Made in Italy Fund

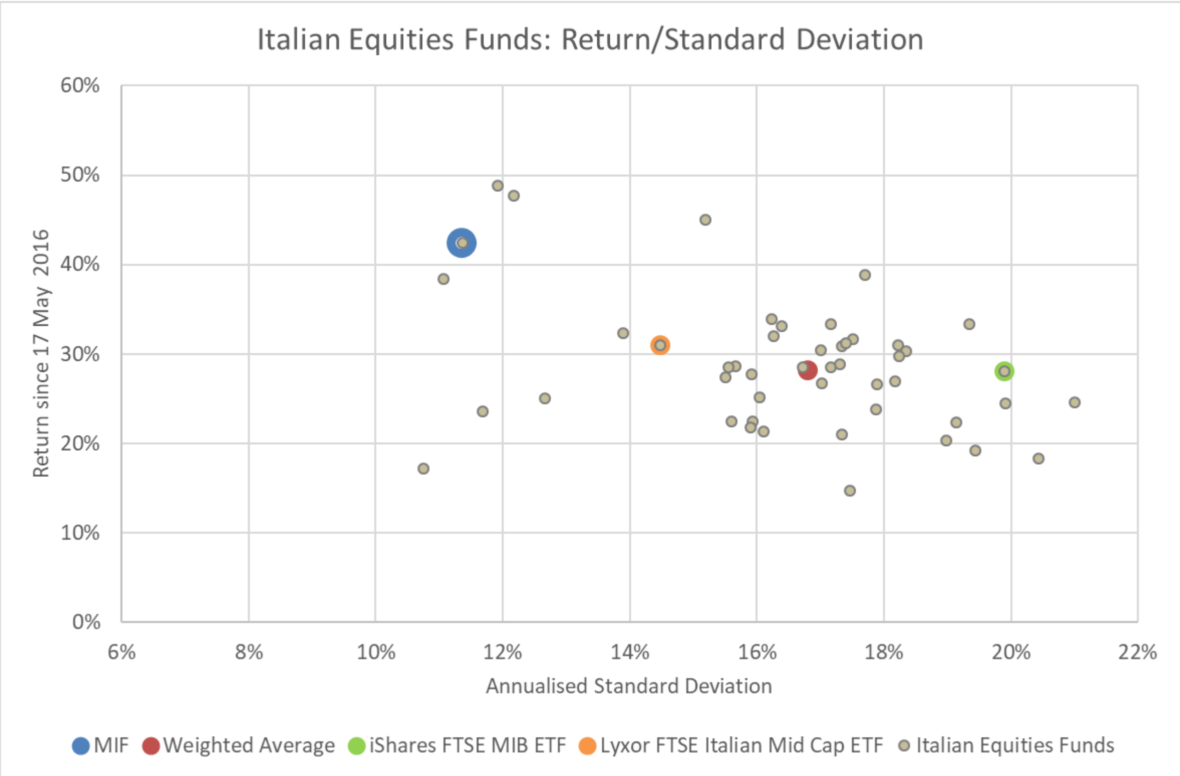
Bayes Investments

Investor letter – Third Quarter 2018

Dear Fellow Investors,

The Made in Italy Fund (MIF) had a return of 1.3% in the third quarter of 2018. The return since inception (17 May 2016) is 42.4%. Returns are net of all fees and administration costs.

During the quarter, the MIF increased its advantage over the Italian Equities fund universe, whose weighted average return since MIF's inception is 28.2%:



Source: Factset

The MIF return is well above the 31.0% return of the most comparable ETF – the Lyxor Mid Cap Fund – as well as the 28.1% 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 11.4%, compared to 16.8% for the weighted average fund, 14.5% for the Lyxor ETF and 19.9% for the iShares ETF.

Third Quarter 2018

Our 1.3% return for the quarter compares with a weighted average return of -2.2% for the Italian Equities universe, -0.9% for the Lyxor ETF and -3.8% for the iShares ETF.

The Fund was up 3.6% in July, well ahead of the FTSE Small Cap index as well as the main market MIB index. But as political turmoil resumed, August was a negative month – one more negative middle month for a fourth quarter in a row – with the MIB index down almost 9% and the yield on the 10-year BTP spiking to 3.2% from a low of 2.5% in mid-July. Again our Fund did better, limiting its loss to -4.3%, also ahead of the Small Cap index. Finally, September's return was positive, with the Fund up 2.1%, ahead of the Small Cap index and slightly below the MIB index.

Notable performers in the quarter included Gruppo MutuiOnline, up 18%, and Tamburi Investment Partners, up 10%. Most of the laggards mentioned in the Q1 and Q2 letters had a good rebound, notably Gefran +10%, La Doria +9% and Panaria +7%. Not so, however, for Banca Ifis, which continued to slide – down 25% in the quarter – along with the rest of the banking sector, and El.En., down 24% despite reporting strong results.

Our positive return amidst a declining equity market led to a substantial reduction of the lag we accumulated in the first half of the year. In the nine months to September, the MIF is down -5.6%, versus -2.7% for the weighted average fund, -3.2% for the Lyxor ETF and -2.8% for the iShares ETF.

We wrote at length about the first-half gap in our Q2 2018 letter, where we highlighted the substantial underperformance of the FTSE Small cap index versus the MIB index as well as the FTSE STAR index, and argued against the common interpretation that sees this as a redress of the PIR-related small cap outperformance of 2017. We notice here that in the third quarter the Small Cap index was down -3.7%, in line with the -3.6% of the MIB index, whereas the MIF return was slightly above the 1.2% return of the STAR index. Year-to-date, the MIF return is well above the -9.3% return of the Small Cap index.

