



MAY 2022 • PARTNER LETTER

Protean Select

Dear partners,

Protean Select closed its first month up 2,42%. Most of the indices in the Nordic region were slightly down in the same period. Our positioning has reflected a view of heightened uncertainty: defensive, risk-averse, and with no single large bets. In top-down driven markets, like these, where market-wide allocation flows and indiscriminate risk on/off-sentiment impact all stocks alike, the individual character of a single stock temporarily takes to the back seat as all correlations gravitate towards 1. This has served Protean Select well: despite a low but positive net exposure of 10% to 30% we have generated consistent positive returns with low volatility. Some 1,1%-points of the return stem from our Swedish Match position, which was bid for by Philip Morris. The rest are from a diverse bunch: single stock shorts, small-cap longs, short-term opportunities, futures/swap exposures, and written options.

Our two core buckets of large-cap longs and SMID-cap longs have - true to the long-term strategy - remained largely unchanged during the month, while the more tactical and trading-oriented third of the portfolio has seen high activity considering the volatility. We will happily pocket a few basis points from trading if we identify a stock deviating ridiculously from its intrinsic value for non-economic reasons. May 2022 was unusual in the respect it offered many such opportunities.

Overall, we are pleased. Operationally we have had no notable mishaps. All trades have settled, all counterparties are operational, and we have all the resources and system support we need. I'll admit that the unprecedented 7% flash crash on the Swedish stock exchange, occurring about 1 hour into Protean Select's first day of operation, and we were running 40+ orders in the market, had us sweating bullets. We did capitalize on the crash, however, by quickly stopping sell-orders and accelerating buy-orders. The forensics show the benefit ultimately ended up being rather marginal (single-digit basis points) due to low volumes and circuit breakers, but our takeaway is we acted correctly despite being scared.

Lessons reinforced

The first month has hammered home what we have known all along: being small is an immeasurable benefit. One example: we owned Nolato. When the Q1 report was released, we noticed they communicated their biggest client would start "dual sourcing" - i.e. no longer be using Nolato as a sole supplier - far down in the next part of the release. As analysts when they get a report tend to first focus on the numbers (to populate a deviation table and send a quick comment), we were quick in realizing this

is a material negative issue, so far undiscovered. Hence, we quickly turned around and were able to sell our entire stake at an unchanged share price. It closed the same day down 10% Two days later down 20%. Owning 5% of the company, you can only dream of exiting within the hour rather than a month. With a 3% position in a small fund, you have room to maneuver.

Swedish Match also deserves its mention, as an example of how our competencies combine to drive returns. Right after the European market close on the 9th of May, the Wall Street Journal published the news that PMI was in “advanced discussions regarding a potential bid at or above 15bn USD”. The PMI stock advanced a couple of % on the news. Almost immediately both Swedish Match and PMI, independently, sent out press releases “confirming ongoing discussions”. Having seen these types of situations before, and with Carl’s experience as an IR officer at a large-cap, our conclusion from the smoothness of the process (a board of a large-cap does simply not sign off on a press release within an hour) was this is pre-mediated and likely a done deal. PMI simply picked a channel to leak the story voluntarily, wisely choosing the reputable WSJ, to gauge shareholder reactions to a potential bid. As the reaction was benign, they went ahead. In the morning of the 10th, all we knew was the rumored “15bn USD or above” level, which translated to some SEK 100 per share. We reflected that SEK 100/share would be too low, and that applying a typical risk-arb-discount to a level above 100, say a final bid of 120, would easily justify SWMA stock trading above 100, even on just the news of the discussion. When one of the global banks kindly made a market in SWMA before the open on the 10th, we more than doubled our position at 94 SEK.

On May 11, the recommended SEK 106 bid was announced. For some reason or other, most likely unusually few risk-arb funds participating, the stock over the next few days fell back from 103 down to 100. As we have had several discussions with fellow shareholders around the world – some already in our network, some heard about our view via our vocal opposition in the press – our conviction kept growing. PMI is pot-committed to the bid and needs the asset to fulfill its publicly stated strategy. With likely more upside to the bid-level, SWMA at 100 offered too good risk-reward to ignore, why we added again to the position. It is now a 9% position in the fund, and almost treble the size of the next largest position. As our goal is absolute returns, via asymmetric bets, we believe this position suits our strategy well.

We choose to mention specific stocks here since they serve as examples. One we’re no longer involved in (currently), and the other we have publicly commented on in the local business press.

