INSIGHTS

FEBRUARY 2023

BUILDING BACK BETTER

THE FUTURE OF DIGITAL ASSET HEDGE FUNDS AFTER THE YEAR THAT WAS

EXECUTIVE SUMMARY

2022 was a year of high drama for digital assets. From the Terra Luna crash in May to the FTX collapse in November, there was little time for fund managers to take stock. Chief among the succession of events was the fall of FTX trading and its cryptocurrency exchange, the ramifications of which will be felt for years to come.

And that is where this report starts, of course. The immediate aftermath of the FTX collapse, yes, but the more enduring effects, primarily – the heightened counterparty risk for managers, the loss of confidence among investors, and the influence on lawmakers, on both sides of the Atlantic, as they take their first steps towards creating a framework for cryptocurrency regulation.

Few considered the FTX collapse fatal, but some readers may be surprised by the extent of the optimism on display here – long term, if not immediate – from the hedge fund managers surveyed and interviewed for this report, crypto natives and traditional finance alike.

A key theme from our research, then, is that the crises of 2022 have served to redraw and strengthen the digital assets hedge fund industry. There has long been a sense that, for the industry to take its next step, there needed to be an effective mix of innovation and institutionalisation. After the events of last year, that may finally be possible.

TONY GRIFFITHS
HEAD OF RESEARCH & INSIGHT

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METHODOLOGY

Hedgeweek surveyed and/or interviewed over 50 hedge fund professionals in January and early February 2023 on the topic of digital assets and disruptive technologies. Of the group surveyed, about one third ran a flagship fund product focused on digital assets. The findings in this report are based on the results of that survey, research interviews with a range of named and unnamed hedge fund sources, and several third-party data sources.

KEY FINDINGS

1

The digital assets industry is going to 'build back better'

Despite last year's failures, hedge fund firms are very bullish on the long-term future of digital assets. Many see the industry as emerging from a necessary stress test, weaker initially, but rebuilding stronger, and finally ready to demonstrate institutional credentials. In fact, a Hedgeweek survey found more respondents saying the events of 2022 had 'strengthened' their plans for digital assets than 'weakened' them.

2

FTX – not Terra Luna – has hit interest from institutions

Four in five hedge fund firms surveyed by Hedgeweek said that institutional investors' appetite for digital asset hedge funds has weakened since this time last year, including half who said it had weakened significantly. This is primarily due to a loss of confidence following the collapse of FTX in November. But there is a difference – the few large allocators already invested in digital assets will be harder to win than those still evaluating.

3

From broader AI and Big Data to tokenization and ChatGPT

Most digital asset hedge funds have made up their minds on artificial intelligence and Big Data. Among those firms surveyed, almost no-one was exploring the use of these 'disruptive technologies' if they weren't using them already. Of greater interest – for now – is ChatGPT, the headline-making chatbot from OpenAI, which a third of firms are actively exploring, and fund tokenization, a common area of interest among interviewees.

4

The industry's biggest risks are counterparty and regulatory

Counterparty risk in the wake of the FTX collapse is front and centre for digital asset hedge fund managers (and their investors). But some industry experts suggest regulatory risk is even greater, particularly for the US, where, unlike in the EU, lawmakers are yet to make formal progress on an official framework. A key, lingering concern is that new regulation (when not if) ends up stifling innovation and therefore the industry.

REWIND, REBUILD

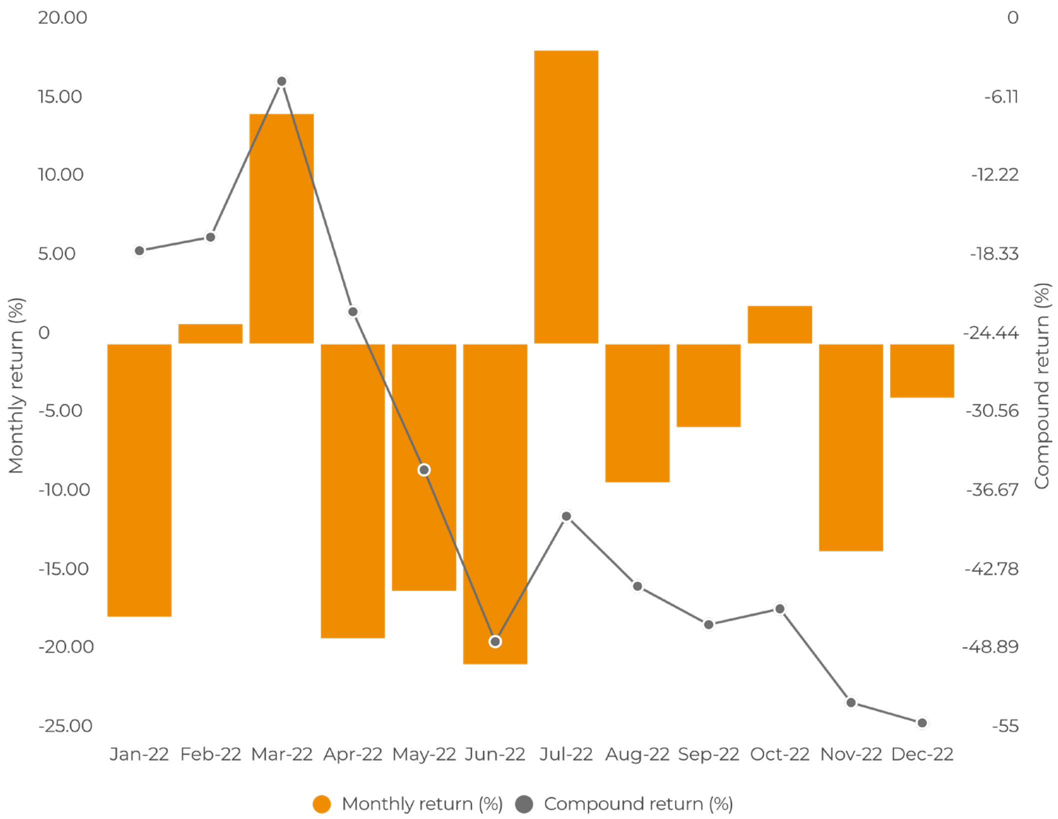
It's been a little over three months since the collapse of FTX Trading and its cryptocurrency exchange. For fund managers, that's a lifetime.

In a 12-month period featuring multiple high-profile failures and challenges, FTX remains at the forefront of digital asset hedge fund managers' minds.

Yes, the crash of stablecoin Terra Luna in the spring resulted in a bigger hit for crypto hedge fund performance – with a drop of 15.7% in May versus 13.2% in November when FTX collapsed (see Figure 1.1) – and the value of bitcoin (see Figure 1.2), but the fall of FTX Trading and its centralized exchange will likely have the more enduring impact on the crypto ecosystem – for better, many fund managers say.

The consensus: the FTX event was different because of who was affected. While the Terra Luna crash was, in many ways, a retail event, FTX managed one of the largest exchanges for crypto investments. It was a so-called 'safe haven' for larger entities, investors at the more risk averse end of the digital asset investment spectrum. Some large fund managers had

Figure 1.1 Cryptocurrency hedge fund performance in 2022, monthly return and compound monthly return



Source: Hedge Fund Research

significant capital with FTX – losing hundreds of millions of dollars in some cases – but many institutional allocators were also affected as part of their initial forays into the asset class.

One year on

The shift in mood among digital asset hedge fund managers since the spring, and culminating in the FTX collapse, has been palpable. If the start of 2022 saw managers (and headlines) preoccupied with the potential for dramatic outperformance, 2023 has begun with conversations around improved processes, due diligence, and risk assessment – and the tone is being set from the top down. Mike Novogratz, CEO of Galaxy Digital, perhaps the crypto hedge fund industry's best-known manager, has said "rebuilding trust" will the digital asset investment industry's key theme for 2023.

