Made in Italy
Fund

Bayes Investments

Investor letter – First Quarter and April 2020

Dear Fellow Investors,

At the end of March we took the unprecedented step of postponing our quarterly Investor letter. Investor letters are meant to be still pictures, reflecting on the main events in the quarter and on the likely way ahead. But with the coronavirus pandemic raging wild, we felt that a picture taken at the end of such an earth-shattering month would be too blurred to make any sense. We sent out a note on 9 March, urging investors to keep their composure and resist the temptation to participate in the ongoing panic, and another one on 12 March, praising the brave investor who defied the storm and bought more units in the Fund. Auspiciously, that date turned out to coincide with the market bottom, and we are extremely pleased to say that the Fund registered no redemptions over the entire quarter.

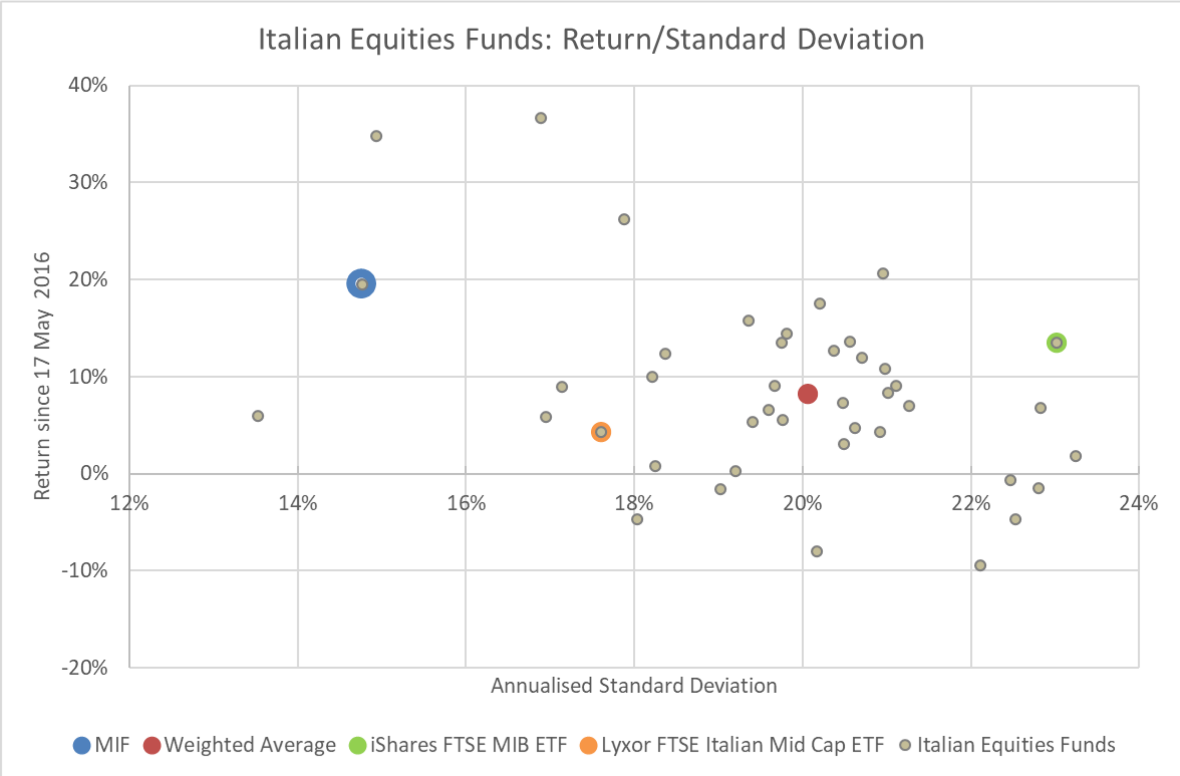
The fearsome escalation of the coronavirus pandemic took everyone by surprise. We were not exempt, complaining in our January Factsheet about our strong performance being “dragged sharply and foolishly down in the last week of the month by worldwide jitters about the coronavirus”. What then looked like a localised episode came much closer to home in February, eventually hitting global equity markets hard by the last week of the month and pulling them down until mid-March in what appears ex post to be a vertical fall but was actually infused with extreme daily volatility, with the VIX index reaching the highs of late 2008. The fall abated when early signs started to show that the lockdown measures which by then had been adopted in most countries were having some effect in slowing down the pace of infections. By the end of March, markets started to discount the probability of an out-of-control nightmare scenario and to focus on gauging the shape of the eventual recovery. Such positive attitude gained strength in April, allowing stocks to recoup some of the lost ground and driving the VIX index back down.

