Made in Italy Fund

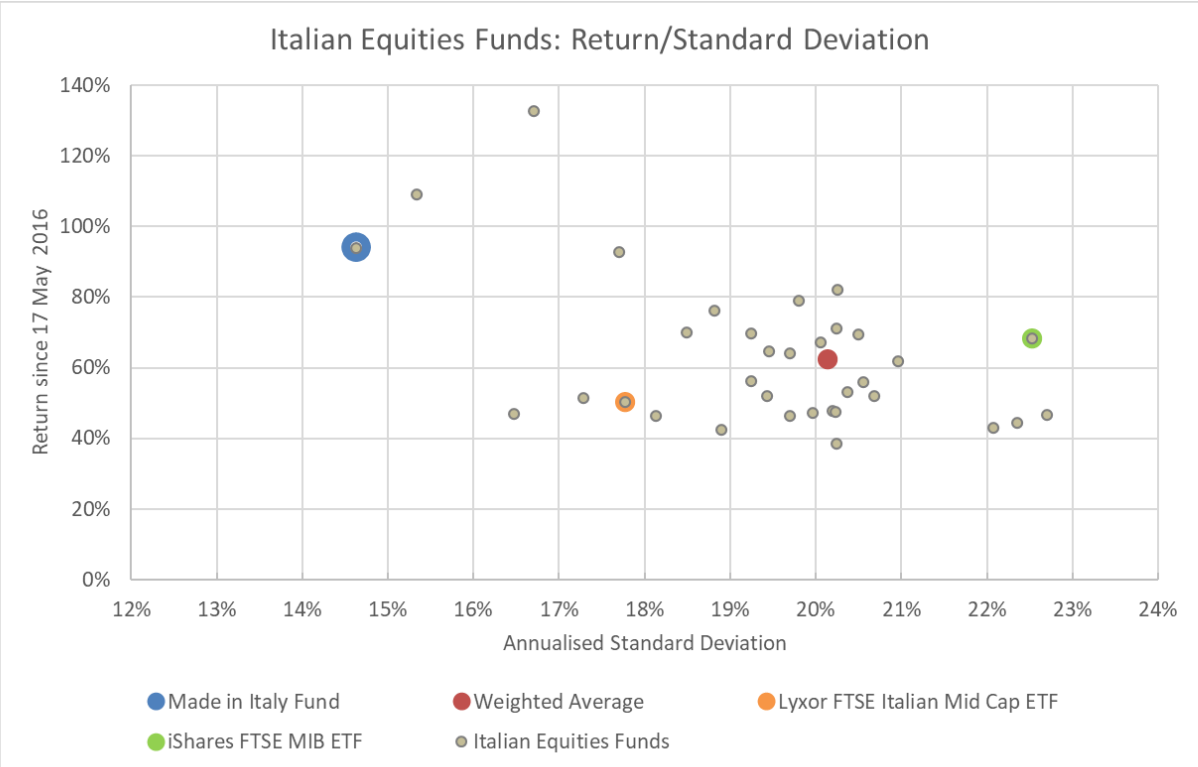
Bayes Investments

Investor letter – First Quarter 2022

Dear Fellow Investors,

The Made in Italy Fund (MIF) had a return of -9.6% in the first quarter of 2022. The return since inception (17 May 2016) is 94.0%. Returns are net of fees and all administration costs.

The MIF remained well ahead of the Italian Equities fund universe, whose weighted average return since our inception is 62.4%:



Source: Factset

The MIF return is significantly higher than the 50.2% return of the most comparable ETF – the Lyxor Mid Cap Fund – as well as the 68.4% return of the main Italian Equities ETF – the iShares FTSE MIB.

The MIF return continues to be accompanied by lower volatility. The annualised standard deviation of its daily returns is 14.6%, compared to 20.1% for the weighted average fund, 17.8% for the Lyxor ETF and 22.5% for the iShares ETF.

First Quarter 2022

Our -9.6% return for the quarter compares with a weighted average return of -9.3% for the Italian Equities universe, -12.1% for the Lyxor ETF and -8.2% for the iShares ETF.

