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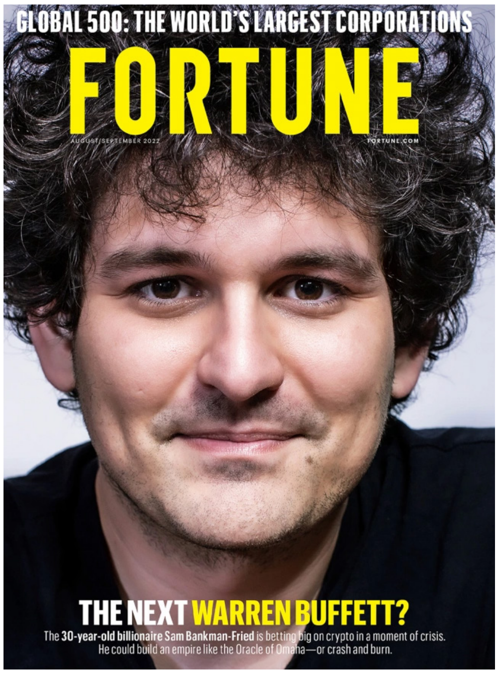
focus

Cryptocalypse: The Wild West of financial markets

Leading financial news headlines over the past week has been the collapse of FTX, the world's third largest crypto exchange. The pace of unravelling was stunning — in the space of a few days FTX has gone from a leader in the crypto economy with a US$32 billion valuation to bankruptcy with up to US$10 billion of customer deposits missing. The exact details behind the exchange's collapse are still being uncovered, however, it once again emphasises that crypto is the Wild West of financial markets where speculation and scams are rife and investors aren't afforded the protections they have in traditional asset classes.

FORSYTH BARR



What is FTX?

FTX is a Bahamas-based cryptocurrency exchange — similar to a stock exchange except for digital currencies. The company was founded in 2019 by its CEO Sam Bankman-Fried (often referred to as SBF) and Zixiao "Gary" Wang.

At its latest funding round in March, FTX raised US$400 million at a valuation of US$32 billion. The company's shareholders included high profile names such as Singapore sovereign wealth fund Temasek, venture capital firms Sequoia and SoftBank, Blackrock, the Ontario Teachers' Pension Plan, US football superstar Tom Brady, his ex-wife supermodel Gisele, and tennis player Naomi Osaka.

FTX grew rapidly. Its profile was boosted by prominent "brand ambassadors" including Brady, Gisele, Osaka, basketball stars Steph Curry and Shaquille O'Neal, Major League Baseball players David Ortiz and Shohei Ohtani, and "Seinfeld" co-creator and actor Larry David (they are all now facing lawsuits over their involvement). FTX also dived into high profile sports sponsorship including a reported US$135 million deal with the NBA's Miami Heat which included stadium naming rights, the Mercedes Formula 1 team, and Major League Baseball.

SBF, FTX's 30-year old CEO, was lauded as "crypto's golden boy" and the "king of crypto". At his peak it was estimated he was worth over US$26 billion.

The FTX collapse

The FTX meltdown happened extremely rapidly. Details of exactly what happened are still coming to light.

The main issue appears to be that FTX lent its customers' funds to Alameda Research, a cryptocurrency trading firm also founded by SBF. Customers were unaware their funds were being lent out.

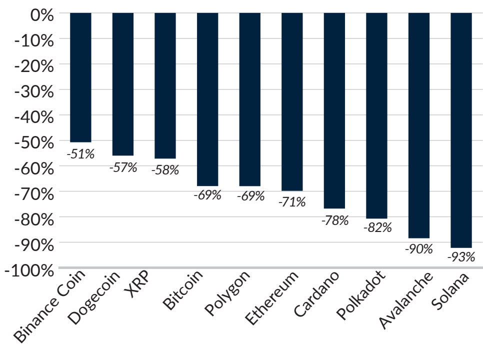
Early this month media reports raised questions around the relationship between FTX and Alameda. Those concerns triggered many customers to pull their funds from FTX — similar to an old fashioned bank run. As withdrawal requests mounted FTX froze redemptions due to insufficient funds. Due to trading losses, theft or other wrongdoings (it's not yet clear why) Alameda doesn't have sufficient money to repay its loans to FTX. The company declared bankruptcy, with around one million creditors left owed up to US$10 billion. Many FTX employees have fled the Bahamas, some abandoning their cars at the airport. Pending regulatory and criminal cases are mounting quickly.

