



JUNE 2022 • PARTNER LETTER

Protean Select

Dear partners,

June saw Protean Select down 1,23%. Since our start, at the beginning of May, Protean Select has therefore returned 1,16%. During the short May-June period, markets have been on a roller coaster ride heading firmly south. As examples we note the Swedish all-cap index (SAX) is down 13,2% for the period, and even the broad MSCI Nordic (the 85 largest companies in Scandinavia) is down 10,9%. As we anticipated this has not been in a straight line: we have lived through a drop of 10%, a 10% pop, followed by a 12% drop, whipsawing investors every which way in multiple asset classes. To make matters worse, many times the moves were contrary to old rules of thumb. The narrative keeps changing, sometimes on an intra-day basis. Suffice to say there's been ample opportunity to lose money. We have not. We are proud of our result since launch, as we have (so far) proven we can navigate treacherous markets and avoid material drawdowns. It remains to be seen if we can capitalize on any potential upside, but we believe we are both positioned and able. To be honest it's a too short period of time to draw any serious conclusions, but at least we have not screwed up: we have not lost money.

When we designed the fund back in October 2021, versatility was the key tenet. At the time, growth and small caps were all the rage (oh blissful times). We anticipated to play THAT game for at least a while. But markets change and so do we. Our portfolio today reflects a conservative view, as we believe negative tail risks from geopolitics are lurking, and the bigger picture is market participants are collectively nursing a massive hang over from an almost decade-long liquidity party that ended in runaway inflation.

Our holdings have above average balance sheet strength and management quality, paired with below average cyclicalities and estimate risks. The fund has more and smaller positions (we have but ONE position with above 4% weight) than what we assume will be the average over time, and is running a low but positive net exposure, well below what we anticipated when starting out. True to our ambition we try to adapt to the market. We are leaning more "market neutral macro fund" than "growth tilted small- and mid cap hedge fund" right now, but do not anticipate – or, indeed, hope – this will be a permanent state.

That said, we are fierce believers in human ingenuity, and there's no denying that the big negative market moves YTD have chopped a lot of wood. In fact, we have seen the largest ever nominal draw-down for bonds and equities combined (16+ trillion USD, not counting make-believe crypto). It is darkest before dawn, and having witnessed numerous examples of missed bottoms due to unwillingness or inability

PROTEAN™

JUNE 2022 • PARTNER LETTER

to change mindset, we stubbornly continue to position ourselves for an eventual improvement rather than continued deterioration. This comes at a cost – to be net long significantly falling markets will lead to challenged returns. We think the opportunity cost to miss out on the upside is greater over longer periods of time.

Basically, Protean is Bubba Gump Shrimp Co. When the other (long only) fishing vessels are battered by a severe storm, Forrest Gump's "Jenny" is dry-docked (well hedged) and is therefore the only boat unscathed, able to fish all by itself when the storm abates, potentially reaping significant long-term rewards. If you can compound off a base of assets that sees less severe drawdowns, you have a powerful advantage.

Although the storm keeps howling outside, we are seeing opportunities emerging at sometimes ludicrous valuations, and have started to dip our trawler in the water. But keeping the boat largely intact is the key priority (to be able to buy shares in a 1000-bagger "fruit company" for the profits, remember?).

There is nothing usual about this market

It seems we're jumping back and forth. One week we're pricing aggressive central bank tightening (selling duration, real estate, buying banks), followed by recession fears (selling banks, materials, consumer durables), followed by a realization that recession would curb the rate hiking enthusiasm, again causing a rally in growth and tech on lower discount rates. Only to peter out again. I don't know what type of animal is supposed to be able to participate, and capitalize systemically and sustainably, in a market that looks like this?

Zooming out, the direction appears clear: downward. It is a polite slow-motion crash with unusual characteristics: central banks hiking into a slow-down, but with consumer balance sheets still in good shape, a relatively strong labor market, significant and broad-based inflation, plus a looming energy crisis and various unpredictable geopolitical risks on the rise. Thing is, whenever the half-glass-empty narrative takes hold, there's no end to the negativity. Yes, all these things are real problems (and one could easily name a smattering of additional issues such as climate change, immigration, demography etc), but the world has ALWAYS had real problems. Just because we have chosen to be blissfully ignorant of them for a few years does not mean they have not been present. We have very recently seen such a broad-based deterioration in the outlook (PMI's, US housing sales, European house price data, negative GDP estimate revisions etc) that if the assumption is "we're hiking because of an inflation driven by too much demand and too little supply" – that problem will sort itself out in the coming quarters, as consumers start tightening their purse strings, directed so by the rising discount rates. This is what's

going on right now I think – the market is smart, and forward looking, we're always pricing expectations of what next year is going to look like. A simple look at several multi-year charts suggests the Covid-excess unwind is largely done, with the market actually pricing FED cuts by mid-year 2023. There is a silver lining around here somewhere, yet to be discovered, and hence the market is jumping the gun, front-running a fed turning more dovish as the inflation expectations could potentially be muted by recession fears.

