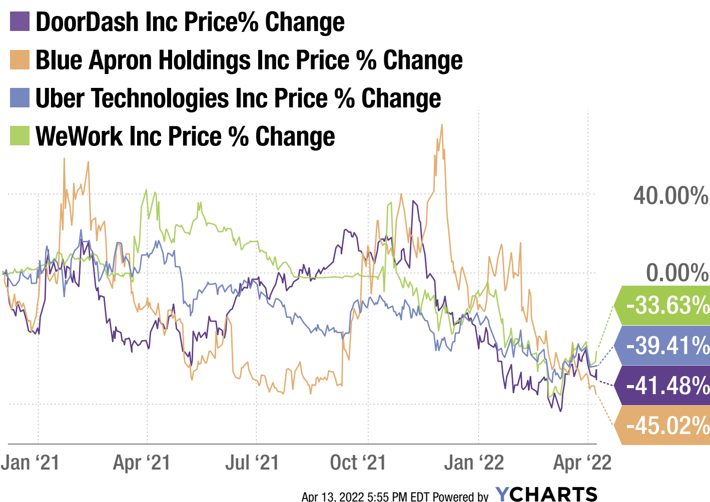
ILLIQUIDITY PREMIUM

While markets around the world have stabilized considerably since the early days of the Russian invasion, uncertainty still reigns. With the Ukrainians holding their own and possibly even winning, the risk for some kind of serious escalation or geopolitical accident goes up and up with each passing day. Meanwhile, the world order is changing before our eyes, inflation is raging and the Fed is tightening. Even COVID, which seems like a distant memory here in the US, is still a serious global problem. As I write, Shanghai, one of the largest cities in the world, is under an extreme form of lockdown. Make no mistake, this is no time for complacency.

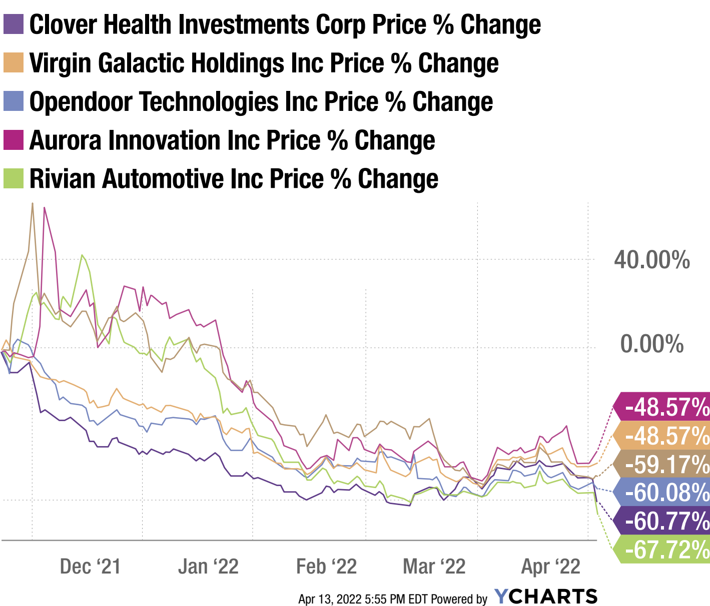
Looking at recent price action, the market seems pretty resilient. But behind the headline numbers there's something else going on and I think it's kind of a big deal. For some reason, there's this large and growing disconnect between private market and public market valuations. It feels as-if the public market is rejecting whatever it is that is driving the private venture market psychology. I first picked-up on this from a research note put out by ARKK, which pointed out that over 1/3rd of the companies that IPO'd over the last 4 years are trading below their previous private market valuation rounds. ARKK by the way might hold the record for the fund that went from the most loved to most hated in the shortest amount of time. It was just a few months ago when we are all talking about the "exponential age" and celebrating Cathie Wood as a visionary. Things sure change quickly, don't they?

