Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2019			0.1%	0.3%	4.3%	-4.2%	0.1%	-0.1%	0.9%	-4.1%	7.5%	6.0%	10.5%
2020	-6.2%	-2.0%	2.5%	12.4%	3.6%	-6.6%	19.6%	12.1%	-3.0%	-7.1%	2.1%	11.9%	41.6%
2021	1.1%	3.5%	-0.5%	6.3%	19.5%	-3.2%	4.0%	-5.2%	6.0%	9.9%	-8.1%	-1.4%	33.0%
2022	1.5%	11.5%	5.7%	3.7%	1.6%	-5.9%	-1.9%	1.0%	0.2%	-1.4%	5%*		22%*

- **The Cypress Fund returned 0.2% in September, -1.4% in October and an estimated 5% in November; YTD the fund is up around 22%.**
- **The Nasdaq 100 experienced the largest one-day drop this year on 13th Sep (-5.5%), as well as the largest rise on 10th Nov (+7.4%). Neither are bullish indicators.**
- **We share our thoughts on the FTX situation and use it to highlight some frameworks that we find useful for investing.**
- **First, we describe the capital cycle approach through the lens of crypto and how we apply it in our investments.**
- **Second, we touch upon investor psychology and its impact on investor decision-making; ie high confidence leading to FOMO.**
- **Third, we discuss contagion and the possibility that Tether is the next shoe to drop in crypto.**

Dear investors,

Markets continue to trade in a schizophrenic fashion since our last investor letter nearly three months ago; global markets were weak in September, mediocre in October but strong in November. During this time, the Cypress Fund managed to eke out a cumulative return of around 4%, for a YTD figure of 22%.

Largest 1-day Gains in NASDAQ Index (Feb 1971 – Nov 2022)

Date	Gains	Bear Market
01/03/2001	14.2%	YES
10/13/2008	11.8	YES
12/05/2000	10.5	YES
10/28/2008	9.5	YES
03/13/2020	9.4	YES
04/05/2001	8.9	YES
03/24/2020	8.1	NO
04/18/2001	8.1	YES
05/30/2000	7.9	YES
10/13/2000	7.9	YES
10/19/2000	7.8	YES
05/08/2002	7.8	YES
12/22/2000	7.6	YES
11/10/2022	7.4	?
10/21/1987	7.3	YES
04/06/2020	7.3	NO
04/18/2000	7.2	YES
03/10/2009	7.1	NO
03/23/2009	6.8	NO
04/25/2000	6.6	YES
04/17/2000	6.6	YES

Charles Schwab, Bloomberg

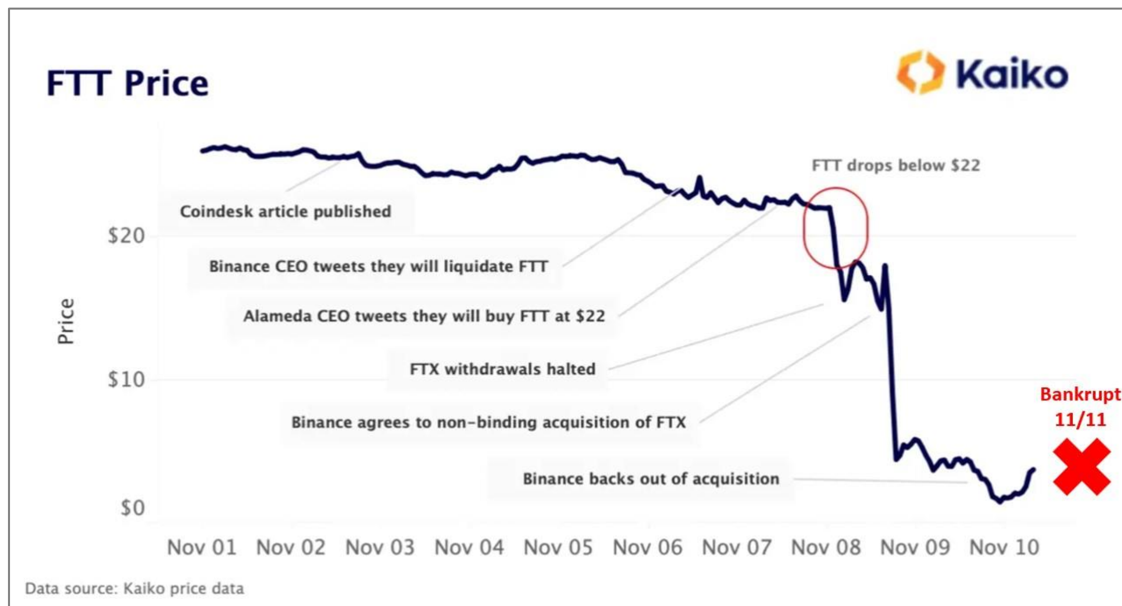
This period also produced both the largest one-day rise (+7.4%, 10th November) and decline (-5.5%, 13th September) in the Nasdaq 100. Both of these are extremely large moves; years can go by where there is not a single daily move exceeding 4%. In fact, the November rally ranks as the 14th largest one-day rally since 1971. Such large rallies are overwhelmingly associated with bear markets – 16 of the 20 largest daily gains occurred during bear markets (see table). This association is similarly true for large one-day declines.

