Made in Italy Fund

Bayes Investments

9 September 2019

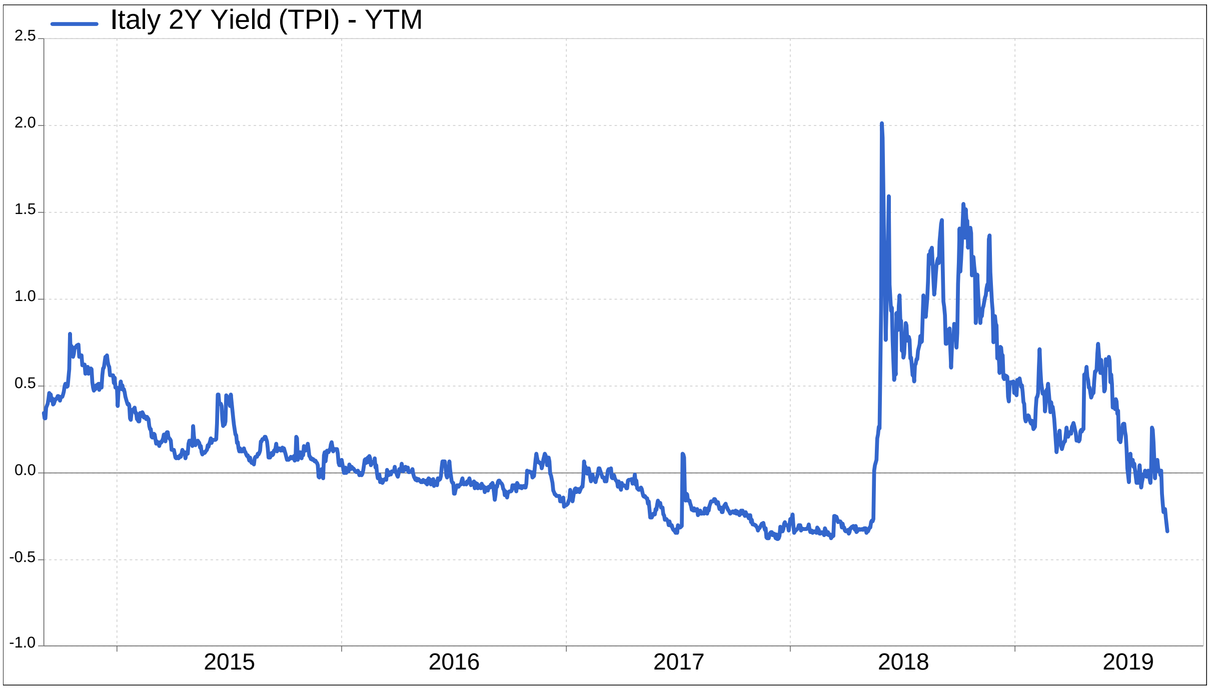
Made in Italy Fund 12-month outlook

Dear Fellow Investors,

As the summer recess draws to a close, we would like to share with you our thoughts on the outlook for our Fund in the next twelve months.

Before launch, as we thought of a name for the Fund, the idea of calling it 'Made in Italy' came quite naturally. It is, by some measure, the third most recognised brand in the world after Coca Cola and Visa and – we checked – there was no legal impediment to using it.

As simple as it was, people loved it. That is until mid-May 2018, when their attitude quickly changed from 'Ah yes' to 'Oh no'. There is no better picture of this abrupt change of mood than this:



In the space of two weeks, the 2-year BTP yield – a sensitive measure of investors' concerns about the state of Italian public finances – jumped from negative territory all the way up to 2%, following the turmoil about the formation of the new 5Star/Lega government resulting from the outcome of the March general elections. All of a sudden, 'Made in Italy' stopped being a hip tag and became a source of worry. People still got and appreciated our main message: our fund was never meant to be a top-down 'country' fund but a bottom-up collection of Italian companies selected on the basis of the attractiveness of their intrinsic value. Still, in the midst of all the uncertainty and doubts about the convolutions of Italian politics, they preferred to wait and see.