Our Fund fell broadly in line with the market in the first part of the quarter but fared distinctly better in the phase of steep descent. This encouraged us to abandon a half-hearted attempt in early March to hedge the portfolio by shorting MIB futures, and to rely instead on the resilience of our stocks in sorting an equivalent effect (see p. 3). Clearly, this did not spare us from partaking in a globally horrible March and Q1. But it had a substantial effect in April, where our performance far exceeded the main market rebound and vindicated our decision to postpone the letter, in order to present a sharper image of our portfolio.

On this premise, we present our numbers in the usual format:

The Made in Italy Fund (MIF) had a return of -17.4% in the four months to April 2020. The return since inception (17 May 2016) is 19.5%. Returns are net of fees and all administrative costs.

During the period, the MIF increased its advantage over the Italian Equities fund universe, whose weighted average return since MIF's inception is 8.1%:



Source: Factset

The MIF return is well above the 4.3% return of the most comparable ETF – the Lyxor Mid Cap Fund – and above the 13.5% 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 14.8%, compared to 20.1% for the weighted average fund, 17.6% for the Lyxor ETF and 23.0% for the iShares ETF.

First four months of 2020

Our -17.4% return for the first four months of the year compares with a weighted average return of -22.9% for the Italian Equities universe, -21.8% for the Lyxor ETF and -24.5% for the iShares ETF.

Far from being the harbinger of perfect vision, 2020 kicked off with an out of the blue bombshell that consigned all prognostications to the wastepaper basket. The unprecedented measures taken since early March to control the spread of the coronavirus are producing devastating effects on economic activity, countered by an equally unprecedented amount of monetary and fiscal stimulus.

The end result will be crucially dependent on the evolution of the pandemic. If the ongoing flattening endures and the contagion permanently recedes, economies may recover in the second half of the year as sharply as they are collapsing in the first. If it doesn't, and the easing of lockdown leads to a recrudescence, there will be no recovery and any stimulus will peter out, no matter its size.

Markets are currently favouring the first scenario, counting not only on better contagion numbers but also on increased preparedness after the initial shock, as well as the eventual prospect of cures and vaccines. We tend to agree but remain wary of the risks ahead.

The steep fall in the middle of the quarter was brutal. After briefly surpassing the 2017 High Watermark in mid-January, our NAV started a rapid descent in the last week of February, which by early March obliterated the entire progress made in 2019, and for a few sombre days in mid-March even drove the NAV below its initial 100 level. At the end of February and for a few days in the March tumult, for the first time in the Fund's history we experimented with shorting MIB Futures, in an attempt to cushion the blow. It didn't last long, as massive intraday volatility played havoc with margin calls. We gave up on hedging on 12 March, when a mighty -17% fall in the MIB index caught us unhedged but was met by a much smaller fall in our NAV of 'only' -8%, thus giving us the same effect as hedging half of the portfolio. That, plus the bold inflow that arrived on the same day, convinced us that the best way to take care of our portfolio was not to dabble with market timing, but to disregard the senseless price falls and be close to our companies, making sure that they were coping as best as they could with the dire times.

Never as clear as in such exceptional circumstances is the value of a comprehensive knowledge of companies and a personal relationship with their managers. A solid balance sheet, a flexible structure and capable management are the key traits of a company's ability to withstand adversity. Work done *beforehand* to identify these traits is an investor's best remedy against turbulence, as it gives him the necessary confidence to sail by the most violent price drops, knowing that they have nothing to do with true values. Let's take a few cases:

Openjobmetis – an employment service provider we own since Fund inception – fell -50% in Q1, with -37% just in March, as CEO Rosario Rasizza lay in hospital with Covid-19. But we knew the company, we knew Mr Rasizza and other managers. We hung on, and the stock was up 30% in April (with a fully recovered CEO).