ARK Innovation ETF Price

Let's put that story aside and look at some of the charts. Here's one of some of the more high-profile IPO's in recent history:



This is a terrible picture, suggestive more of companies in dying industries like coal than future tech titans. Something similar is happening with the SPACs, which were all the rage not too long ago:



Meanwhile, the private market is acting like nothing is wrong here. Just recently, Yuga Labs, a highly profitable but also rather speculative company raised at almost 10x sales. And a company called Ramp, which offers fintech type products for streamlining corporate spending, raised at an eye-popping 100x sales. Just what is going on here and does it make any sense?

There's this long-held idea in finance that the more illiquid a market the more likely the chance for a valuation anomaly. There's a certain logic to the idea—the more people actively buying and selling something the more likely it is that the valuation will be reasonably determined. Usually, this manifests an environment where illiquid assets tend to trade for less than they "should." This is where the whole idea of a liquidity premium comes from in the first place. Here we have something crazy happening—i.e., the exact opposite. The market is sending this clear-as-day signal to the private world—"Hey, we aren't buying into this!"—yet the private market doesn't seem to care.

To me, this looks, well, completely unsustainable. Either private market valuations have to start coming down or public market performance has to improve. Even for the well-established funds out there like Tiger Global, which was purportedly down something like 25% in the first quarter, this dynamic is existentially threatening. Given all the macro headwinds, I think it's unlikely to resolve in the form of higher prices for IPOs. A friend of mine is out raising a Series D for his regular (i.e. non-crypto) venture and is reporting that the fundraising environment is already decidedly more challenging.

As usual, things are different in crypto land. There, at least, the euphoric dynamics behind the illiquidity premium phenomenon are still going strong. Things have been going so well, for so long and companies have raised so much money, so quickly that a sort of internally reflexive dynamic has developed. What I mean by that is this: each successive raise in crypto is reflexively supportive of even higher future valuations because a big chunk of each raise goes right back into the crypto ecosystem.

This happens in all sorts of ways. The main channel is the proliferation of direct venture-style investments by startups. When you really stop to think about it, this is kind of crazy. In many cases, what we are talking about here is this: unproven teams and businesses taking venture money and investing it, not in their own company, but in those of other unproven teams and businesses. I almost cannot believe the VC funds are letting this happen. But they are and its happening a ton. Think how many crypto companies have their own venture arms. It seems like every day we hear about another one starting up. Some companies have raised so much money that they are even making big investments in already established businesses. Binance, for example, had enough money lying around to invest a mere $200M in Forbes and recently FTX announced that it is buying a "significant" stake in IEX Exchange, a very well-established traditional Wall Street player. Interesting, right?

My partner in our new CERES Fund, Alex Fleischman, who you all met here last month, clued me into another interesting dynamic at play. It turns out that in crypto land not all VC's are created equal. Yeah, yeah I know this is something that's always

been true but like many things in crypto the differentiation has taken on some new dimensions. Emboldened by the magical possibilities of tokenomics, a new kind of player has emerged on the scene: the pump-and-dump VC. Here's what Alex had to say about it:

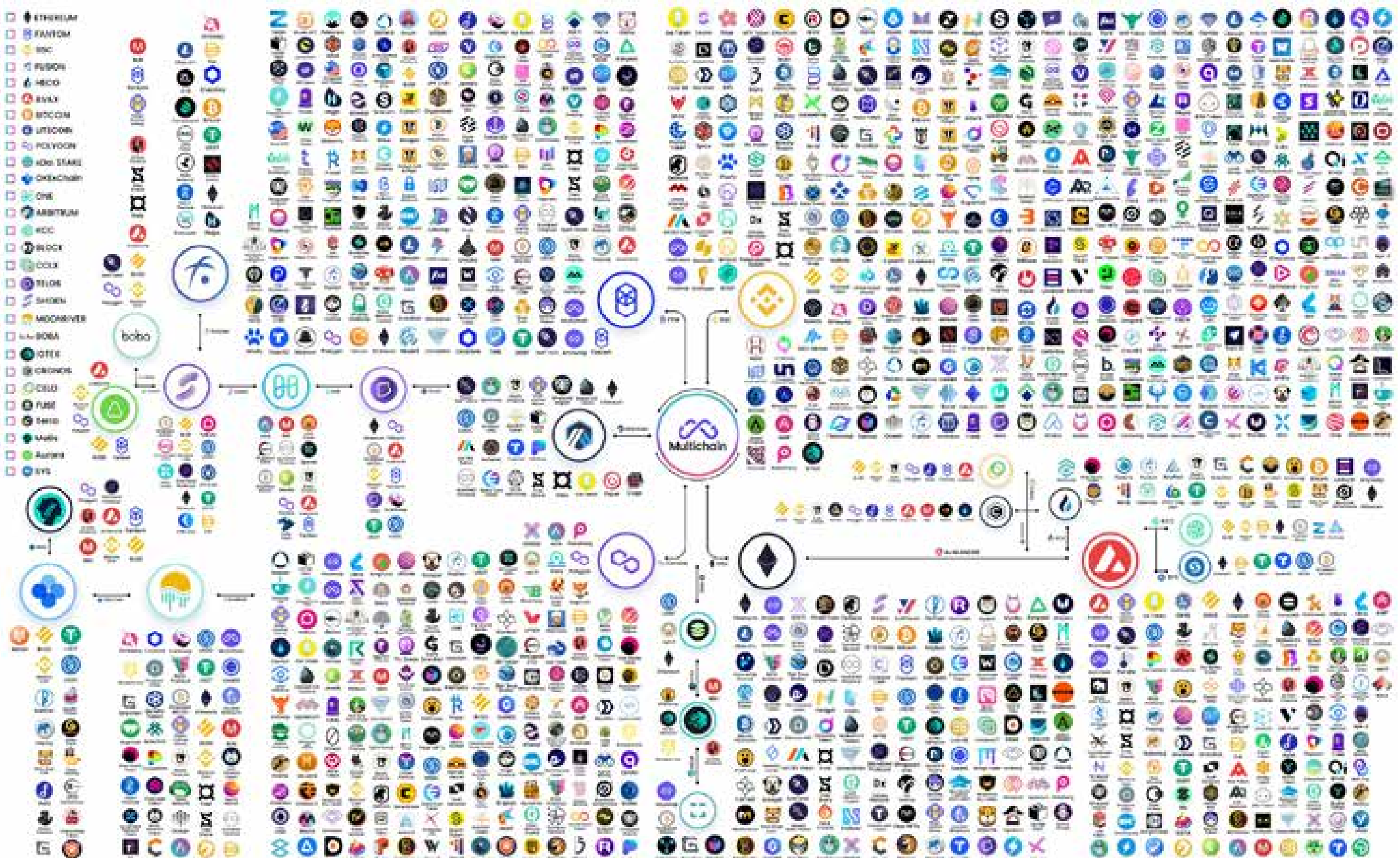
"Crypto VCs are generally split into two categories: pump-and-dump vs. ecosystem investors. The "quick pump" type VCs are throwing money at any project that has the potential to give them an immediate multiple and quick exit liquidity (build hype, launch token, retail becomes exit liquidity, rinse and repeat). There are still ecosystem investors seeking to improve the tech, though they're typically overshadowed during crypto bull cycles."

To be fair, there is a sense in which the pre-crypto world featured a similar dynamic—i.e., relying on the magic of the IPO market. But while the process was psychologically similar—that is, selling the dream to retail investors—ultimately it was quite a different animal. For one thing, it was actually regulated. And another, in the old days Wall Street firms cared at least a little about their reputations and brands. The "rug pull," an all too common move in crypto, is definitely something new.