We wrote at length about all this in our quarterly letters and additional notes, where from the beginning we took the view that investors' worst fears – an escalating clash with the EU, leading to a Euro exit and the return of the Lira – was misplaced.

We were right. It took a while, but the 2-year yield is now back to where it was. Likewise, the 10-year yield – an approximate measure of what the Italian state pays on average on new debt – first went back to its initial 1.8% level in July and then proceeded to fall all the way down below 1% in August – a level last reached in September 2016 – as the 5Star/Lega government was being replaced by a new 5Star/Democratic Party (PD) government, which is likely to be less fractious and is certainly and unambiguously pro-EU. The 10-year yield is now at around 0.9%, 150 basis point above the -0.6% of its German counterpart, close to its pre-election level and less than half the level reached at the height of the turmoil.

Italian equities have followed a similar pattern, with the MIB index falling -22.5% from mid-May 2018 till the end of the year, and then rebounding this year by almost the same amount. In our last Q2 letter we lamented the decision of those investors who, failing to keep a steady hand, sold equities on the way down, and praised the few who took the opportunity to buy at low levels, following our recommendation to do so in a presentation we sent out at the beginning of November.

<u>It is worth noticing, however, that this year's rebound has been mostly index driven.</u>

As shown in the following table, in the eight months to August the MIB Total Return index was up 20.7%, vastly ahead of the 8.3% performance of the Small Cap index. The MIB had also done relatively better in the downturn from mid-May to the end of 2018, and more so for the whole year, down -13.2% vs. -24.1% for the Small Cap index. The combined returns over the entire period are +4.8% for the MIB index and -17.8% for the Small cap index.

	MIB	Small Caps
YTD to August	20.7%	8.3%
Mid-May to end 2018	-22.5%	-25.0%
2018	-13.2%	-24.1%
2018 to August 2019	4.8%	-17.8%
2017	17.3%	28.5%
2017 to August 2019	22.9%	5.6%

A common interpretation of such large divergence is to regard it as a redressing of the small cap outperformance in 2017, seen in turn as the effect of the introduction of PIR funds. We argued against such interpretation already in our Q2 2018 letter, where we estimated that PIR-related small cap investments would account for only 1.3% of total small cap market value. We reiterated the point in our November presentation. In any case, even since 2017 returns now stand at 22.9% for the MIB index and 5.6% for the Small Cap index.

Our own explanation for such a yawning gap is that small and mid cap stocks were unduly hit in the 2018 downturn due to their lower liquidity, as domestic and foreign investors summarily cut their Italian exposure across the board, amid political uncertainty combined with an overall reduction in equity allocations. Then in 2019, as investors toned down their anxiety about the state of the global economy and came to realise the incongruity of their nightmare political scenarios, they returned to Italian stocks in the same indiscriminate fashion and bought the MIB index.

If we are right, the outlook for Italian small caps for the next twelve months is distinctly positive.

The new government is solid and likely to be long lasting. We are particularly encouraged by the appointment of MEP Roberto Gualtieri as Economics Minister and of ex-Prime Minister Paolo Gentiloni as European Commissioner, possibly replacing Pierre Moscovici at Economics and Financial Affairs. Gualtieri has a long and creditable European experience and is ideally positioned to step in ex-minister Tria and ongoing Prime Minister Conte's efforts to constructively negotiate more fiscal leeway. At the same time, Gentiloni could play a significant role in pushing the agenda for a much needed revision of European fiscal rules, which make no sense at the current level of interest rates.

Encouraged by renewed political stability, investors are likely to increase their exposure to Italian equities in a more discerning fashion and move beyond passive index buying.

In this environment, we are particularly confident about the outlook for the Made in Italy Fund.

