diffusetap
Virtual Event Series

# Demystifying Crypto Yield

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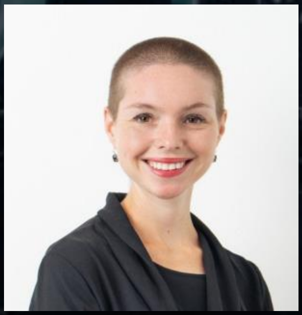

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# DiffuseTap: Demystifying Crypto Yield

Last time on DiffuseTap, Matt Leisinger, Product Lead at Figment, and Alyson Russ, Head of Business Development - Staking at Figment, talked to us about some of the hottest DeFi projects that generate massive yield, the risks associated with each, and understanding the infrastructure behind lending and staking.

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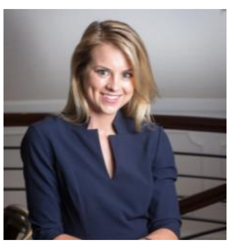
## DiffuseTap

This networking session is part of our weekly virtual events series. Networking (you'll bump into at least a dozen high caliber fund managers) meets purposeful (you'll tap into brand-new sources of ideas) … straight from your armchair like a boss.

## Meet the Speakers

Matt Leisinger is a senior director who has a strong background as software engineer, project leader, and team builder in the financial services industry. Currently he is the Product Lead of Figment, a staking, middleware, and application layer solutions provider that is building the infrastructure for token holders operating on proof-of-stake blockchains. LinkedIn: @matt-leisinger



Alyson Russ is an experienced consultant and business development expert with executive experience in a string of major traditional finance companies, including as vice president of Morgan Stanley and private wealth advisor at Goldman Sachs. She is currently the head of business development of staking at Figment. LinkedIn: @alyson-russ

## About Diffuse

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KENNY ESTES: The speakers of the day are Matt Leisinger and Alyson Russ. Matt, please introduce yourself.

MATT LEISINGER: Thanks, Kenny. Super happy to be on DiffuseTap. I am the product lead at Figment, where I'm constantly working on new products. I have spent about 15 years in the trading industry developing prop trading systems. I joined Figment about six months ago, and just love the crypto space. I'm happy to talk about DeFi and yield today.

KENNY: Great, thanks for joining. Alyson, do you want to give a little bit of your background and maybe a little bit on Figment as well?

ALYSON RUSS: Yeah. Good morning. I'm Alyson Russ. Thrilled to join you for episode 88. I joined Figment last year as well, and I sit on the staking side. We do a lot of things, but we are most well-known for our staking infrastructure, which we can talk about a little bit today. I work with hedge funds, VCs, and traditional asset managers, and I connect them into the proof-of-stake world. I grew up in the TradFi space. I was formerly at two large banks in portfolio construction for ultra-high net worth individuals and institutions.

AYLA KREMB: Beautiful. With that, we'll toss you right down the deep end. What we realize is that the definition of everything we talked about is always almost up in the air. So, we'd love to start with a simple thing. What on earth is DeFi? Especially when we think about yield generating projects in that context. Maybe Alyson you should go for it.

ALYSON: Yeah, I'll start. You're right. DeFi has taken on a new connotation in my personal experience. Traditionally, it means any sort of financial transaction that you would normally execute via a bank or a centralized authority but is now executed on the blockchain. Now, that can mean a lot of things. It can be borrowing, lending, insurance payments, market making, etc. All the benefits of the blockchain are open access, global, peer-to-peer, and decentralized.

I think over the last 12 to 18 months, people have been associating DeFi with a place where you can get outsized returns. But then, what does that even mean? In some ways, it's like a lot of people have lost sight of the fundamental reason why a lot of these platforms and opportunities exist. DeFi came out of the ICO bust of 2017 and 2018. And then later, 2020 and 2021 became really fundamental years. Last year in particular, we saw these outsized returns and growth in much of the crypto space. One quantitative metric that you can look at is TVL, or total value locked, which is essentially the value of crypto assets locked into these DeFi protocols.

We started 2021 at about $20 billion of TVL, and we ended the year at about $280 billion. It's a massive growth. Some of it was just the appreciation of underlying tokens, but a lot of it was also driven by the increased usage of these protocols.

KENNY: That's great, very thorough, Matt, anything you'd like to add to that?

MATT: Alyson covered it pretty well. But I think for many, the permissionless aspect allowed the retail audience to interact in ways that the financial markets weren't able to previously. Some of those aspects are participating in market making. If you said that retail would be participating directly in market making three years ago, it would have sounded crazy. I think that that is how we're seeing this hype, where a lot of these end users are getting first access into this type of market. It's really exciting from that perspective, and I think that's why we're seeing this type of growth.