The Wild West of financial markets

The FTX saga adds to crypto's horrible year. Pretty much all digital currencies have plunged. Bitcoin and Ethereum, the two largest, are both down -77% from their November 2021 peaks.

...FTX is a strong reminder the industry remains the Wild West of financial markets...

CRYPTOCURRENCIES RETURN YEAR-TO-DATE



Source: CoinMarketCap

FTX is the latest in a long list of crypto frauds and scandals, and is a strong reminder the industry remains the Wild West of financial markets. The industry lacks the regulations and investor protections afforded in more established asset classes.

Furthermore, there is limited transparency into the financial health of many of the companies operating in the space — they do not disclose their accounts. Many are devoid of basic management processes and financial controls. Despite FTX having raised US$1.8 billion from external investors it had no independent persons on its board of directors. The early observations of the insolvency lawyer brought in to run the company have been damning:

> *"Never in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information as occurred here. From compromised systems integrity and faulty regulatory oversight abroad, to the concentration of control in the hands of a very small group of inexperienced, unsophisticated and potentially compromised individuals, this situation is unprecedented."*

Crypto is a sideshow

For the many thousands of crypto investors who held assets with FTX there will be financial pain, but for the broader economy ructions in crypto is nothing more than a sideshow.

Despite the extensive media coverage it attracts the crypto universe isn't actually that big. The total value of all cryptocurrencies peaked at around US$3 trillion. Today it's about US$850 billion. That sounds large but to put it in perspective it's about half the size of the Australian stock exchange, a third of the market cap of Apple, the world's largest company, 7% of the world's gold reserves, or 0.8% the size of the world's stock markets.

Crypto is not systemically important to the broader economy. If all of crypto went to zero from here, it would be roughly similar to the drop in the market cap of Meta (the company formerly known as Facebook) - one single company - from its September 2021 peak.

Does crypto have a future?

The latest scandal is leading some to ask "does crypto have a future?". It's the sort of question that typically generates passionate responses both in the affirmative and negative.

We can't speak for everyone at Forsyth Barr but, in our opinion, 14 years after the launch of Bitcoin, a huge amount of hype, and a lot of investment, speculation followed by scams and money laundering remain the principal use cases for cryptocurrencies. There is yet to emerge a compelling use case to launch them into the mainstream. (We see it as a more plausible notion that the underlying blockchain technology — secure databases — will find use cases, for example in the infrastructure of the financial system. This is different from speculative tokens or coins that run on blockchain technology.)

Speculation déjà vu

While all investing involves taking risk, it should be measured risk balanced against the potential reward. "Investing" in assets like crypto which don't produce any cash flow and have no underlying intrinsic value makes this assessment highly challenging (at best). The only way you make money is if the price people are willing to pay climbs higher and higher (this is different to a stock where a company's earnings can grow over time).

Undoubtedly there are some who have made huge returns from crypto — and those "get rich quick" opportunities can sound appealing — but they are a minority. Crypto has been very effective in shifting money from many to a few — around 80% of current Bitcoin owners are underwater on their entry price.

The risk investors are bearing is compounded by the lack of regulatory or governance oversight. You are reliant on the motives and capability of a few individuals without the checks, balances, and protections from rules and regulations, public financial disclosures, and independent directors. How many crypto investors really investigated or understood these risks they were taking? Support from sporting stars, actors, and social media influencers should be taken more as a red flag than a reassurance.

As long as there have been financial markets there have been speculative fads — Dutch tulips, the South Sea Company, canals, railways, the Nifty 50, 1980s Japan, dot.com stocks. We believe there's a decent chance cryptocurrencies will be added to this list. Despite the substantial plunge in cryptocurrency prices, our view remains buyer beware.

Matt Henry
Head of Wealth
Management Research

If at any time you want to discuss investment options and opportunities, your Forsyth Barr Investment Adviser is available to provide you advice and assistance.

0800 367 227

forsythbarr.co.nz