Made in Italy Fund

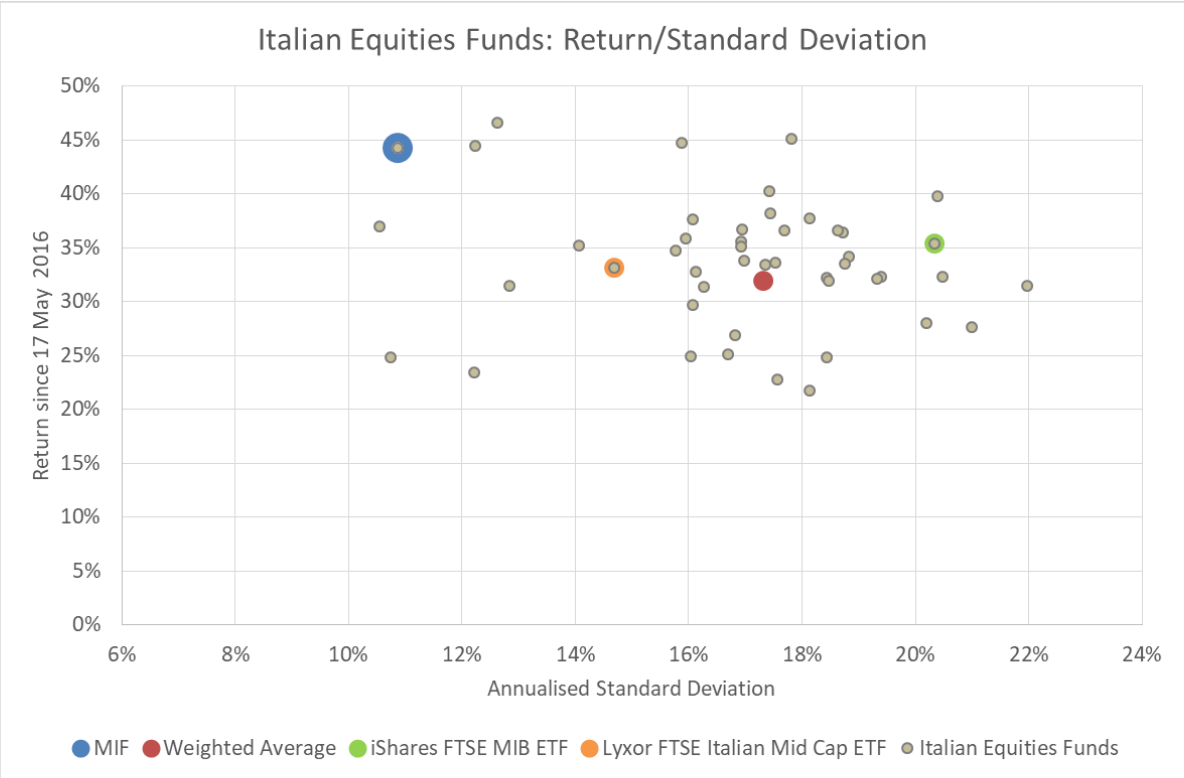
Bayes Investments

Investor letter – First Quarter 2018

Dear Fellow Investors,

The Made in Italy Fund (MIF) was down -4.4% in the first quarter of 2018. The return since inception (17 May 2016) is 44.2%. Returns are net of all fees and administration costs.

During the quarter, the MIF reduced its advantage over the Italian Equities fund universe, whose weighted average return since MIF's inception is 31.9%:



Source: Factset

The MIF return remains well above the 33.1% return of the ETF most comparable to the MIF – the Lyxor Mid Cap Fund – as well as the 35.4% return of the main Italian Equities ETF – the iShares FTSE MIB.

The MIF return continues to be accompanied by low volatility. The annualised standard deviation of its daily returns is 10.9%, compared to 17.3% for the weighted average fund, 14.7% for the Lyxor ETF and 20.3% for the iShares ETF.