Other things of note these past few months include central bank interventions by the BOJ and BOE in September, the election of Xi Jinping to a third term as president in October, and more recently the potential relaxation of China's Covid-zero policy and the sudden blow-up of FTX. We will devote the rest of this letter to the latter and use it to illustrate some investment frameworks we find useful.

* November 2022 based on preliminary estimates

The Collapse of FTX

Even those of you not familiar with the crypto markets would have heard about the very rapid unravelling of FTX, which until recently was one of the highest profile and most successful crypto exchanges. Their founder, Sam Bankman-Fried, was hailed by mainstream media as the J P Morgan of our times as well as [“The Most Generous Billionaire”](). Along the way, the company raised billions from extremely sophisticated investors, including Sequoia, Blackrock and Temasek.



Yet in little more than a week, this was no more. On 11th November, the entire FTX group filed for voluntary bankruptcy in the US. The graphic above shows the rough timeline. To recap what happened for posterity, on 2nd November, CoinDesk published an article that claimed that Alameda Research (a hedge fund in the FTX group) held $14 billion of assets against $8 billion in liabilities, of which nearly $6 billion were FTT tokens issued by FTX. This already raises serious concerns about Alameda’s solvency but the market really panicked on 6th November when Binance’s CEO shared that they will be liquidating their $500 million stash of FTT tokens. This precipitated a collapse in FTT token price and by association confidence in the entire group, prompting a rush by FTX clients to withdraw their funds from the exchange. Unfortunately, FTX did not have enough assets to fund redemptions; withdrawals were halted on 8th November and Chapter 11 filing ensued. At least $8 billion in client funds are missing.

