Kevin Duffy, editor **1/24/2023** Volume 4, Edition 1

THE COFFEE CAN PORTFOLIO

FTX COLLAPSE
Lessons for investors

"It's only when the tide goes out that you learn who has been swimming naked."

~ Warren Buffett

Booms hide a multitude of sins. They foster herding, impulsiveness, intolerance for dissent, detachment from reality, moral laxity, impatience, overconfidence and gullibility. In other words, they create the ideal conditions for scam artists and get-rich-quick schemes.

To even a budding student of financial bubbles, the collapse of 30-year old Sam Bankman-Fried's $32 billion cryptocurrency empire comes as no surprise. At first blush, there are plenty of obvious lessons:

1. **If it sounds too good to be true, it probably is.** FTX offered customers near-zero trading fees and up to 100x leverage (before dialing that back to 20x). A few months before the collapse, it enticed depositors with 8% interest on U.S. dollar balances and bitcoin.

2. **The crowd is always wrong, eventually.** In 2021, inexperienced speculators were out of control, plunging into meme stocks, money-losing tech unicorns, cryptocurrencies and NFTs. That this would end badly was only a matter of time.

3. **Experience matters most when it is ignored.** Seasoned investors like Warren Buffett, Charlie Munger and Jim Grant were highly critical of cryptocurrencies, but dismissed as "out of touch with the times" the longer the boom went on.
4. **The business media are suckers for meteoric rises.** SBF graced the covers of *Forbes* and *Fortune*, reminiscent of similar appearances by Elizabeth Holmes in 2014-15. (Holmes was recently sentenced to 11 years and 3 months in prison for her part in the Theranos scandal). Whenever the press compares a young, rising star to Steve Jobs, Warren Buffett or J.P. Morgan, be skeptical… be *very* skeptical.
5. **Corporate reputation can't be bought.** Expensive Super Bowl commercials and

stadium naming rights deals are signs of hubris and ghosts of bubbles past.

6. **Celebrities show up late to the party.** Just because Steph Curry, Matt Damon and Kim Kardashian are giving investment advice, doesn't mean you have to listen. While most were paid shills, some took equity in FTX which is now worthless.
7. **ESG ratings are a scam.** FactSet's Truvalue Labs gave FTX a higher score on "leadership and governance" than ExxonMobil.
8. **Virtue signaling is the latest con.** Flashing success by wearing linen suits and driving a Lamborghini is old school. SBF's disheveled image was carefully crafted to appeal to leftist ideology.
9. **Do your own homework.** Relying on highly regarded investors like venture capital firm Sequoia Capital or hedge fund Tiger Global is not doing due diligence. Their investments in FTX were embarrassing, but a rounding error.
10. **Regulators can't protect you.** SEC chair Gary Gensler, who claimed exclusive regulatory dominion over crypto exchanges, has come under criticism. Congressman Ritchie Torres (D-NY) is calling for an investigation: "If the SEC has the authority Mr. Gensler claims, why did he fail to uncover the largest crypto Ponzi scheme in history? One cannot have it both ways, asserting authority while avoiding accountability."

A paid-up subscriber writes:

> FTX was a case of new shiny objects distracting people from good judgement. Twenty-somethings with no track record doing anything running a firm connected to obviously speculative/Ponzi assets, no board of directors and an auditor with an address in the metaverse under normal circumstances would have been enough red flags to throw a Chinese military parade.

Early influences

On the surface, the overnight collapse of crypto exchange FTX and its sister trading operation, Alameda Research, appears to be an open-and-shut case of "get woke, go broke." Sam Bankman-Fried was raised on utilitarian ethics by Stanford law professors and majored in physics at MIT. His polyamorous sidekick who ran Alameda, Caroline Ellison, was raised by MIT economics professors and majored in math at Stanford. The two met at trading firm Jane Street Capital where they shared a passion for "effective altruism," the subject of a *Time* magazine cover story in August. The EA movement, which advocates "using evidence and reason to figure out how to benefit others as much as possible," was popularized by 76-year old utilitarian philosopher Peter Singer and 35-year old William MacAskill, associate professor in philosophy at Oxford. According to *Time*, MacAskill's latest book, *What We Owe the Future*,

> makes the case for "longtermism," the view that positively influencing the long-term future – not just this generation or the next, but the potentially trillions of people still to come – is a key moral priority of our time. Through analyzing the risks of climate change, man-made pathogens, nuclear weapons, and advanced artificial intelligence, MacAskill has come to believe we're living at a pivotal moment in human history, one where the fate of the world depends significantly on the choices we make in our lifetimes.