And this is only part of the story. Crypto companies are also doing things like cross-advertising on each other's platforms and competing with each other for the best development talent. Of course, they are often paying in crypto as well. And when crypto founders get liquidity from one of these funding rounds, they almost always diversify their holdings into other projects and protocols rather than regular market instruments. All of this creates more and more demand for crypto, driving prices and valuations up and up. Crypto haters love to talk about how the whole thing is one big ponzi scheme. While I don't buy the critique, this self-reflexive dynamic is ponzi-like in that the continuation of higher prices and valuations is dependent upon ever more new money coming into the system. It's hard to tell right now exactly what could trigger a stop to all this but I think paying close attention to the general health of the venture funding ecosystem is a good idea. Yet another thing to put on the radar, I guess.

Moving on for now.

One of my biggest concerns about the whole Web 3 movement is the extent to which it seems to be evolving along some of the same key pathways as Web 2. There's no question, for instance, that the early years of crypto have been absolutely dominated by speculative activity. In some sense, the whole thing is one giant bet. There's more to it than that obviously but gambling is a key feature, just as it was in the early days of the internet. This is especially true since the onset of COVID. I don't know why but whenever I see charts like this it makes me think of the Tulip Mania:



One of the things that happened with the tulips is that people got all caught-up in the excitement about the potential for different varieties. Enterprising people started cross breeding tulips to create ever more exciting tulips, each with distinct and "special" features. The problem, back then at least, is that they were dealing with plants and had to wait out the winter to see any results. Of course, by the time spring came around it was too late! Many crypto investors find themselves in a similar position. They've bet on a project that has all sorts of interesting features and potential use cases but there's nothing really there quite yet. Look, there's much more to crypto than tulips but I suspect many of the hundreds of coins and tokens out there will be gone before too long.

To be fair, this speculative propensity is spreading beyond crypto. Just look at what happened in the world of online gambling. All the way back in 2018, a Supreme Court ruling paved the way by ruling that state bans on online gambling were unconstitutional. But it wasn't until COVID set in that things really took off. Last year, the American Gaming Association reported that online betting revenues hit $3.3B for the first 3 quarters of 2021, up a mere 624% from the comparable pre-pandemic period in 2019! Perhaps fellow investor Mike Effle is right that a kind of financial nihilism—or "finihilism"—has taken hold of our culture. When enough people feel like the economy is rigged against them and nothing seems to reflect value, speculating might make a lot of sense. While there are many, many problems with speculative fever, the one that concerns me the most is its addictive quality. If Web 2 was about addicting users with dopamine hacks, Web 3 is looking like a classic gambling trap.

A similar dynamic is emerging with the metaverse and the whole idea of user engagement. Recently, I had the opportunity to interview Janine Yorio, the CEO of Every Realm, the most prolific and well-funded of all the metaverse investors. In our fascinating discussion on Real Vision (well worth a watch by the way—here's a clip), Janine mentioned that they have already looked at over 300 metaverse projects! Which kind of blew my mind. The race for the future is fully on. Anyway, Web 3 proponents love to talk about how the decentralized nature of the underlying technology is going to somehow make things different from Web 2 when it comes to things like consumer protection and privacy. But in truth the commercial viability for any of these 300 metaverse projects comes down to the same old Web 2 metric: user engagement. The question is: are the metaverse developers going to do the same kinds of things the Web 2 companies did to juice user engagement? While Janine was careful about answering my questions about all this, in the end I think there was a tacit recognition that "user engagement" and "being addictive" probably go hand-in-hand.

Love it or hate it, one of things that's undeniable about the Web 2 era is the extent to which businesses pursued deliberately manipulative strategies. While this, perhaps, has always been a feature of capitalism—this is basically the point of things like marketing and advertising—it's never been as scientific as it is today. And it certainly doesn't help that the current state of technology has allowed us to create devices ingeniously well-suited to the task. In a sense, it's never been easier to manipulate consumers (and voters sadly). If you listen to crypto enthusiasts and the genuine Web 3 builders, you'll hear how we shouldn't worry so much this time around. But I don't buy it. Yes, the technology is different and more empowering of the individual, but Web 3 companies are ultimately going to face the same kind of pressures that produced the Web 2 behavior in the first place. One day all these companies are going to have to actually make some money, right? Otherwise, they'll have charts that look like the SPACs and the most recent round of IPOs. ▫