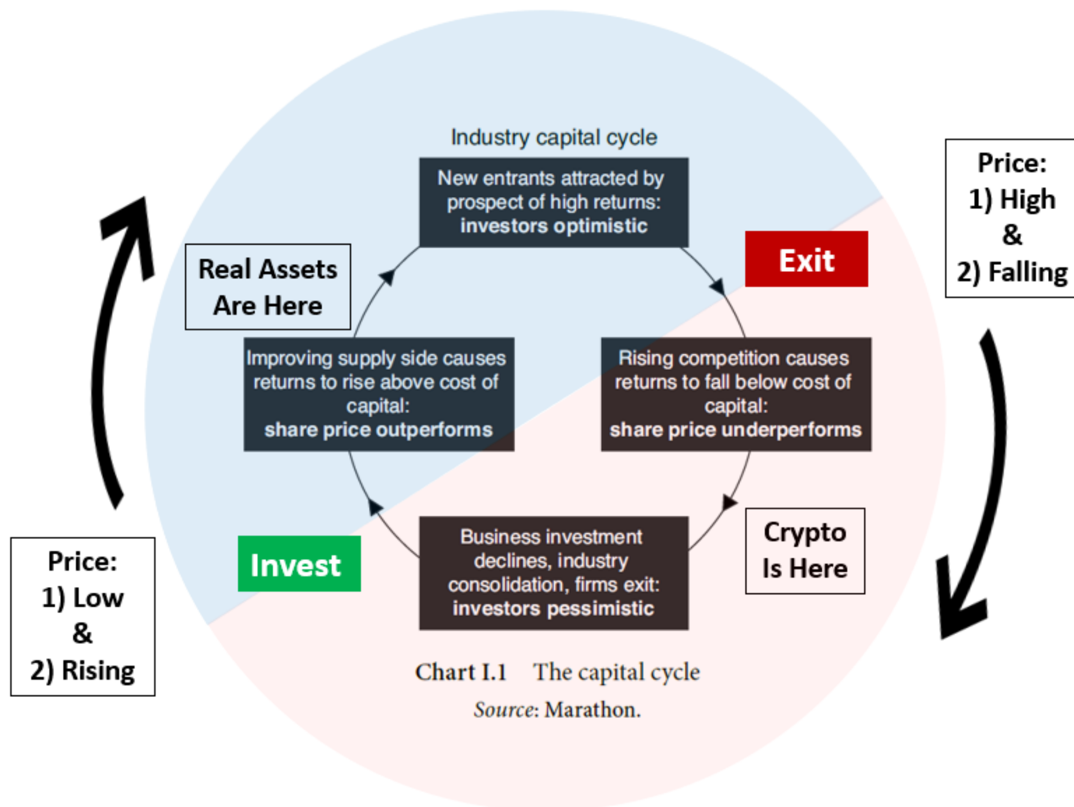
With the rapid collapse of the FTX group in circumstances that are likely to be criminal, many now believe this is the death knell for the crypto market. As this is playing out, we wanted to share some thoughts triggered sparked by the FTX situation. These are investing frameworks we find useful; hopefully they will help you in your investing journey as well.

I. The Capital Cycle – What it is, how it applies to crypto and how it guides our investing
II. Confidence and Decision-Making – FTX shows that market confidence is on the decline
III. Contagion in Markets – There is never just one cockroach, could Tether be next?

I. The Capital Cycle

The capital cycle framework helps shape how we invest and so we wanted to take this opportunity to introduce it. Commonly associated with [Marathon Asset Management](), it helps to explain not just the recent developments in the crypto market but also the boom-bust cycles in many other industries. We show that we tend to invest in industries at the start of a new capital cycle, when money is just returning after a long exodus, and where potential returns are the greatest.

The capital cycle framework states that capital is attracted to high-return businesses and flees when returns fall below the cost of capital. When capital flows in, it leads to new investments, increased competition, greater capacity and higher valuations. Over time the increase in capacity leads to lower returns on the invested capital. When these returns fall below the cost of capital, money exits causing valuations to fall. Capacity is reduced, until eventually, profitability returns and the cycle starts again (see appendix for a stylized example).



We invest (green) at the start of the cycle after long periods of capital flight and exit (red) after capital has flooded into the space for an extended time. Real Assets are at the part of the cycle (blue semicircle) where investors are starting to take notice and price is rising. Crypto is at the beginning of the capital flight phase.

The first bitcoin was mined in January 2009 but for the next 8 years, the entire ecosystem was nothing more than a fringe experiment. The first gold rush happened in 2017, catalyzed by the entrants of high-profile investors like Fidelity and Paul Tudor Jones and the ICO fundraising boom. That year, the market

grew nearly 50-fold; individual crypto tokens experienced 100 and even 1000-fold increases, creating generational wealth for early adherents.