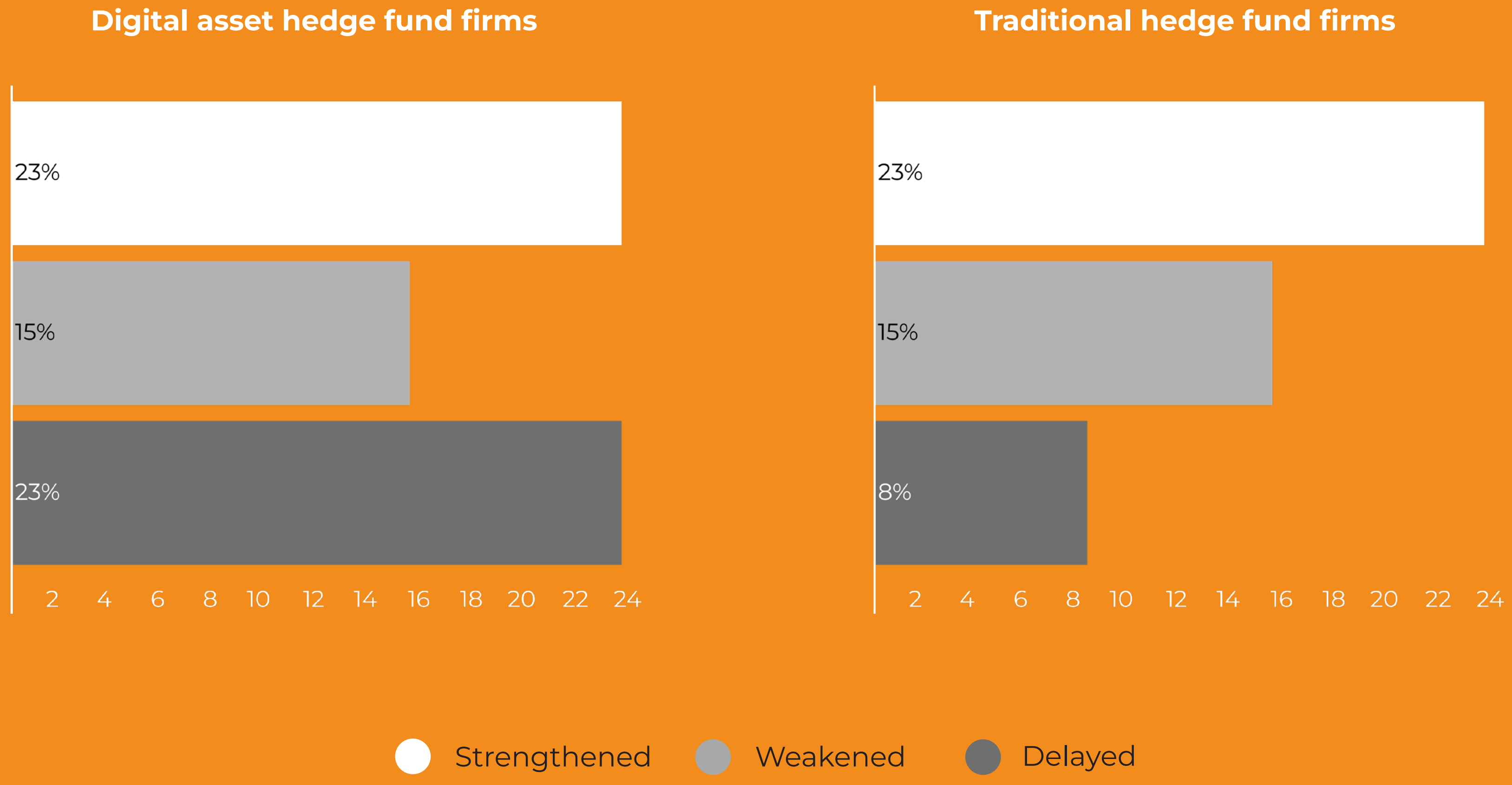
"Last year was a setback," Novogratz states, during a Hedgeweek research interview. "Our industry proved to be immature, with various players lacking proper governance and risk controls. That ended up causing a breakdown in trust within and across the industry." This will be repaired by fund managers "stepping up and deepening due diligence practices", he adds. Novogratz is not alone in saying hard work – and time – is now required. Some commentators have said the FTX failure could set the cryptocurrency investment market back five years or more.

But the fund managers Hedgeweek spoke to for this report expect the industry to make that

KEY FINDING

Managers – crypto native and traditional – are undeterred by the events of 2022

The impact of events last year on hedge fund managers plans for digital assets:



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time count. Though the events of last year caused huge upheaval, they have also created an opportunity for an ‘immature’ yet rapidly growing industry to rewind and rebuild on stronger foundations.

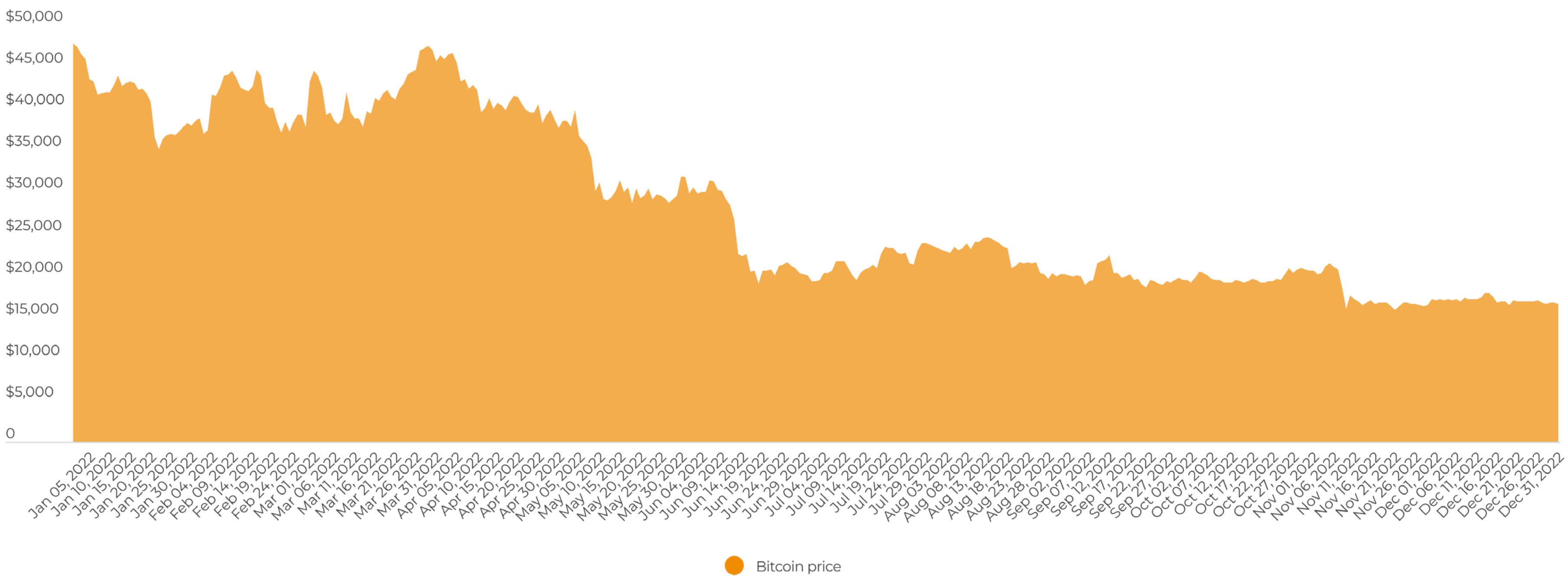
“Many of the players running big crypto companies were only there because they were early in a bull market,” says Emil Van Essen, co-founder of quantitative hedge fund specialist and crypto investor Katonah EvE. “These early successes were reckless and irresponsible, and we needed a big shakeout to get rid of these weak players to clear the way to more growth.”

Samed Bouaynaya, portfolio manager for Altana Wealth’s digital assets fund, suggests 2022 will be remembered as “very productive” for the future of digital assets, not the “year to forget” that some investors have ascribed it.

Plans delayed, strengthened

Product development, at least, is ongoing. During a survey of hedge fund managers in January and early February 2023, Hedgeweek found a greater proportion of respondents saying the events of 2022 had ‘strengthened’ their plans for a digital assets product or service than had weakened it, albeit from a low base (see figure 1.3). This was true for both digital asset hedge fund managers and other hedge fund managers. Indeed, news broke in mid-November – just two weeks after the FTX collapse – that Man Group was pushing ahead

Figure 1.2 Price of Bitcoin in 2022 (USD)



Source: Coinbase

with plans to launch a dedicated cryptocurrency hedge fund.