But.

It's never that easy, is it? Should inflation prove to be stickier than anticipated, and the hikes inefficient, we will certainly see higher rates – and with it: lower asset prices. When exogenous factors such as food and energy shortages wreak havoc with consumer purchasing powers, cancelling the very intellectual approach (as opposed to real-world) “core inflation”, that, for some reason, excludes very tangible food and energy, there's little monetary policy can do.

You can watch the FED all you want, but that's not where the puck is going. You can't fertilize with dollar bills, nor drive your car with Euro coins. Note the emergence of significant industrial action: strikes where workers are calling for 7-8% salary hikes. Not what you want when trying to keep inflation expectations down. Note also various national government attempts to alleviate the cost-of-living crisis brought by food and energy inflation: freshly printed cash sent to consumers in various forms of direct subsidies. Now, printing money to stave off inflationary effects - ironic, is it not?

From weakening, to weak

We venture to guess the next leg is the economy going **from weakening, to weak**. With still negative real rates in the short and medium term, it's anyone's guess what type of rates will be needed to suppress inflation. And the crux of the matter isn't so much when inflation will **peak**, but where it will **trough**. I read more and more commentary (and indeed the actual pricing of the FED-funds futures) suggesting “inflation will peak roundabout now” – which is probably a reasonable guess (it's a y/y number after all, eventually it will peak just from mathematics). But the peak isn't interesting. The trough is. And here I think we risk underestimating the stickiness, which could lead to a realization in the markets that (real) rates have (a lot) further to go. Protean is currently expressing this view via shorts predominately in real estate and consumer durables. It deserves to be remembered, also in this new era of Central Bank-watching, that curbing unacceptable inflation is always an unpleasant exercise, but not rocket science: rising real rates leads to unemployment, leads to a recession, leads to lower inflation. Disco.

Depending on how you slice and dice the discount factor you could make the argument the latest correction comes from a combination of a) silly-H2 2021-mania-year-end-print as a starting point, and b) going from discounting an abnormally low real rate to today's spot rates. If your expectation is earnings are set for a decline (we have witnessed some early cuts in predominantly consumer discretionary already) and real rates for a further climb, this market has further downside. We'd love to be wrong.

What we're thinking and reading

- **How to position in a (looming) downturn**

We have seen enough markets to realize that correctly estimating the fact "Atlas Copco's margins barely budged during the financial crisis, so that's fine to own" did not keep you from suffering through a -63% top-to-bottom journey between April 2007 and October 2008. On this theme we revised our exposures to Nordic banks during the past month. The theme of Swedish property coming under pressure has immediate sentiment spill-over-effects to the Nordic banks. Swedish banks in particular. Our view is that this is likely an exaggerated concern, and the most bearish internationals appear to not fully understand how the Swedish market functions. We don't think the world will come to an end (this time either): the banks are very well capitalized, thoroughly regulated and lending processes are strict and amply collateralized. Adding to that: the banks themselves are very (very) cheap.

This, however, does not negate the fact that the misunderstandings are pervasive and tend to have outsized effects on flows and positioning. The marginal buyer of Swedish banks is a foreign investor prone to misunderstandings. Who, that does not have to, wants to own financial institutions with material exposure to one of the optically priciest and bubbliest real estate markets in the world? Fewer and fewer it seems. We aim to stay ahead of that. We do like the banks, we even own some banks, but our net exposure to the space is now negative (we're overweight insurance, however, we love insurance).

For color, here's an actual example from one of the global banks' earnings previews on Nordic Banks, published Monday June 4th: "We expect 2Q22 QoQ will exhibit robust NII growth and underlying asset quality will remain intact, albeit we anticipate weak fees and capital headwinds. However, we think the focus will be related to the Nordic Banks' commercial real estate exposures. We remain negative on the Nordic Banks."

- **Why credit analysts are boring (and the grown-ups at the party)**

Having been an equity sales person for the better part of two decades I know for a fact you don't have a case just with numbers. You need a

narrative. A story. Why is this company a particularly intriguing investing right now? As a morning meeting captain at several brokerages, moderating the analysts ideas every morning for over a decade, the one question I always asked is “what’s new” when they changed their ratings. This, having read a number of dead boring credit analyst notes in the past years, is not something that can be asked of debt investors. They’d rather NOTHING changed. Ever. Their best case is to be repaid at par. That the company didn’t go bust. That the risks they identified at time of investing have turned out as planned. They don’t need a company to be successful, just that the company doesn’t fail at what it is currently doing. Credit investors are an entirely different breed compared to equity investors. They simply want their money back. Equity investors are fine with losing some money, as long as the option to make multiples of the original investment still is a viable path forward.

