

Protean's wager

What a month.

About the time Russian tanks crossed the border into Ukraine I was busy cajoling my reluctant 9-year-old to hospital, facing a serious (4-hour) surgical procedure that would see us spending 6 days in the hospital, with junior mostly sleeping and recovering from surgery.

Thankfully surgery went well, and since yesterday we are back home, with the freshly downloaded FIFA 2022 game as (rather efficient) consolation. Suffice to say this has been an emotionally tumultuous period. The perspective offered by events in Ukraine, however, leads to everything fading into the background. I find myself being slightly offended by anyone NOT consumed by World events right now.

I grew up on the strategically important island of Gotland in the middle of the Baltic Sea, and did my military service there, as a conscript 2nd lieutenant in the Swedish Army. At the time, the Swedish Armed Forces had a massive presence on Gotland. After a nearly complete dismantling in the past 20 years, it's now in the process of being built back. During my time in fatigues, I played all the tactical war games on the flats around the town of Roma and the harbour of Slite, to practice countering any theoretical attempts from "Superpower Red" to capture our territory. In the woods north of Tingstäde Träsk I suffered the (now banned) one-week Survival Training that included scarily realistic prisoner interrogations by Russian-speaking mock-officers. I've studied the Russian language for over four years, both at High School, University and during my brief stint at the Swedish Foreign Ministry. I know a bit about Russia but certainly don't claim to be an expert (and have frankly forgotten 90% of my Russian language skills). The Russian conundrum has, however, been a staple in my household for a long period of time, and I have been a cynic throughout. It's fine to HOPE things come good, but it has little place in long term strategic planning; in the words of Jack Reacher: hope for the best, plan for the worst. Europe in particular, needs to get its act together, on both energy and national safety policy. We have seen some tentatively encouraging signs of this in the past days, particularly from Germany, but there is a need of several long-held sacred cows to be led to slaughter.

Generally, despite the madness going on, being short mankind and long apocalypse is not a trade that will be useful in the long term. Falling prey to despair and suffering from defeatism is easy when hit with a barrage of negative news, but we have come back from things worse than this multiple times throughout history. We need to fight it through and make sacrifices, but there's no doubt in my mind we will prevail. And although pecuniary problems as mundane as investments take a back seat when

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the World appears at major cross-roads, the question we are grappling with as professional investors, with a fiduciary duty to our investors, is how to fight the righteous battles while also focusing on returns and preservation of capital. We owe it to ourselves to be professional and rational.

Keeping faith in mankind, and the vivid expression of our ingenuity that is global markets, is, I think, the only rational position to take. Not unlike “Pascal’s wager”; the philosophical position presented by 17th-century philosopher Blaise Pascal, arguing we should all logically live as if God existed, instead of occupying ourselves with trying to prove His eventual existence. The crux of the argument being that by sacrificing only a little, we would potentially receive infinite gains (e.g., Heaven), while if we didn’t choose to believe in God, we would risk eternity in Hell. Hence, I choose to logically believe in markets. In human ingenuity. In the efficacy of creative destruction. We’re a tremendously adaptive species, and we want to do good (but also suffer terribly stupid and evil spells with annoying regularity). Protean Select remains >50% net long. Protean’s wager, if you will.

The purpose of this partner letter is to offer insight into how we operate at Protean Funds, and I must say I truly believe hedge funds are making a come-back. Whilst being invested in long-only themes, small caps and what not in the past decade has undoubtedly been a winning strategy, it can also transform into underperformance and volatility in times of multiple regimes shifting, of the kind we’re now witnessing. Being a large long-only manager in times of significant upheaval is like being a one-legged man in an ass-kicking contest. When you put your money to work with a portfolio manager that runs multiple billions of USD, you are investing like YOU are the one with that kind of money – with all its drawbacks on liquidity and stock selection. Being a small, nimble institution with the ability to utilize all kinds of financially creative instruments, with limited market impact, and perfect skin-in-the-game-manager alignment – is miles apart from investing alongside the billions of others at an AUM-maximizing institution.

