

**NFTs –**

**Fad or fundamental?**

## NFTs – FAD OR FUNDAMENTAL?

*The reason big new things sneak by incumbents is that the next big thing always starts out being dismissed as a “toy.”* – **Chris Dixon**, internet entrepreneur and investor<sup>1</sup>

*Non-fungible tokens (NFTs) exist so that the crypto grifters can have a new kind of magic bean to sell for actual money, and pretend they're not selling magic beans.* – **David Gerard**, cryptoasset blogger March 2021<sup>2</sup>

*Beauty is in the eye of the beholder* – **Ancient proverb**

*NFTs are here to stay and will be foundational to our new world* – **Jimmy Chang**, technology commentator for The Shadow, April 2021<sup>3</sup>

### Introduction

Non-fungible tokens (NFTs) are the subject of the latest price frenzy in the world of cryptoassets, but what exactly are they? Are they worth investing in? And what does this novel form of tokenization signify? NFTs are ways of cryptographically immortalizing asset ownership. Although these assets consist mainly of digital art and historical digital artifacts, the possibilities are endless — for example, house deeds, sports collectibles or special computer game assets, such as charms or costumes. Fungibility in finance is a concept of equivalence; that is, one dollar is as good as another. “Non-fungible,” in this case, simply means each electronic token is unique.

### NFTs and their first major use case: Art and collectibles

The digital artist Beeple (also known as Michael Joseph Winklemann) hit the headlines this year as he sold a portfolio of digital artworks (just over 5,000 patch-worked pieces) in an NFT for around 42,000 ether (approximately US\$69 million at the time) on February 16 2021.<sup>4</sup> This was the highest profile NFT sale to date, although approximately 86,000 NFTs changed hands daily in May 2021.<sup>5</sup>

This is the first major use case for NFTs: encoding digital art or historical documents. When we refer to high prices for NFTs, we are therefore mostly talking about *art* having high prices. Historically, being the sole owner of an original piece of art has been profitable. I can display a print of the Mona Lisa on my wall for a small amount of money, but the French Republic owns the priceless<sup>6</sup> piece of art exhibited in the Louvre Palace. Similarly, it's possible to pay to use Beeple's images for a fraction of the cost of owning the originals.

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<sup>1</sup> Dixon C. “The Next Big Thing Will Start Out Looking Like a Toy,” available at <https://cdixon.org/2010/01/03/the-next-big-thing-will-start-out-looking-like-a-toy>

<sup>2</sup> Gerard D. “NFTs: Crypto Grifters Try to Scam Artists, Again,” Attack of the 50 Foot Blockchain, March 11, 2021, available at <https://davidgerard.co.uk/blockchain/2021/03/11/nfts-crypto-grifters-try-to-scam-artists-again/>

<sup>3</sup> Oxfim. “The Metaverse, Web3, and the Inevitability of NFTs,” *The Shadow*, April 10, 2021, available at <https://medium.com/the-shadow/the-metaverse-web3-and-the-inevitability-of-nfts-18c8fff1db2a>

<sup>4</sup> “Beeple's Opus,” Christies.com, available at <https://www.christies.com/features/Monumental-collage-by-Beeple-is-first-purely-digital-artwork-NFT-to-come-to-auction-11510-7.aspx>. Reyburn S. “The \$69 Million Beeple NFT Was Bought With Cryptocurrency,” *The New York Times*, March 12, 2021, available at <https://www.nytimes.com/2021/03/12/arts/beeple-nft-buyer-ether.html>

<sup>5</sup> Hoogendoorn R. “What Crypto Crash? NFT Trading Volume Tripled,” DappRadar, May 26, 2021, available at <https://dappradar.com/blog/what-crypto-crash-nft-trading-volume-tripled>

<sup>6</sup> “Priceless” means works of the perceived quality of the Mona Lisa are institutional — they don't come on the market and therefore have no “price” — but if the Mona Lisa did come on the market, we would likely see a multiplication of the current auction record.

## Why have prices been soaring?

NFT prices have been rising for two major reasons:

- (1) **Blockchain is the habitat for both NFTs and cryptocurrencies.** We see a similar ownership spectrum with cryptocurrencies and NFTs, as NFTs are purchased with cryptocurrencies, such as ether or tez. This currently provides some degree of price linkage, despite fundamental differences in the assets. If owners pay for NFTs with their cryptocurrency holdings, NFT prices share in the gains cryptocurrencies have experienced.
- (2) **The NFTs in question are artworks, and art has been doing very well.** Art prices have been appreciating throughout the century so far, and art received a boost from the recent COVID-19 lockdowns as the wealthy redirected their free time into pursuing art collecting as a hobby.

Art as an investment has had a buoyant period in the 21st century — a blue-chip art index has outperformed listed equities from 2000 to 2021.<sup>7</sup> NFTs are a recent joiner<sup>8</sup> in this champagne period for both art (since 2000) and cryptoassets (since 2009).

