BKCM LLC

Digital Asset Strategy

May 2017

Upcoming Events

June 30, 2017

BKCM Digital Asset Fund Opens to New Investors

Founders Shares Available to all Investors as of June 30, 2017.

Sell in May and Go Away?

The month of May was extraordinary for the BKCM Digital Asset Strategy. Our monthly return was +210.75%, bringing our year-to-date return to +747.51%. Bitcoin's monthly return was +65.93% and year-to-date return is +131.01%. Investors might wonder if we should take the summer off. We shouldn't.

I encourage any doubters to listen the podcast "The Quiet Master of Cryptocurrency" in which Tim Ferris and Naval Ravikant (the founder of Angelist) interview Nick Szabo – a polymath, legal scholar, pioneer of "smart contracts", and creator of Bitgold - the precursor to bitcoin. The interview masterfully explores the revolutionary nature of bitcoin and blockchain technology and explains how it will not only reshape commerce but also social organizations.

My favorite quote from the podcast is that "*bitcoin is a global currency that it not yet widely distributed.*" This simple sentence crystallizes the thesis that we are in the first inning of this investment cycle. Despite the hype that surrounded bitcoin touching $3000, only a small percentage of the global population uses the currency. Skeptics will say this proof of bitcoin's failure. I see it as future growth.

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.

The objective of the BKCM Digital Asset Strategy 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	May	YTD
BKCM Digital Asset Fund	**+62.33%**	**+68.01%**	**+210.75%**	**+747.51%**
Bitcoin	-9.33%	+24,84%	+65.93%	+131.01%
S&P 500	-0.30%	+0.99%	+1.14%	+7.58%
US Aggregate Bond Index	-0.26%	+0.70%	+0.95%	+2.03%
US Dollar Index	-0.79%	-1.51%	-1.17%	-5.37%
Gold	0.00%	+1.58%	+1.00%	+7.60%
Oil	-5.91%	-3.17%	+2.32%	-12.43%

Risk-Less Return?

My enthusiasm for the asset class should not be taken to mean the road ahead is not without risk. In fact, digital assets face two unique risks; one that clouds the short term outlook and one that is omnipresent.

First is the risk of technological failure; while bitcoin has been around since 2009 it still is an emerging technology that has many hurdles before it is ready for primetime. The ability for Bitcoin, Ethereum and other digital assets to handle the exponential growth in transactions is an unsolved problem. This problem, known as "scaling" has now reached an inflection point for both Bitcoin and Ethereum.

The problem with "scaling" is as much political as it is technical. Since bitcoin is an open source, community run, software platform there is not a central authority that has permission to change the original code. This is a feature, not a bug.

Bitcoin was designed to be resistant to change, it is what Nassim Taleb calls anti-fragile. This feature strengthens the security of the immutable record of transactions but comes at a cost. The price of immutability is an almost impenetrable defense against evolution.

The first major test of this defense system will come at the end of July when a software upgrade is scheduled to take effect for the bitcoin network. This upgrade will allow more transactions to be processed on the bitcoin network. The debate about how to implement this upgrade has been raging for three years and it appears that over 80% of the network community has agreed upon a solution.

However, there is still a non-negligible risk that some influential miners do not follow through with the agreement causing bitcoin to split into two separate coins. In my view, a split of bitcoin would have a detrimental impact public perception – it's difficult enough for the public to accept bitcoin, therefore ladling uncertainty on top of complexity is unlikely to help.

It is no longer my view that a coin-split would be a deathblow for bitcoin. The coin-split of Ethereum proves that two similar but competing technologies can co-exist. There appears to be enough financial support on both sides of the debate that in the unlikely scenario where bitcoin splits into two, the sum of parts might equal more than the whole. This is exactly what occurred when Ethereum split.
If bitcoin were to split it would certainly be a public perception nightmare, but this anti-fragile technology was designed for long run survival.

Nonetheless, as the upgrade date approaches the volatility in the price of bitcoin is likely to increase. This presents a challenging environment for a portfolio manager. We must weigh the potential for extreme volatility against the opportunity to own two coins that have a greater value than the original.

Our plan to handle the opportunity and volatility involves two steps. First, we intend to remain long bitcoin ahead of the event in anticipation of catching a euphoric speculative rise as investors bet on a successful upgrade. If we are correct about a speculative rise then it is probable that we will reduce our position as the price appreciates – thereby locking in profits and reducing risk. If we are wrong about a speculative rise or detect a problem with the upgrade we intend to reduce our position significantly.

The second part of the plan involves a hedge. There are few viable derivative products in the digital asset sector thus our hedge must be structured as a purchase of another digital asset. In our view, the most likely asset to benefit form a disruption in bitcoin is litecoin. Litecoin is a clone of bitcoin with a few subtle but important changes. Most significantly litecoin has already successfully upgraded its software without a split.

The combination of a software upgrade and code base like bitcoin makes litecoin an easy substitute for organizations building products on top of the bitcoin blockchain. In fact, we have already seen some defections from bitcoin to litecoin, most notably Yours.org.

I am generally reluctant to indicate strong short term views on assets as I believe mental flexibility is key component to successful investing. However, the potential for a split of bitcoin is so significant that it requires me to explain our plan to investors.

The second risk is found in all assets that are touched by human beings – it is speculative excess. While Bitcoin, Ethereum and other digital assets solve a lot of problems they do not resolve human fear and greed.

The impressive rise in digital assets has drawn a lot of speculative interest and has caused some to call bitcoin a "bubble". While I understand the view that parabolic price increases are one sign of a bubble it's important to look at the bigger picture.

Last month I wrote about the madness of crowds and the reflexive nature of these markets. This month I intend to explain why this price rise is more of a "bubbl-ette" than a true bubble destined for an immediate pop.

In addition to meteoric price increase a bubble requires the excessive use of leverage and subsequent withdrawal of that leverage. The bubble price increase is a result of investors buying on margin pushing the speculative asset higher. It is not until the margin loans are called that the bubble pops.

In the case of digital assets, leverage is a very small part of the ecosystem. Moreover, the leverage that has been employed is typically done via exchanges that have automatic liquidation protocols. Many of the large downward price spikes are the result of margin positions being automatically closed. This market dynamic keeps the amount of leverage from building to dangerous levels. I am quite sure that someday digital assets will experience a leverage fueled bubble (all markets do) but that day is not today.

The other prerequisite for the popping of a bubble is a lack of new investors. With so few institutional investors in the space it is unlikely that digital assets are about to suffer from a lack of buyers. In fact, my personal experience over the last month leads me to believe that there is a wall of money poised to enter this asset class.

I recognize that my positon as portfolio manager of a digital asset fund undoubtedly has an impact on my perspective, but my goal is to be mentally flexible. In the podcast, I mentioned at the beginning of this letter, Nick Szabo calls this mental flexibility "quantum thought" or the act of keeping two opposite scenarios in one's mind at the same time. I suspect the next month will require that I exercise quantum thought to recognize and act on all the potential outcomes.

-BK

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