These exceptional returns attracted new capital to crypto, creating a positive feedback loop as institutional investors, investment banks and other respected parties entered and legitimized the market, sending prices higher still. However, the flood of capital and promise of quick riches also brought nefarious characters out to take advantage of a new and opaque market. Scams, ponzis and hacks proliferated as credulous investors threw caution to the wind – fear of missing out overwhelmed fear of loss. Money continued to flow in for a while but eventually the gap between hype and reality became unsustainable – we have reached the phase of the capital cycle where capital is leaving and FTX is a symptom of this capital flight.

This capital cycle boom-bust framework may sound like common sense, yet investors often ignore it despite how common it is. In recent years, we experienced similar cycles in tech (1990s), shipping (2001-2007), US housing (2002-2007), commodities (2001-2008), just to name a few. Each started with strong fundamentals that brought capital inflow but eventually ended in tears when investor optimism became excessive. When to invest in therefore key to superior performance/wealth preservation.

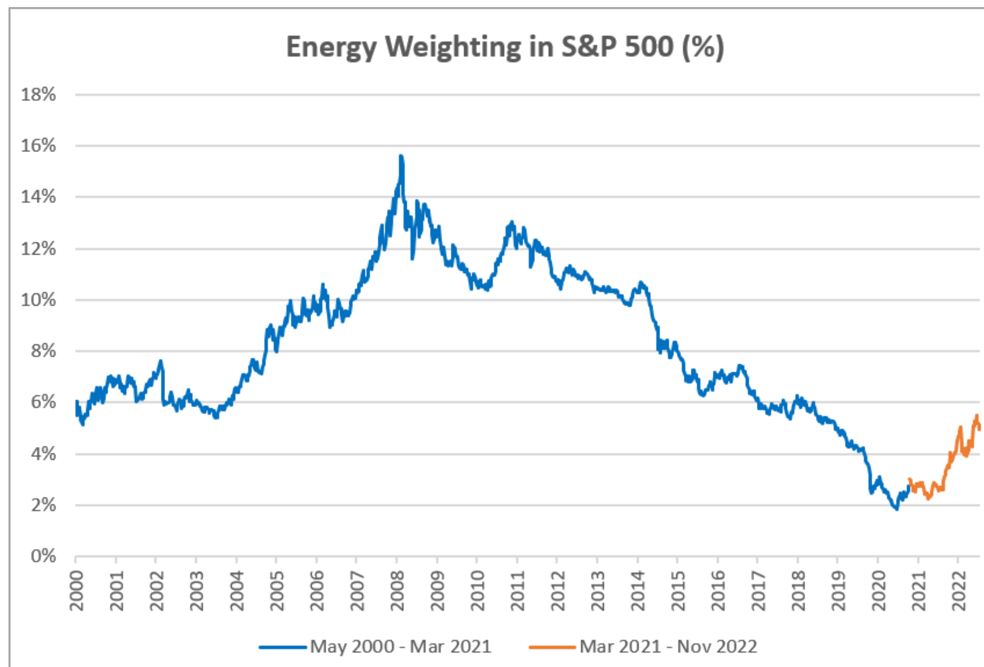
Naturally, we seek to invest in companies near the beginning of a new capital cycle, long after the bust/hot money has left and as fundamentals are starting to improve. We try to do this before too much capital has come in, when valuations are still low and upside potential therefore substantial. As we wrote in our 2021 March Investor Letter:

> *Mining capex has been declining over the past decade with the result that many commodity markets are now in a supply deficit… The historically low capital allocation by investors to energy and commodities means that should narratives change, there could be a rush by investors to re-allocate to this space, with potentially explosive impact on prices…the market is structurally short commodities…*

As we have previously pointed out, some of the themes we are invested in are exactly at the point of the cycle where improving fundamentals beget investor optimism, capital influx and of course higher prices.