August 22, 2022

This is pretty heady stuff, catnip for progressive top-down world-improvers. Before starting Alameda, SBF worked briefly for MacAskill's Centre for Effective Altruism. Until recently MacAskill advised the FTX Foundation's Future Fund, whose website still reads:

> When Sam was 20 years old, he set out to make as much money as he could, in order to give away everything he earned to charity.

Was Bankman-Fried a crypto version of Mother Theresa or more akin to Al Capone? According to *Wikipedia*,

> Capone apparently reveled in attention, such as cheers from spectators when he appeared at ball games. He made donations to charities and was viewed by many as a "modern-day Robin Hood."

While there is ample evidence that SBF was drinking plenty of effective altruism Kool-Aid (his first 15 hires came from the EA pool), the cinematic version of wokeness run amok is a stretch. Below the surface is a more nuanced and diabolical story.

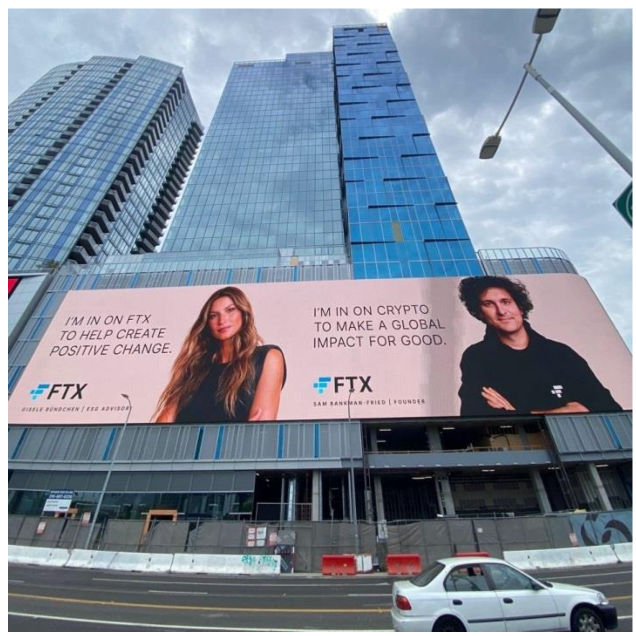
Early success

After a successful three year stint at Jane Street, SBF moved back to the San Francisco Bay Area. According to an in depth profile about SBF on Sequoia Capital's website (since removed),

> He spent his vacation just soaking everything in: It was his first time in the Bay Area as an adult, and he found his home turf unexpectedly thrilling. It was where all the new technology was. It was where all the startups were. It was where the bulk of the EA community was starting to congregate. SBF ended up hanging out a lot with his younger brother Gabe, who was living in an EA commune on nearby Stuart Street. At that time, everyone in the tech world was talking about crypto… Curious, SBF had started looking into crypto—and almost immediately noticed something strange. Bitcoin was trading at a higher price in Japan and Korea than it was in the U.S. In theory, this should never happen because it represents a riskless profit opportunity—in other words, a free lunch… [H]ere was Bitcoin, trading at around $15,000 in South Korea: an unheard –of 50 percent price premium.

To exploit this arbitrage in any meaningful way, SBF needed to overcome a number of logistical hurdles. He also needed a sizable grubstake. The EA community provided both.

> In 2017, when he was merely 25, SBF collapsed the so-called kimchi premium, an anomalous delta between the price of Bitcoin in much of Asia and its price in the rest of the world. It was a daring feat of arbitrage – SBF is the only trader known to have pulled this off in any meaningful way – one which quickly made him a billionaire and achieved the status of legend.