KENNY: Gotcha. My background is market making and high frequency trading. In high frequency trading, apparently all I do is make markets. But now in DeFi, infrastructure has a very specific meaning. It's low Earth orbit satellites, microwave towers, and all those things. In the space you're playing, what does the infrastructure look like in staking DeFi? What are the key things to focus on when we think about infrastructure? Matt, I'll go with you.

MATT: I'll let Alyson take this one.

ALYSON: At a high level, as a non-technical person, I will say that most of the DeFi applications are built on Ethereum. We think that Ethereum will maintain the lion's share of activity. Last year, we did see some of these layer-ones get their foot in the door, like Solana, Avalanche, Terra, and a few others. They started to make a name for themselves, but it's still much smaller relative to Ethereum.

One of the reasons why we still think that Ethereum will maintain a stronghold is an upgrade that's going to happen on the network called the beacon chain merge. Transactions are currently verified on Ethereum via the proof-of-work consensus mechanism, which is mining. Most people are familiar with the mining concept, because that's how transactions on Bitcoin are verified. But Ethereum later this year is going to transition to the proof-of-stake consensus mechanism, where actual token holders are responsible for verifying transactions. And the rewards accrue to the token holders.

It's going to make Ethereum more scalable, secure, and sustainable. And obviously, those benefits also accrue to DeFi. We think that there are exciting opportunities in staking itself, and we also think that this new upgrade is going to further support the DeFi universe.

KENNY: I have to do a knock on that. I've heard a lot about Solana, Avalanche, and all of these Ethereum killers or competitors. Obviously, Ethereum is bleeding market share to them in a pretty significant way. Do you think that's reversible if they get the transaction fees back to a low price? I mean, for context, it costs a couple hundred bucks to do anything on Ethereum. Do you think that that is a reversible trend?

ALYSON: I think Ethereum has that first mover advantage, and I also think that it is still very much a trusted source for operations. However, we don't think it's a zero-sum game. On a company level, we support Solana in all of these other proof of stake networks. But part of the start of the beacon chain merge is to address some of these problems that you mentioned, and how expensive it is to interact on Ethereum. We're long term bullish that it's going to occur, and it's going to benefit the network in the long term.

MATT: Just to touch on that a little bit. We're seeing a lot of what they call layer two protocols that are coming in. And essentially, because it's so open, we start to solve that scalability problem. We're seeing Arbitrum and Matic or Polygon really starting to solve a lot of these scalability problems and just using Ethereum as more of a settlement layer. I don't want to go too far down the rabbit hole, but there are different options there to solve that problem.

I think there will be a bit of a race here. We're also seeing a lot of bridges between networks. Earlier I opened the call with a few people talking about super chains and that concept. I think this will be a year where we see that play out a bit.

AYLA: Beautiful. I'll ask you a little bit about the yields themselves, which is the thing that's got DeFi all of the rep. How would you categorize the returns that are available? How can one generate returns in DeFi? What are the categories? And how much could one hope to earn with what kind of risk exposure in each of those buckets?

MATT: That's a great question. I usually bucket it in three different ways. You essentially have borrowing and lending, which is generally going to be driven by the basis trade. That's what the spot and the futures are for, which will largely drive the yield that you see in these borrowing and lending structures. The catch, however, is that you have counterparty risk. You're lending into a pool which could potentially be liquidated, so we have to take that into consideration.

Another area, which we discussed previously at the topic of market making, is these automated market makers where you can deposit your tokens and earn trading fees. There, I would say you can generate yields that are higher. But it's largely driven by two categories, which are the trading fees themselves and then the incentives that the protocol also layers in. The risk there, though, is that the price moves in such a way that you suffer in permanent loss. And so, if the price goes out of line and you exit the pool before it goes back in line to when you entered, you'll suffer losses. That's the main risk there.

The third bucket, which I would say is on the risk averse spectrum, is protocol staking. It is essentially what Alyson described as proof-of-stake networks, which is an inherent part of the network itself. It actually drives the consensus model. With this, there are a couple components to the yield. You have the transaction fees themselves, as well as the scheduled inflation for that network.

Overtime, what you see is that as more folks lock or deposit their tokens into the network, staking yield may decrease. But generally, it's probably one of the more "risk free" rates of crypto (as we jokingly call it) because there's really no counterparty. You're interacting directly with the protocol. Your only risks are what they call slashing or downtime.

Figment is a staking provider. If you deposit with Figment, we will essentially stake your assets. And with that, you earn a yield. The only real problem there is if we get slashed, if our infrastructure double signs a transaction, or if our infrastructure is down, then you obviously incur a small penalty.

From riskiest to least risky, borrowing and lending and market making are going to be on the riskier side. Sometimes you will get outsized APYs, which go anywhere from 10% all the way to, in the case of Olympus DAO, 9,000%. Those are obviously highly incentivized. But I want to caveat that those are on the riskier side.

