



OCTOBER 2021 • PARTNER LETTER

Dear partners,

Protean Capital Management closed the month of October up 2,9% (at mid-day Oct 29). The market return for the period has been positive and, depending on benchmark chosen, both better and worse than PCM's performance. I'm pleased with the result, since it's been generated with cautious positioning and well-timed hedging. Since inception we have generated returns of 12% and the market return has been negative. Although I'm not a huge fan of comparing returns to an index, particularly with an absolute return strategy like this, I do think it serves as a reminder of what the weather is like out there. No return is created in a vacuum. I enter November with 37% net exposure and 80% gross, still not fully invested. This is because some of the core holdings I want to own have yet to present a good enough buying opportunity. Patience required. The biggest event of the month for Protean Capital is undoubtedly that we're doubling in size! A friend and old colleague, who also happens to be a respectable investor has decided to join me and Protean in the endeavour of finding returns wherever they might be. He is currently managing a ridiculously big small cap fund at a well-known Swedish fund management company. I can't begin to tell you how thrilled I am to team up with such a thoughtful and skilled investor. It's probably fair to say he's over the years pointed me in the direction of great stock ideas more than anyone else I know (and this despite my job having been to sell ideas to him). The only concern I have is whether his judgment is becoming clouded, since he's decided to partner with me despite clearly being the smartest and most capable guy in the room. His resignation has not yet been communicated externally by his employer, why I shall refrain from naming at this time. Now, one of my pet-peeves when it comes to investing is the productification and institutionalisation of investment strategies. Add massive regulatory pressures and you have a recipe for less than ideal results for the actual end investor, but significant advantages for fund management companies operating at scale and/or with captive distribution. The more complex and specialised, and the more convoluted labels you can put on a product, the better. As any university student of financial economics will be able to testify, many conjectures have been made trying to formalize the optimal composition of an investment portfolio. Just consider the talent and computer power populating the vast trading floors of hedge funds, banks and asset managers around the world: the amount of time, number of highly skilled individuals and energy spent on torturing data points (to eke out the last bit of theoretical returns) is borderline perverse. Yet, the incentives for the companies active in the financial industry are designed for sub-optimal investor/client outcomes. Why? Since no letter from an aspiring investment thinker is complete without a Charlie Munger-quote: "Never, ever, think about something else when you should be thinking about the power of incentives." From first principles (and own experience) comes

that an individual portfolio manager, at any given point in time, has a limited number of high conviction ideas. In my investment career, I can honestly say I don't think I've ever had more than – at an absolute maximum – three at the same time. The academic literature has some interesting results on this topic, particularly [this publication](#) on “Best Ideas”, from which I borrow a few snippets to this month's letter. The publication shows how ex-ante “highest conviction ideas” outperform both the market and the other ideas in the fund by a wide margin. Therefore, why not concentrate and only own this limited number of ideas? It really should benefit investors, no? Higher returns, that's why we're in this game in the first place? Well. Remember Munger: incentives matter. Owning just a handful of names would increase volatility, price impact from trading, illiquidity concerns and regulatory risk. Your typical fund investor does NOT like this. Adding zero (or low) alpha holdings to the tail end of a fund reduces volatility, improving the all-important allocator darling metric “Sharpe ratio”, therefore maximizing the institutional attractiveness. But the biggest incentive is likely that adding more names to the portfolio enables greater assets under management – and therefore higher management fees. Since we are optimizing creatures, a fund manager will therefore likely dilute the maximum alpha from his or her best ideas with low/no-alpha ideas to the point where the assets under management (i.e. management fees) are maximized, rather than investor return. Equilibrium is reached when the investors receive zero after-fee alpha. Not a conundrum: quite exactly the observable macro result of the asset management industry! Cynical? Perhaps. But it's not a secret that both the regulator and the rating agencies (like Morningstar's 5-star system, widely used in plenty of fund marketing) advocate diversification to protect from volatility. The consequence is that the closer-to-optimal return-focused portfolio is shunned by both managers and investors. Funny that. Example: if you run a standard UCITS fund, the so called 5/40-rule stipulates that the investments you own that individually weigh above 5%, cannot at any time, when added together, weigh above 40% of the portfolio. Very frustrating in any product with additional limitations: I co-managed a Finland-only fund of 1,4bn EUR at one point, and since the Finnish market is made up of a handful of very large companies, a small mid-cap space, and limited small cap space, it was a nightmare to have strong positive views on more than one or two large-caps without breaching the rules daily. Another example: concentrated funds experience higher idiosyncratic risk (i.e., company specific, not market, risk), which means even if they show a phenomenal average return over time, they will have a very hard time getting a 4-5 star rating from Morningstar and the likes, and therefore be at a disadvantage when trying to raise assets. Thinking about this from the investor's perspective, the regulation and rating only makes sense if you assume the investor allocates 100% of his money to one fund. Then I would understand the obsession with diversification. But in fairness, the investor