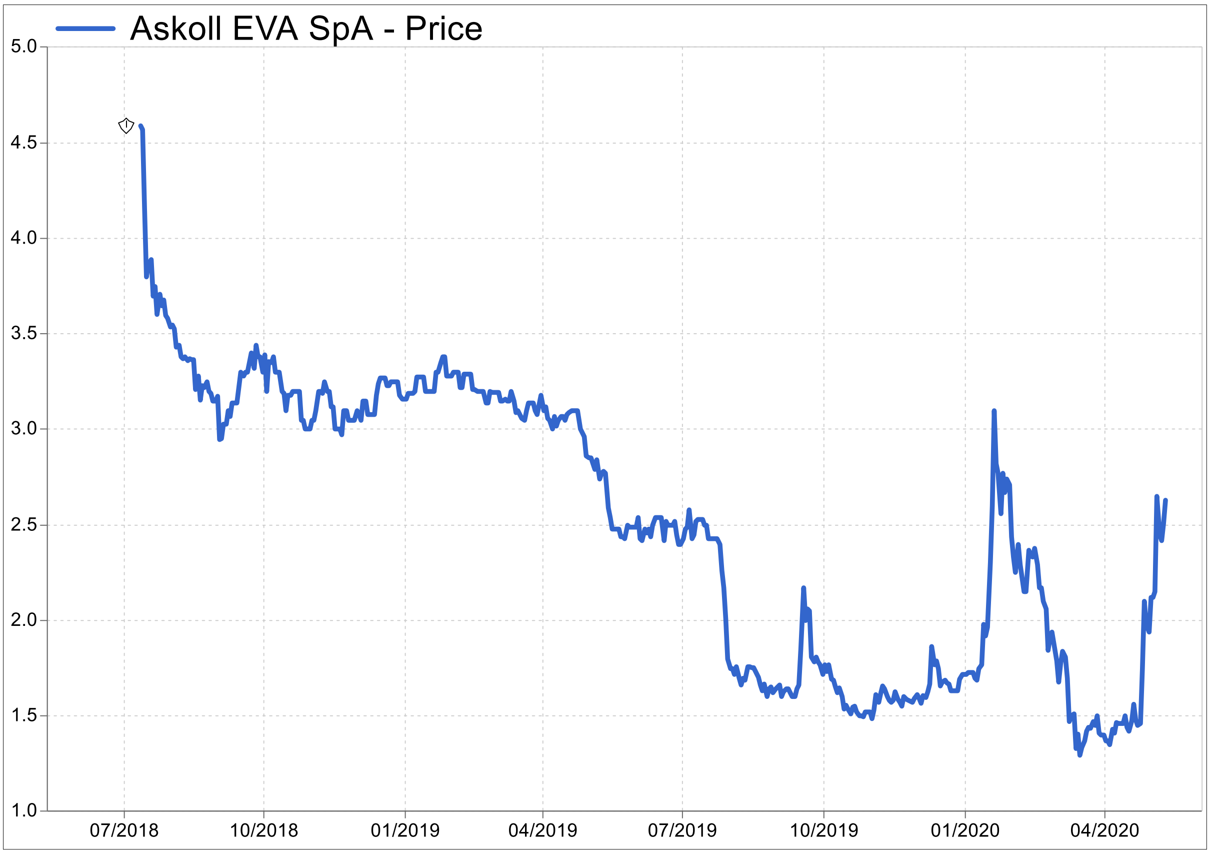
Esautomotion – a producer of numerical control machines we own since its IPO in 2018 – was down -44% in Q1, with -31% in March. But we talked to Chairman and major shareholder Franco Fontana, we went through the likely impacts on supply and demand and the company's efforts to cope with both. We remained comfortable, and the stock rebounded 37% in April.

Neodecortech – a manufacturer of printed décor paper and other materials for the furniture and flooring industries that we own since its 2017 IPO – was down -24% in Q1, with -18% in March, as the company coped with major disruptions coming from operating in the Bergamo area, one of the worst hit in Lombardy. Troubles included the demise of its CFO, who sadly succumbed to the virus. But we talked to CEO Luigi Cologni, we heard him explain his plans to get through the tough times. We held on, and the stock was up 22% in April.

Of course, no company can withstand permanent adversity. But strong, agile and well managed businesses can endure heavier blows for longer. Like **Longino & Cardenal** – a company right in the eye of the storm, as it caters high quality food for top restaurants in Italy and other countries – where, after securing ample credit lines with its banks, CEO Riccardo Uleri took the opportunity of the shutdown to develop an online shop delivering products directly to consumers throughout Italy.