Motivated to make the greatest impact on society, SBF parlayed his winnings to launch FTX in May 2019, even though he gave the crypto exchange just a 20% chance of success. *Expectation* is what mattered, i.e., if the upside x probability of success far exceeded the downside x probability of failure, full speed ahead.

VCs come calling

"Bankman-Fried had adopted a posture, nourished by the current philosophy of Effective Altruism, omnipresent within Silicon Valley and the prestigious universities… The FTX debacle shows that those who sign the checks are inspired by those who look like them, who have been to the same schools as them, who come from the same socioeconomic backgrounds as them, who share their realities. If you're different, you're almost out of luck."

~ *TheStreet.com*, November 24, 2022

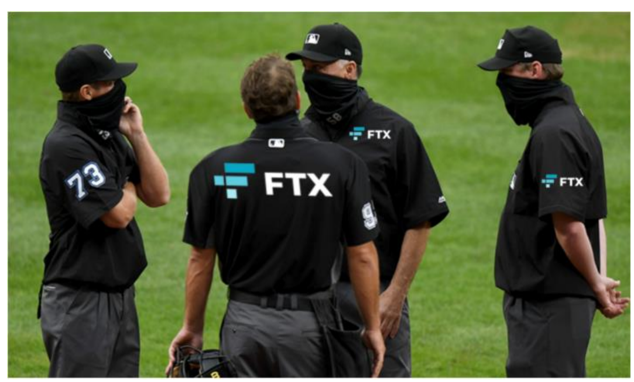
U.S. venture capital doubled in 2021 to $342 billion, or 1.4% of GDP, topping the previous record of 1.2% set during the 2000 dot-com bubble. (Globally, VCs took in $643 billion.) It was in this heady environment that caution gave way to FOMO (fear of missing out). In the spring of 2021, a who's who of Silicon Valley, led by Sequoia Capital, came knocking on Sam Bankman-Fried's door. At Sequoia, partners Michelle Bailhe, 28, and Alfred Lin, 49, drove the capital raise:

> Bailhe remembers it the same way: "We had a great meeting with Sam, but the last question, which I remember Alfred asking, was, 'So, everything you're building is great, but what is your long-term vision for FTX?'"
>
> That's when SBF told Sequoia about the so-called super-app: "I want FTX to be a place where you can do anything you want with your next dollar. You can buy bitcoin. You can send money in whatever currency to any friend anywhere in the world. You can buy a banana. You can do anything you want with your money from inside FTX."
>
> Suddenly, the chat window on Sequoia's side of the Zoom lights up with partners freaking out.
>
> "I LOVE THIS FOUNDER," typed one partner.
>
> "I am a 10 out of 10," pinged another.
>
> "YES!!!" exclaimed a third.
>
> What Sequoia was reacting to was the scale of SBF's vision. It wasn't a story about how we might use fintech in the future, or crypto, or a new kind of bank. It was a vision about the future of money itself—with a total addressable market of every person on the entire planet.

Credibility at all costs

"Alameda was not immune to the exchange-level shenanigans that gave crypto as a whole its sleazy reputation. But FTX had an ambition to change that. It was built to be the exchange traders could count on. SBF needed to get the word out. He wanted FTX to be known as the respectable face of crypto. This required ad campaigns, sponsorship deals, a charitable wing – and a war chest to pay for it all. FTX *did* need money, after all. And it needed that money from credible sources so it could continue to distinguish itself from the bottom-feeders who came to crypto to fleece the suckers."

~ Sequoia Capital, September 22, 2022



In the winner-take-all world of Silicon Valley, the notion of first mover advantage is seductive. "Go large or go home" is often a matter of survival. Bankman-Fried had the grand vision; he needed credibility. An over-the-top marketing blitz is one thing, but why the push for regulation, putting SBF at loggerheads with the rest of the crypto industry, which prided itself on being decentralized and apolitical? Appearing on Jim Cramer's *Mad Money* on December 20, 2021, SBF gave his rationale:

> I think that, at its core, markets regulation by the CFTC, I think asset issuance regulation by the SEC make a ton of sense for the industry… A lot of the goal is, "how do we get from where we are today to a truly mainstream global industry that has the consumer protection and the trust that people have come used to?"