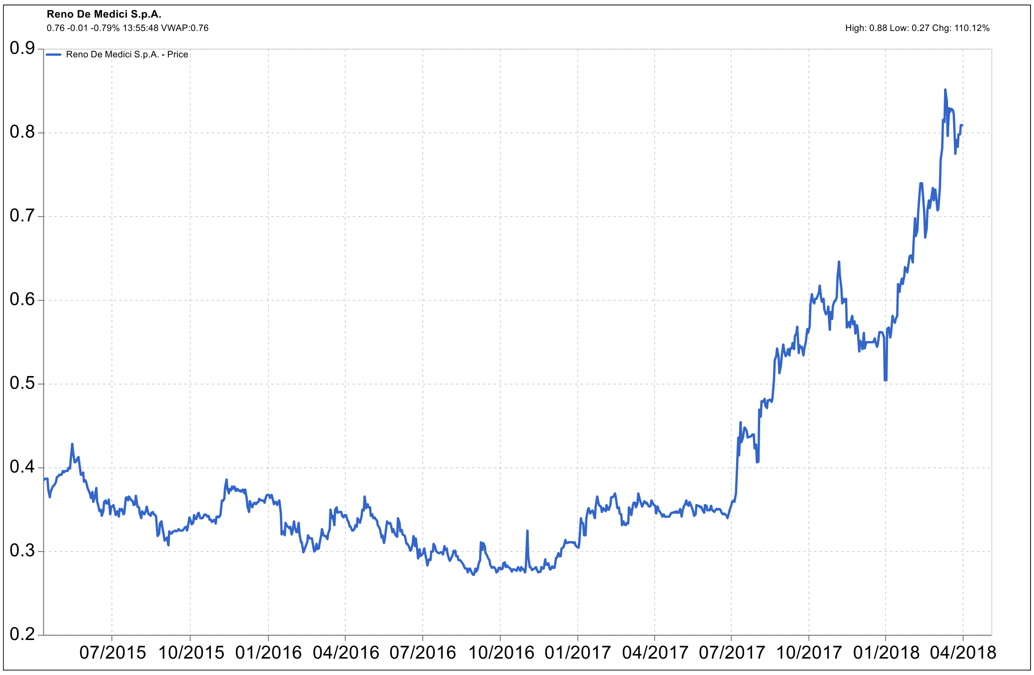
First Quarter 2018

Our -4.4% return for the quarter compares with a weighted average return of 0.4% for the Italian Equities universe, -1.6% for the Lyxor ETF and 2.7% for the iShares ETF.

The new year got off to a good start in January, with the Fund advancing 2.9%, albeit below the main market, whose FTSE MIB index jumped ahead 7.9%, helped by Financials, FCA and Ferrari. As in Q4 last year, however, the second month of the quarter saw a sharp drop, triggered this time by worries about the pace of monetary tightening in the US and, towards the end of the month, about global trade tensions. Italian general elections took place at the beginning of March and, as expected, resulted in a hung parliament. Stronger than anticipated, however, was the success of the Five Star Movement and the setback of the Democratic Party, which prevented the desirable continuity of the incumbent government. At the same time, the poor showing of the newly formed leftist party removed the negative scenario of their forming a government coalition with Five Star. The resolution of electoral uncertainty produced a market rally in the first half of the month, subsequently reabsorbed by renewed global stock market jitters in the second half.

Such heightened volatility left the Fund with a negative return in the quarter, in line with Europe (STOXX Europe 600 index -4.7%, Euro STOXX 50 index -6.1%) and slightly below the FTSE Italia Small Caps index (-3.0%), but lagging the FTSE MIB index, which ended the quarter up 2.8%, well ahead of the weighted average of Italian Equities funds.

As companies in our portfolio started reporting 2017 results, there was a wide dispersion of price reactions. On the positive side, Reno de Medici, a producer of White Lined Chipboard and Folding Boxboard paper, was up 60% in the quarter, adding to its 67% return in 2017. The MIF owns the stock since inception, at an average purchase price of 0.34 euro, vs. 0.81 at quarter-end.