Therefore, I’m quite concerned credit appears to be capitulating, but equities are not. Credit analysis rests on cashflows and ability to repay debt. Equity analysis rests on estimated future cash flows and (sometimes) lofty and optimistic assumptions. When I see the equity market dropping 20%, but grown-up, sober debt instruments dropping MORE, I pause to take stock.

Credit squeeze moves to cash bonds, equities appear to lag credit’s capitulation trade



Source: Macrobond, SEB Strategic Research

I mean whoa, this scenario suggests there’s a fairly wide distribution of outcomes.

While one shouldn’t make too much of a macro analysts chart-fitting exercises (always, ALWAYS, check the axels for chart-crimes), I kind of agree that the mayhem in credit YTD appears to be more significant (not the least in terms of standard deviations) than the correction in equities. This is the kind of thing we could be looking back at in 12 months time and say “Why didn’t we pay attention that?” This, among other things, is the reason Protean Select remains in the low net-exposure range of 10-30% we’ve been travelling in pretty much since the start two months ago. Our

shrimp trawler is ready to leave the dock, but is still moored relatively solidly to the pollards. We'd like to think we're the grown-ups at the equity party.

- **Taking care of Cary group**

The avid reader of our Partner Letter (and our Twitter feed) will remember we published a short case back in April, detailing our negative stance to the Cary Group equity at SEK 72. We were arguing they had multiple headwinds, not least sector specific and valuation. We hadn't even started our fund, so had no position on, yet the stock dropped 10% on our publication of the short thesis. Regardless, we did indeed short the stock once the fund became operational on the 2nd of May, and on the 28th of June the stock troughed at SEK 40,6. A 44% drop in less than two months. Sadly, we covered our short well below the bottom, for valuation reasons, but our thesis still generated a healthy return to our investors. Little did we know the PE-fund that put the stock on the market would see fit to roll the company into a fund of a more recent vintage at a 60% premium. Notable is, however, that the optically material premium only translates to an 11% performance for the Cary Group equity for the month of June. I'm not surprised to see some long-term owners of the equity protesting this is an unfair bid (although I personally would take the money and run). Case closed for Protean: we could have timed our exit better, and could of course have been long at time of the bid, but are generally happy with our execution. Onwards to the next one.

- **The Beastie Boys Book**

One thing that I keep repeating to myself is "we're rarely unique". If the general public rates something highly, it's because it has a quality that holds general appeal. There's a reason the Phantom of the Opera has played for a full house every night in London since 1986. The same (sort of) holds true in reverse: if I believe something is good, there's every reason to think more people will have the same experience – but it matters if you are early to experiencing it! This is very much applicable to the stock market as a whole, and the very reason curiosity and open-mindedness is a core skill to have as a fund manager. If you can find a good company and story early, you are bound to have a lot of followers. I was an early fan of the Beastie Boys, starting already with the somewhat challenging Paul's Boutique, released in 1989 (let's be honest, "Licenced to Ill" was rubbish). The band has followed me through grade- and high school and through my short period as part-time a DJ at Umeå University. Last year a big 450-page book was released, with 100-odd stories written by both band members and others involved in the 1980s NYC-clique that created the B-boys. I can't recommend it enough if you're into the emergence of hip-hop and what it was like to be a punk-slash-rap-artist



JUNE 2022 • PARTNER LETTER

emerging in the late 1900's. I found it highly enjoyable, and I'm sure others like me would too. Read it.

- **On a Serious Note**

Protean Select continues to try and thread the needle of protecting the downside but being open to capitalize on the upside. An impossible task, maybe, but our core belief is that a small enough fund, with portfolio managers fully aligned and invested in the strategy themselves, should have the best institutional opportunity to do just that. In the very short term, we may underperform in a serious up-market (since it doesn't rhyme with our current core belief) and we could very well continue to have negative absolute returns, should markets continue to significantly contract. But I promise you this: we're in this together, and we eat what we cook. We're proud of what we've achieved in the first two months, but remind both you and us : this is a long term game. To profit from the next up-cycle, we need to first make it through this down-cycle with our chip-stack largely intact. **For now, our focus remains on protecting the downside. But we hope it changes, soon.** Hope does not a portfolio build, however, why we remain cautious, for now.

Pontus Dackmo
CEO and Investment Manager
Protean Funds Scandinavia AB