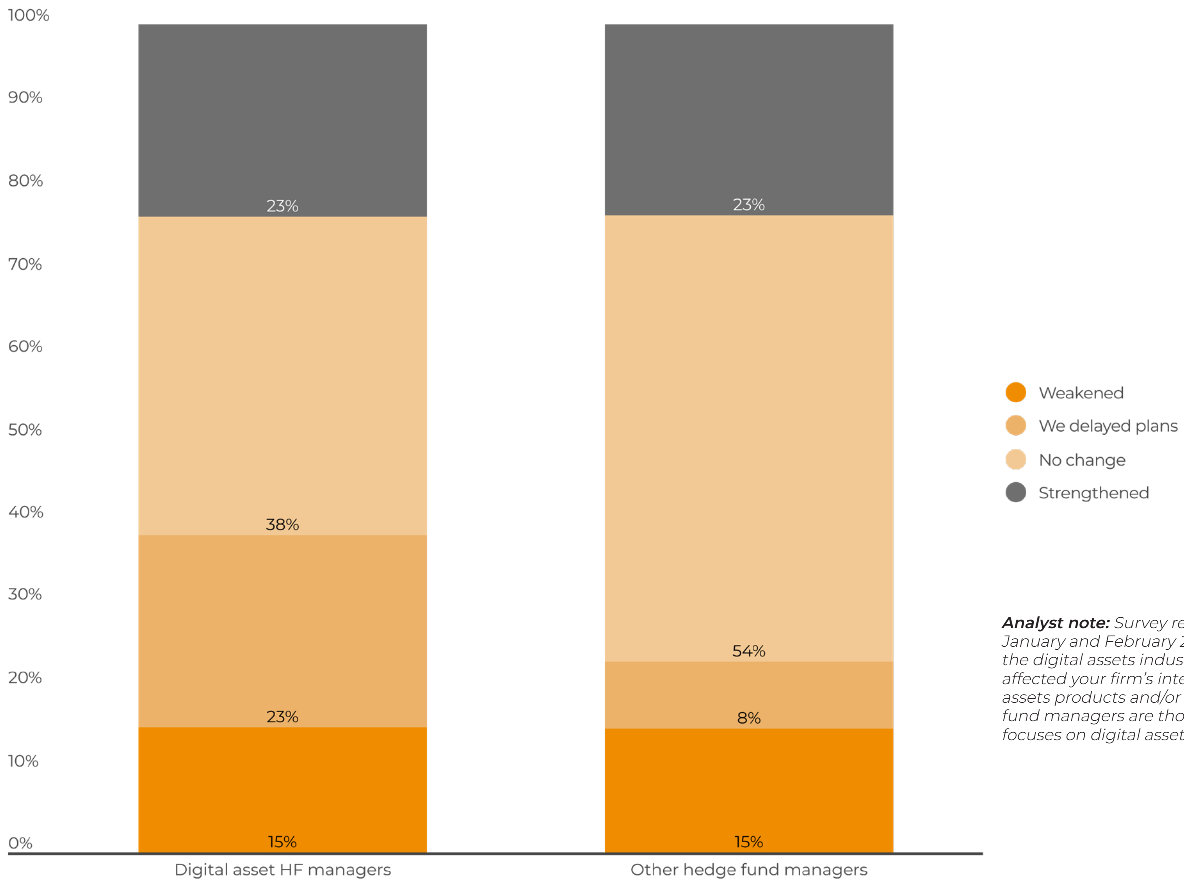
"Speculative bubble implosions pave the way for creation, progress, and maturity," Bouaynaya wrote in Hedgeweek's Global Outlook 2023 report in January, articulating an approach to last year's events that many in the crypto industry have adopted. Looking back, he notes that, had it not been for investment in the DotCom bubble and its subsequent implosion, we wouldn't have unleashed the power of today's internet.

The comparison to the DotCom bubble – as well as 2008 – is reasonably made and, perhaps unsurprisingly, commonplace during Hedgeweek's research interviews.

"The biggest risk now is not market risk – it's counterparty risk," says Arianna Luna, COO of digital assets fund manager Campsor Capital, pointing to the technological advances in the crypto trading infrastructure – from finetuning option products and the proliferation of OTC options desk, to decentralised finance – as reasons for fund managers to be optimistic. "The opportunities are still available, but it's paramount, now more than ever, to balance potential returns and expected risks, especially counterparty risk."

How, then, to better address these risks? According to Novogratz, the events of 2022 should prompt fund managers to reassess the financial health of their counterparties and push for regular dialogue. "When evaluating exchange risk," he says, "due diligence should

Figure 1.3 Impact of 2022 events on hedge fund firms' interest in developing digital assets products



Analyst note: *Survey respondents were asked January and February 2023, 'How have events within the digital assets industry over the past 12 months affected your firm's interest in developing digital assets products and/or services?' Digital asset hedge fund managers are those whose flagship product focuses on digital assets.*

Source: Hedgeweek Readers' Survey Q1 2023

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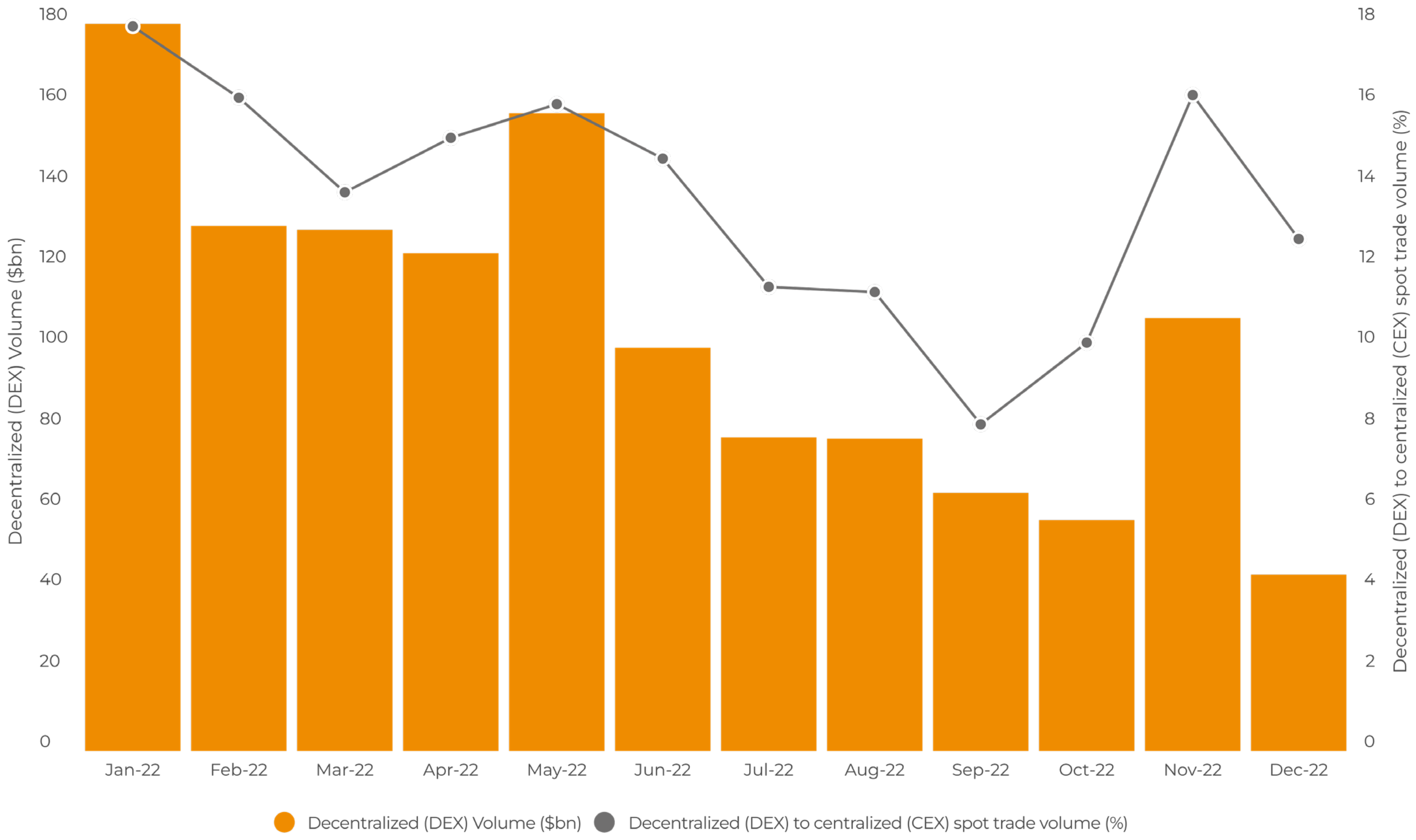
A big part of how the industry rebuilds trust is by stepping up and deepening due diligence practices

Mike Novogratz
CEO, Galaxy Digital

Figure 1.4 Trading volumes at decentralized cryptocurrency trading exchanges



Analyst note: *Decentralized exchange match buyers and sellers without the need for a centralized custodian. The DEX volume data includes spot volume of DEXs. Monthly decentralized exchange volume divided by centralized exchange volume (as a percentage). Includes largest exchanges with trustworthy reporting of exchange volume metrics.*

Source: The Block, The Graph, CoinGecko include a close look at the firm's financials and if they are audited, whether the exchange provides proof of reserves, and more details on governance and controls, including whether the firm employs a chief risk officer or utilises an independent board of directors."

Roland Roventa, Bouaynaya's co-portfolio manager at Altana Wealth's digital assets fund, sees signs of progress through exchanges releasing the proof of assets Novogratz mentions, and "custodians launching off-exchange settlement solutions".

The rise of DeFi?

Roventa – and other interviewees – also point to the increased trading volumes at decentralised finance (DeFi) exchanges following the FTX collapse as a welcome shift away from centralised finance (CeFi) and towards the DeFi ecosystem. DeFi's proponents – easy to find, with decentralisation being at the core of the entire crypto ethos – argue that this is a positive step for the industry. Traditional investors will need convincing.