Investment Theme	**Background**	**Current Situation**
Shipping	7 years of low charter rates resulting in old fleet and low order books	Rising charter rates yet not enough shipbuilding capacity; **Prices higher**
Resources/Mining	Capex in sector at 15-year lows; declining for 6 years straight	Post-Covid resource shortage; **Prices higher**
Nuclear Energy	Nearly 10 years of capital outflow after Fukushima	Realisation that nuclear power is essential; **Prices higher**
Oil & Gas	8 years of underinvestment due to ESG / energy transition	Record profits for upstream O&G companies; **Prices higher**

We also updated the chart below with the latest energy weighting in the S&P 500 since we last shared it. This has ticked higher since as capital has been returning to energy but we reckon there is much more to go before we see the end of the capital cycle for the entire real assets complex.



<u>II. Confidence and Decision-Making</u>

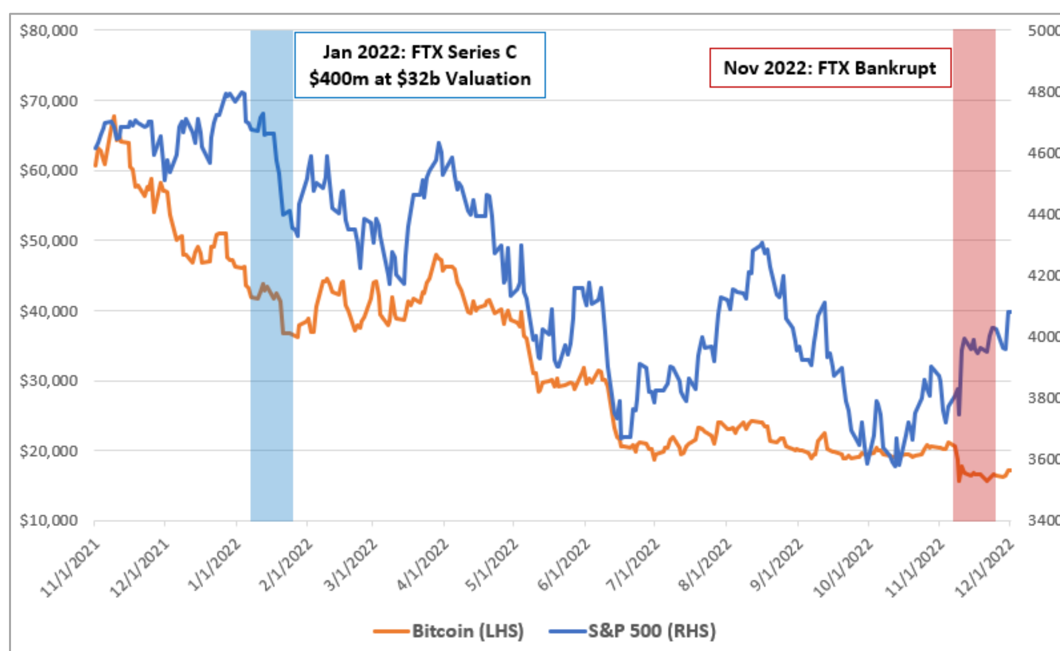
The capital cycle approach merges industry fundamentals with investor psychology in a positive feedback loop. In the section, we turn our attention to psychology, showing how investor confidence has swung from wild optimism to pessimism.

A consequence of the bankruptcy of FTX is that Sam Bankman-Fried has been replaced by John Ray III as FTX CEO. In John's own words taken from his declaration for the Chapter 11 filing:

> *4. I have over 40 years of legal and restructuring experience. I have been the Chief Restructuring Officer or Chief Executive Officer in several of the largest corporate failures in history. I have supervised situations involving allegations of criminal activity and malfeasance (Enron). I have supervised situations involving novel financial structures (Enron and Residential Capital) and cross-border asset recovery and maximization (Nortel and Overseas Shipholding). Nearly every situation in which I have been involved has been characterized by defects of some sort in internal controls, regulatory compliance, human resources and systems integrity.*
>
> *5. <u>Never in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information as occurred here</u>. From compromised systems integrity and faulty regulatory oversight abroad, to the concentration of control in the hands of a very small group of inexperienced, unsophisticated and potentially compromised individuals, this situation is unprecedented.*

These are strong words, but perhaps just as shocking as the sheer failure of controls at FTX are the somewhat incredible claims from prominent FTX investors like Temasek and Tiger Global (collectively lost hundreds of millions) that they *conducted 8 months of extensive due diligence* and *spent millions hiring Bain to carry out due diligence on FTX*.

