Crypto VC Portfolio Management: Navigating the Opportunities and Challenges of Illiquid Liquidity

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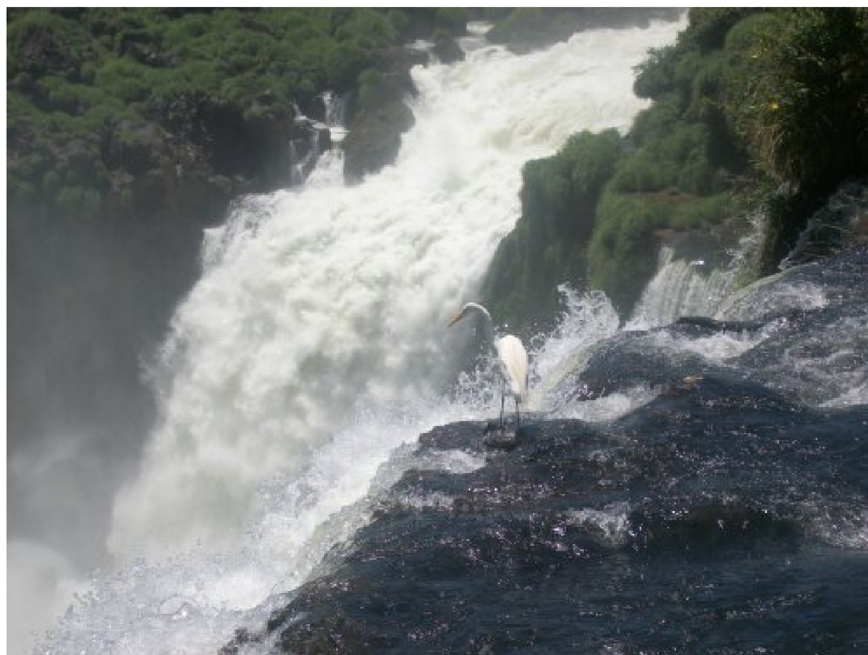

Not unlike this bird at waterfall's edge, crypto VCs may find themselves wondering how to deal with an abundance of liquid assets

Crypto VC Portfolio Management: Navigating the Opportunities and Challenges of Illiquid Liquidity

Portfolio management for traditional venture capital funds has historically been relatively straightforward. The big decisions are number of deals per fund, initial check size and follow-on/reserves strategy. For the small fraction of investments made by an early stage venture fund which hold IPOs, the manager also will need to determine a liquidity strategy for its public holdings post lockup. In the past, I was closely involved in the publics strategy at Greenspring Associates so have first-hand experience both managing this process and watching how a wide range of other venture managers have approached this challenge.

The public strategy will take into account factors such as 1) how liquid the stock is, 2) how much they own, 3) company performance and valuation, and 4) what is the fund's return on investment. Some funds will occasionally buy more at or post-IPO, but primarily the decision is when and how to sell. Further, a public company expects its venture backers to liquidate their holdings in a prudent fashion post-IPO (unless it's a pre-revenue life sciences company) given the fund's hold period has likely been at least several years.

Decisions around these public holdings for an early stage fund can be important to its success, as IPOs typically represent successful outcomes and thus large positions. But for a given fund, there will be a relatively small number of, if any, public holdings for which the manager needs to determine a strategy. And typically the only decision is when to sell, in which case no further reserves are required post-IPO. This makes the process of managing public positions rather simple, despite sometimes having high impact on fund performance.

For illiquid venture capital funds investing in crypto assets ("Crypto VCs" for simplicity sake), increased liquidity for an illiquid fund is a significant benefit but portfolio management can be more complicated. Especially if the liquid assets held are related to a network which is still "early stage" in nature. In my view, there are several challenges and questions which arise, listed below:

1. If Crypto VCs have achieved a strong return on a liquid asset but which is still at an early stage, when does it become prudent to sell and in what quantities?

1a. Should Crypto VCs maintain a long-term buy-and-hold approach or more actively manage liquid assets during a hold period?

1b. Will there be signaling risk if Crypto VCs sell early stage assets in the public market?

2. Should Crypto VCs liquidate under-performing early stage crypto assets and reinvest into more promising opportunities?

3. How should Crypto VCs manage reserves?

4. Relative to traditional VC funds, should Crypto VCs increase the ability to recycle distributions and reinvest capital in the LPA?

5. Should Crypto VCs have a shorter fund term if they are investing primarily in crypto assets?

6. Will the three-year hold requirement for GPs to have their carried interest taxed as long-term capital gains decrease alignment between Crypto VCs and their LPs?

Below, I have provided my thoughts on how Crypto VCs might approach these portfolio management questions related to liquid crypto assets.

1—If Crypto VCs have achieved a strong return on a liquid asset but which is still at an early stage, when does it become prudent to sell and in what quantities?

Fund managers holding liquid assets should always be thinking about how and when to get liquidity for Limited Partners. Certain managers have stated publicly they haven't sold a single crypto asset from their funds. This may be to show their dedication to the market, or more likely they want to differentiate from those who are flipping tokens once they are liquid. Regardless, while I appreciate their long-term commitment and the message which the public statement sends other entrepreneurs, there is no honor as a fund manager in holding just for the sake of holding.