One reason blue-chip art prices have been rising is the improving fortunes (relative to the broader population) of ultra-high-net-worth (UHNW) individuals who compete for art with ever-higher sums of money. Art prices are largely subjective, as encapsulated in the opening quote: “Beauty is in the eye of the beholder.” From a practical utility perspective, art prices make no sense; however, once you factor in the tax efficiency of art for some investors and the desire of individuals to show off their connoisseurship and prosperity, the price levels are more understandable. Still, it seems mystifying that some ostensibly rudimentary art, pixelated eight-bit portraits of “CryptoPunks,” has reached prices associated with mansions.<sup>9</sup> This is reminiscent of tulipomania in 17th century Holland, where some tulip bulbs were changing hands for sums similar to mansion prices on the Grand Canal in Amsterdam.<sup>10</sup>

The global expansion of money supply explains to a degree why the fortunes of UHNW individuals have improved. This has increased asset values across the board to historically high levels and forced investors into alternative and increasingly esoteric corners. The combination of cheap money and universal stimulus handouts has also increased frothiness<sup>11</sup> in the markets, which has extended into cyberspace.

The market in art-object NFTs is fascinating and is seeding transformational change in the creative arts. As an investment, these NFTs are ultra-speculative, difficult to value and manage and not institutionalized.

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<sup>7</sup> The Artprice100© index has risen 405% between January 1, 2000, and January 1, 2021; “Artmarket.com: The Artprice100© Index Is Continuing to Grow... +405% Since 2000,” *Business Insider* press release, March 2, 2021, available at <https://markets.businessinsider.com/news/stocks/artmarket-com-the-artprice100-index-is-continuing-to-grow-405-since-2000-1030140214>. The MSCI AC World (Net) over the same period has risen 228% according to Thomson Reuters Datastream.

<sup>8</sup> Although the proof of concept for NFTs occurred in 2014, serious sales started later in 2017 with digital cat collectibles called CryptoKitties.

<sup>9</sup> “Covid Alien,” CryptoPunk 7523, a picture of an alien punk in a mask, sold for 4,250 ether, equivalent to US\$11.7 million in June 2021; Locke T. “‘Covid Alien’ CryptoPunk NFT Sells for Over \$11.7 Million to Billionaire Buyer in Sotheby’s Auction,” *CNBC Make It*, June 10, 2021, available at <https://www.cNBC.com/2021/06/10/covid-alien-cryptopunk-nft-sells-for-11point7-million-in-sothebys-auction.html>.

<sup>10</sup> Dowd B. “Tulip Mania: When Tulips Cost as Much as Houses,” *FocusEconomics*, September 15, 2017, available at <https://www.focus-economics.com/blog/tulip-mania-dutch-market-bubble>.

<sup>11</sup> For further reading, please see our paper: *Social Media to Social Markets: Viral Trading and Short Squeezes*, February 21, 2021, available at <https://www.mercer.us/content/dam/mercer/attachments/north-america/us/us-2021-mercer-social-media-to-social-markets-feb-21.pdf>.

## NFTs as a catalyst for transforming creativity

There are various ways in which the world of NFTs can transform the creative industries:

- (1) **Disintermediating purchases.** Although many NFT purchases have been intermediated by traditional auction houses, NFT sales can occur without intermediation.<sup>12</sup> This could embolden artists catering to a broader spectrum of tastes and interests than is reflected by gallery owners and influential collectors. An example is an explosion in digital 3D art, viewable in virtual reality, or a proliferation of art focusing on ingenuity (think Rube Goldberg machines, clever looping videos, and experiences with narrative twists and perspective shifts) — more nerdy art for a more nerdy tech-savvy purchaser base.
- (2) **Disintermediating and democratizing art finance.** As with sales, finance can be disintermediated. NFTs offer an innovative way to commission new art; they can be used as a type of crowdsourcing. A creator can pitch a project, and investors can invest in the NFT before the production of the work. Various NFT projects are paving the way for fractional ownership, which helps with this disintermediated crowdsourcing. In a sense, this would be fungible ownership of NFTs (the collector owns a piece of the artwork).<sup>13</sup> Various fractional projects are slated for launch soon or have recently launched.<sup>14</sup> Fractional ownership in NFTs could essentially see a democratization of the art world, which could lead to a shift to more popular art — think Banksy and Vetriciano as opposed to Beuys and Twombly.<sup>15</sup> Wider participation in NFTs from outside the traditional art owner base, unmediated by art world gatekeepers, has also led to more irreverent work.

## A cautionary note

Unsurprisingly, with an emerging asset class, there are many cautions to heed, for example:

- (1) **Early days.** The NFT market is in its infancy, and it is not yet clear whether NFT artworks will hold their value within NFTs. For example, many of the headline auctions have been for charitable purposes, in part or in whole, and some realized prices may therefore represent generosity as opposed to fair value.
- (2) **What's the attraction owning the original?** With a physical artwork, there is a genuine difference between the artwork and a reproduction, both physically and sentimentally. The original of Edvard Munch's "The Scream" has remnants of the candle wax used for lighting while he was painting and has texture that a reproduction lacks. In the digital world of NFTs, there is usually little to no difference between an original and a reproduction.
- (3) **Legal infancy.** Although NFT owners may see themselves as the owners of original digital assets — and this view is certainly immortalized in a blockchain — a court may decide otherwise. A body of case law does not yet exist. (For example, what happens if a radio station plays an NFT-encoded song without permission?) We have also seen pieces of art converted into NFTs without artist permission. Purchasers in NFTs should make use of legal advice and be aware of the lack of precedent for settling ownership disputes in the field.