In November, trading volumes at DeFi exchanges hit $107bn, up from $57bn in October (see Figure 1.4). Those trading volumes, though, have since normalised. "While DeFi exchanges and liquidity providers have been discussed as a potentially attractive alternative to CeFi, operational, legal and regulatory considerations have inhibited material migration to these platforms to date," explains Travis Williamson, head of Hedge

Damage limitation

Writing for clients in November 2022, Albourne Partners' Travis Williamson, head of Hedge Fund Investment Due Diligence, and Steven D'Mello, Partner, senior operational due diligence analyst, said that a confluence of factors had limited the damage from counterparty exposure to FTX for some managers:

- FTX did not pass every manager's counterparty due diligence framework, given the opaque nature of the relationship between FTX and its hedge fund, Alameda Research, and the lack of robust financial reporting and policies. Additionally, managers may not have needed to use the type of leverage that the FTX platform facilitated.

- FTX.com was challenging for some US-based fund managers to access (FTX.com vs FTX.us). FTX.com offered derivatives and was not CFTC registered. For managers that did not have offshore traders or offshore entities, it was difficult to access the FTX.com platform.

- FTX.us did not offer derivatives and allowed withdrawals for a longer period of time than FTX.com did, allowing some of those managers to reduce that exposure as events unfolded.

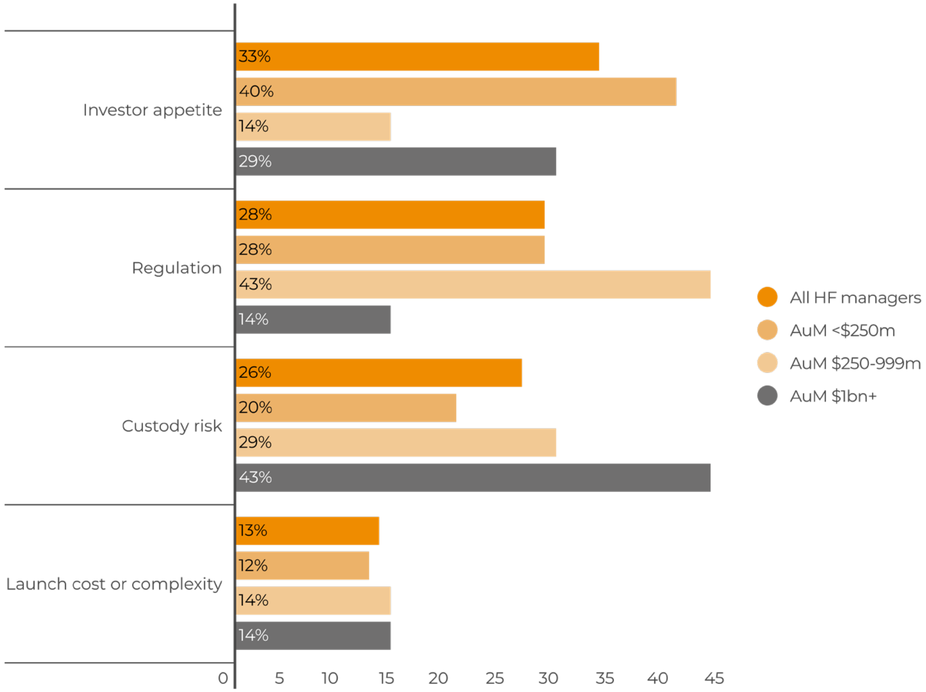
- Many managers reduce their exposure to exchanges as much as possible by sweeping assets off the exchanges into segregated trust accounts.

- There was relatively limited forced selling, as a large portion of the highly speculative investments in digital assets had been washed out after the collapse of Terra Luna earlier in the year.

- That being said, investors should be wary of clawback risk emanating from the FTX bankruptcy proceedings that may have the result of increasing exposure to FTX beyond numbers reported by fund managers.

"Traditional investors will need convincing.

Figure 1.5 Hedge fund firms' greatest obstacle to launching a digital assets hedge fund strategy currently



Analyst note: *Survey respondents were asked in January and February 2023, 'What do you see as the greatest obstacle to launching a digital assets hedge fund strategy currently?' Data covers all hedge fund firm types, including digital asset specialists.*

Source: Hedgeweek Readers' Survey Q1 2023

Fund Investment Due Diligence at Albourne Partners, co-writing for Hedgeweek with Steven D'Mello, a partner within Albourne's Operational Due Diligence team. "Until some of these considerations are resolved, usage of centralised counterparties will likely continue, and we expect to see fund managers continue to push for greater transparency from counterparties."

There could be a shift towards centralised exchanges that offer more transparency, Williamson and D'Mello add, but proof of reserves may lack granularity on the liabilities side of the balance sheet.

Ultimately, though, the pair believe that the impact of the FTX collapse on the industry, in crypto terms, "has been relatively muted compared to other events of this nature" (see boxout).

Of course, managers are just three months out from FTX – and nine from Terra Luna. There is much still to process and more consequences to come: not least the lingering impact on investor appetite for cryptocurrencies, the top-rated obstacle to launching a digital assets fund according to hedge fund managers surveyed by Hedgeweek (see Figure 1.5) and the focus of this report's second chapter.

"Failure to understand counterparty risk, custodial management, operational security, along with the lack of ability to audit code means that we will likely see some fund managers make crucial mistakes and lose much of their LP's money," warns Ray Ng, CIO at emerging crypto fund Alt-Tab Capital. "2022 should have been the wake-up call needed for the industry," Ng adds. "But, while I see some additional short-term vigilance, the hard lessons will be learnt through individual experience."

KEY TAKEAWAY

For managers | The implosion of subpar investment funds during the events of 2022, and the improved processes and greater appreciation for counterparty risk at those that remain, have actually set the digital asset hedge fund industry on surer footing. How long it takes investors to see that, is another matter.

BACK ON THE SIDELINES

Institutional allocations to digital asset funds – a genuine prospect this time last year – have been delayed again after the events of last year. But other investor types see opportunities.

In early 2022, Hedgeweek's last digital assets Insights report found an industry excited by the prospect of long-awaited institutional inflows. After years spent addressing credibility issues and building the foundations of an institutional-grade ecosystem, managers believed that larger investors were ready – finally – to make meaningful commitments.

Twelve months and several crises later, 80% of the hedge fund managers surveyed by Hedgeweek in January and early February 2023 said that institutional investors' appetite for digital asset funds has since weakened, including nearly half who said it had weakened significantly.

Respondents from non-digital hedge funds were more likely to say institutional interest had weakened significantly (54%) than digital asset hedge funds (38%), but the high scores for both groups suggest a general uphill struggle (see figure 2.1). Among larger hedge fund firms (AuM $1bn+), the proportion of 'weakened significantly' was higher still, at more than 70%.

As Galaxy Digital CEO Mike Novogratz explains, many investors last year "bought at bad levels" and "trust was damaged". He points to those institutions that entered the space late and suffered losses, such as some Canadian pensions, forcing them onto the side lines.

"Conversations with institutional investors have somehow slowed down," admits Arianna Luna, head of investor relations and COO of digital asset hedge fund firm Campsor Capital.

"Despite the collapses in the spring and summer, there was still significant interest from institutional investors and a desire to allocate to the asset class heading into the fourth quarter. But the FTX event was different – that undermined confidence in the asset class even if the issue lies with certain counterparties' governance structures and unethical behaviour rather than with the asset class itself."

Says Emil van Essen of Katonah EvE: "Investors are still interested but likely won't flock to cryptos until a new bull market happens."

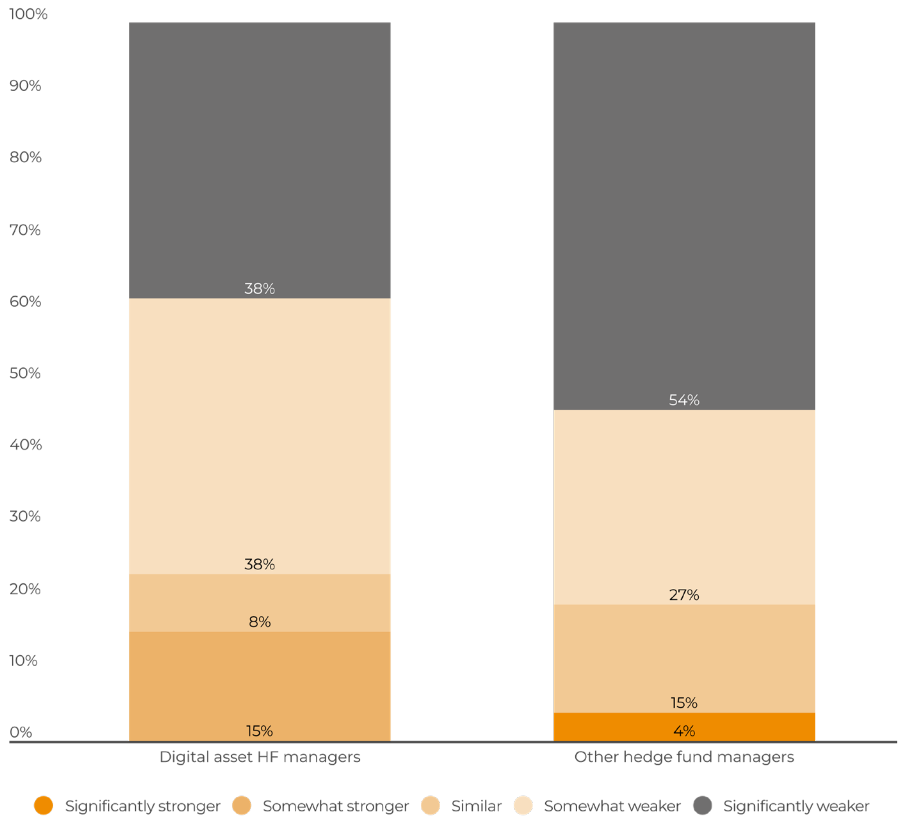
A solid start to 2023

Data from CoinShares had net investor flows into digital assets funds last year at $430m, the lowest annual total since $220m in 2018 (see figure 2.2). In 2021, net flows were over $9bn.