The quarter was dominated by the fallout of Russia's invasion of Ukraine. The year started in a negative tone, as growing tensions at the Ukrainian border combined with market concerns about inflation and interest rates. Worries quickly escalated into panic as war broke out at the end of February, triggering widespread and indiscriminate price drops, reminiscent of the frenzied market reaction to the first outbreak of the Covid pandemic exactly two years earlier. Back then, the panic lasted for about a month – mid February to mid March – as investors came to terms with the possibility of a precipitous and uncontrolled spread of the virus on a global scale. Thereafter, the fall gave way to a hefty rebound, as early signs started to show that the drastic lockdown measures adopted in most countries were having some effect in slowing down the pace of infections (our Q1 2020 investor letter brings back sobering memories of those tumultuous days).

This year's panic was shorter-lived, lasting eight market days, from the sudden invasion of Ukraine on 24 February to 7 March. The dread equivalent was the even scarier possibility of a catastrophic escalation of the conflict into World War 3, with the optional bonus of nuclear annihilation. But the valiant resistance of the Ukrainian populace and the measured, supportive, and united response of NATO, together with a modicum of presumed rationality on the part of an otherwise unhinged Russian ruler, helped investors to regain composure and equity markets to stage a partial rebound by the end of the quarter.

In both cases, panic was well founded – it would be wrong to call it irrational, even with the benefit of hindsight. What was irrational, however, was the impulsive reaction of some investors, who could not resist the urge to join in the blanket selling. As in 2020, we did not participate, this time not even dabbling with derivative hedging. We rather spent time making sure that none of our companies would be substantially affected by the war, and that none of their share price drops had a valid justification. In this we were once again helped by the poise of our investors. In fact, some of them took the opportunity to put more cash into the fund, thus helping us to increase some positions. With their contribution, March ended with a small positive return for the MIF.

Nevertheless, as in Q1 2020, panic selling prevailed in the quarter and dragged down most of our stocks, irrespective of sector, size or any other specific characteristic. Now as then, however, we know that those price drops are unrelated to the fundamental value of our companies. If they were attractive investments at the beginning of the year, they are now even more attractive at cheaper prices. The Ukrainian war is ongoing, and it is impossible to know when and how it will end. But end it will and, like in 2020, markets will rebound in advance.

At the start of the year, we began the planned reduction in the number of stocks in the portfolio and sold three positions. A fourth sale occurred in mid-February, as **Be Shaping the Future** – a provider of business and IT consulting services to the financial sector – received a takeover and delisting offer from its controlling shareholders and related parties. The offer came at 3.45 euro per share, 31% above the previous day close and 7 times the 0.49 euro price we paid when we first bought the stock in June 2016, a month after the launch of our Fund. We subsequently accumulated the position over time at an average price of 1.1 euro, thus realising a 208% capital gain plus dividends as we finally sold the entire position at 3.33 euro. The stock had doubled in the first year after our initial purchase, but then spent the following three years fluctuating around 1 euro, before starting a steady climb in November 2020 to the February epilogue – one more reminder of the importance of patient investing.

We suspended the planned sales in the second half of February, as market conditions deteriorated.

At the end of March we participated in a new IPO:

Farmacosmo. The company operates a health, pharma and beauty online store, under a highly successful just-in-time procurement and zero warehouse policy. It has a 90 million euro market value and 2021 sales of 58 million, growing at more than 50% per year in the last 5 years. Operations are organised along three main activities: 1) Logistics, dealing with up to 12,000 orders per day delivered within 20 hours at positive margins; 2) Intelligence, defining competitive positioning and customer journey for almost 200,000 clients, 74% of whom are recurring, and an average ticket of almost 100 euro, with a high conversion ratio; 3) Node, encompassing R&D, process innovation and IT infrastructure. The company is geared to continue its profitable expansion in an underpenetrated and rapidly evolving eCommerce space, with high cash generation benefitting from strong economies of scale. We paid 2.25 euro per share.

