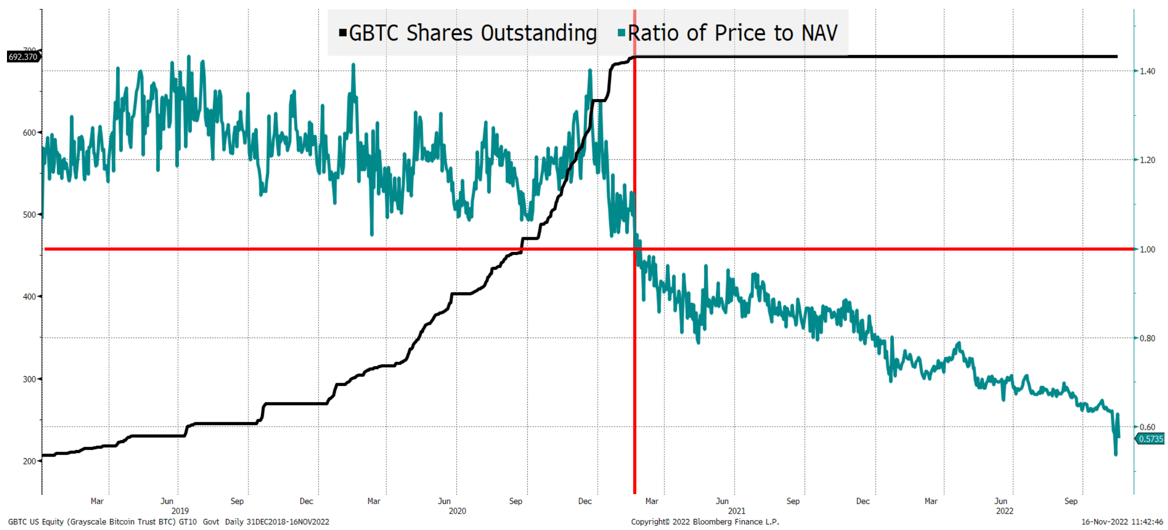
Quick Thoughts on GBTC

In many ways the Grayscale Bitcoin Trust has been a part of the bitcoin story. It was one of the easiest ways for retail to get exposure to bitcoin without needing to figure out keys or use obscure entities. Even as that edge dissipated over time (as many platforms were created making it easier to get access to bitcoin) GBTC remained relevant since it traded as a CUSIP, and people could easily hold it in brokerage accounts. However, it is not an ETF. If it was, the 2% fee would make it one of the biggest revenue generating ETFs out there. Even now, at around $10 billion in value, 2% is not chump change. I have no idea if they charge the fee on the current price or NAV or if there are other fees to be paid.

It also allowed a lot of sophisticated players to make money in the "arb" space.



I use the term "arb" very loosely, but creation and redemption of additional "units" (probably not the correct legal term) are determined by the manager of the trust. Most ETFs have "create and redeem" processes in place designed to keep the ETF trading at close to fair value. That is easier to accomplish in equity ETFs compared to high yield bond ETFs, but it exists.

So, until early in 2021, GBTC traded at a premium. Periodically, new units would be created. Fund total assets peaked at just over $40 billion in April (and November) of 2021 and $40 billion * 2% is a big number.

The "trade" was to short GBTC to "retail" and then buy futures or bitcoin spot. One would then hope for more units to be created (which would at least temporarily reduce the premium), thereby allowing "smart" money to profit from their trades. My understanding is that this trade was incredibly more complex and difficult to execute than a traditional ETF arb. While the trade included issuing more units, the incentives of the trust operator and the "arbitrageurs" were aligned (by creating more units, they could expand the base on which they were charging the 2% fee). This was perfectly logical and perfectly reasonable.

The "arb," which could work in one direction, does NOT work in the other direction. There is little reason for the trustee to reduce share count as that just eats into their revenue stream. It is not a coincidence that since the month that GBTC crossed from trading at a premium to trading at a discount, the share count has remained unchanged!

What Does it All Mean?

There should have been a window of extraordinary profits if you were short GBTC and long bitcoin as the positions worked out well. Even without unit creation you could just buy GBTC on the open market and sell your bitcoin to close out positions.

I cannot tell if some people tried to "arbitrage" this the other way. Go long GBTC at a discount and short bitcoin? Some may have thought that the trust would shrink in size over time, but that wouldn't have been logical, so let's assume no one tried that.

The other reason to try to "arb" it this way is the expectation that it would go back to trading at a premium (or even less of a discount). That seems logical if you made money by being able to close out trades the other way. Why wouldn't GBTC go back to trading at a premium? The people who would do this type of trade are the crypto experts and they do tend to believe in crypto, so the return of retail might even have been a "foregone" conclusion in their analysis.

However, it hasn't worked. The discount to NAV has basically gotten worse in almost a straight line. It is at a 37% discount as of noon EST today (better than the closing low of 41.6% just a few days ago).

One theory I've heard on why this trend has persisted is that some of the "hedge funds" that closed had this trade on and had to liquidate. That would force their liquidators to sell GBTC and buy bitcoin (somewhat supporting the price of bitcoin, while causing the discount to shrink).

So, what closes this discount?

I see four clear paths to the discount being closed:

1. Retail and institutional investors embrace bitcoin at these levels and decide that the discount to NAV embedded in GBTC is the way to express that bet (ARKK reportedly started buying GBTC recently, which would lend credence to this potential).
2. Bad positioning at "hedge funds" is over and so long as there are no more blowups in the crypto world, the selling from liquidations is also over (would be nice).
3. The operator decides to reduce shares outstanding dramatically. Personally I think that they would do this by buying them back in the open market and accumulating a large position, then terminating it and making a huge profit that more than offsets the lost income and would reduce the discount for everyone involved.
4. A "spot" ETF is created, which might put pressure on the owner of this to close it out quickly or to convert it to enable them to capture a part of the broader ETF market.

So, if you like bitcoin, this could be the way to nibble here!

I would be remiss to point out that Digital Currency Group has a stake in Grayscale along with a myriad of other investments in the space. I do not know the size of any of their investments or whether they have large or small stakes. It is also very common in this space for investors to own pieces of many companies as they spread their investments across a wide variety of opportunity sets. I only point this out because circularity is a theme that is coming up frequently in my thoughts on the space.

As a reminder, I'm more focused on the space because of the impact that I think it can have on markets and the economy rather than as an investment in its own right (though GBTC could be interesting in a stable market if the discount collapses).

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