

PROTEAN™

NOVEMBER 2021 • PARTNER LETTER

Dear partners,

Protean returned 6,2% in November, despite markets contracting, thanks to a mid-month tactical shift from “rather cautious” to “very cautious” and a handful of successful stock picks. The positioning shift was triggered by “proprietary indicators” on sentiment (a.k.a. gut-feel!). We could argue about what drove the correction: the overextended positioning? The persistent and accelerating inflation pressures? Or was it indeed the emergence of yet another Covid-19-mutation? I argue it was none of them, or all of them. It doesn't really matter. It was simply due. Markets didn't sell down on news of the Delta-mutation, nor did the market tank on earlier inflation concerns, and regarding positioning one can always add more leverage so who's to say what's enough? The truth is as always somewhere in between (and what is truth anyway?). Protean has now returned 18,3% since inception in mid-August of this year. On the last day of the month we adjusted to a more neutral positioning.

To follow up from the last Partner Letter, I'm glad to announce that the honourable Carl Gustafsson has joined Protean Capital Management as a partner. Carl has managed the small cap fund at Swedish independent asset manager Didner & Gerge for the past six years, prior to which he was Head of IR at Hexagon. He has also been a sell-side analyst and financial journalist. For me Carl is a dream partner, since he compliments me on both knowledge, temperament, and network. We look forward to deploying a more adaptable approach to investing!

- Why Markets Move

I've always been fascinated by markets, and by how every transaction we witness on the tape has its very own way of ending up right there right then: was it an algo driven by metrological data, an allocation decision by a macro fund, a private individual with a massive model on the company taking a long-term bet, a corporate pension scheme adding its monthly allocation to equities, a program trade, an ETF, a HFT? Nobody knows, yet there it is. Occasionally the combined actions of all these players create a blip, or a crash if you will. Like the -4% move in indices on November 26.

One of the best contemporary financial thinkers I know of, Michael Mabooussin, has a great analogy for these types of market reactions: imagine the market as a pile of sand. If you keep adding grains of sand to the top off the pile, it grows higher but eventually becomes unstable. Finally, the top of the sand pile comes crashing down. Theoretically, then, you could model every grain, the entire structure and probably identify exactly which individual grain of sand caused the slide. But would you be any smarter? Do you need to know exactly why the market crashed? I think it was simply due, the pile had become unstable. Therefore, I do not

try to outsmart the market by being a macro-Einstein, but instead by being curious, nimble and hard-working.

- Evolution as an example

A great example of a complex adaptive system suddenly crumbling could be witnessed live in the markets in the past few weeks as Swedish live-casino supplier Evolution has come crashing down close to 40% in just two weeks. Remarkable for such a large market capitalization (USD 20bn post-crash). On the face of it the catalyst was an anonymous, sloppy and clearly biased report handed in to the New Jersey Division of Gaming Enforcement, arguing EVO's games can be accessed in countries under US sanctions. The report, as far as I could tell, doesn't really contain something even the casual observer of the online gambling business would be unaware of. One simply must assume anything online can be accessed from anywhere, if you just try hard enough.

The classic Greek definition of a tragedy is "a hero's strength becomes his weakness, and eventually leads to his fall". Evolution (the hero) is dominant in live casino, globally, and from what I can tell still miles ahead of competitors on UX, operational excellence and innovation (the great strength). Hence the amazing combination of both durable growth and margins as the industry accelerated its digitalization during the pandemic. BUT – if you have the greatest product, bad guys want to play too! The strength becomes the weakness. Ergo: EVO's equity narrative is a classic tragedy.

It's not a secret much of EVO's growth in the past years have come from so-called grey markets, un- or semi-regulated, but this has casually been brushed aside or forgiven as the numbers have been fantastic and the stock has gone nowhere but up. My view on EVO has always been that it's an ESG-problem in the making, but that these issues won't matter until they suddenly do! The issues have been notoriously highlighted over the years by both short-sellers (RIP until last week) and that one analyst who had the guts to take the other side (and thus be wrong for a long time, until he suddenly wasn't). One could also certainly argue that the company would have enjoyed significantly higher multiples had the contribution from grey markets not been discounted at least to some degree.

The shareholder base has drifted from 36% foreigners (i.e. domiciled outside of Sweden) five years ago, to 70%+ today. I venture to argue this has coincided with every domestic Swedish institution and their grandmother (and dog) becoming fierce ESG-proselytes, where such a terrible animal as an online casino certainly does not find solace. The same trend, albeit at an almost glacial pace, can be observed also among global financial institutions these days: more and more, the marketing

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allure of ESG-investing is gaining ground (Grow Your AUM You Bum!) and is slowly becoming a hygiene factor rather than a product differentiator.

Now, here's what I think happened: imagine being the Chief Investment Officer at a substantial US or UK (or wherever) asset manager. One of the many funds you oversee happen to own Evolution. It's a great company and a great stock. It's been going up. It's helped returns. Great. It doesn't really fit this emerging ESG-trend, but hey they don't deal with the cash or face the actual end client, they are just the "picks and shovels in the digitalization of gambling" you rationalize to yourself. Then a report surfaces that contains the words "Iran" and "Assad". Yikes, hit right in the feels! What do you do? Keep the stock? Buy more as it drops? Crickets...

Experienced as you are, you know that every. single. client. from. now. on. will. have. questions. on. "How do you ESG?". You will therefore have to spend at least 20 minutes of every 1-hour meeting explaining the rationale behind your (tiny, in the grand scheme of things) EVO-position, instead of expanding of the great "proprietary models for CO2-intensity in the fund" you have recently developed at great cost and effort. I think you sell EVO. Almost regardless of price.