Crypto VCs also cannot focus solely on short-term profits in making investment decisions while ignoring long-term ramifications, whether strategy or reputation oriented.

There two key levers that shape my thinking on how Crypto VCs should handle liquid assets which have achieved a sizable return but remain early stage: 1) future risk/return profile of the investment from the current valuation and 2) implementing a long-term strategy that both LPs and entrepreneurs expect.

The first lever, making investment decisions based on the risk/return profile, is not complicated. Fund managers in theory should sell or not sell liquid assets based on the potential future upside, risk profile, and level of conviction. Depending on the result, in some cases a partial sale could also make sense, to de-risk while retaining future upside potential.

However, investment decisions should not be made without proper context. The second lever is that venture managers need to keep in mind the expectations of both Limited Partners and entrepreneurs, specifically that they are aligned, long-term focused partners driving for big outcomes.

Limited Partners invest in venture capital, and specifically emerging categories such as crypto and blockchain, primarily in hopes of achieving outsized returns over a long hold period which is meaningfully in excess of their benchmark, typically either a public market equivalent or a fixed annual target return. LPs do not want their venture funds to be short-term traders. They want exposure to one or more of the massive outcomes that drive venture returns and make for high net fund return multiples to LPs (Facebook, Uber, Airbnb, etc.).

For example, it's a good outcome if a fund can achieve a 20x multiple on a crypto investment in two to three years once it becomes liquid. And if it is unlikely to achieve further material appreciation, then realizing some of the investment may be appropriate from a portfolio management lens, but that alone won't drive outsized fund returns. But if it's a high conviction investment with the potential to move from 20x to a 100x or 1000x return in another five or more years, that's the type of outcome that truly makes a fund. LPs want their venture funds to take their time, build valuable companies (or networks), and go for the home runs which can generate a 5x-10x+ net fund return to Limited Partners.

All this goes to say, if a venture fund is sitting on a liquid, early stage crypto asset which has provided a significant return to date, it should be careful not to sell too much of something that could be meaningfully more valuable in the future—LPs will be fine waiting.

Entrepreneurs also need to be considered when deciding on how to sell early stage liquid crypto assets. Similar to traditional venture capital, crypto entrepreneurs want their venture investors to be long-term partners who are committed to the future vision of the business or network and are actively providing value through guidance, introductions, network participation, etc.

If a traditional venture fund were to sell its equity holding in a startup after five years instead of waiting for the exit in eight to ten years, this

would damage their reputation as a valuable partner to entrepreneurs and hurt their ability to execute on promising deals in the future. It would also potentially be a negative signal for future investors in the business. This is especially the case for lead investors writing larger checks, whereas smaller funds who are not leading rounds and writing smaller checks may have more flexibility.

Blockchain and crypto venture funds need to maintain this same discipline and not sell out early just because they can. Even if it might be a prudent investment decision in isolation, if a Crypto VC decides to sell its holdings in a crypto network right away post lockup this may leave a bad taste in the mouth of the entrepreneur and thus impact the fund's ability to access other promising deals in the future. The future impact on a fund's reputation with entrepreneurs and the ability to consistently generate returns over several funds cannot be overlooked as portfolio management decisions are made.

2—Should Crypto VCs liquidate under-performing early stage crypto assets and reinvest into more promising opportunities?

One of the comments one consistently hears from venture capitalists is that they spend too much time with struggling portfolio companies that need a lot of attention, relative to the impact of those companies on their fund returns. This is natural, as the best companies often don't need as much time from their VCs once they are at a certain scale and trajectory. But, applying this to crypto networks, what if Crypto VCs could bypass this problem by selling their under-performing assets which carry low expectations and reinvest that time and money elsewhere, hopefully into a small number of the most promising investments from a given fund.

From a pure investment standpoint this likely makes sense in certain cases and should be considered by funds holding liquid crypto assets even if they are still relatively early stage. But revisiting the second lever from earlier, crypto VCs must determine if this will be consistent with the strategy LPs are paying them to implement and will it impact their standing with entrepreneurs such that it will impair future deal flow and access.

On the LP side, there should not be any issues. Doubling down on your best companies, in the vein of the Peter Thiel's power law, is a prudent

strategy aimed and maximizing long-term returns.

For entrepreneurs, I expect this will be more case-by-case for Crypto VCs to judge if there will be any impact to reputation. But in at least some cases, I expect that Crypto VCs could exit under-performing assets in a manner that does not significantly impair the network's value. And if they were otherwise good partners and expectations are low then other entrepreneurs will not blame them for selling early—especially if the venture fund is a sought-after partner.

As such, I would encourage venture funds holding liquid crypto assets to actively consider selling their lower conviction early stage assets and to reinvest in other higher conviction portfolio companies. It won't always be the proper decision, but it should at least be on the table.

3—How should Crypto VCs manage reserves?

