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INSIDE DIGITAL ASSETS
with RIC EDELMAN

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THE PREMIUM/DISCOUNT FEATURE OF DIGITAL ASSET OTC TRUSTS

If you understand this feature, you don't need to fear it.

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Buy $100 worth of bitcoin. Assuming the price doesn't change, and ignoring expenses, how much bitcoin do you own?

It's not a trick question, but yeah, it's a trick. You might be surprised to discover that you could own more or less than $100 worth of bitcoin. This article explains how this can happen.

If you mine bitcoin, or buy it directly from an exchange, the value of your bitcoin will always equal the price of bitcoin (ignoring expenses). But a different answer applies when you buy bitcoin via bitcoin OTC securities, often referred to as "bitcoin trusts." (This conversation actually applies to all OTC trusts of digital assets; we're using the term *bitcoin* as a catch-all phrase.)

These trusts look a lot like mutual funds, so don't confuse them with the kind of trusts that are associated with estate planning. Why, then, are they called trusts instead of funds? That question is not relevant to this conversation. Work with me here, people.

Although I'm not going to tell you why they are called trusts, I will tell you why the digital asset community has created them. There's just one reason, and it's the SEC's fault. To date, the SEC in its wisdom has refused to approve the creation of bitcoin ETFs. With that door closed, the digital asset community has used a window. And that window can be a trap door for the unwary or a launch pad for knowledgeable investors.

More on that in a moment. First, there's that ETF issue. There's an obvious need for a bitcoin ETF. Without one, buying bitcoin is a challenge. You could mine for bitcoin, but that's like trapsing into the woods to find some blueberries. People would rather just go to the grocer. So, forget mining. And going to the grocer – called an *exchange* in bitcoin parlance is also a hassle. Exchanges aren't familiar names, can be of questionable financial solvency, are cumbersome to establish, require

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connections to your bank account, are exposed to hacker risk, and force you to obtain and safeguard passwords or private keys which, if lost, could mean your bitcoin are lost forever. For most Americans, all this is rather scary.

But investors love mutual funds and ETFs; these securities have been around for decades and are offered by some of best-known companies in the world, including BlackRock, Fidelity and Vanguard, and thus hold tens of trillions of dollars for tens of millions of investors.

Since the SEC has refused to approve any of the many applications for a bitcoin ETF, the crypto community has released OTC-traded trusts instead. That's a reference to securities that trade over-the-counter, usually at OTCQX® Best Market (OTCmarkets.com). Although paying $100 for bitcoin at an exchange will get you $100 worth of bitcoin (again, excluding expenses), putting $100 into an OTC bitcoin trust could get you bitcoin exposure that's worth a whopping $500 or a teeny $50.

"Putting $100 into an OTC bitcoin trust could get you bitcoin exposure that's worth a whopping $500 or a teeny $50. "

How could this happen? Well, let's start at the very beginning which is, with thanks to Julie Andrews, a very good place to start.

With mutual funds, the share price is called the Net Asset Value; it's simply the total value of the assets held by the fund divided by the number of shares that investors own. For example, if the fund owns $100 worth of bitcoin and there are 20 shares outstanding, the NAV of the shares is $5.

Want to cash in your shares of a mutual fund? You don't really "sell" them; you "redeem" them – meaning you give them back to the fund company, which essentially erases them from its books and gives you whatever they were worth when doing so. Using our above example, if an investor redeems three shares, only 17 will thus exist and the fund's total assets will thus be $85. And all the outstanding shares will still be $5 each.

But that's not how a bitcoin OTC trust operates. Each of these vehicles raises money privately from institutions and "accredited investors" (wealthy individuals) via a "private placement;" the investors receive NAV shares of the trust, and the trust buys bitcoin with the money raised. After 6 or 12 months, the trust's shares trade OTC. Because the trust doesn't create or eliminate shares when they are bought and sold as mutual funds do, the OTC share value can deviate from the value of the bitcoin the trust holds.

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Indeed, if there are more investors buying shares than selling them, the price can rise above the NAV. This is called a "trading at a premium to NAV" or in shorthand, a *premium*. If there are more sellers than buyers, the share price can fall below the NAV. That's called "trading at a discount to NAV" or in shorthand, a discount.

And perhaps the most fascinating aspect of this phenomenon is that the price of the shares can – and often does – move independently from the price of bitcoin itself. In other words, the shares might rise while bitcoin is falling and vice versa. (This occurs when there are lots of buyers for the shares while there are lots of sellers of bitcoin and vice versa.)

Sound familiar? It ought to, because it's the same with closed-end mutual funds. But where those securities tend to trade pretty consistently at a small (under 5%) discount, shares of bitcoin OTC trusts have been known to swing from 500% premiums to 20% discounts. Yep, investors have been willing to pay $500 to buy $100 worth of bitcoin (huh?) while others have paid just $80 to buy $100 worth (cool!).

A Gambit

This premium/discount feature creates a fascinating opportunity for shrewd (aka aggressive) Accredited Investors. If that describes you or your clients, consider this strategy: You buy shares of the trust at NAV via the private placement – bypassing any premium or discount that might exist with the shares trading OTC.

Then, you wait a while (called a "restricted period" of usually 6 to 12 months). After that, you transfer the shares to a brokerage account and sell them OTC, same as all the publicly traded shares. If the shares are trading at a premium, you can sell them for a profit because you bought them at NAV – and this profit is independent of the price of bitcoin itself!

Say bitcoin is trading for $100 and you buy accredited shares at NAV. Say that a year later, bitcoin is trading 50% higher. Ordinary bitcoin investors have a 50% gain. But if the trust's share price is trading at a 75% premium, your gain would be 162.5%.

There's even a way for non-accredited investors to engage in this gambit. If the shares are trading at a discount, you buy them in the OTC market – essentially buying a dollar's worth of bitcoin for less than a dollar. If the discount shrinks or becomes a premium, you enjoy a profit that's independent of the price movement of bitcoin itself.

Of course, the gambit adds risk. Accredited investors buying shares at NAV via the private placement must wait for the restriction to end; during that time, the OTC trading price could become a discount. And although all investors can buy OTC shares while they're trading at a discount, that discount might grow instead of shrink, resulting in losses instead of gains. This has happened before and is an important risk.

Although some OTC purchasers of these trusts may not be aware of the premium/discount feature, many are – and I'm one of them, both as an investor and equity holder of sponsors. Why

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would I (or anyone) knowingly buy a product whose price might vary significantly from NAV? Lots of reasons, including:

1. In the absence of a bitcoin ETF, these trusts are the most convenient and transparent way to buy bitcoin within a brokerage account, which allows these securities to be seamlessly added to a diversified portfolio. That, in turn, allows for easy dollar cost averaging, rebalancing, recordkeeping and tax reporting;
2. If you're working with a financial advisor, use of these trusts makes it very easy for your advisor to assist you with all the above. As with the rest of your portfolio, your advisor can help you avoid costly mistakes;
3. The premium/discount feature offers an opportunity to enhance the profit potential, much like buying on margin;
4. When discounts have occurred, there have been large purchases of trust shares, which in theory should reduce the discount; and
5. Many sponsors of OTC trusts say they plan to convert the trusts into ETFs as soon as the SEC permits them to do so. If that were to occur, shares trading at a discount could be expected to rise to NAV. But the opposite is also true: any shares trading at a premium could fall to NAV.

These OTC securities have become a popular way for investors to gain exposure to this new asset class. As you consider these securities, either via the open market or private placement, be sure you understand the premium/discount feature.

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