At the time of writing – on an industry that moves faster than most – the cryptocurrency market has made a solid start to the year, with strong net inflows and an uptick in retail volumes. "That's on the back of a lot of selling last year and the clearing out of excessive leverage," notes Novogratz.

In fact, bitcoin has just had its best-ever January, its price rising 35% last month, from under $17k to over $23k. "A few more months like that and those investors – who are looking for the bottom of the bear – are going to realise they have already missed it." says Michael Silberberg, head of investor relations at US-

Figure 2.1 Hedge fund firms' greatest obstacle to launching a digital assets hedge fund strategy currently



Analyst note: *Survey respondents were asked in January and February 2023, 'In your experience, how does institutional investors' appetite for digital asset investment products compare to this time last year?' Digital asset hedge fund managers are those whose flagship product*

Source: Hedgeweek Readers' Survey Q1 2023

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Investors are still interested but likely won’t flock to cryptos until a new bull market happens

Emil van Essen
CIO, Katonah EvE

based Alt-Tab Capital, an emerging digital assets hedge fund manager.

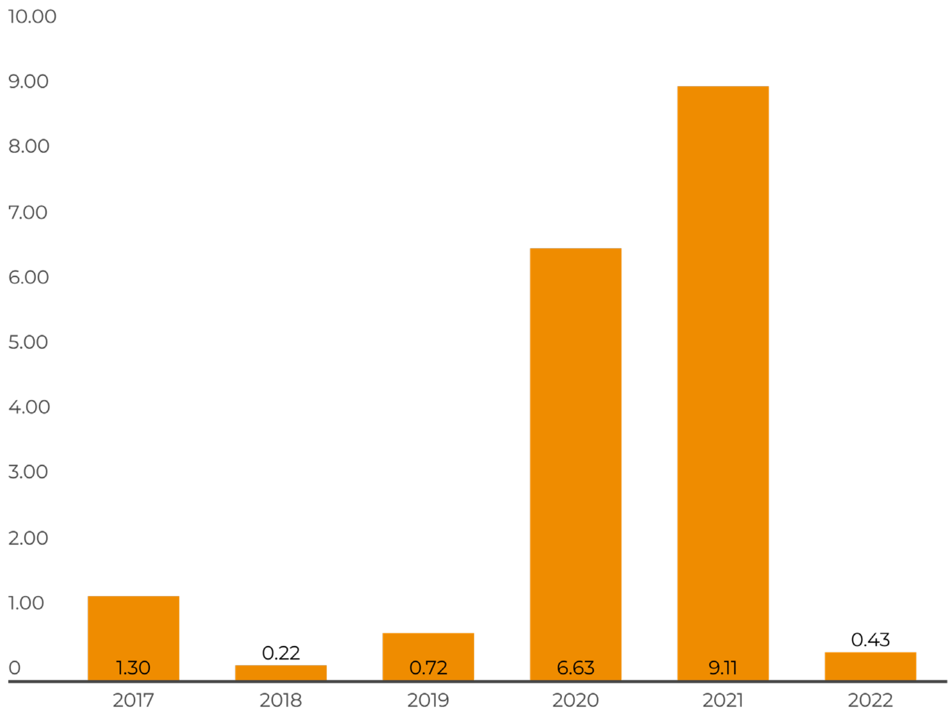
Silberberg distinguishes institutions entering crypto for the first time and those who have ridden through the previous market cycle. Allocators who have had exposure through the bear market of 2022 are waiting for more confirming signals to further allocate into the market, even as their pro-crypto thesis stays intact. However, many allocators who are looking to get in for the first time are excited by the price action in play and are moving quickly to gain smart exposure before the market's early recovery movement concludes.

By comparison, the 'crypto believer' institutions that were already in the market when it crashed will be slower to reinvest. They were burned badly last year, and their investments are going to need to recover, to some extent, before reinvesting. In short, those institutions that believe in digital assets but hadn't invested in 2022 are more likely to enter the market faster than those that had invested.

Institutional investors may be back on the side lines, but many others are making active enquires. According to Hedgeweek's recent survey, 46% of respondents said they had fielded a request from an allocator for a digital assets vehicle in the past 12 months, up from 39% this time last year (see figure 2.3). Among respondents at digital assets hedge fund firms, the 2023 figure was 69%.

Galaxy Digital is among the firms seeing opportunistic buying. "Investors who have

Figure 2.2 Net investor flows into digital assets funds, 2017-2022 ($bn)



Source: CoinShares

small positions feel now is a good time to start adding, while others who have long eyed the space feel they're closer to getting in," says Novogratz.

Savvier investors

Back in November 2022, a Hedgeweek survey of alternative investment allocators found modest interest in digital asset hedge fund strategies in the aftermath of the FTX collapse (see figure 2.4). None of the institutions surveyed had an allocation to digital asset hedge funds nor planned to, while at the other end of the spectrum, nearly one quarter of private wealth investors intended to increase an allocation to the strategy, reporting similar levels of interest to hedge funds generally.

As might be expected, smaller investors were the dominant source of enquiries last year for digital asset hedge fund managers – nearly 70% of those managers surveyed by Hedgeweek in January and February 2023 reported interest from smaller investors in the past 12 months (see boxout for more).

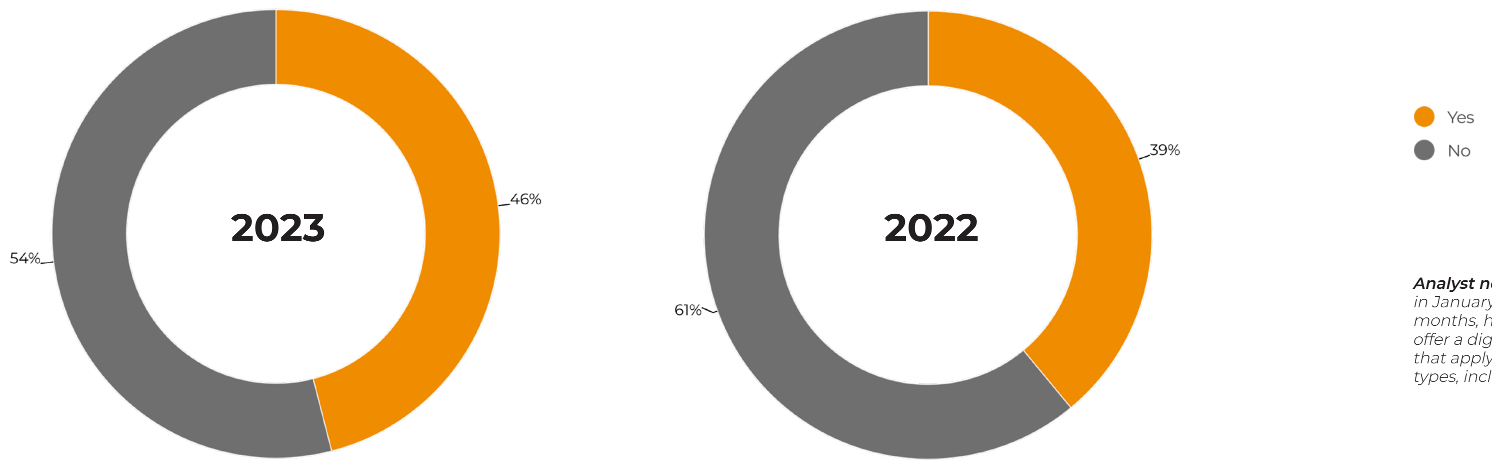
Fund of hedge fund (FoHF) managers, meanwhile, occupy a middle ground in terms of appetite for digital assets, according to Hedgeweek survey data. But for some, the asset class represents more than just an investment – it is an opportunity to provide added value, or even for reinvention, when the FoHF industry's very relevance remains a talking point.

Richard Byworth, the new head of liquid alternatives at Geneva-based Syz Capital, a provider of FoHF products, acknowledges that, with many traditional hedge funds now institutions in their own right, the need for investors to mitigate risk through FoHFs has become less salient.

"However, as crypto emerges as a new asset class, it brings with it many more challenges around wallet management, smart contract risk, insufficient hedging tools, and younger managers who have had typically little experience in traditional finance," he adds.