SBF surely understood that the extra red tape would tie his smaller competitors in knots, an added benefit.

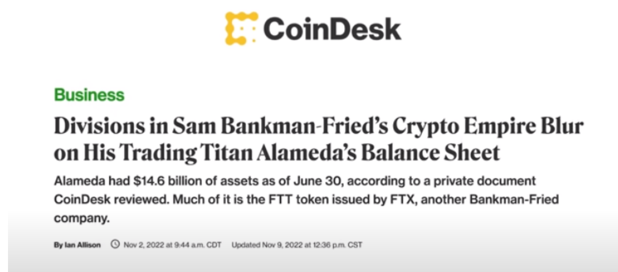
Crash

"How did you go bankrupt?" Bill asked. "Two ways," Mike said. "Gradually and then suddenly."

~ Ernest Hemmingway, *The Sun Also Rises*

SBF's $40 million penthouse in the Bahamas

On November 8, 2021, total crypto market cap peaked at just over $3 trillion. A year later, that had fallen below $1 trillion. As the tide went out on cryptocurrencies, SBF desperately tried to maintain overall confidence, perhaps fearing a run on the bank. To exude an aura of calm, he extended lifelines to failed crypto brokers and lenders such as Voyager Digital, BlockFi and Celsius, earning him accolades in the press as a white knight. For his bailout contribution, some compared SBF to Warren Buffett, J.P. Morgan and even the Federal Reserve.



CoinDesk

Business

Divisions in Sam Bankman-Fried's Crypto Empire Blur on His Trading Titan Alameda's Balance Sheet

Alameda had $14.6 billion of assets as of June 30, according to a private document CoinDesk reviewed. Much of it is the FTT token issued by FTX, another Bankman-Fried company.

By Ian Allison Nov 2, 2022 at 9:44 a.m. CDT Updated Nov 9, 2022 at 12:36 p.m. CST

On November 2, *CoinDesk* published a copy of Alameda's balance sheet with this warning:

> That balance sheet is full of FTX – specifically, the FTX token issued by the exchange that grants holders a discount on trading fees on its marketplace. While there is nothing per se untoward or wrong about that, it shows Bankman-Fried's trading giant Alameda rests on a foundation made up of a coin that a sister company invented, not an independent asset like a fiat currency or another crypto. The situation adds to evidence that the ties between FTX and Alameda are unusually close.

As we now know, intertwining Alameda and FTX was like putting a fireworks stand next to a dynamite factory. FTX had lent Alameda $10 billion backed by just $2 billion of liquid assets. On November 9, Changpeng Zhao, a.k.a. "CZ", founder of Binance (largest crypto exchange in the world) and early FTX investor, spooked by the *CoinDesk* article, tried to unload $500 million worth of FTX tokens (called "FTT"). In 24 hours, FTT went from $22 to $5, bringing down the whole house of cards. Two days later FTX filed for bankruptcy.

CZ 🔶 Binance @cz_binance · 9h

9/ You don't have to be a genius to know something don't smell right at FTX. They were 1/10th our size, yet outspent us 100/1 on marketing & "partnerships", fancy parties in the Bahamas, trips across the globe, and mansions for all of their senior staff (and his parents).

After the fall

"This is really old-fashioned embezzlement. This is just taking money from customers and using it for your own purpose, not sophisticated at all."

~ John Ray III, caretaker CEO of FTX

After his empire collapsed, Bankman-Fried revealed a more cynical side to a reporter at Vox. On regulators: "They make everything worse. They don't protect customers at all." On ESG: "ESG has been perverted beyond recognition." On virtue signaling: "[It's] this dumb game we woke westerners play where we say all the right shibboleths and so everyone likes us."