Such strong performance is a fitting recognition of the company's effort, led by newly-appointed CEO Michele Bianchi, to increase revenues – up 19% to 570 million euro in the year – while drastically improving operating margins – EBIT went from 7.8m to 23.5m and Net Income from 3.4m to 14.6m. We have been able to appreciate and monitor management efforts over several meetings in the last two years, and are pleased to report that our view has been rewarded. (Here is a link to a recent company presentation).

Another good performer was El.En., a producer of laser equipment for medical and industrial use, up 24% in the quarter. The MIF holds the stock since inception as well, with an average purchase price of 18.1 euro.

The company reported 2017 revenues up 21% to 306 million euro, with an EBIT of 30.5m, up 10% from a year earlier. (Here is a link to their recent presentation). Notice that El.En.'s price went through considerable volatility in 2017, starting the year at around 24 euro, going up to 34 in May and down to a low of 21 in November, ending the year at 26. Yet, over the whole period we never considered selling our position. Each stock in the Fund is there for the sole reason that we believe there is a substantial gap between its intrinsic value and the market price. We will only sell the stock if the gap is reduced beyond a certain margin of safety. There are two ways for the gap to shrink: stock appreciation or a reduction in intrinsic value. The core of our investment process is to form an idea about a company and transform it into an estimate of intrinsic value. We constantly monitor and challenge our estimates against company news, reported results and any other development that may affect valuation. By its very nature, however, valuation is a long-term measure: the value of a company is the discounted sum of its cash flows over the indefinite future. Hence short-term fluctuations in company results have a limited impact. For instance, if a company has a 'bad' quarter its intrinsic value remains virtually unchanged, unless – and this is a key point – the reported numbers signal the risk of a permanent, structural shift in profitability or growth prospects. But as long as these remain intact, a price drop actually widens the value gap and makes the stock more attractive, thus creating an opportunity to increase our position and patiently wait until value is restored.

We brought up the same theme in our Q3 2017 letter, when we discussed La Doria and its move from 7 euro at the end of 2016 to 15 euro by the end of September 2017. The stock proceeded to end the year above 16 euro. But in the first quarter of this year the price traced back to just above 12 euro.

There was no fundamental reason for the price drop, most of which actually happened over the February global falloff, before the company reported 2017 results in mid-March. Results were positive and ahead of expectations, accompanied by a revised three-year plan including 115 million future investments, aimed at increasing production efficiency and operating margins, and further moving the product mix towards higher value-added segments, such as ready-made sauces and bio products. The 25% drop in the quarter offered once again a good opportunity to increase position in a company whose intrinsic value we estimate to be well above its year-end price level. La Doria is in the portfolio since inception, at an average purchase price below 10 euro.

A similar phenomenon occurred to Datalogic, a company we discussed several times, latterly in our Q4 2017 letter. The drop happened this time after the company reported Q4 results on 21st March.

These were once again record results (here is the link to their presentation), with solid growth in revenues and profits and an increase in annual dividends from 0.30 to 0.50 euro per share. The only 'disappointment' came from some hitch in the US, namely a retail product launch delay which, together with an adverse FX impact, caused a 4% year-on-year sales drop in the region. This was apparently a good reason for some investors to disregard everything else (including a 55% y-o-y sales increase in China) and sell the stock, taking the price down to 25.5 euro at quarter-end (-17% in the quarter) and again creating a good buying opportunity for patient investors. Datalogic is in the portfolio since inception, at an average purchase price of 15.7 euro.

One more example was ceramic tiles producer Panaria which, like La Doria, was caught in the February selloff and, like Datalogic – and for similarly temporary, weather-related glitches in the US – came under further pressure after reporting 2017 results in mid-March, ending the first quarter down -33% to 3.9 euro, despite results being good overall, accompanied by a positive outlook for 2018 (here is a link to their recent presentation). Panaria is in the portfolio since February 2017, at an average purchase price of 3.8 euro.

