DIGITAL ASSETS DIVERSIFIED

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GALAXY
FUND MANAGEMENT

The world is rapidly digitizing, and blockchain will play a critical role in this global transformation. For those interested in exposure to this trend, a basket of digital assets provides diversified exposure to the major categories of blockchain technology.

Investing in an index product has historically provided investors the opportunity to capture the upside of a new category—without having to worry about picking “winners” during its emergence.

This approach allows investors to broadly participate in the overall trend of digitization through exposure to thematic areas of its growth in a diversified way.

WHAT ARE DIGITAL ASSETS?

In the mid-1990s, “digital assets” originated as a term encompassing items such as audio, video, images, and documentation. In the decades since, technological advancements have expanded the term’s use to cover a broader range of items. One technology in particular, blockchain, has evolved the term’s use to include bitcoin and other digital assets across three main thematic categories: digital store of value assets, decentralized internet or “Web 3.0” assets, and digitized payment assets.

To understand digital assets as a new investable asset class, it is important to first understand the basics of blockchain technology. Blockchains can best be described as computing platforms, or software, that operate in accordance with pre-set rules and are not controlled by any one party. Instead, they are controlled by all their network participants collectively. This is achieved via an incentive mechanism—an underlying native digital asset (e.g., a coin or token) unique to each blockchain—that incentivizes all network members to protect the respective ledger’s contents and support the network’s purpose. As more users join or interact with a given blockchain network, demand for that specific network’s underlying coin or token rises.

Bitcoin is the first widespread application of blockchain technology, and its native digital asset, bitcoin with a lowercase “b”, has become a global digital store of value akin to gold. But bitcoin is just one of the many emerging types of native digital assets enabled by blockchain technology.

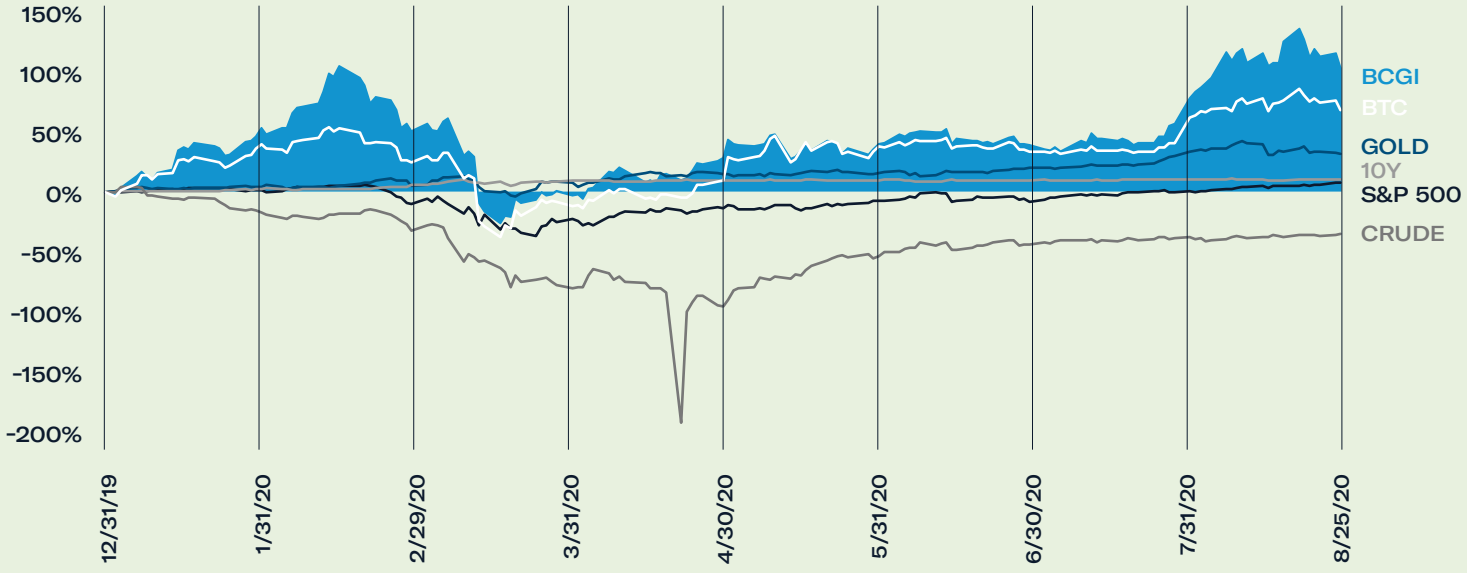
WHY DIGITAL ASSETS MATTER

Digitization is one of the most prominent and deeply-rooted global trends unfolding today, and it intersects with and offers solutions for virtually every industry and aspect of life. Digital assets enable forward-thinking investors to participate in this evolutionary transition from a previously analog world to a more digital one. While this evolution is still in its early days, bitcoin as a digital asset investment has outperformed all major asset classes over the 3-, 5-, and 10-year periods.[1] Additionally, digital assets offer investors the diversification benefits of a historically uncorrelated asset class at a time of persistent market volatility and macro uncertainty caused by COVID-19.