What's around the corner

Our overall picture of the world suggests we will ultimately end up with markets below the pre-pandemic levels. The road there will be neither straight nor easy, with intermittent rips and dips. Zooming out it appears inevitable that the withdrawal of quantitative and fiscal stimulus is decidedly nothing less than a substantial regime shift. We are going from a backdrop that has lasted ever since 2009, on top of a sentiment change towards more caution and fear of inflation, which will keep a lid on optimism for some time ahead. So far, the breadth of the correction, and the notable absence of negative earnings revision, make this more about the discount factor in the DCF (simply put multiples have contracted, not earnings). Worth noting in this context is that aggregated EPS estimates are a lagging indicator, both on the downside and the upside, and so far, they are lagging the market by some 20%.

Important for us is to keep an open mind. And by this I do not mean that we simply listen to alternative descriptions of reality – I mean that we actively question our conviction and seek opinions of those that have a contrary view. Constantly. Nobody would be happier than us if we change our minds about the outlook in the coming months. The simple reason we have designed Protean Select to be a net-long fund is we believe in the ingenuity of humanity and the forward progress we are capable of. “Show me a wealthy pessimist” rings true for a reason. But we still choose to call it as we see it – with cautious positioning currently – because we are fully invested in the strategy ourselves. And we hate losing money. For now, we remain neutral in our exposures – a vast majority of what we own are profitable companies and have solid balance sheets with little disruption risk. We have dipped our toes in a selection of fallen growth stars that we judge offer superior risk/rewards, but remain cautious with sizing.

The false comfort of ESG

The focus on sustainable investing in recent years, and indeed the absolute tsunami of inflows these types of funds have seen, has brought us several consequences, both intended and unintended. One is a bubble in green assets. When something is bought for uneconomic reasons, “it does good” rather than “this is trading below our model of its discounted cash flow”, valuation is not only a residual – it’s irrelevant. This means that when the music (inflows) stops, the bubble deflates. And since every fund is now ESG-branded (I’m exaggerating, but not by much, at all) it doesn’t matter anymore. This bubble is already quite far in the process of deflating.

Another is that perfectly able companies have seen an exodus of mainstream funds from their shareholder roster. Swedish Match is the perfect example: a well-run company with a leading portfolio of oral

nicotine products, cash generative, growing, and not breaking any laws. Their consumers (I'm one of them) are generally happy, voluntarily choosing their branded products in a healthy, competitive, and strictly regulated market. But, since a significant part of their revenues and profits stem from tobacco, a product that no doubt is harmful, but people voluntarily choose to consume (and, again, is legal to consume), it's gotten caught up in the general nervousness of ESG. Cue the bid on the company from US giant Philip Morris - looking to accelerate their transformation from a smoking company to a less harmful nicotine supplier. Protean Funds has been in the local press twice arguing the price paid is far too low and undervalues Swedish Match's long-term prospects. We're quite alone. Heck, PMI's stock went UP on the announcement of the recommended bid, which means it is deemed by the market as particularly good for one group of shareholders (hint: not SWMA's). It's an abject failure of the Swedish fund industry to allow a company operating well within the rules of the law, with this cash flow and growth profile, a unique and global appeal to be so under-owned and undervalued that the Board of Directors of SWMA are allowed to even think about recommending a bid at such a low price. Frankly, it's a disgrace.

The same goes for the exodus from Swedish defense company SAAB. Why is it considered unsustainable? They manufacture weapons! That kill! Brr! Uncomfortable! Unsustainable! But. We have armed forces. I'm a highly motivated 2nd Lieutenant in the Swedish Army myself. For a reason. Why do we want to starve our home-grown defense industry of capital? It might be a poorly run company, and it may not be a good investment, but to deliberately and indirectly make it more costly to fund operations via ESG-motivated exclusions makes no sense. Since the Russian invasion of Ukraine, many Swedish mainstream funds have backtracked and are again allowing SAAB in their investable universe. Embarrassing, but: about time.

A similar line of thought is the exclusion of oil and gas companies: the one effect exclusion of Nordic oil and gas companies have, is it on the margin could theoretically raise their cost of capital. This means their competitors get an advantage: with a lower cost of capital, more projects are profitable, allowing growth at the expense of Nordic players, now less able to compete. Who are the competitors? Largely state-owned enterprises in corrupt nations, with little or zero regard for efficiency or environmental concerns. So, the consequence of them being excluded, is we bolster the competitive powers of rogue nations like Russia, Libya, Venezuela, and Saudi. Note: this is not saying fossil fuels have a future in our energy mix - I strongly believe we need to accelerate the transition to greener fuels - but there's reality and realpolitik to consider as well. Plus, again, the financial markets are a poor instrument to enact the type of sweeping change that's needed to change course.