These and other unwarranted price drops – e.g. Banca Ifis -23%, Gefran -17% – coinciding with some sizable fund redemptions driven by profit-taking, resulted in a poor quarter, coming on top of a negative Q4 2017.

These price moves make us more positive for the rest of the year. Undoubtedly, the electoral outcome was not our or the market's favourite. A hung parliament dominated by untested newcomers is likely to result in a fractious government and possibly in a new electoral round before the end of the year. But at the same time it means that the likelihood of a new government adopting a substantive EU-defying stance – the only meaningfully disruptive possible development – remains remote, as reflected in the steadfastness of the 10-year BTP, which at 1.80% is 15 basis points below year-end and remains 50 basis points below its level of 12 months ago. This is no reason for complacency – we need to remain vigilant and open to a change in outlook. But, barring renewed global geopolitical tensions, we continue to expect a catch-up of Italian stocks vis-à-vis the rest of Europe, as illustrated in our Q3 2017 letter, and a recovery of the small cap edge versus large caps after the last two quarters' correction. Hence we remain fully invested and confident about the store of value embedded in our portfolio.

The sector composition of the fund at quarter-end is the following:

	Number of companies	% Weight
Producer Manufacturing	8	25.1%
Electronic Technology	4	12.5%
Process Industries	4	12.1%
Consumer Non-Durables	1	3.7%
Commercial Services	4	12.3%
Distribution Services	1	2.8%
Technology Services	4	10.1%
Consumer Durables	3	8.1%
Finance	3	10.3%
Retail Trade	1	1.2%
Total	33	98.1%
Cash		1.9%

The Valuation Gap

An interesting issue about a Value Investing process based on the gap between intrinsic value and market price is its correspondence with other valuation metrics. A common view of Value Investing associates value to a low Price-Earnings ratio or similar measures, such as Price to Cash Flow, Price to Sales, Price to Book Value and Enterprise Value to EBITDA. There is an obvious sense in which this is true by definition: a lower stock price implies a higher gap as well as a lower ratio, and vice versa. But it is important to realise that this is not the same as saying that a *high* gap necessarily implies a *low* ratio.

The intrinsic value of a company is the discounted sum of its future cash flows. This is the basis of any valuation framework. The PE ratio can be shown to be the output of the simplest model, in which a company's earnings are assumed to grow at a constant rate and are distributed to shareholders at a constant payout ratio. But such model fails to take into account the relationship between profitability and growth. A company that can generate a higher return on capital and is able to grow earnings at a higher rate for an extended period of time deserves a higher valuation compared to a company with a lower return and growth prospects. Hence it might be the case that the former has a higher valuation gap, and is therefore a more attractive investment, despite having a higher PE ratio (see here for a schematic introduction).

A low PE ratio, or a similarly low ratio, says nothing by itself about the attractiveness of an investment. Simply using low ratios as criteria for stock selection risks biasing a portfolio towards mature businesses that have no franchise value, and away from businesses where a well-managed competitive advantage justifies a premium that may not be adequately reflected in the market price. The conventional dichotomy between Value and Growth is a misleading representation of the investment process. An investor does not need to opt for one or the other: he needs to build reasonable and prudent growth assumptions in the context of a model in which a company earns extra returns on capital over a certain franchise period, and compare the resulting intrinsic value to the current market price. Profitable and growing companies can be valuable and attractive investments while at the same time exhibiting higher ratios than less profitable and slower growing companies.

The correct measure of the value embedded in a stock portfolio is not its average PE ratio. It is its average or, more precisely, its median valuation gap. The current median in the MIF portfolio is 85%.

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During the first quarter, Bayes Investments Ltd. moved its Appointed Representative status from MET Facilities LLP to New College Capital Ltd. This coincided with a change in the Company's shareholding, which saw the departure of some individual shareholders and the arrival of new institutional shareholders.

The new shareholders bring to Bayes an important endowment of knowledge, experience and competence, which we believe will be extremely beneficial to the Company's future.

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