SBF shows all of the classic signs of narcissism: grandiosity, sense of entitlement and lack of empathy. According to the Vox reporter,

> The grief and pain he has caused is immense, and I came away from our conversation appalled by much of what he said. But if these mistakes haunted him, he largely didn't show it.

Why the willingness to talk to the press, giving his lawyers fits? Says venture capitalist David Sacks,

> I just think that these guys – you can call it a narcissistic fraudster – they think they can talk their way out of anything.

In fact, for a solid month after the collapse, SBF freely granted interviews, bringing to mind Jeff Skilling of Enron fame. From *The Smartest Guys in the Room*:

> More than anyone else, Skilling had come to personify the Enron scandal. Part of it was his audacious refusal, in the face of a dozen separate investigations, to run for cover. Alone among Enron's top executives summoned before a circuslike series of congressional hearings, Skilling had ignored his lawyers' advice to take the Fifth and defiantly spoken his piece.

I asked the book's co-author, Bethany McLean, what she thought of the similarities between Skilling and SBF. She responded,

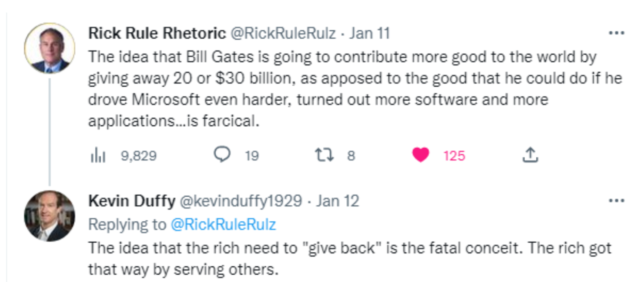
> Exactly the same thing! The delusion of the narcissist, fed by public accolades, resulting in a creature who genuinely believes that what he thinks to be true is truth.

Game theory

The mantra of effective altruists is "earn-to-give." The objective is to make as much money as possible in order to solve big societal problems. Profit is seen as dirty and exploitative (win-lose), a means to an end. If good people enter the business world, they can tilt the scales and save humanity, a seductive message to bright young people steeped in such a zero-sum game worldview.

Of course, this is a delusion. The real world is positive-sum, win-win. True entrepreneurs are passionate about solving problems; profit is a byproduct. To succeed, they must make everyone around them better off: consumers, suppliers, employees and shareholders. Not easy.

I doubt SBF was ever interested in addressing the evil of government-run money, unlike most of his competitors. He saw cryptocurrencies as a means to an end, a way to game the capitalist system. His hubris was not just in thinking he could pull it off, but that charity – not free enterprise – is the main driver of human progress. Not surprisingly, his backers shared the same twisted ideology.



The value of antimodels

"People focus on role models; it is more effective to find antimodels – people you don't want to resemble when you grow up."

~ Nassim Taleb, *The Bed of Procrustes*

If Sam Bankman-Fried is the antithesis of a business owner we would trust with our capital, why not invert? In a famous episode of *Seinfeld*, George Costanza, whose life is a long trail of poor decisions, tries doing the opposite. In that spirit, the table below provides a checklist for attributes of entrepreneurs and corporate cultures we should seek and avoid.

Attributes of Entrepreneurs and Corporate Cultures

Category	Seek	Avoid
Entrepreneur Personality	Humble, works behind the scenes	Arrogant, craves the spotlight
	Focused	Grandiose
	Contrarian, non-conformist	Crowd-pleaser
	Educator	Self-promoter
Motivation	Passionate about solving a problem or filling a need	Craves money and power to make up for insecurity
Work habits	Detail-oriented	Superficial, overuses buzzwords and platitudes
Moral compass/ Dedication to reality	Integrity is sacrosanct	The ends justify the means
	Reports bad news, admits mistakes	Avoids bad news, never admits mistakes
	Grounded	Deluded
Corporate culture Time preference	Delayed gratification, get rich slowly	Instant gratification, get rich quick
Politics	Apolitical, independent	Political, dependent, promotes official narratives
Advertising	Stresses value and function	Makes unrealistic promises and emotional appeals
	Self-deprecating humor	Attacks competitors (often using straw man arguments)
Corporate brand	Built organically over time	Built quickly through aggressive marketing

Money's boxing ring

The gloves are off amongst contenders for the monetary prize. Bitcoin "maximalists" accuse over 9,000 copycat cryptocurrencies of creating money out of thin air, failing to explain how bitcoin's genesis is any different. Establishment defenders of fiat currencies, like *The Economist*, have been quick to dance on crypto's grave:

> The high-speed implosion of FTX has dealt a catastrophic blow to an industry with a history of failure and scandals. Never before has crypto looked so criminal, wasteful and useless.

