-day exchange volume is growing at 183% year-over-year. If we assume these growth rates will continue over the next year, our model predicts a fair value of $1794.47, which amounts to approximately a -3% decline.

These growth assumptions seem fair given our view that bitcoin is following a similar trajectory as internet usage. However, our caution is rooted in the observation that the current price of bitcoin already accounts for the expected growth over the next year.



As the onramp to digital currencies, new investors continue to support the price of bitcoin, but the current valuation makes us prefer other digital currencies to bitcoin at the moment. Nonetheless, we have no right to impose our opinions upon the market.

ETHEREUM TOKEN SALES

As I mentioned last month, Ethereum is one of our largest positions – even larger than our bitcoin position – this positioning was a driver of our outperformance. In April, we took large positons in both Ethereum (ETH) and Ethereum Classic (ETC) with the view that both would be the beneficiary of the new money entering the digital asset class. Additionally, I viewed the euphoria surrounding many of the Ethereum-based token sales as supportive of the underlying platform.

We very well may look back on April 2017 as a crescendo of sorts for token sales. The highlight of the month was Gnosis, a decentralized prediction market built on the Ethereum blockchain.

More accurately, Gnosis is a project currently in the development stage with a product that has yet to be released. Nonetheless, on April 25, 2017, the Gnosis token auction raised $12 million in less than 15 minutes, which valued the entire Gnosis project at $300 million.

For perspective, when Twitter was first funded in 2007, it was valued at $20 million; Uber's Series A funding round in 2011 valued the company at $60 million; and when Airbnb graduated from its YCombinator class, it was seeking a $1.5 million valuation. Viewed from this perspective, the Gnosis token sale looks to be extreme.

This is not to take away from the Gnosis project – the developers have no control over the madness of crowds. Importantly, projects like Gnosis and Augur have the potential to disrupt the insurance industry and could easily grow into the valuations.

It is worth noting though that valuations of many of these projects have reached what appears to be an extreme level. The same thing happened during the internet boom, which is simply the result of human fear and greed. As active managers, we plan to continue to ride the waves of emotion.

Reflexivity and Digital Assets

The madness of the crowd that we witnessed in April highlights a noteworthy feature of the current digital asset investment landscape – reflexivity.

Reflexivity is a theory invented by George Soros to explain how the price of an asset can influence its underlying fundamental value. A recent example is the housing boom and bust in the early 2000s.

As the price of homes increased, individuals could borrow an increasing amount against the new "equity" in the home. This cash could then be used to improve the property or buy another home. This created a virtuous circle where home prices climbed, causing banks to lend even more.

The housing boom evolved into a bubble as leverage was ladled onto the witch's brew. As we now know, once home prices began to decline, the process reversed and ended in the 2008 financial crisis.

A similar phenomenon is occurring in digital assets. Bitcoin has the lead as the largest network by total network value (number of outstanding coins x price). The very nature of digital assets, like bitcoin, makes a larger network value a more secure network. This happens because the security of the network is a function of how much money it would take to control the network. The more valuable the network, the more money it takes for a malicious actor to gain control. This means that the fundamental value of a digital blockchain asset is dependent on the price of the coin or token used to operate the network.

This particularity of digital/blockchain assets creates a reflexive environment. As the price of a digital asset rises, the underlying value of the network increases. This, in turn, attracts more capital, which raises the price, and a virtuous cycle ensues.

How and when does it end?

We know from watching every other boom/bust cycle that it ends when the price begins a sustained decline. The more difficult question to answer is when.

Despite the extraordinary environment that now exists for digital assets, I still believe that we are just at the beginning of this cycle. To be sure, there will be pullbacks and many of those declines will be quite severe. However, the underlying driver of this cycle is rapid adoption of a revolutionary technology. Using this yardstick as a comparison for internet adoption rates indicates that there is plenty of runway left.

-BK

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