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<sup>12</sup> A digital asset like bitcoin can be transferred via ETF, exchange or directly on the network depending on investor preferences and familiarity with the digital world. Similarly, purchasing under the auspices of an auction house may offer an investor in NFTs comfort based on their familiarity with that world and the opportunity to delegate some due diligence on the purchase to the intermediary.

<sup>13</sup> Fractional NFTs (F-NFTs) are fungible tokens of NFTs.

<sup>14</sup> For more information, see Young M. "Going to Pieces: Fractionalized NFT Projects Gather Steam," CoinTelegraph, March 18, 2021, available at <https://cointelegraph.com/news/going-to-pieces-fractionalized-nft-projects-gather-steam>.

<sup>15</sup> The former are artists popular with the general public whose work is highly accessible, the latter are artists whose works are "difficult," often esoteric and requiring both contextualization and knowledge of art history and theory.

- (4) **Reliance on the fortunes of UHNW individuals relative to the broader population.** As mentioned above, the improvement in the fortunes of UHNW individuals relative to the general population since 2000 has been a tailwind for the art market and, by extension, NFT artworks. This trend cannot continue forever without triggering some form of societal backlash. There could conceivably be periods when it goes in reverse, as it has done from time to time in the past — for example, through the introduction of a wealth tax or a clampdown on monopolistic activities and/or tax shelters or if the bull market in broader financial assets were to come to an end.

## The future for NFTs – 1) NFTs in the real world

NFTs have the potential to be equally adept at demonstrating ownership of both real-life and digital assets. For example, NFTs, in concert with blockchain, could record physical land ownership. This is currently done in a centralized way through national land registries but could transition to decentralized record keeping on blockchain. This system of record keeping could also apply to ownership of anything from household valuables to infrastructure assets once binding regulatory frameworks are established.

NFTs could be increasingly important in the era of the Internet of Things, where real-world objects and devices are connected to and controlled via the digital world. Below are some example use cases:

- (1) **Certification of “trusted assets.”** For example, a delivery drone could provide credentials to be within your airspace.
- (2) **Encoding of “trusted information” for insurance.** For example, an NFT might serve as an unalterable record of biometric or location information that could be used to lower insurance premiums and decrease fraud risk to an insurer.
- (3) **Use in secure environments.** For example, an NFT could serve as an inviolable record of a retinal scan at an airport terminal or depository institution.

## The future for NFTs – 2) security in the new digital world / metaverse

*It will take some time before the world understands the true power of NFTs, but being able to create a unique digital file opens up a lot of doors. What we are seeing right now is just the beginning.” – Andreas Wannerstedt, digital artist, April 2021<sup>16</sup>*

As investors interested in the unfolding future and looking at the next phase of economic transformation, it's important to contextualize NFTs. NFTs may come to provide a fundamental piece in a puzzle that could revolutionize the world in which we live.

The next stage of digitization could usher in the metaverse, a virtual reality world in which we spend much of our time. Currently, the metaverse is mainly realized by the gaming community, whose members interact with one another in complex, artificial and fully immersive environments for entertainment purposes. The metaverse, however, could be the space where most of our activity takes place in the future. This might sound like a crazy idea, but it probably won't sound so crazy in 10+ years to children born today (and their parents). How do we ensure permanence, ownership and disintermediated existence in this brave new world? NFTs could be the answer. Your castle in the sky, silver surfboard and e-pooch could all be tethered to the metaverse by NFTs. A pioneering example of NFT usage in the metaverse is a collection of surreal furniture by the artist Andrés Reisinger, 10 pieces that sold for approximately US\$450,000 this year.<sup>17</sup>

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<sup>16</sup> Hahn J. “NFTs Will Usher in a ‘Creative and Artistic Renaissance’ Say Designers,” *Dezeen*, April 9, 2021, available at <https://www.dezeen.com/2021/04/09/nfts-impact-design-architecture-fashion/>.

<sup>17</sup> Cormack R. “This Designer Just Sold a Bunch of Trippy ‘Virtual Furniture’ for Nearly Half a Million Dollars,” *Robb Report*, February 23, 2021, available at <https://robbreport.com/shelter/art-collectibles/andres-reisinger-virtual-furniture-attracts-over-450000-auction-1234598157/>.

## Conclusion

To date, NFTs have mainly been publicized as a new ownership technology for digital art and collectibles. However, we must be careful not to dismiss them too quickly; as our opening quote relates, the next big thing often starts out being dismissed as a “toy.”



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July 2021