As the following table shows, the Fund has done better than the FTSE Small Cap index in each year, and its cumulative performance since inception is more than double that of the index.[1]

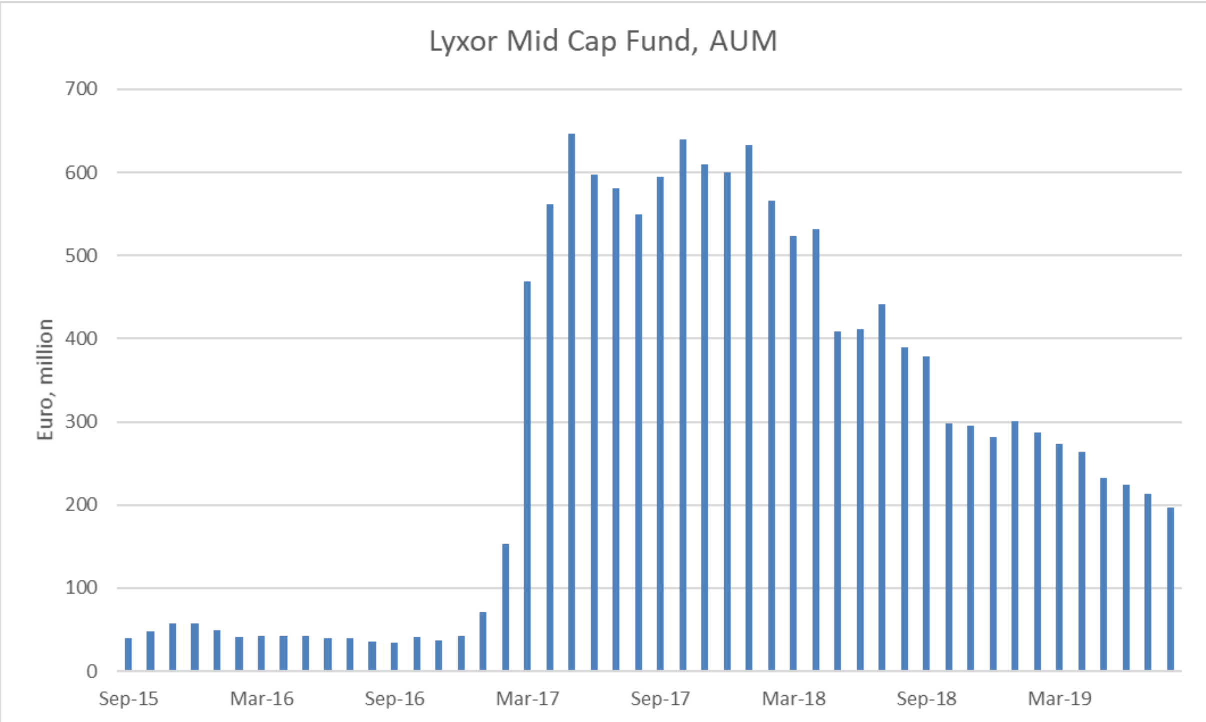
	MIF	Small Caps
YTD to August	9.2%	8.3%
2018	-18.4%	-24.1%
2017	35.9%	28.5%
2016 (from 17 May)	11.0%	10.5%
Since inception	34.4%	16.7%

[1] Notice that the index numbers in the table are Total Return and therefore higher than those contained in our monthly Factsheet, which are Price Only.

As small cap stocks close their performance gap, we are confident that the MIF will continue to outperform. The 2018 downturn and the ongoing strong results reported by our companies have widened the gap between their intrinsic values and market prices. We estimate that many of them are now worth more than double their current price.

The MIF should also continue to do better than its most comparable ETF, the Lyxor Mid Cap Fund. As we have seen in our last quarterly letter, the ETF is slightly ahead of the Small Cap index but lags far behind the MIF – its return since MIF's inception to August is 19.5%. That, by the way, is significantly behind the 27.7% return of the FTSE Mid Cap index which it is supposed to track.

As shown in the following graph, investors poured a vast amount of money into the passive Lyxor ETF in 2017 in the wake of PIR legislation, only to take most of it away in 2018 and 2019.



They would have done much better buying the Made in Italy Fund. This is as true now as it was then.

Investors who share our positive outlook on Italian small caps should buy the MIF rather than the Lyxor ETF.

Conclusion:

Since May last year, the word 'Italy' in our Fund's name has evoked doubts, raised fears and kept investors at bay.

Bond investors, who are most sensitive to macro/political issues, have put this all behind them. Passive equity investors have increased their Italian exposure or covered their shorts buying the MIB index.

We believe there is now an attractive opportunity to pick up Italian small cap pearls on the cheap.

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