It is not our intention to pick on the above investors; everyone makes mistakes. Rather, we want to highlight just how far the pendulum of market confidence has swung and show how confidence maps to investing behaviour. Barely a year ago (when markets, and therefore confidence, were at all-time highs), the most sophisticated investors in the world injected $400 million into FTX at a $32 billion valuation after limited due diligence. Same time this year, it is all wiped out days after a competitor's tweet. When confidence is high, huge investments can be easily justified and rapidly deployed. Conversely when confidence has been lost, even the most innocuous events can trigger a collapse.



It might be useful to revisit our 2020 July Investor Letter when we wrote about Stanford professor Baba Shiv, who conceptualized human decision-making into two modes – Type I mindset and Type II mindset:

> *The Type I mindset is fearful of making mistakes. In this mindset, to fail is shameful and painful. Because the brain becomes very risk averse under this line of thinking, individuals with such a mindset seek comfort, typically by minimizing risk and sticking to the status quo.*
>
> *Conversely, the Type II mindset is fearful of losing out on opportunities. When individuals have this mindset, what is shameful is sitting on the sidelines while someone else takes risks and succeeds. Failure is not bad; it can actually be exciting.*
>
> *There are two interesting observations here. The first is that in both mindsets, action is motivated by fear, only the object of the fear is different. The second, explained by Baba, is that*

under periods of high stress and pressure, the Type I mindset is dominant. Only after the stress has been alleviated and replaced with comfort, can a Type II mindset kick in.

We believe that at the crypto market peak a year ago, confidence was sky high and Type II mindset dominated. Is it any surprise then that millions were invested at an outrageous valuation into FTX? Similarly, it is probably fair to surmise that Type I thinking reigns today; which would help explain the almost instantaneous collapse of an erstwhile market darling.

Extending this to traditional markets, we believe that after a year of declining asset prices, confidence is waning and so investors are likely wearing their Type I hats today. One could argue that since confidence is already so low, it may be a good time to invest (how much lower can it get?). While this may indeed be the case, regular readers will know that we see no need to front-run this dynamic. Until we see signs of improving confidence, we will continue to navigate a cautious path – by staying both substantially invested and substantially hedged.

III. Contagion in Markets

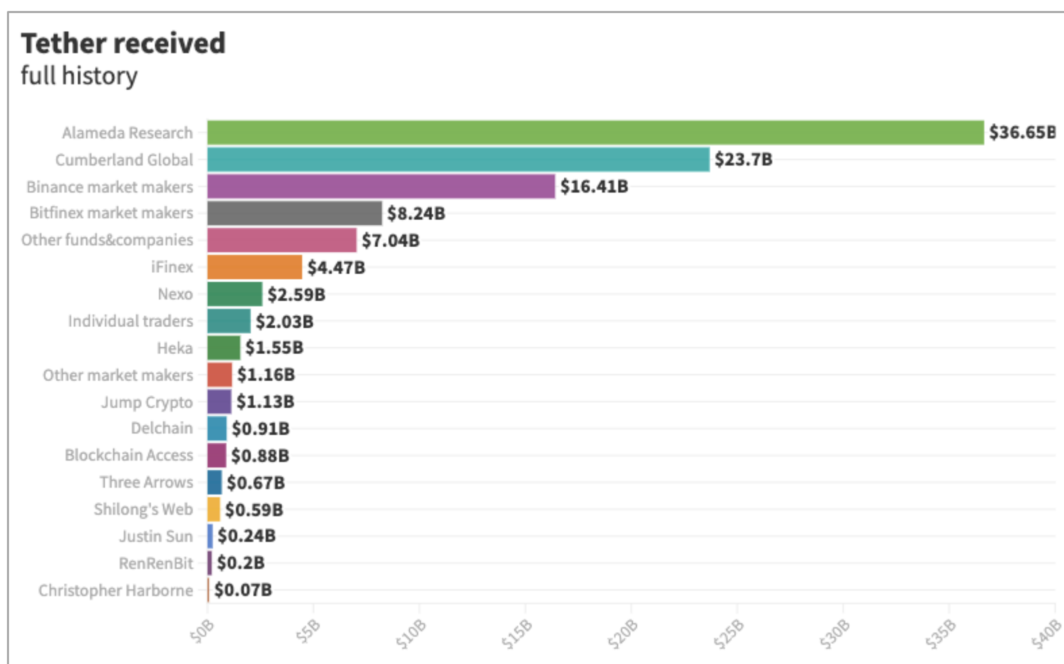
A consequence of Type I thinking is that doubt, once raised, is hard to dispel. As Warren Buffett said "…there's never just one cockroach in the kitchen when you start looking". After FTX, it would not surprise us if other actors in this space fall – we assume contagion spreads until proven otherwise. In this section, we re-visit Tether.