In one sense the ESG-mania probably is a pressure valve for the frustration with the inability of global politics ability to deal with the major climate and inequality challenges. A world lacking coherent policies and action plans to alleviate what is perceived as an existential concern by more and more people will inevitably see the emergence of alternative private initiatives. From that viewpoint it is unfortunate that ESG-funds are shown to be inefficient vehicles for our convictions, leading to not only underperformance but also a false feeling of action. This is likely the most dangerous part of the whole problem: the false sense of achievement, undermining demands for real policy action and actual progress.

Protean Fund's approach to ESG is simple: use common sense! Our mission as a fund is to protect capital and generate returns. Not to argue we change the world because we exclude this, that, or the other according to some grand proprietary branded strategy. We certainly don't disregard risks connected to environmental, social, or governance issues. Quite the opposite: these are very real risks to various if not all businesses - not least because they are relevant for more and more citizens and consumers, and therefore to both top and bottom line at any given company. And this is the way it should be: ESG should be part consumer-driven and part regulatory-driven, not arbitrarily applied by middle-aged fund managers and freshly minted ESG-bureaucrats relying on some half-baked third-party ranking methodology, no matter how swanky and quantitative.

We must exercise our rights as citizens and consumers and stand up for what we believe in with action - only then can we have a real impact on the direction of the world. Believe you me, a company seeing a 50% drop in sales from consumers voting with their feet will be much more cautious and quickly change its way, than a company being ignored and excluded by any number of mainstream ESG-funds. Climate change, perhaps the most pressing issue of all, needs substantial political action. Not another sustainable fund giving us the false impression of making a difference.

“Real” Assets

Using first principles is helpful when approaching complex matters. Reducing an issue down to its core, removing as many assumptions as possible, and leaving the underlying problem open for unencumbered analysis. We have applied this to property development in Scandinavia, a sector where a not insignificant number of companies have found their way to the equity market in recent years. Fueled by cheap and plentiful credit from both the bond and equity market, there's been no lack of aggressiveness and creativity in structuring vehicles of varying quality to put on the stock exchange. A smattering of family offices, yield-hungry pension funds, and random sovereign wealth animals have together generated an almost insatiable appetite for anything with a cash-flow

stream that in addition has the enviable nickname “Real Asset” (as opposed to everything else being unreal assets?). With this backdrop it’s not a coincidence these opportunistic operators, elbows deep in debt, find themselves sitting on substantial paper profits from continuous re-valuations.

But. All is not well in property development land. Financing costs are up significantly. One property company CEO told us the bond market is all but “closed” now, particularly for newer players. Building material costs have exploded, to the extent that construction companies now refuse to quote fixed prices. We have already seen signs that projects sold on “forward purchase” contracts are causing write-downs to construction companies, as delays and cost inflation take their toll on profitability. When you on top of this have a P&L that has seen its revenue and profit line immensely flattered by years of continuous POC- and planning progress-driven re-valuations, things could get hairy at the drop of a hat when your bond financing is subject to equity ratio covenants, in turn, contingent on already booked paper profits. Furthermore, the re-valuations driving P&L profits (mind you, not cash profits) are in several instances not even from projects moving forwards towards completion, but from adding and recognizing profits from “building rights” created out of thin air.

This is, in my book, a rather dubious exercise, as the valuation of building rights is highly subjective, and rests on many assumptions, several years into the future. You must be comfortable projecting not only the time to completion, the cost of funding, and the cost of building, but also the end-market demand for, and cash flows from, the potential assets you’ve dreamt up. It’s nothing but remarkable that investors accept the valuations at which these companies “realize value” from projects and portfolios by “divesting” to closely associated companies, spin-offs, and joint ventures.

It reminds me of the artist that on a whim created one-billion-and-one digital tokens, sold one for a dollar, and promptly announced he was a billionaire since he undoubtedly owned a billion of the things valued at one dollar. I could argue one could build a 3,000m tall building with 600 flats on my front lawn, and that the pre-planning building rights are surely worth 600m SEK, but could I realize it as “profit” in my P&L at next quarter end? Yet this is exactly what’s going on. Protean Select is trying to express our view by being short some of the more gregarious examples of this phenomenon. Since we’re small, we can travel in the smaller caps in the space, some of which are an order of magnitude nuttier than the larger ones. We are convinced the day of reckoning will come.

Pontus Dackmo
Investment Manager & CEO



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