ICO Series Discussion 3

The Private ICO Investor As VC

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Given the hypothetical nature of this paper's hypotheses, investors will find this paper in the ICO Series Discussion more truncated. Nevertheless, it is hoped it makes for entertaining reading at the very least.

In the previous paper I discussed how firms are confabulating numbers raised in Initial Coin Offerings (ICOs). I suggested that the reason entrepreneurs might do this was to create the image of a successful ICO so that the tokens, once they reached market, would trade briskly. Inherent in this suggestion is the implication that a certain degree of premining is the driving force behind the confabulation, especially when we consider that the raise amounts frequently correlate with the listing value of the tokens.

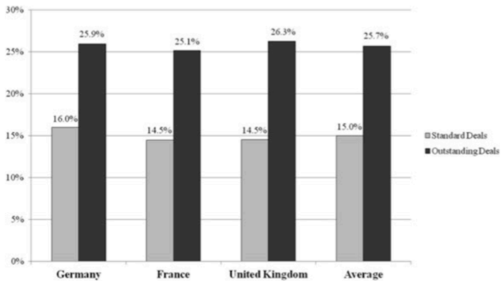
For example, suppose that a company was to indicate that they had raised $1,000,000 – a respectable sum (and, remember, the ICO average 90% of the time). In this case, $1 million would be the value that, ordinarily, via the DAO and Dutch Auction methods of raising money, the ICO would list at. Now suppose however that the ICO indicated it had raised $100 million, while still only having raised $1,000,000. Suddenly, the investors comprise just 1% of the total raise.

Who do 99% of the tokens go to then? Look no further than Venture Capital firms.

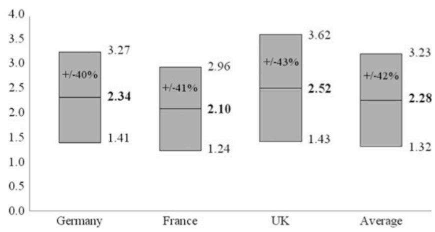
VCs are notorious for slicing pieces of private equity up and selling to one another at inflated prices pre- IPO. It is, after all, the only way in which one can guarantee in that game a liquid balance sheet; essentially, the game amounts to price-fixing with other VC firms. This is why the culture of VCs is deeply institutionalised; it is also why the investment landscape favours larger – rather than more innovative-looking – VCs in general.

Simply, the money made by VCs is not done speculating on fantastic innovations, but rather on passing around slices of private equity that everyone is talking about at inflated valuations. Rinse and repeat enough times and it amounts to what is a sort of Ponzi scheme of *venturetastic* proportions.

It is clear from the relative stability of capital investment levels in VC finance that some sort of pass-the-parcel game is going on.



Simply, one would intuitively expect that such an industry would, as indeed it does at the lower levels, experience bursts of investment and non-investment. This is because there would naturally be periods in which long passages of time passed before one was able to identify a suitably innovative investment. But this is not the case; in fact, the standard deviation of the average VC fund return holds up much more consistently than that of any other fund.



TVPI averages and (relative) standard deviations by country

The standard deviation of the S&P 500 is around 14%, depending on the year, with a targeted return of 8%-12% annualised. For VCs, the targeted return is about the same on an average deal, and about twice that on an outstanding deal. Thus, one would expect a standard deviation of around 20% or so per investment. Instead, standard deviations between the returns VCs get on their investments is roughly one-tenth the amount that public equity markets get.

The lower liquidity of such investments combined with the higher Beta (volatility) between performances simply doesn't match up at all with the logic that the returns between VC investments would vary so proportionately lower, unless some sort of price-fixing is going on.

It is impossible to imagine more evidence of foul play if one tried than these statistics. When VCs approach the world of ICOs, they do so with the same price-fixing mentality in mind. VCs have by and large encouraged the rise of the mega-ICO, which as I discussed in the previous paper, is most likely false. TenX, EOS, Chron, Bancor and others, all of which "raised" high 8-figure, and even, 9-figure sums of money in a matter of "minutes" were all VC-funded.

It is not just improbable these ICOs raised their stipulated amounts; it is on a practical level impossible. Conveniently enough, such giant raises however correspond with a very low level of external investor participation at the "premining" level. ICOs, for want of a better term, are basically the premine equivalent of coins: they are the chance to participate in ownership of assets prior to the sale of such assets on exchange. For a VC with an enormous premine and very few initial investors who participated at all in the raise to sell on open, there is literally nothing to stop him making hundreds of millions of dollars as he sells into a sharply climbing token price.

If all this sounds quite depressing, it doesn't have to be this way. For if it is possible for a VC to engineer a guaranteed return, then it should, in practice, be possible for any investor to do similarly. How might an investor community engineer their own free profit?

First of all, one would require a relatively cheap – or even free – participating investment in the ICO in the first place. This would limit potential liabilities and maximise potential gains.

One could potentially achieve this effect by selling discounted options at an ultra-low price and asking the investor community to send them in to swap them out for real ICO tokens while keeping the ICO token price nice and high to reflect a much greater post-ICO market value. Second, one would want there to be an infinitely greater sum of non-selling tokens than there were tokens for sale; at least 5 times the amount and preferably much more; maybe 20x-50x the amount of tokens would be "sold" at ICO.

These tokens would have to be kept safeguarded and not used to crash the post-ICO price of course, but providing that was the case, almost certainly there would be much more aggressive buying than selling. The investment community concerned could then freely offload their newly-inflated post-ICO tokens onto the market buyers of the tokens, who would quickly materialise. This is because many investors – the majority, in fact – only purchase tokens once they get listed on exchange: at that point, there is a steady stream of demand. Because the investor community engineering their VC-style "fix" on the ICO would hold a proportionately much lower percentage of tokens than that which was being purchased, they would be able to sell quite freely at the inflated price either as the price only declined a very small amount or even eventually as it started to rise.

Of course, this example is only hypothetical, and not to be taken literally, but it's fun to think of so many people in a community of investors counting their post-ICO returns like the idle boneheads of Silicon Valley. Unfortunately, the plan involves the requirement for a socially-responsible larger investor to hold the lion's share of tokens and be trusted not to sell at the higher price. If such an investor could be found, however, the small investor would be able to turn the ICO market into nothing less than his own private VC-esque profit bazaar. Φ