would – from a theoretical portfolio optimization standpoint – be much better off by investing in a handful of concentrated “best ideas” funds. It would be optimal to think about the contribution to Sharpe ratio (or “efficiency”) from an overall portfolio standpoint, then individual fund standpoint. But, achieving this is likely a chimera. It really is one of the biggest mysteries of fund management that you are structurally and culturally obliged to dilute the performance of the highest conviction ideas by adding a tail of meh-stocks. It’s a fundamental truth that diversified portfolios are just as risky as concentrated ones. You are simply taking on another type of risk: systemic instead of idiosyncratic. I much prefer idiosyncratic risk. So much actually that I’m willing to short the market to accentuate the effect, by allowing me to leverage the company specific elements of the portfolio. Taking another page from the investment greats: when you find your conviction, swing for the fences! Since numerous studies show that even those considered the “best” and most successful investors on average only pick winners 49% of the time, the secret to returns lies rather in how you execute and size your positions, rather than having a high batting average. On this topic, I’m reluctant to share a book-tip (that’s how good it is) but Lee Freeman-Shor’s “The Art of Execution” really hit home with me. It details several things mentioned above, with plenty of anecdotal evidence (actually numerical, but the sample lacks statistical significance) from real world settings. In Summary, Lee was a capital allocator at a large institution (Old Mutual), and tested the idea to have a handful of the world’s greatest investors manage an individual highly concentrated “best ideas” portfolio, with real money (50-100m USD each, I believe). The book is basically an analysis of the outcomes. If you have a detailed interest in how to do, or not to do, when executing your ideas, I can’t recommend it enough. Personally, I’ve lost count of the examples where I’ve bought a stock well, held on to it for a couple of months, realised a decent gain, and five years later concluded that “had I just held on to that stock I wouldn’t have had to do anything else, ever”. But I’m learning. Actively. And since you are reading this, so are you. “The Art of Execution” has underscored something I’ve intuitively been doing for the past couple of years: the best returns in the experiment were generated by those who held on to multi-baggers, and their secret sauce was instead of selling out of a big winner completely, they trimmed it. Acknowledging that we’re human, with human fallibilities, is a first step to overcoming them. The first level (dopamine fuelled) satisfaction of crystallizing a win is the mirror image of how painful it is to cut a loser. But the second level approach is to do exactly the opposite. This is how you can achieve awesome returns despite missing half the swings: cut the losers (but not too soon, do allow for market movements) and ride your winners (but do forgive yourself for trimming and being human occasionally). My experience tells me it’s easier to ride winners when you have a multi-year view, and the business is boring. It also helps if you’re not staring at the price every week, or even

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OCTOBER 2021 • PARTNER LETTER

month. In my current set-up, in August I purchased a stock that looked very promising. I gave it a 5% allocation as a start since I wanted to find more data-points and understand the business better. The company was active in an industry new to me. A few days later the stock weighed 6,5% all by its own doing, having appreciated 30% at the drop of a hat. This caused some frustration, because a 5% position is really neither here nor there, and the data points I kept finding all pointed to significant long-term upside. I decided to almost double the position, despite the pop. This took some mental gymnastics. But when you have conviction: make it count. Fast forward to today, and the stock has doubled from the initial purchase.

I admit I have trimmed, but it now keeps a meaningful weight in the portfolio, and I anticipate this boring business will continue to outperform for years to come. But – importantly – I haven't (yet) fallen for the very tempting option of exiting completely. This is an example of how I try to incorporate experience, theory, and fundamentals. I, of course, could also detail several investments gone wrong, where I have cut the losers quickly – sometimes only to see them significantly outperform immediately after my sell-ticket was filled. But, bottom line, I will not let losers sit idly: “up or out” is the mantra. I.e. either the poor performance is an excellent opportunity to add, or it's a sign I'm simply wrong, in which case it's out the door. Doing nothing is a very poor alternative for me. The headlines from the August Partner Letter are worth revisiting in this context. I believe for Protean to be really successful over time we need to have **Patience** in order to allow for multi-baggers to do just that, multi-bag. We need **Curiosity**, as you're not going to find those 2-3 high-conviction ideas per year unless you're always looking for them. We need to **focus on the micro** (as opposed to macro) as that's where the potential edge is. Given we will stay small, we should “**Go Small**”, since the greatest alpha factory in the world is in small caps, unavailable to large funds. Finally: **don't lose money**. But risk is not volatility, risk is permanent loss of capital. Someone tell that to Morningstar and the regulator? There will be times, even extended ones, where Protean will underperform, experience draw-downs and generally look like an idiot sandwich. Sadly, it's just simple mathematics and part of the game. I'm not looking to reduce idiosyncratic risks, rather I'm looking for the right risks to take: the asymmetric ones. The “small upside but no downside”, the “huge upside and tolerable downside”, the “reasonable upside but limited downside” – and size accordingly. To end on a high note: having a skilled stock-nerd join me in the endeavour to generate awesome long term returns enables crossing off the last item on my wish-list for Protean Capital (“having great company”), and is the obvious highlight of the month.

We're getting ready. Come what may!



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