"A FoHF that can bring traditional operational

Figure 2.3 Hedge fund firms to field an allocator request for a digital assets vehicle in the past 12 months



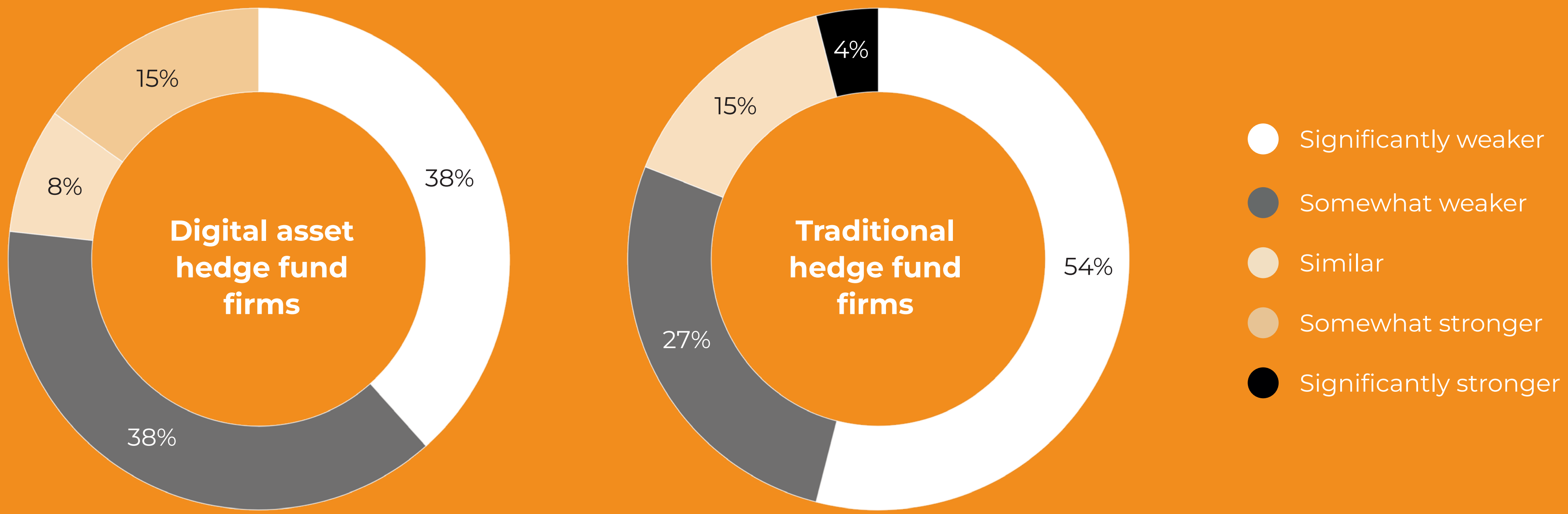
Analyst note: *Survey respondents were asked in January and February 2023, 'In the past 12 months, have you been asked by allocators to offer a digital asset vehicle? (Please select all that apply)' Data covers all hedge fund firm types, including digital asset specialists.*

Source: Hedgeweek Readers' Survey Q1 2023

KEY FINDING

Institutional interest in digital asset funds has weakened significantly

Change in institutional interest in digital asset hedge funds over the past 12 months, according to hedge fund firms.



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In fact, in most mature commodity markets, it is not necessary to custody assets to trade

Family office faith in market-neutral crypto strategies – is it misplaced?

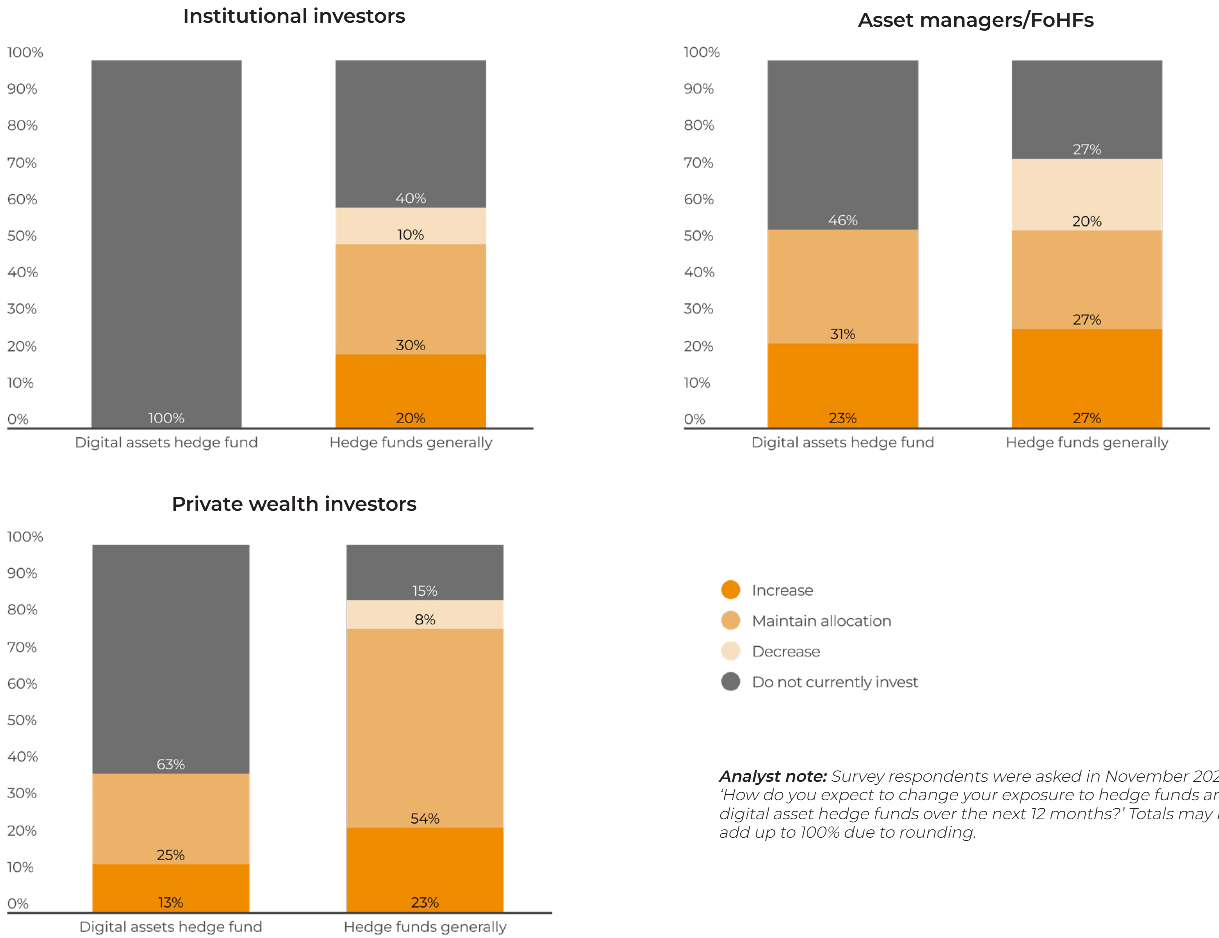
By Michael Silberberg, head of IR, Alt-Tab Capital

In 2022, we met with 100s of family offices, RIAs, and accredited investors, and one of the most common themes we heard was a desire for market neutral strategies due to the perception that these strategies are of lower risk. However, our analysis shows that, at the present time, this may not be the case. Why? Counter-party risk.

Let’s take family offices as an example. Family offices are generally considered to be risk averse; more concerned with preserving and growing their assets than pursuing high-risk, high-reward investment strategies. In theory, a strategy that would reap consistent, if not exponential, returns regardless of the market cycle would be perfect. The private credit market and real estate investment are generally highly represented across portfolios because they serve this demand exceptionally well.

Market-neutral strategies aim to minimise the impact of market movements on the performance of a portfolio. Most of these strategies leverage slight price differences in assets, markets, or time (convergence strategies) to take many small gains very quickly and are generally algorithmically traded to perform in this manner. For this type of trading to occur, these funds must have their assets nearly fully deployed on exchanges. In markets with mature and well-regulated exchanges, this is generally accepted. In fact, in most mature commodity markets, it is not necessary to custody assets to trade. However, in the emerging digital assets market, to trade cryptocurrency, it must be held on the exchange, which opens traders to counter-party risk. This is an existential risk to both funds and investors who choose to pursue the market-neutral path at the present time.

Figure 2.4 Investors' plans for digital hedge fund allocations in 2023, by investor type



Analyst note: *Survey respondents were asked in November 2022, 'How do you expect to change your exposure to hedge funds and digital asset hedge funds over the next 12 months?' Totals may not add up to 100% due to rounding.*

Source: Hedgeweek, Investor Interest 2023, December 2022

due diligence to this new industry, spotting red flags but also adapting to the new risks in those diligence assessments, provides valuable protection to investors looking to benefit from the extreme alpha available in crypto."

Education remains an important part of a digital assets fund manager's pitch. The crypto market moves quickly, and it can be difficult for those on the edges to stay informed. Even so, Campsor's Luna echoes the sentiment witnessed in several interviews saying investors – institutions especially – have become savvier on cryptocurrencies, with a notable improvement to one year ago.