Given the nascent nature of digital assets, it is still too early to determine who the ultimate "winners" may be. While bitcoin continues to be the industry's largest digital asset by market capitalization, there are many other digital assets vying for dominance in their respective categories. Just as the Internet did not produce one "winner-take-all" company, it is likely that a similar pattern will persist with digital assets. Similar to how an investor might look to express an investment thesis in technology stocks by purchasing a basket of "FAANG" stocks, some investors in digital assets may be inclined to diversify their exposure across a basket of digital assets, spreading their bets among the potential thematic areas of growth.

[1] Source: Galaxy Digital Research as of 8/31/20.

BLOOMBERG GALAXY CRYPTO INDEX RETURNS YEAR TO DATE



Source: Bloomberg as of 8/31/20

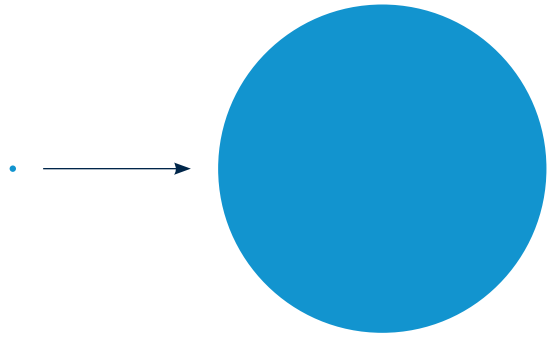
DIGITAL STORE OF VALUE ASSETS

Historically, society has sought the time-tested reliability of gold as a safe, durable store of value. Investors look to gold in times of market stress as a "flight to safety" to preserve wealth and protect against inflation in the financial system. Bitcoin shares many of the same attractive properties of gold that have made it a great store of value for centuries. Yet, bitcoin has modernized and improved properties that position it as an attractive complement to gold in a digital world.

Originally conceived as a peer-to-peer electronic cash for the Internet, bitcoin has become a next generation store of value resistant to political censorship or interference and governed by the mathematical principles of its open source code. It is built on a long history of technological advancements in computer science, cryptography, and digital scarcity, and its disinflationary nature is designed to facilitate trust-minimized, peer-to-peer transactions without a centralized intermediary in a highly secure and transparent way. Interest in bitcoin as a store of value asset has increased sharply since COVID-19 and the unprecedented levels of fiscal stimulus it sparked. Top investors and large institutions are adopting it as an inflation hedge, including macro legend Paul Tudor Jones and MicroStrategy Inc., a publicly-traded business intelligence software firm (NASDAQ: MSTR). In August, MicroStrategy announced a balance sheet investment of $250 million into bitcoin—nearly 20% of the firm's overall cash position. In September, they made an add-on investment of $175 million.[2]

In addition to its potential macro hedge function, bitcoin is an attractive growth asset. Gold's market capitalization is currently over $12 trillion. Bitcoin's value, on the other hand, is currently around $200 billion, less than 2% of the gold market.[3] That presents a potential greater than 60x market expansion opportunity if bitcoin grows to gold's level as an alternative, digital store of value asset.

60X MARKET EXPANSION OPPORTUNITY AS A DIGITAL STORE OF VALUE



[2] Source: MicroStrategy company announcements.
[3] Source: Coin Market Cap as of 9/18/20

DECENTRALIZED INTERNET OR "WEB 3.0" ASSETS

The current Internet infrastructure (known as Web 2.0) resulted mainly from the explosive growth of smartphones. That quickly led to increased demand for mobile computing by the centralized applications built on top of mobile operating systems. Most of the successful Web 2.0 companies are merely applications with pleasant user interfaces atop databases that aggregate vast amounts of user data and benefit from sharing and selling this data to undisclosed third parties.

Web 3.0 improves upon this legacy system by enabling the self-sovereign ownership of individual user data and by reconstructing the rules of the base layer to make things more open and decentralized. By building from the ground up, these new digital asset protocols create a more efficient operating system for the next iteration of the Internet.

Ethereum (ETH) and EOS are two examples of investable digital assets that are enabling the early success of Web 3.0. Both Ethereum and EOS serve the functions of base layer (Layer 1) validator platforms that enable secure general-purpose computing and smart contract logic. The ability to program custom logic into the execution functions of these digital asset networks enables great flexibility and composability for developers. As a result, hundreds of blockchain-related applications have been built atop these "smart contract" platforms in recent years, with demand for those applications indirectly driving demand for ETH and EOS (the respective digital assets of the Ethereum and EOS blockchains). The decentralized finance (DeFi) ecosystem on Ethereum saw its most active month ever in August 2020, with the "Total Value Locked" in associated Ethereum smart contracts climbing from $4.1 billion to $9.6 billion; ETH has had a YTD increase of 228%.[4]

With quicker block processing times (15 seconds for Ethereum and 500 milliseconds for EOS) than bitcoin (10 minutes), these blockchains are able to support far greater transaction volumes and, as a result, can stimulate large ecosystems of active users utilizing these networks for many different types of Web 3.0 applications including data storage, gaming, decentralized financial services, video transcoding, and so much more. It is likely that the emerging winner in this "smart contract" category will function as the global base layer for the next iteration of the Internet and is likely to accrue significant value as a result.

