INVESTING IN YOUR FIRST SMI

2019

What you need to know

"…there is no dispute that nowadays systemic risk inseparably belongs to the main issues associated with modern financial systems…. Interdependencies among financial institutions are a hidden threat to the financial system as a whole." Jana Procházková

Kenton-Dau LLC

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WHAT YOU NEED TO KNOW

ABOUT THIS GUIDE

This guide takes you through details of the Self-Managed Investment (SMI) asset class. It looks at:

- what are SMIs, their benefits and risks
- how to purchase and exit
- ways to optimise your investment.

We use examples from Bitcoin Enhanced, an SMI trading a long/short Bitcoin strategy.

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WHAT ARE SMI?

SMIs are a digital hedge fund where token ownership is secured on a distributed ledger, a blockchain.

Their purpose is to provide strategy-based returns without the counterparty and systemic risks of a traditional hedge fund. For investors this enables a return to genuine portfolio diversification – the bedrock of sound investing.

To achieve this goal SMIs do not trade assets like a hedge fund. Instead they run simulated strategies.

Because the strategy is simulated the value of SMIs remains independent of institutional counterparties.

ASSETS OF INDEPENDENT VALUE

SMIs share their independence with a small list of other assets:

- property, owned outright
- commodities, owned outright and preferably physically held
- non-collateralised digital currencies such as Monero, Litecoin and Bitcoin.

SMI BENEFITS

- SMIs seek to mitigate one of a portfolio's greatest risks – loss of genuine diversification due to the dependence of financial institutions upon each other for their solvency.
    - All assets in a portfolio that depend upon institutional counterparties to realize their value share this single point of failure.
    - This is exactly the situation that arose on 15th September 2008 with the collapse of Lehman Brothers and the resulting financial crisis.

> **"In my view derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal." Warren Buffet**

- Because SMIs are based on investment strategies they have better upside potential than other assets of independent value.
- SMIs provide better returns than a traditional hedge-fund because they have no fees.

AN EXAMPLE SMI

The Bitcoin Enhanced SMI simulates the trades of a long/short Bitcoin strategy.

The strategy is long unless forecasts are made to short Bitcoin.

Short forecasts are irrevocably time-stamped (on a blockchain) before their start date to prevent fraud.

The results of the simulated strategy are published on the website as a Target Price

Because the only reason to hold tokens is to trade at the Target Price it is in the interests of investors to do so. This expectation and self-interest maintains the peg.

Tokens can be bought and sold on the Waves digital exchange.

RISKS

The risks of SMIs are similar to the risks faced by Venture Capital firms.

- Without underlying assets (collateral) SMIs have a built-in lack of liquidity in their early days. VCs invest in start-up companies that also lack liquidity.
- An SMI may fail at any point in its development through the non-performance of its strategy or for other reasons. Likewise, the failure rate of companies a VC invests in is around 60%.

To mitigate these risks VCs use a proven business model that has out-performed most other asset classes over the last 20 years. The same model can be used to mitigate the risks of SMIs.

RISK MITIGATION – THE VC WAY

A VC mitigates the risk of low initial liquidity and potential failure of a business through the following steps:

- Diversification – a VC invests in multiple start-ups to spread the risk of any specific failure.
- Patience – the VC is aware that liquidity is not present in the early stages of a company's development.
- Active Investing – a VC actively supports and promotes its companies in order to bring them to a liquidity event such as trade sale or IPO where the VC is able to exit.

RISK MITIGATION FOR SMI

An investor can manage the liquidity and failure risk of SMI's by following the VC model:

- Diversification - spread the risk of failure by investing in more than one SMI. If few SMIs are available, other assets of independent value such as commodities or digital currencies can be used.

- Patience – Recognition that low-liquidity is built into the SMI structure enables the investor set appropriate time horizons. By way of example, it took Bitcoin until 2013, 4 years from inception to attain significant liquidity across multiple exchanges. For Monero, after an initial spike, the timeframe was two and a half years.

- Active Investing – Publically declaring a holding in an SMI can increase confidence in the asset and promote further adoption. As with VC firms investors can choose their level of involvement in their SMIs.

Liquidity for an SMI means sufficient buyers on digital exchanges where the token is listed.