The crypto market has long been associated with bad behaviour but 2022 takes the cake with the $50 billion collapse of Luna/UST followed closely by the downfall of prominent crypto hedge fund Three Arrows Capital. This catalyzed a string of collapses including that of Voyager, Celsius and now FTX. The contagion continues to spread, likely claiming Genesis and most recently Blockfi. Could Tether be next?

In our 2021 June Investor Letter, we wrote:

> *We want to highlight Tether (USDT) because it poses systemic risk to the entire crypto ecosystem. Today, it is the largest stablecoin in the ecosystem and is reportedly used in 40-80% of all transactions on crypto exchanges. At best, Tether is operating as an unregulated bank with negligible equity, substantial regulatory risk and potential for a "bank run". At worst, it is a scam waiting to unravel. Regardless, it is a bomb waiting to go off.*

We encourage you to read our note from last year as well as do your own research about Tether. For what it is worth, out of over $80 billion in USDT that has been issued, over $36 billion (43%) was issued to the now-insolvent Alameda Research. These were probably issued in exchange for Alameda IOUs, so good luck trying to recover that.



If you own any Tether/USDT, at a minimum convert them to other stablecoins; preferably to fiat. You should also withdraw any holdings from crypto exchanges and other custodial services to hardware wallets. Traders should also pay close attention to the USDT peg and monitor changes in Tether market cap for signs of large redemptions.

Again, Tether is systemically important to crypto. It will be hard to imagine the damage that a Tether bust can cause. We also worry that collapsing confidence in crypto can spill over to traditional markets as well.

Conclusion

It has been a torrid year for markets; understandably, many are now looking forward to 2023 in the hopes of smoother sailing. By now, we must sound like a broken record. The coast is still not clear – the capital cycle, falling investor confidence and risk of contagion are all headwinds for risk-taking in general. Stay safe.

Sincerely,

Yongchuan Pan
5 December 2022

Appendix

Excerpted from Capital Returns: Investing Through the Capital Cycle (2016, Palgrave)

A STYLIZED CAPITAL CYCLE

Here's how the capital cycle works. Imagine a widget manufacturer – let's call it Macro Industries. The firm is doing well; so well, that its returns exceed Macro's cost of capital. The firm's CEO, William Blewist-Hard, has recently featured on the front cover of *Fortune* magazine. His stock options are in the money, and his wife no longer complains about being married to a boring industrialist. Of the nine investment bank analysts who cover Macro's stock, seven have buy recommendations and two have holds. The shares are trading at a price-earnings multiple of 14 times, below the market average. Macro's stock is held by several well-known value investors.