[4] Source: DeFi Pulse as of 8/31/20

DIGITIZED PAYMENT ASSETS

Growing awareness of digital assets has changed the way many people think about money and has helped accelerate their use as forms of digital payment. While people in the United States still primarily purchase goods and services with credit cards and cash, in China, payments are now dominated by WeChat and AliPay QR readers, with approximately $2 trillion of value transacted in digital payments in 2020 alone.[5]

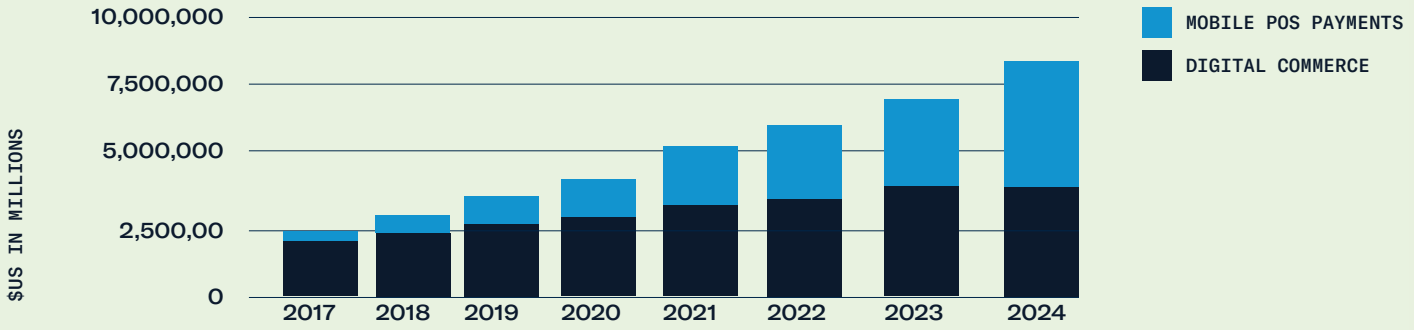
Across the world, cash is slowly getting phased out for more virtual forms of money that can be stored online in the form of a digital wallet or token.

The idea that alternative means of global value exchange are now possible via digital tokens has led to increased innovation and competing platforms. On the banking side, JPMorgan introduced a framework for JPM Coin, a global settlement token to process payments across its organization and for its clients. Facebook is working diligently on its own digital currency, called Libra, and its digital wallet infrastructure, Novi, that will provide access to affordable financial services and allow users to send money easily around the globe. Moreover, on the consumer side, PayPal is integrating bitcoin transactions for its 325 million users, and bitcoin alone drove $17 million in gross profit for Square's CashApp in 2Q20, up 154% from 1Q20.[5] These types of novel digital payment tokens and mediums of exchange are a solution to the friction that exists in legacy global payment rails, such as SWIFT, the international payment network used by banks and financial institutions to settle wires and interbank transactions.

The ability of public blockchain networks to settle immense value across borders 24/7 is unprecedented in the history of money, positioning these technologies to look much more attractive relative to legacy financial infrastructure. Ripple (XRP) is one example of an investable digital asset primarily focused on the digital payments use case. Ripple is a real-time gross settlement system, currency exchange, and remittance network created by Ripple Labs Inc., a US-based technology company. XRP, the native digital asset token on the XRP ledger, is used to facilitate cross-border, real-time global payments anywhere in the world.

Digital payment tokens like XRP will continue to be a large area of growth in digital assets. Exposure to this category of digital assets allows investors to achieve potential returns from the disruption of the legacy global payments infrastructure and the transition to digital payment solutions of the future.

THE TOTAL TRANSACTION VALUE IN DIGITAL PAYMENTS IS STEADILY INCREASING



[5] Source: Statista: Digital Payments Worldwide [5] Source: Square company filings.

DIGITAL ASSETS TOMORROW

Digitization is accelerating at a rapid pace, and digital assets enable investors to participate in different areas of this technological progress. It is tough to predict what the digital world of the future may look like, and no one can say with absolute certainty which investments or assets will emerge victorious. Bitcoin has a large head start as the leading global store of value alternative to gold. Other digital assets are still competing to become market leaders in their respective categories, including the next generation of Web 3.0 assets and digital payment assets of the future.

Billions of dollars of investments have been made in the last few years to support the industry's growth, and provide institutional investors the tools and opportunity to invest, trade, and instantly transact with billions of dollars in daily liquidity. From Fidelity and Tudor Investments, to IBM and ICE, major financial institutions have made and continue to make sizable investments in the industry. As mainstream awareness and participation continue to grow, this increased demand is expected to create a strong tailwind for digital assets as an asset class. A basket of digital assets could be attractive for investors seeking to achieve proper diversification and broad exposure to key growth themes in the space.

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