PERFORMANCE

Unlike a hedge fund, SMIs charge no fees. This can make a significant difference to the returns. For example $100 invested into a strategy that returns 20% per annum, after 10 years the SMI structure would has returned $619 compared to $379 for a hedge fund with a 2% management and 20% performance fee structure (returns reinvested). This represents a 35% increase in returns over the 10 year period. By year 20 the SMI is returning 180% more than the hedge fund.

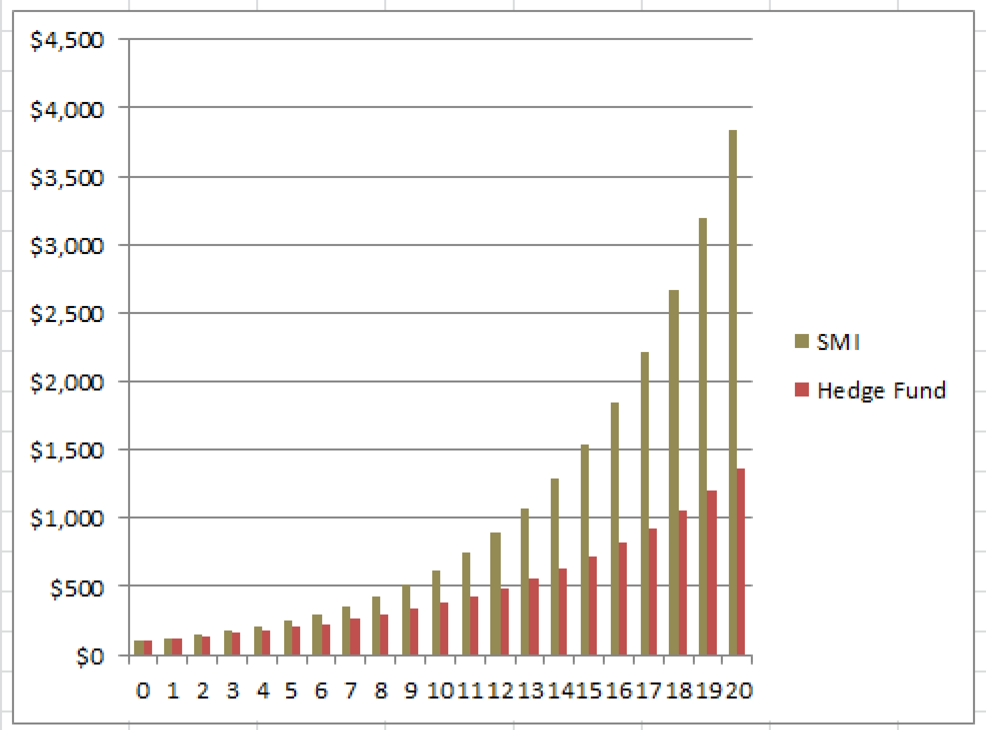

Figure 1 Comparing returns of a $100 investment in an SMI with a traditional hedge fund structure for the same strategy returning 20% per annum.

HOW TO INVEST & EXIT

SMIs are digital tokens. They can be purchased on the digital exchanges where they are listed.

Example: Bitcoin Enhanced tokens are listed against the USD on the Waves DEX.

Investors cash out from an SMI by selling their tokens on the same exchanges.

Investors may wish to use a 3rd party such as https://copper.co/ that can provide secure digital asset custody, acquisition and transfer.

TAKING AN EQUITY STAKE

Some SMI issuers may allow early investors to take an equity stake in the operating company as well as purchase tokens. An equity stake is another form of active-investing. It helps to build market confidence in the SMI and attract more investors.

An equity stake also benefits investors by giving them early access to liquidity. SMI issuers earn their revenue from the sale of tokens. Equity investors participate in this revenue stream in the form of dividends from the company. This revenue may be in advance of sufficient liquidity in the tokens to cash out of the investment.

THE LONG TERM

Many SMIs hard-cap the number of available tokens in order to create scarcity which in turns helps generate demand. Once all tokens are sold the issuing company has no further source of revenue. At this stage the issuer establishes a trust that continues to run the strategy and provide updates to the Target Price. Token holders are unaffected. They continue to enter and exit an investment of stand-alone value where all available tokens are now in circulation.

MORE INFORMATION

The following resources give more background to SMIs and the problems they seek to solve for portfolio managers:

- What Protects Investors from the Greatest Risk of All?
- Introducing Genuine Portfolio Diversification
- Introducing Self Managed Investments (SMIs)

Branton Kenton-Dau
Principal
branton@kenton-dau.com

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