"The education element is still there, but we're not starting from the basics any longer," she says. "We spend less time explaining the building blocks of the ecosystem and more time on the latest industry developments."

KEY TAKEAWAY

For managers | In an industry used to dramatic swings, digital asset fund managers won't be getting carried away with the strong start to 2023. However, a few more strong months, a savvier investor base, and some sensible regulation, mean the next signs of institutional interest could be the real deal.

REWARDS AND RISKS

It's been easy for digital asset hedge fund managers to look back of late. But what lies ahead? Consolidation, opportunity, and the looming question of regulation.

The consensus among crypto natives is that last year's events have disrupted, remodelled, and fortified the industry's foundations and created a trading environment rife with opportunity. Traditional hedge fund managers feel similarly, research suggests.

More hedge fund managers – crypto natives and traditional – plan to launch a digital assets fund now than they did 12 months ago. Last year, 31% of hedge fund firms surveyed by Hedgeweek in January were planning a launch. This year, it's 41%. Naturally, the 2023 figure is higher for crypto natives (62%), but the 31% of traditional hedge fund firms developing a new digital assets product (Hedgeweek research, see Figure 3.1) and the 38% now investing in digital assets (PwC research, published in June) suggest that, despite the disruption, there is real faith in the industry's future.

"Historically, digital assets have had four-year cycles, and we believe 2023 will be a time of consolidation," says Roland Roventa, portfolio manager at Altana Wealth's digital assets fund. Altana Wealth launched to outside investment in 2011 with a focus on FX. It began investing in cryptocurrencies in 2014 – one of the first London-based hedge fund firms to do so.

KEY FINDING

In terms of disruptive technologies, interest is shifting to tokenisation and ChatGPT

Disruptive technologies and themes that digital asset hedge fund managers are exploring:

✓ Tokenisation	✗ Broader artificial intelligence
✓ ChatGPT	✗ Big data

"Every bear market has created a higher low and built a base for the next expansionary phase," Roventa continues. "The current market provides investors a unique opportunity to find fundamental value in this emerging asset class at distressed prices."

Roventa describes Altana as "overly bullish on the future of digital assets long term" but "cautiously optimistic for 2023". Others, like Anthony Scaramucci, appear less cautious, more optimistic. His Skybridge Capital had a poor 2022 from losses on FX and cryptocurrencies but is betting bitcoin hits $35k this year.

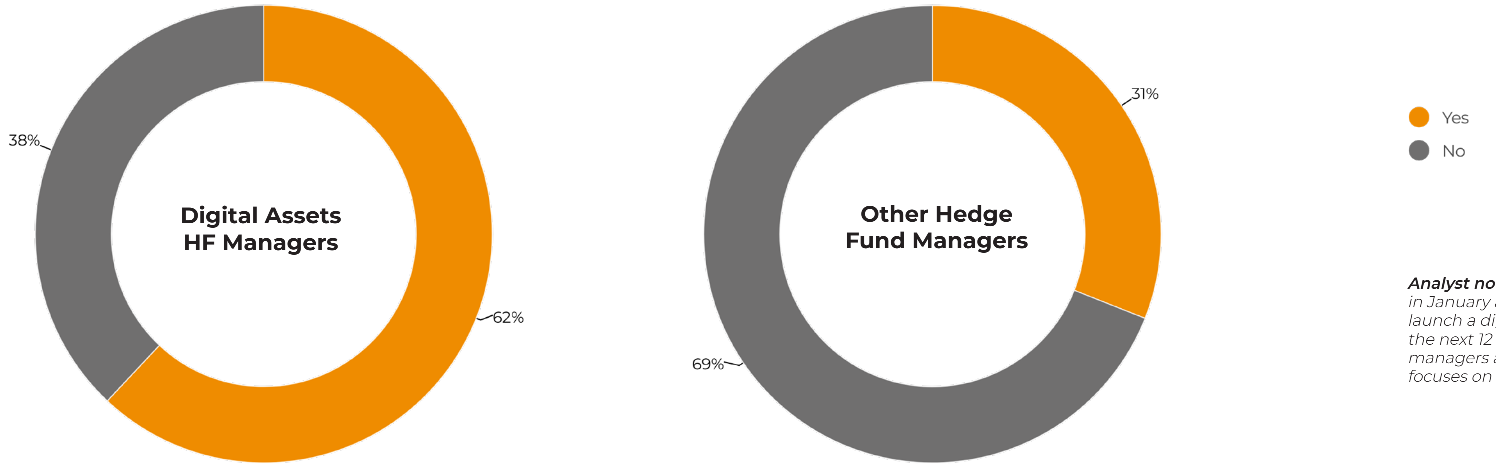
And many hedge fund managers agree. Of those surveyed by Hedgeweek – mostly in January, as bitcoin's price surged – more than 70% said they expected bitcoin's price to peak beyond $30k during 2023. Interestingly, respondents from digital asset specialist firms congregated around the mid-tier $30-40k band, arguably displaying the aforementioned 'cautious optimism'. Respondents from traditional hedge fund firms, meanwhile, were more likely to select a bullish (>$40k) or bearish (<$30k) option (see figure 3.2).

Opportunities through tech

As noted in a previous chapter, the crises in 2022 overshadowed some significant technological advances in the crypto trading infrastructure around options products and decentralised finance. In 2023, analysts expect digital asset hedge funds to seek opportunities for alpha in the growth of NFTs (non-fungible tokens) and Web3, and to benefit from the tokenisation of real-world assets and investment funds.

A tokenisation fund would effectively give retail investors the opportunity to invest in products

Figure 3.1 Hedge fund firms planning to launch a digital assets hedge fund strategy in the next 12 months



Analyst note: *Survey respondents were asked in January and February 2023, 'Do you plan to launch a digital assets hedge fund strategy in the next 12 months?' Digital asset hedge fund managers are those whose flagship product focuses on digital assets.*

Source: Hedgeweek Readers' Survey Q1 2023

with high minimum investments by buying a fraction – or token – of that larger investment rendered digitally on a blockchain. Last March, research from Token City found that 65% of fund managers thought hedge funds would be the most likely vehicle to first see significant tokenisation. More than 70% said private equity.

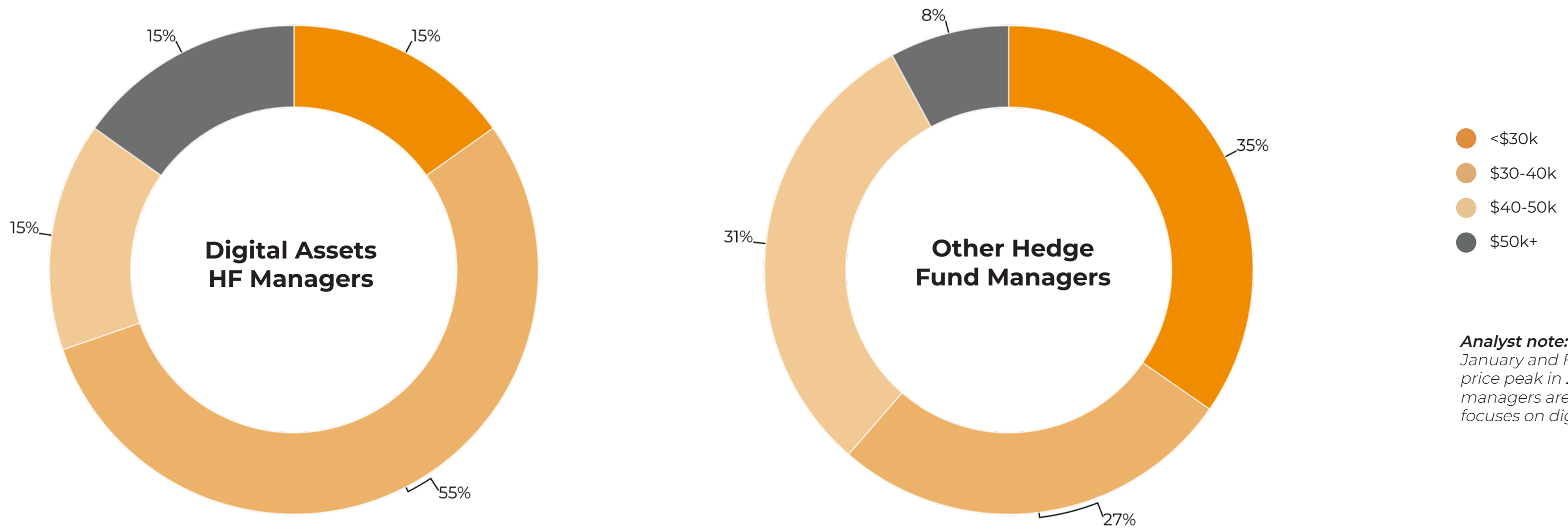
Several large private market specialists have made headlines in recent months by launching tokenised funds. These include $800bn investment manager Hamilton Lane, who announced in October plans to tokenize three funds through a partnership with digital-assets securities firm Securitize. It opened the first of these on the Polygon Blockchain earlier this month.