A special mention is due for **Intred**, a company we first highlighted along with Longino & Cardenal in our Q3 2018 letter and we own since then. Like Neodecortech, it operates in eastern Lombardy, focused on the worst hit provinces of Bergamo and Brescia, where it provides broadband communication services. What better shorting candidate, then, for a quant trader unleashing his fancy algorithms in search for easy preys to profit from the mayhem? Well, the trader has been in for a surprise, as the stock went up 13% in Q1, with no particular news other than that in 2019 revenues were up 21% to 21 million euro, EBIT up 37% to 6 million for a 27% EBIT margin, and dividends increased 50%. Despite trimming our position in March, the stock remained one of our top holdings and was up a further 32% in April, for a year-to-date return of 49%, coming on top of an 82% return in 2019. One more instance of the flawed equation: economy=stock performance. The quant knows nothing about Intred and never met its CEO Daniele Peli. We do know the company, and we did meet Mr Peli many times.

Finally, we like to mention **Askoll EVA**, a producer of electric scooters and bicycles we first talked about in our Q2 2019 letter and we own since its IPO in 2018. At the beginning of the year, the stock started to finally meet our long standing expectations, and did so in spectacular fashion, jumping from 1.7 euro all the way to 3.1 by 20 January. But as the early inkling of the coronavirus crisis started to appear, the stock reverted rapidly to where it started from, and by mid-March reached a low of 1.3, eventually closing Q1 down 19% at 1.4. However, to the despair of momentum traders, the price reverted its course again and grew 51% in April to 2.1 euro, up 23% year-to-date. Over the period, we had several conversations with CEO Gian Franco Nanni and increased our position, bringing down the average purchase cost to the current price.



The current sector composition of the MIF is the following:

	Number of companies	% Weight
Producer Manufacturing	6	12.0%
Electronic Technology	2	4.9%
Process Industries	3	14.1%
Consumer Non-Durables	1	2.6%
Consumer Durables	3	10.9%
Industrial Services	1	4.4%
Commercial Services	5	14.8%
Consumer Services	1	3.5%
Technology Services	5	14.6%
Finance	2	3.6%
Health Technology	1	1.0%
Communications	1	5.8%
Utilities	1	4.9%
Total	32	97.0%
Cash		3.0%

What’s next?

We don’t know.

We ended our Q4 Investor letter with these last famous words:

> It has been a challenging two years. 2018 started off with a global stock market downturn in February. Then in May came Italian political turmoil, which accompanied us throughout the year, culminating in a steep global market drop in the fourth quarter. We regarded this as an excellent investment opportunity for 2019 and invited our investors to rise above ‘stagnant prudence’ and discern the sunny outlook ahead. Indeed, 2019 turned out to be one of the best years on record for Italian equities.
>
> We are now saying that 2020 will be another good year, especially for Italian small caps. We shall see if we will be right again.
>
> Happy New Year.

On 17 January we overtook our 2017 High Watermark and enjoyed it for a week, before disaster struck. Since then, 2020 has been anything but a happy new year.

Two things, though, we got right. One, the catch up of small caps versus large caps, which had started in Q4 last year after almost two years of underperformance, continued in Q1. Two, within small caps, AIM stocks made up a lot of ground, with the AIM index falling -13.9% in the four months, versus -22.1% for the Small Cap index and -24.4% for the MIB index. These relative moves helped the MIF to restore its performance advantage since inception versus the iShares ETF and the MIB index, which had been briefly lost in the second half of last year.

The resilience of small caps in this year’s downturn is in sharp contrast with the Q4 2018 decline, when small caps bore the brunt of investors’ restlessness, and Italian equity funds, including ours, experienced heavy redemptions.

We won’t venture to guess what will happen to world stock markets in the rest of this eventful year. But we stand by our small cap call. Many of our stocks had strong rebounds in April – our monthly return was 12.1% – but most of them are still down, some of them heavily, from their year-end levels. If the world continues to move, however tentatively, towards more normal conditions, as it did from March 2009 following the Great Financial Crisis, Italian small caps will be, as they were then, at the forefront of the rebound.

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