The concept of holding reserves is tied to the way that startups have traditionally raised capital, namely a series of financings in which existing investors can and are expected to continue investing capital. So, if you invest in a Series A financing, you need to "reserve" capital in case you want/need to also invest in the Series B, Series C, etc. Typically, VCs might put 50% toward initial investments and reserve 50% for follow-on investments. Some companies won't raise additional financings so for the companies that actually use the reserves the total follow-on investment is, on average, more than the initial check.

For investments in private crypto assets, there may be multiple private token sales before an asset becomes publicly tradable on exchanges, but one does not expect the same quantity of financing rounds for which funds need to reserve capital. Thus, while there could be some reserves needed/wanted for future private sales, reserves for Crypto VCs becomes less about supporting the company and more about pure return maximization for the fund.

In my view, to adjust for a lower level of required reserves, there are three core reserve approaches Crypto VCs could consider: 1) increase initial check sizes and lower reserves, 2) do more deals per fund at same initial check size and lower reserves, or 3) maintain a traditional reserves strategy knowing that for liquid assets there may be the opportunity to increase positions in certain networks at attractive prices.

I would recommend option #3 above. Small initial check sizes help with risk mitigation, keeping large checks from being sunk into companies or networks that fail within the first couple of years. So, all else equal, writing larger initial checks is not desirable. Funds also should not increase quantity of deals in a fund than they currently find appropriate just because they can. This would lead to over-diversification, potentially a lower bar for investment, and make each successful investment less impactful.

Broadly, lower reserves would keep venture funds from following on as heavily in its best investments. I expect that there will be attractive opportunities for Crypto VCs to increase their holdings of early stage liquid assets through the public markets, and if implemented successfully that this can lead to higher returns for Limited Partners.

All that said, one outstanding question is if venture funds take early liquidity (whether full or partial) for some liquid crypto assets, would the ability to recycle that capital into other opportunities in part reduce the need for reserves? Its certainly possible, but there is no guarantee of early liquidity, so I would proceed with caution for the time being.

4—Relative to traditional VC funds, should Crypto VCs increase the ability to recycle distributions and reinvest capital in the LPA?

Yes. Regardless of the fund's intentions, it is prudent to maintain maximum flexibility in case the more actively managed portfolio management approach becomes warranted. Traditional VC funds usually can invest up to 110–120% of committed capital (via recycling of realized proceeds). While Crypto VCs will have to refine over time how much recycling is appropriate for their specific strategy, I would suggest increasing the reinvestment cap by another 20 percentage points to start for a fund that invests 100% in crypto assets, or pro rata thereof (i.e. another 10 percentage points for a fund investing 50% in crypto assets).

5—Should Crypto VCs have a shorter fund term if they are investing primarily in crypto assets?

No. Four to six years (if one assumes a six-year term and a two-year investment period) is not likely to be enough time to allow seed and early stage investments to mature sufficiently to consistently maximize value and achieve venture returns. Just because something is liquid it

doesn't mean you should sell. As such, I expect funds doing this to either extend way beyond the initial term or sell prematurely in certain cases and leave money on the table for Limited Partners.

6—Will the three-year hold requirement for GPs to have their carried interest taxed as long-term capital gains decrease alignment between Crypto VCs and their LPs?

In January 2018, a new law was introduced effective immediately dictating that an investment must be held by a venture capital fund for at least three years for the General Partner's carried interest to be treated as capital gains. Prior, the cut-off was a one-year hold period.

This new law clearly incentivizes venture funds of all kinds to hold assets for at least three years, in order to receive friendlier treatment on their carried interest. For traditional venture funds, the change is not significantly impactful, as most investments—especially the ones that outperform and generate most of the carry—require hold periods in excess of three years anyways.

For Crypto VCs, however, holding assets which become liquid more quickly may lead to situations where its ideal to sell investments in less than three years, including those which generate meaningful carried interest for the General Partner. In this scenario, GPs may be incentivized by tax considerations to hold assets longer than would otherwise be optimal for LPs. It also means that GPs could be less likely to implement a more active management strategy for liquid crypto assets unless the alpha generated provides incremental carried interest to at least offset the change in tax treatment. On the positive side, this should deter Crypto VCs from trying to be traders or pursuing a strategy of doing quick flips of newly liquid crypto assets.

There is no answer to the potential for lack of alignment in certain cases and it would be naive to think that the GPs of Crypto VC funds are not keenly aware of how their carry will be taxed in different situations. One would hope that GPs will prioritize the interest of Limited Partners, both as high integrity stewards of their capital and due to their fiduciary duty to Limited Partners. But Limited Partners will clearly need to be vigilant to ensure that Crypto VCs are reminded of this and manage portfolios to optimize LP returns.

Conclusion

I do not believe there is “correct” approach to Crypto VC portfolio management in the age of increasing liquidity which applies consistently to every situation. Over time I expect certain best practices will emerge. But I believe those who are more proactive in determining how they can use the increased liquidity of crypto assets to their benefit will be able to generate alpha in the process. First time venture funds are often prone to portfolio management mistakes in the traditional venture world and I fear that without proper forethought that many within the blockchain and crypto world will also learn the hard way. Its important that Crypto VCs consider these topics as they establish funds and that LPs cover them in their diligence efforts, to ensure funds are structured properly and GPs are thoughtful in their approach to portfolio management.