Macro's strategy department anticipates strong demand growth for its products, especially in emerging markets where widget consumption per capita is less than one-tenth the level found in the advanced economies. After discussions with the board, Macro's CEO announces his plans to increase manufacturing capacity by 50 per cent over the next three years in order to meet growing demand. A leading investment bank, Greedspin, arranges the secondary share offering to fund the capital expenditure. Stanley Churn of Greedspin, a close friend of Macro's Blewist-Hard, is the lead banker on the deal. The expansion is warmly received in the *FT*'s Lex column. Macro's shares rise on the announcement. Growth investors have lately been buying the stock, excited by the prospect of rising earnings.

Five years later, Bloomberg reports that Macro Industries' chief executive has resigned after longstanding disagreements over corporate strategy with a group of activist shareholders. The activists, led by hedge fund Factastic Investment, want Macro to shutter under-performing operations. Macro's profits have collapsed, and its share price is down 46 per cent over the last twelve months. Analysts say that Macro's problems stem from over-expansion – in particular, its $2.5bn new plant in Durham, North Carolina, was delayed and over budget. The widget market is currently in the doldrums, suffering from excess supply. Macro's long-established competitors have also increased capacity in recent years, while a number of new low-cost producers have also entered the industry, including Dynamic Widget, whose own shares have disappointed since its IPO last year.

The market for widgets is suffering from the recent slowdown in emerging markets. China, the world's largest consumer of widgets, has vastly expanded domestic widget production over the last decade and has lately become a net exporter. Macro is reportedly considering a merger with its largest rival. Although its stock is trading below book, analysts say there's little near-term visibility. Of the remaining three brokerages that still cover Macro, two have sell recommendations with one hold.

The ups and downs of this fictional widget manufacturer describes a typical capital cycle. High current profitability often leads to overconfidence among managers, who confuse benign industry conditions with their own skill – a mistake encouraged by the media, which is constantly looking for corporate heroes and villains. Both investors and managers are engaged in making demand projections. Such forecasts have a wide margin of error and are prone to systematic biases. In good times, the demand forecasts tend to be too optimistic and in bad times overly pessimistic.

High profitability loosens capital discipline in an industry. When returns are high, companies are inclined to boost capital spending. Competitors are likely to follow – perhaps they are equally hubristic, or maybe they just don't want to lose market share. Besides, CEO pay is often set in relation to a company's earnings or market capitalization, thus incentivizing managers to grow their firm's assets. When a company announces with great fanfare a large increase in capacity, its share price often rises. Growth investors like growth! Momentum investors like momentum!

Investment bankers lubricate the wheels of the capital cycle, helping to grow capacity during the boom and consolidate industries in the bust. Their analysts are happiest covering fast-growing sexy sectors (higher stock turnover equals more commissions.) Bankers earn fees by arranging secondary issues and IPOs, which raise money to fund capital spending. Neither the M&A banker nor the brokerage analysts have much interest in long-term outcomes. As the investment bankers' incentives are skewed to short-term payoffs (bonuses), it's inevitable that their time horizon should also be myopic. It's not just a question of incentives. Both analysts and investors are given to extrapolating current trends. In a cyclical world, they think linearly.

The Macro example also shows the lag between a rise in capital spending and its impact on supply, which is characteristic of the capital cycle. The delay between investment and new production means that supply changes are lumpy (i.e., the supply curve is not smooth, as portrayed in the economics textbooks) and prone to overshooting. In fact, the market instability created by lags between changes in supply and production has long been recognized by economists (it is known as the "cobweb effect").

The capital cycle turns down as excess capacity becomes apparent and past demand forecasts are shown to have been overly optimistic. As profits collapse, management teams are changed, capital expenditure is slashed, and the industry starts to consolidate. The reduction in investment and contraction in industry supply paves the way for a recovery of profits. For an investor who understands the capital cycle this is the moment when a beaten down stock becomes potentially interesting. However, brokerage analysts and many investors operating with short time horizons generally fail to spot the turn in the cycle but obsess instead about near-term uncertainty.