One of the world's foremost investors in Global small caps (still active, oversees ridiculous sums, I hope he writes a book one day!) once told me a story on the topic of Evolution: once, when he was a freshly minted portfolio manager in the ancients, he found an awesome case in the Playboy stock. "Can I invest in this" he asked his superior who responded "Sure, but beware you will be spending half of every meeting with clients explaining why they own a part of something as controversial as Playboy. Your call". He ended up not investing. It just wasn't worth the hassle.

I've owned Evolution in my personal (pension) account on and off for a long time. For exactly the reasons above I sold them all when the amateurish report surfaced. Not because it changed my fundamental company specific case, but because my suspicion of what will happen at "Glancing-At -Branding-Ourselves-An-ESG-Fund" headquarters. Stupid? Maybe. But the market is not going to react a certain way just because YOU think it's being irrational. EVO might be firing on all cylinders and could very well beat analyst expectations in the coming quarters, but the ESG-cat is out of the bag proper now, and my suspicion is the flow from nervous lip-servicing ESG wannabes will put a lid on the share price. I'm wide open to being wrong, but I'm right now not willing to make a bet either way. It's simply too hard to know where it stabilizes. Either they clean up Asia, or they get rapped on the knuckles by the regulator, potential US customers get nervy, or none or a mix of the three. I admit I'm leaning towards a positive inclination, and I will keep monitoring, but right now I think my attention is better served elsewhere. I'm not going to get any smarter or get any more data points by fretting about EVO all day.

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One final thing about EVO: it's got a lot of fans, as any stock that has delivered astonishing returns over a long time will. Now is a particularly interesting time to observe sentiment: it's a rare feature as a human to be interested in hearing what you don't want to hear – it's much easier to just disregard negative data points. Various fans are now claiming it's all a conspiracy and simply slander. I find that interesting, because how would one know? Because the company said so? That's not necessarily a source I would trust an awful lot in cases like this. While it could certainly prove to be true – that the report is the result of a malign actor trying to discredit EVO for whatever purpose – it doesn't take away the sharp market reaction. Personally, whenever I feel the urge to be annoyed with how the markets treat a favourite stock, or otherwise have “feelings” about a name, it's a tell-tale sign it's time to move on and focus attention elsewhere. It's far too easy to become consumed, and my experience tells me there's not much alpha to gain from it, particularly relative to the effort.

General approach: when a single stock takes up too much mental bandwidth, rid yourself of it, there are several thousands more with less mental baggage. Luckily.

- Be Protean

The entire idea with Protean is to manage assets the only way I know, with focus on returns. As I've written before, I think there are less than ideal industry incentives where many products are designed to maximize size of assets under management rather than performance. The corporate playing field is structurally tilted towards the interests of the incumbents, rather than the clients. My professor during a course in marketing aptly noted: “companies that do a lot of advertising have one thing in common: their product is largely generic”. Worth pondering in this context!

Protean will never be big because with our strategy too much size is negative for returns. We will never be on the front page of the local business paper arguing “here are three stocks that could double” because we want to maintain mental flexibility and an open mind about all positions. If we publicly talk about how great a stock is, and go on to change our minds a week later because we found new information, will we be able to sell as easily or will we have reinforced our positive bias by advocating the case publicly? I don't know – I strongly suspect it will be harder – but we don't necessarily want to find out! We will also never shrug at negative performance with a “our strategy is underperforming right now” because we want to be adaptable to all market climates. After all, it's our money, and returns are more important than principles. One cannot eat principles. Particularly not obsolete ones.

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We want to make money owning small and midcaps for the long haul (the multi-baggers are an alpha factory!). We want to own great companies of any size at the right price. We want to make money shorting valuation outliers, structurally broken businesses, pie-in-the-sky-stocks when the music stops (Aegirbio at 5bn SEK anyone?), excessive exuberance and relative valuation spreads. We want to hedge market risk to a varying degree to amplify the fundamental idiosyncratic risk we choose to take in the portfolio (and hopefully even make money in a down market). We want to take advantage of special situations, both on the long and short side. We want to make additional basis points with covered calls and other option constructions, stock lending, occasional and modest leverage. We want to be active when opportunities are plentiful, and passive when they are scarce.

The timing for deploying a flexible long/short approach to the market I believe is great right now. The market climate created by floods of central bank liquidity, benign fiscal policy, and digitalisation of the savings market (driving retail participation), can only be described as exuberant. This has contributed to valuation levels that make the public market a very attractive place to sell your equity. Cue an explosion in listed companies. When the investing public (and fund managers) are willing to look decades out to find value and cash flow to discount, you can be sure companies are going to line up to go public. It's as simple as Economics 101: when demand drive prices higher, supply will eventually follow (or, as the British investment banker colloquialism has it: if the ducks are quacking, feed them!). This supply, I argue, is rife with opportunity. The sheer volume of companies listed means the opportunity for mis-pricings have never been greater as the same number of investors and analysts now have more companies on which to spread their already thin attention span. For someone perennially curious and endlessly fascinated by equities and markets, this is the best of times!

However, I don't think team Pontus and Carl are smarter than most investors out there. Given how many talented and thoughtful individuals I've met over the years I know for a fact we are not. This means we need two things to outperform.

One: build structural advantages and leverage them as much we can.

And two: outwork everyone else.

This is exactly our ambition.

Pontus Dackmo
Investment Manager