Tokenised hedge funds have been slower to materialise – or at least slower to make headlines. One of the few examples in the public domain is a global macro product run by Asia Genesis CIO Chua Soon Hock that was recently listed on ADDX, the Singapore-based digital securities private markets exchange.

A report last year from ADDX and global consulting firm BCG said tokenisation could be a $16 trillion business opportunity by 2030. It is certainly starting to capture the imagination of managers. The topic was the most cited example of an emerging 'disruptive technology' by Hedgeweek survey respondents.

In terms of what might be considered established disruptive technologies, digital asset hedge funds appear to have stopped developments around artificial intelligence (AI) and Big Data. Among the 38% of digital asset

Figure 3.2 Hedge fund firms' predictions for Bitcoin's price preak in 2023



Analyst note: *Survey respondents were asked in January and February 2023, 'Where will Bitcoin's price peak in 2023?' Digital asset hedge fund managers are those whose flagship product focuses on digital assets.*

Source: Hedgeweek Readers' Survey Q1 2023

hedge fund firms surveyed by Hedgeweek that do not currently use Big Data in a meaningful way, none planned to. Among the 62% that do not currently use AI/machine learning, only 8% planned to (see figure 3.3).

Of greater interest, for now at least, is ChatGPT – the chatbot from OpenAI made available to the public in November 2022. Nearly a third of digital asset hedge fund firms surveyed by Hedgeweek were exploring how ChatGPT could benefit their business (see boxout for ChatGPT's own thoughts on this). Incredibly, nearly 25% of digital asset hedge fund firms – and 11% of traditional hedge fund firms – are already using it.

Regulatory risks

Ultimately, though, all the technological progress, all the opportunities from an expanded trading toolkit, and all the cautious optimism for coin price could be eclipsed by the actions of one group – regulators.
According to Galaxy Digital CEO Mike Novogratz, the biggest risk to the digital asset hedge fund industry, particularly in the US, is around incoming regulation, which must balance protecting investors and the broader financial system with innovation. "If regulation ends up stifling innovation, there's the potential that the US's role as a leader in crypto adoption and innovation is ceded to other jurisdictions, some of which may be less friendly to US interests," he says.
So far, the US is yet to unveil formal plans for cryptocurrency regulation – though it is one of the few areas of policy that enjoys bipartisan

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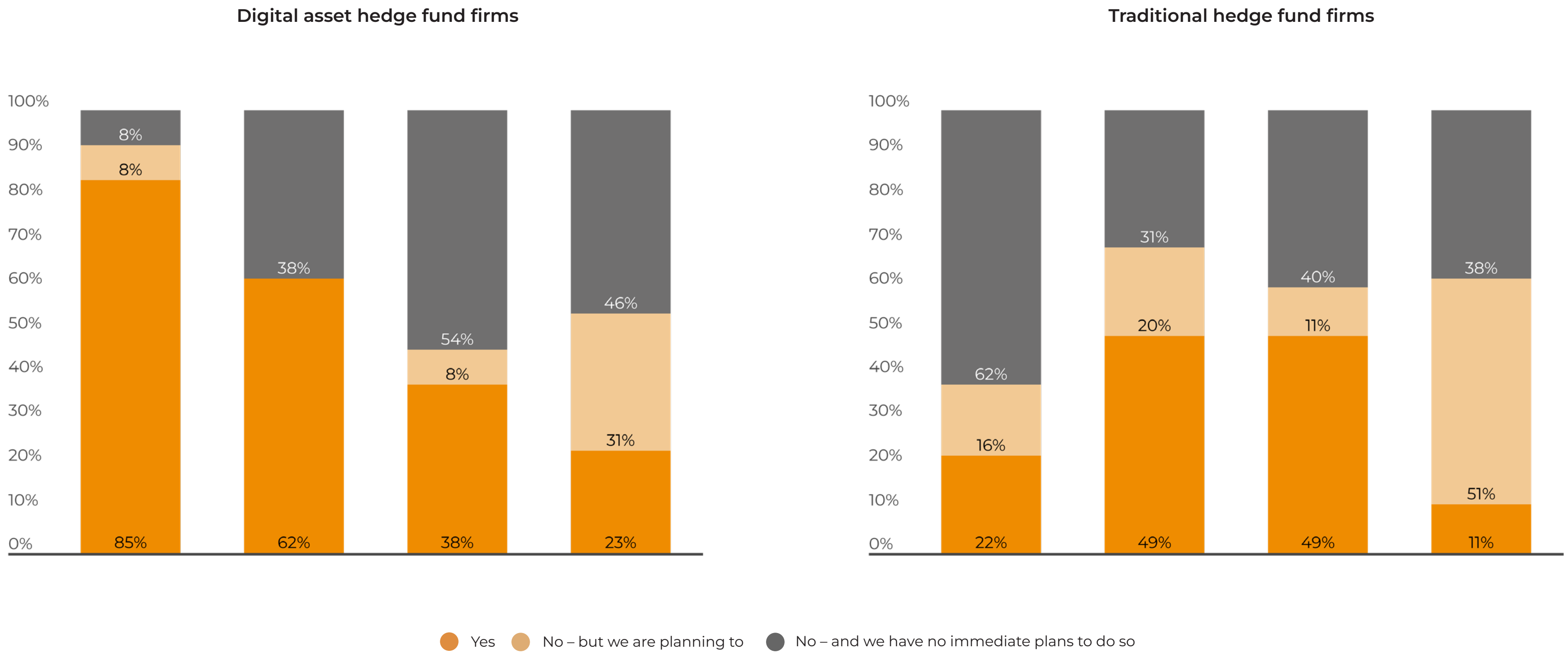
Nearly a third of digital asset hedge fund firms surveyed by Hedgeweek were exploring how ChatGPT could benefit their business

Figure 3.3 Digital assets hedge fund firms' use of selected disruptive technologies



Analyst note: *Survey respondents were asked in January and February 2023, 'Does your business use the following technology in a meaningful way?' Digital asset hedge fund managers are those whose flagship product focuses on digital assets.*

Source: Hedgeweek Readers' Survey Q1 2023

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The FTX event highlights the need for a globally coordinated regulatory framework

Travis Williamson
Head of Hedge Fund Investment Due Diligence
Albourne Partners

Steven D’Mello, Partner
Senior Operational Due Diligence Analyst
Albourne Partners

How could a cryptocurrency hedge fund benefit from ChatGPT?

We asked ChatGPT that very question. This was the (almost instant) response:

"A cryptocurrency hedge fund can benefit from using ChatGPT in several ways:

1) Market analysis: ChatGPT can be used to generate market analysis reports by collecting and processing large amounts of data on cryptocurrencies and their performance.

2) Trading signals: ChatGPT can be trained to identify patterns and provide trading signals based on market data, technical analysis, and news events.

3) Portfolio optimization: ChatGPT can assist in portfolio optimization by analyzing the performance of different cryptocurrencies and making recommendations for rebalancing.

4) Risk management: ChatGPT can assist in risk management by providing real-time monitoring of market conditions and alerting the hedge fund of potential risks or opportunities*

By leveraging ChatGPT's ability to process and analyze large amounts of data, a cryptocurrency hedge fund can make more informed investment decisions and potentially increase returns.

*Note from Hedgeweek: it is difficult to see how this would work while ChatGPT has an information cut-off of 2021. In short, ChatGPT offers significant opportunities and has significant limitations."

support among US lawmakers, making movement this year likely. For now, confusion remains over whether digital assets should be the jurisdiction of the SEC or the CFTC. For its part, the SEC has been bringing enforcement actions on a case-by-case basis. Some US managers have accused the regulator of prioritising a piecemeal approach over the creation a proper framework.
The EU, by comparison, made steady progress with its Markets in Crypto-Assets (MiCA) throughout 2022 and is expected to have it take effect towards the end of 2024. Across the channel, the UK launched a consultation this month on its own legislation proposals, unveiled to mixed reviews in the aftermath of the FTX collapse.

The hope for all – meaningful collaboration between regional regulators.

The FTX event highlights the need for globally coordinated regulation, say Albourne Partners' Travis Williamson and Steven D'Mello.
A resultant framework should "increase transparency around reserves, ideally separating financing, custody, and trading into separate platforms, although this could be less likely to be achieved amidst the fallout from FTX."

They add: regulatory developments around stablecoins, such as MiCA, could also help participants manage counterparty risk by bringing more certainty around regulated stablecoins.

As one interviewee said to Hedgeweek, government regulation could significantly help or hurt the growth of the digital assets investment industry. For now, it is too early to tell which way the pendulum will swing.

KEY TAKEAWAY

For managers | If the future of digital asset hedge funds is being forged by myriad forces, counterparty risk is chief among them. The dust will take time to settle – and new regulation could yet stifle innovation – but the direction of travel seems to favour those firms with characteristics of both crypto nativism and traditional finance.

HEDGEWEEK

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