However, you can certainly make them less risky. For example, you can do stable coin lending on Compound or Aave. That is going to be a pretty safe bet because you're backed by fiat, and simply lending it out. But we feel that protocol staking, as I mentioned, is going to be one of the more risk averse plays here from a yield perspective.

KENNY: Right. Alison, anything to add to that?

ALYSON: I was talking about this in a breakout room, where the institutions start their journey into the crypto sphere with Bitcoin. And then they buy some Ether, and maybe some alt coins. But as they look towards the yield perspective, as Matt said, protocol staking is almost the next step in the process as people look to continue on their journey.

KENNY: That makes a lot of sense. Appreciate that. So apparently, I guess crypto prices have come down recently. I don't know how much of an impact that has. Alyson, do you think that that has had much of an impact on the yields? Or are they not correlated? What does that look like in your world in terms of yields?

ALYSON: Matt and I were talking yesterday about what this means from a DeFi perspective, and what stresses do decreases in prices actually have on DeFi protocols. Matt, do you want to talk about some of the risks that we had discussed yesterday?

MATT: I think what we've seen recently, especially on some of these lending and borrowing operations, is that a borrow will be liquidated and there is a liquidator role that will step in and buy that liquidated asset at a discount. But then, the liquidator also wants to get out of the position, so they sell at a discount. You can see that there is this downward pressure on prices that can be created by some of these protocols.

Therefore, they have to have certain fail safes in place. I think what we've seen is each time one of these events occur, the protocols react fairly quickly and implement some sort of solution that essentially solves for these events. But yes, there are systematic risks that exist there.

ALYSON: They're not handicapped by a central bank or regulatory authority in implementing monetary or fiscal policy. But Kenny, I think it actually brings up a very good point. Again, as people look to explore the space, you can analyze these instruments or these DeFi protocols like you would traditional financial securities. It's not like a bond, where if prices go down, yields go up.

That's what makes it challenging for people to embrace the space. Traditional risk or return metrics don't exist, or they exist in slightly different fashions. Not to go too far down a tangent, but a lot of what needs to occur in the space is education. There is a need for resources that will allow people to understand what's going on and how to operate a little bit more seamlessly. The current infrastructure (but not blockchain itself) makes it very difficult for people to plug and play.

AYLA: On the subject of regulation, we have one question in the chat. In case somebody runs a fairly large corporate treasury and wants to earn some more yields on our treasury, what are the kind of regulatory restraints and constraints that they should be aware of at the moment? And also, how is the regulatory environment changing in front of our eyes as we speak right now, especially with the new things that have come out just in the last couple of weeks on all things DeFi?

ALYSON: That's a lot. We don't claim to be regulatory experts, but I will say that obviously, banks are the most handicapped as far as operating in this space. We see it on a daily basis with our client types. We can work with everyone that's not subject necessarily to financial regulations, but they have to be comfortable operating in this unknown environment, especially when it comes to taxes.

For example, when you do staking, you earn rewards in the form of newly issued tokens. So, how are those taxed? It largely depends on where you're located. But if you're in the U.S., for instance, it's not like the IRS has standards that you can abide by. And so, you as the company or the individual need to take what you know and come up with a plan and stick with it until we receive updated guidance from the IRS.

As far as banks and more traditional players that are more regulated, we do think that this new wave is coming. And we do think that it will be really good for the space. They can only work in lockstep with the regulation. And as it currently stands, it’s not that they're prohibited from operating in the space and DeFi or protocol staking, but again, it’s that the regulatory framework doesn’t exist. Therefore, these players are just likely to sit on the sidelines.

However, I will say that even though banks and traditional financial players might be sitting on the sidelines waiting to interact with DeFi, they're still very much embracing blockchain. I think that once we do get that clarity, that new wave is coming. I can't tell you when that's happening. I feel like it's not going to happen this year. But hopefully in the next two or three years, we will have that clarity that we need.

MATT: Just to quickly touch on that. I know that there is this thing where they're wrapping DeFi in a TradFi wrapper in a lot of cases, such that certain institutions can interact. We've seen this again and again, where there might be a trust that wraps Ethereum at stake. And so, there are certainly ways to do this. People are being creative. I think at the end of the day, it's going to take regulation to come in and essentially help with this.

I do think that we're going to see a lot of volatility in the regulation, like we saw this last week, where a block explorer is being considered as an exchange. It's crazy to me that something like that is coming down the pipeline. My hope is that they will do the right thing, and particularly in the U.S., that we can operate in a structure that's going to foster innovation. I think we have that to lean on. I do think they're taking some shots in the dark at the moment. But as they learn more, I think they're going to tune in to something that will work for the space.

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