The current sector composition of the Fund is the following:

	Number of companies	% Weight
Producer Manufacturing	9	26.4%
Electronic Technology	4	11.2%
Process Industries	4	11.0%
Consumer Non-Durables	1	3.5%
Commercial Services	5	11.2%
Distribution Services	1	2.3%
Consumer Services	1	3.0%
Technology Services	4	7.7%
Consumer Durables	3	8.8%
Finance	3	6.9%
Communications	1	3.2%
Utilities	1	3.9%
Total	37	99.2%
Cash		0.8%

The increase in the number of companies in the portfolio is due to a number of IPOs in which we participated during the quarter. These are smaller companies that, braving the vagaries of Italian politics, decided to go ahead with their quotation on the Aim Italia market. We highlight two of them:

Longino & Cardenal caters top-quality foods from around the world and distributes them to top restaurants in Italy and more recently in Dubai and Hong Kong. The company came to the market at the beginning of July at 3.6 euro per share and closed the quarter at 4.8 euro. Its current market value is 33 million euro and free float is 22%. In 2017 the company reported revenues of more than 28 million, with an EBIT margin of about 6%. In the first half of this year revenues grew 16% over the same period last year and EBIT grew 53%. The company raised 5 million from the IPO, which is investing to finance organic growth – expansion of product mix and geographical reach – and external growth, including opening a subsidiary in New York City.

Intred provides broadband communication services through a 1700 km proprietary fibre optic network focused in the area of eastern Lombardy. The company came to the market in mid-July at 2.3 euro per share and closed the quarter at 3.1 euro. The current market value is 49 million and free float is 21%. In 2017 the company reported revenues of almost 15 million and EBIT of 3.5 million, for an EBIT margin of 24%. In the first half of this year revenues grew 20% to 8.3 million, with an EBIT of 2.1 million and a further margin expansion to 25%. The company raised 11 million from the IPO, which is being used for network extension and the upselling of new services to existing clients.

From A to B – the Italian way

Our quarterly return would have been higher but for the last day of September, when the MIB index lost -3.7% and our Fund fell -1.9%. This was the day after the Italian government disclosed its 2019 budget deficit provision, which came out at 2.4%, 50% higher than the 1.6% that Finance minister Tria had until then assured it would be.

This unwelcome development was in contrast with our expectations, which, as articulated in our 4 June note, envisaged an acceptable compromise between the government coalition's electoral promises and the need to keep public debt to GDP ratio on a declining path. This would have avoided a mutually damaging confrontation between Italy and the EU, resulting in a positive outlook for Italian equities in the second half of the year.

We were wrong. Defying what, backed by Mr. Tria's pledge, had become a consensus scenario, the 5Star party, which had been losing ground to its coalition partner Lega in the latest polls, imposed the higher deficit number as a means to bolster its popularity. The Lega, in EU defiance mode, followed suit, and Mr Tria was side-lined. As a result, an event we were expecting to bring about a resolution of uncertainty ended up increasing it. We will now have to wait until the end of October, for the actual budget law to be presented in Parliament and then evaluated by the EU and the rating agencies.

We still think that a conciliatory compromise will eventually be reached – in Italian affairs the path from A to B is never a straight line. The real issue is not EU wrangling *per se* – this is not the first dispute between the EU and a national government, and it won't be the last – but the overall credibility of the government plan to stimulate the economy and increase GDP growth beyond the current consensus forecast of around 1%.

The government's best intentions are well summarised in a document issued in early September by the European Affairs minister Paolo Savona (the English translation follows the Italian original). As you will recall, Savona was at the origin of the May turmoil, as the new party coalition's proposal to appoint him as Economics minister was vetoed by President Mattarella on the grounds of Savona's association with the notorious 'Plan B', detailing a course of action for Italy to leave the Euro zone by stealth. Savona, who subsequently entered the government in a different ministry, has been adamant since then to shed his 'Eurosceptic' image and to clarify his vision, which stresses the need to change the EU's economic policy architecture and endow it with effective fiscal instruments to boost aggregate demand. This essentially coincides with Paul De Grauwe's position we highlighted in our June note (here again his F&W June interview).

The risks to the government stance are well summarised, with usual clarity and composure – raising high above the cacophony of caricature and insult on both sides – in this article by ex-ECB Director Lorenzo Bini Smaghi (only in Italian – sorry):

1. Italian fiscal policy has been expansionary and pro-cyclical for most of the last 20 years. Doing more of the same runs the risk of requiring drastic corrections in the future.
2. Lower growth in Italy has more to do with structural bottlenecks than with low aggregate demand. More debt-financed public expenditure may be ineffective and even counterproductive.
3. If North-European 'populist' parties replicate the 5Star/Lega success in next year's European elections, the EU aversion to South-European high debt countries may actually increase rather than decrease.
4. It is wrong to assume that, in case of a loss of credibility and a consequent sharp jump in bond yields, ECB intervention through Outright Monetary Transactions (OMT) would be unconditional. Italy cannot rely on being too big to fail: OMT could only be conditional on a sharp correction of fiscal excesses, enough to regain market confidence.

We shall see in the next few weeks how the saga pans out. But whatever happens, it is important to keep in mind that, whereas heightened uncertainty may depress market prices, the intrinsic value of our companies does not change. First half results have been strong across the board and there is no reason to expect the second half to be any different. A good example is **Landi Renzo Group**, a company we recently presented at the MOI Global European Investment Summit.

In these circumstances, price volatility creates opportunities to increase our positions at cheaper prices.

For a monthly update of the MIF's performance, we invite you to look at our monthly Factsheets, available on our dedicated page on the Atomo Sicav website.

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