An example: two weeks ago, as Russian troops amassed on the Ukraine border, me and Carl drew up a what-if-scenario in case of war breaking out (in my cynical view, with my background experiences, it seemed almost inevitable). We concluded oil (LUNE, EQUINOR) and renewables (VESTAS, ORSTEDT, NIBE) would spike, defense stocks would do well (SAAB), and markets would likely sell off sharply. First-level thinking perhaps, but taking the right actions FIRST in times of significant events is in my experience very profitable.

Forewarned is forearmed. We implemented a handful of the trades immediately (de-grossing, adding to market hedges) and put a basket

trade at the ready (which takes more time than one would think: need to check limits, exposures, liquidity, stock borrow, cash levels etc in order not to breach fund statutes) so we could simply push a button if and when. Sadly, it came in handy quickly, and with hindsight we conclude, in a live scenario, we would have not only protected our capital, but have been up significantly.

I strongly remind you that this is still theoretical – we are just warming up, and although I am mimicking most of this in my personal account, until the fund is approved and up and running, these paper exercises are of very limited value (if any) and serves only as an illustration of our process. I am NOT trying to argue this is a track-record. Let's just conclude it is frustrating to work with a “mockfolio” that does well, but I'll take it any day over one that does poorly. We're champing at the bits to go live!

Reacting to what's on the tape (i.e. what's already happened) is a losing strategy over time, which means right now, even though we are cautiously positioned for continued volatility and further downside, we are pre-occupied scouting for secondary effect of this regime change. What's around the corner? What long-term impacts have we not yet priced? LNG shipping stands out. Slow-moving industry with long lead times, but it should see a significant upturn in the years ahead as we scramble to replace Russian energy. Plenty of other random stocks have de-rated, some more justified than others. There are several companies trading on very sensible multiples now, despite limited cyclicalities and/or good secular growth prospects. All this needs to be paired with exogenous risks: will Putin extend hostilities also to other territories, will Russians stage a revolt, what's China up to, what will NATO do, how will the US react, how's that inflation going, what will CBs do, what's up with semiconductors, supply chains, discretionary spending?

Right now, I believe a balanced approach is the sensible path to take, but we're open to change, and to change quickly. In the wake of the 2008 financial crisis, I witnessed first-hand how several hedge funds got stuck in a pessimistic mindset and persisted with overly negative positioning, arguing “but the data says!”. It is tremendously important to remember this: valuation is an art. Accounting is an art. Running a business is an art. Investing is an art. You cannot therefore base investment decisions on science and data alone. It's more psychology than any of the above ingredients. We are acutely aware of this. An easy measure of temperature is to ask, “What's the pain trade right now?” since it triggers thinking about positioning. If everyone is prepared and positioned for something, it won't impact markets much. Is the pain trade on the upside or the downside? Like Nobel Laureate Daniel Kahneman said “The correct lesson to learn from surprises: the world is surprising.”



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So, this is our mission: we want to manage funds trying to solve the impossible riddle of maximizing returns and simultaneously preserving capital. Our means is to put in place a structure that allows for adaptability (size, humility and mental flexibility!) and curiosity ("research" is just formalized curiosity, right?). We will be launching soon and believe we will start at around 50m USD in assets. This is a princely sum, but not one that enables us to be profitable given the fee structure and costs involved with running a financial institution. We would very much like to reach 100m USD to be borderline comfortable that our business venture is viable. We realize it's a tall order considering a) we do not wish to do marketing and b) we don't have a track record for this strategy and c) don't fit into the regular fund- buckets utilized by professional allocators. But we hope and think our honest and transparent approach, paired with (hopefully) adequate returns over time, will get us there.

The long-term ambition, once we have closed for additional deposits, is to cultivate a partnership with our investors. Ideally you choose to stay invested for the duration, allowing capital to compound for decades. Both me and Carl are in our early 40's – we want, can and will do this for a long time, and hope to be able to.

Wish us luck.

Pontus Dackmo

Investment Manager & CEO Protean Funds Scandinavia AB