(Keep in mind, this is the same business journal that just five months ago declared SBF "crypto's last man standing.")

On December 1, Treasury Secretary Janet Yellen made her first appearance on *The Late Show with Stephen Colbert*. Colbert compared crypto to fiat, pointing out that both are "created out of nothing." He then asked, "Because the United States has a fiat currency, [does] the dollar make any more sense to you than crypto does?" Yellen responded:

> Yes, the dollar makes a lot of sense to me… because it's a national currency, it's well-regulated by the Federal Reserve, it has a clear mandate and people who are accountable to the public and to Congress to maintain the goals of the Fed, which is maximum employment and low and stable inflation, price stability.

Who is she trying to kid?

At this point, other than owning precious metals, I prefer to watch this spectacle unfold from the comfort of my sofa. Government-backed money is clearly the tired, old, overweight title holder. To all challengers, I wish them luck!

Conclusion

Does the scam artist serve a social function? Sam Bankman-Fried unwittingly shed light on the corruption of many institutions: venture capital, elite universities, charities, professional sports, Hollywood, mainstream media, ESG rating services, regulatory bodies and the Democratic Party. Remarkably, he was able to infiltrate their highest levels in the blink of an eye. Just last May, SBF was rubbing shoulders with the global elites at the World Economic Forum in Davos.

In a sense, the defrauded, to the extent they are detached from reality, *enable* the fraudster. In fact, they practically deserve each other. Does the act of duplicity force introspection on the part of the duped and a willingness to challenge long-held beliefs? Not likely. While the miscreant can expect a public flogging and long prison sentence, the crowd avoids any culpability. (Unless the elites are to blame, then "systemically important" institutions are to be bailed out.)

As the tide goes out on the everything bubble, the first layer of uneconomic structures is being laid bare: cryptocurrencies, money-losing tech unicorns, expensive exercise equipment (Peloton), used car vending machines (Carvana) and even schemes to capture asteroids in a giant bag. Meanwhile, Amazon warehouses, Tesla gigafactories, wokeness, ESG and the American empire are coming into view. Still buried below the ocean floor: fiat currencies, central banking, fractional reserve banking and the myth of vigilant and protective regulation.

Busts have their purpose. Jeffrey Tucker, founder of the Brownstone Institute and bitcoin advocate, explains:

> I like markets most when they tell the truth. Politicians don't. Bureaucrats don't. Media does not. But market forces, they can be tricked for a very long time, but in the end there's a hard wall: it's called economic law. And the numbers in the end have to add up. So there's nothing Washington can do about this. We're going to see the truth and I'm excited about these times. As you say, it's going to be painful, but I'm glad for it because you don't want to live in a world of leverage and fraud and fakery forever living off perpetual motion machines that are going to die out.

Hear! Hear! A long, painful bear market may be just what the doctor ordered.

The Coffee Can Portfolio

Kevin Duffy, editor
West Chester, PA

The Coffee Can Portfolio is part diary, part wisdom gained from over 40 years in the investment game meant to be shared with others. Trust me, I've made every mistake in the book. That doesn't mean you need to repeat every one of them. Failure is unavoidable, an essential part of the learning process. Embrace it!

I plan to publish every two months. The cost of an annual subscription is $109 which includes six issues as well as email alerts. If you wish to subscribe, go to www.thecoffeecanportfolio.com.

One goal in writing this letter is to build a network of like-minded people following a similar process. If you have feedback, a topic you'd like discussed, or an investment insight you'd like to share, drop me a note!

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