BKCM LLC

DIGITAL ASSET STRATEGY

March 2017

UPCOMING EVENTS

Consensus 2017

May 22-23, New York, NY

Brian Kelly will be participating on a panel discussing digital currencies as asset class. The discussion will focus on digital currencies as a diversification tool and the future of this emerging asset.

Brian will be available for investor meetings during the conference.

READY, SET, LAUNCH

March marks the official launch of the BKCM Digital Assets Strategy – we have been running the strategy internally, but this is the first month BKCM has accepted outside capital for the digital asset strategy. I would like to personally thank our investors for trusting us with the privilege of managing your capital.

The objective of the digital asset strategy is to provide exposure to the hyper-growth digital asset space by actively managing a portfolio of bitcoin and other digital currencies. It is our view that digital currencies are an emerging asset class that should not be ignored by investors.

Our goal is to beat the performance of bitcoin while providing an investment vehicle that is uncorrelated to all other asset classes. By this measure, March was a resounding success.

PERFORMANCE

The BKCM Digital Asset Strategy produced a +62.35% return for our investors while bitcoin was down -10.16% for the month.

The primary driver of the outperformance was a timely move out of bitcoin and into other digital currencies before and immediately following the SEC's rejection of the Winklevoss Bitcoin ETF. Speculation about an approval of a bitcoin ETF pushed the price of bitcoin to an all-time high of $1350. Immediately following the decision, bitcoin dropped to as low as $976 and reasserted bitcoin's reputation as an extremely volatile currency.

The SEC was correct to reject a bitcoin ETF - the markets are too fragmented and immature to handle the amount of demand an ETF would have created. By some estimates an ETF would have created over $300 million in demand within the first few weeks. While bitcoin liquidity has matured (many days it has traded more volume than the Gold ETF) the massive influx of investment would have had a deleterious effect on the currency. It was entirely possible that the price of would have doubled with ETF demand, but once that subsided the reduced demand would create an air-pocket. The best path for bitcoin and digital currencies is to have volatility decline with maturity.

Of course, as active managers we welcome the opportunity to take advantage of the short-term volatility, but we believe that the long-term success of this asset class depends on normalized volatility.

The rejection of the bitcoin ETF opened the door for other digital currencies to gain dominance, most notably Ether – the currency fueling the Ethereum network. At the end of February 2017, the Ethereum Enterprise Alliance (EEA) was announced. The EEA includes Microsoft, JPMorgan, BNY Mellon, CME Group, Intel, Santander and UBS (to name a few) and was formed to create a standard version of the Ethereum software upon which businesses can build smart contracts.

After attending the launch event in early March, it was evident that the EEA would be game changing not only for Ethereum, but also for digital currencies more broadly. The EEA marks the first step toward real world development using the software and protocols that underpin digital currencies. With this advance, digital currencies have changed from purely speculative assets to investments supported by enterprise level development. It is for this reason that Ether has become one of our largest positions.

Looking Ahead

As we look ahead we see three catalysts and opportunities for digital currencies:

1. Bitcoin Scaling
2. Bitcoin Dominance
3. Initial Coin Offerings

Bitcoin Scaling

The biggest threat to bitcoin is the ongoing "debate" about how to upgrade the Bitcoin network. We put "debate" in quotes because from our perch this fight appears to be an extremely harmful civil war. In fact, there has been so much confidence lost among institutional investors that for the first time ever we are concerned about the long-term viability of bitcoin. That is not to say the future of digital assets hangs in the balance, but the future of bitcoin as a currency is in doubt.

A currency derives value from trust. Trust that it will be accepted as a form of payment and trust that it will not be devalued. Bitcoin was a response to the loss of trust during the Great Financial Crisis of 2008 – it was touted as an alternative currency that could not be manipulated by a central bank. The civil war over scaling bitcoin has eroded this narrative.

The simple fact that a small group of people control how the software is upgraded and if that upgrade is accepted makes bitcoin a centralized currency.

The debate over scaling bitcoin produced the possibility that bitcoin could split into two different coins. A split of bitcoin into two coins could be a death blow for the currency. If holders and users of the currency cannot be sure that the currency will be accepted in the future then trust (value) is eroded. Splitting bitcoin is a de facto devaluation.

Bitcoin dominance

The scaling debate and potential for a devaluation will likely erode the dominance of bitcoin within the digital asset class. Bitcoin's current market cap is close to $20b, while its closest competitor, Ethereum, has a market cap of ~$4b. One result of the bitcoin scaling civil war is likely to be a convergence of market cap. Our current view is that Ethereum will gain market dominance while bitcoin grows slowly (at best) or decays (at worst).

We are not in the "winner take all" camp. The benefits of network effect cannot not be denied, but to assume that one network will ultimately triumph ignores human behavior. If network effect was the only driver of success, then Facebook would not face competition from the likes of Snap Chat and Twitter. Moreover, Pepsi would not exist as the first to market Coca-Cola would have dominated.

Consumers of these iconic products determine success or failure and we suspect the same to be true for digital currencies. The attributes of some digital currencies may have higher value to some users. For example, some may prefer privacy, while others may value the ability to construct a smart contract. The point is that assuming a winner take all stance is to deny consumer preferences which is always a bad business strategy.

Initial Coin Offerings

A concrete example of the impact of consumer choice is the explosion of initial coin offerings (ICO's). ICO's are being used to raise capital for startup projects in the digital asset space. A team will typically release a whitepaper describing the project and then issue a blockchain token to finance the project. This has become an increasingly popular and efficient means of raising capital. In fact, many projects are raising millions of dollars in the matter of minutes via these token crowdsales.

Of course, the ability to quickly raise a lot capital with little more than an idea can be a Pandora's box. Bubbles, scams and other unsavory activity were not invented with digital assets, financial history is replete with examples nefarious characters and schemes. Our job as active investment managers is to thoroughly vet the teams behind the projects and find the diamonds in the rough.

A shining example of our ability to cut through the noise is our investment in Cosmos. The Cosmos network is the "internet of blockchains" and will create the ability for digital currencies to efficiently move between chains. In our view, the Inter-blockchain Communication (IBC) developed by Cosmos could make it one of the top ten most valuable digital currencies. As the initial investors in the Cosmos network, we tripled our investment during the crowdfunded donation period and expect further gains once the token begins to trade publicly in Q4 2017.

Final Thoughts

While I have laid out our view of the digital asset class, I firmly believe that our edge lies in our ability to remain flexible. In global macro investing I have found success by holding two contradictory views and acting only on the view that is validated by the market. This framework served us well in March and I believe that the digital asset space is a perfect match for this style of investing. The combination of entrepreneurial thinking coupled with real world market experience should be the basis for further success.

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