The current sector composition of the Fund is the following:

	Number of companies	% Weight
Producer Manufacturing	6	13.3%
Electronic Technology	2	4.1%
Process Industries	2	3.6%
Consumer Non-Durables	1	2.1%
Consumer Durables	3	6.1%
Industrial Services	1	6.7%
Commercial Services	6	13.7%
Consumer Services	3	6.8%
Technology Services	10	23.2%
Health Technology	2	5.7%
Retail Trade	1	2.8%
Communications	1	2.3%
Finance	2	3.4%
Utilities	2	4.8%
Total	42	98.6%
Warrants + cash		1.4%

Our pledge: we shall not revert to the mean

This quarter's negative return creates an opportunity for investors who may have felt reluctant to buy the MIF after its extraordinary 2021 performance. Such hesitation comes from the misguided expectation that strong positive performance *must* be followed by weak or negative performance. This, in turn, typically results from the belief – founded on the Efficient Market Theory – that in the long run all funds in a certain category will have more or less the same performance, as none of them can consistently do better than the average. Some of them will randomly outperform in any period but will, sooner or later, revert to the mean. Such is the belief underlying the entire industry of index funds and ETFs: all funds are the same, hence cheaper ones are better.

As our regular readers know well, we believe that such theory is profoundly flawed. The Made in Italy Fund would have no reason to exist if an index fund or ETF investing in the same space had a similar return. This is the reason why, since our very first quarterly letter, we have been reporting our performance versus the most comparable ETF available since MIF's inception – the Lyxor Mid Cap Fund (ITAMID). As we know, the MIF has been consistently above the ITAMID – not every month, every quarter or even every year, but definitely over the longer term:

	MIF	ITAMID	ITAPIR	IPIR
17/05/16 - 31/12/21	114.6%	70.9%		
12/05/17 - 31/12/21	49.5%	34.5%	41.2%	
31/08/17 - 31/12/21	48.3%	31.8%	38.7%	33.2%

Since MIF's inception in May 2016 to the end of 2021, 100 euro invested in the MIF have grown to 215 euro, versus 171 euro invested in the ITAMID. It is 44 euro more, i.e. a 62% higher gain. And this is after all costs and fees, including performance fees. And with lower volatility.

Conclusion: funds are *not* all the same, and cheaper passive funds are *not* necessarily the smarter choice. ITAMID investors would have done a lot better if they had invested in the MIF.

THE same is true for the other two comparable ETFs – the Lyxor FTSE Italia All Cap PIR (ITAPIR) and the iShares FTSE Italia Mid-Small Cap (IPIR) – which started after our inception. Absolute returns are lower – our first year performance was particularly strong – but the conclusion is the same: 100 euro invested in the MIF since ITAPIR's inception in May 2017 have grown to 150 euro, versus 141 euro invested in the ITAPIR – a 20% higher gain (notice ITAPIR did better than ITAMID over the period); and 100 euro invested in the MIF since IPIR's inception at the end of August 2017 turned into 148 euro, versus 133 euro invested in the IPIR – a 46% higher gain (IPIR was close to ITAMID over the period and behind ITAPIR). Again, ITAPIR and IPIR investors would have made a much smarter choice if they had invested in the MIF.

As the MIF approaches its six-year anniversary, we are pleased with its absolute and relative performance. But are we justified to expect similarly gratifying results in the next six years and beyond? Or, as we ourselves state in the Disclaimer at the end of this letter, "Any past performance contained herein is not an indication of future performance"?

The phrase is a standard formula, included, in some form or other, in virtually every piece of financial services documentation. But what does it really mean?

There is a sense in which it is obviously true: if a financial instrument had a positive return over a certain period, one should not expect it to have the same or a similar return over the next period. Or even a positive return – what goes up might come down. Obvious indeed – almost patronisingly so.

But, as we have just seen, there is another sense in which is it false: if a financial instrument had a positive return over a certain period, it is wrong to expect it to have an offsetting negative return over the next period. What goes up is *not bound* to come down. On the contrary, while the fact that it has done well in the past is no *guarantee* that it will do well in the future, it does make sense to regard it as an *indication* that it will do so. It is nothing more than the rationale of Buy-and-Hold. As Warren Buffett famously put it: "When we own portions of outstanding businesses with outstanding managements, our favourite holding period is forever".

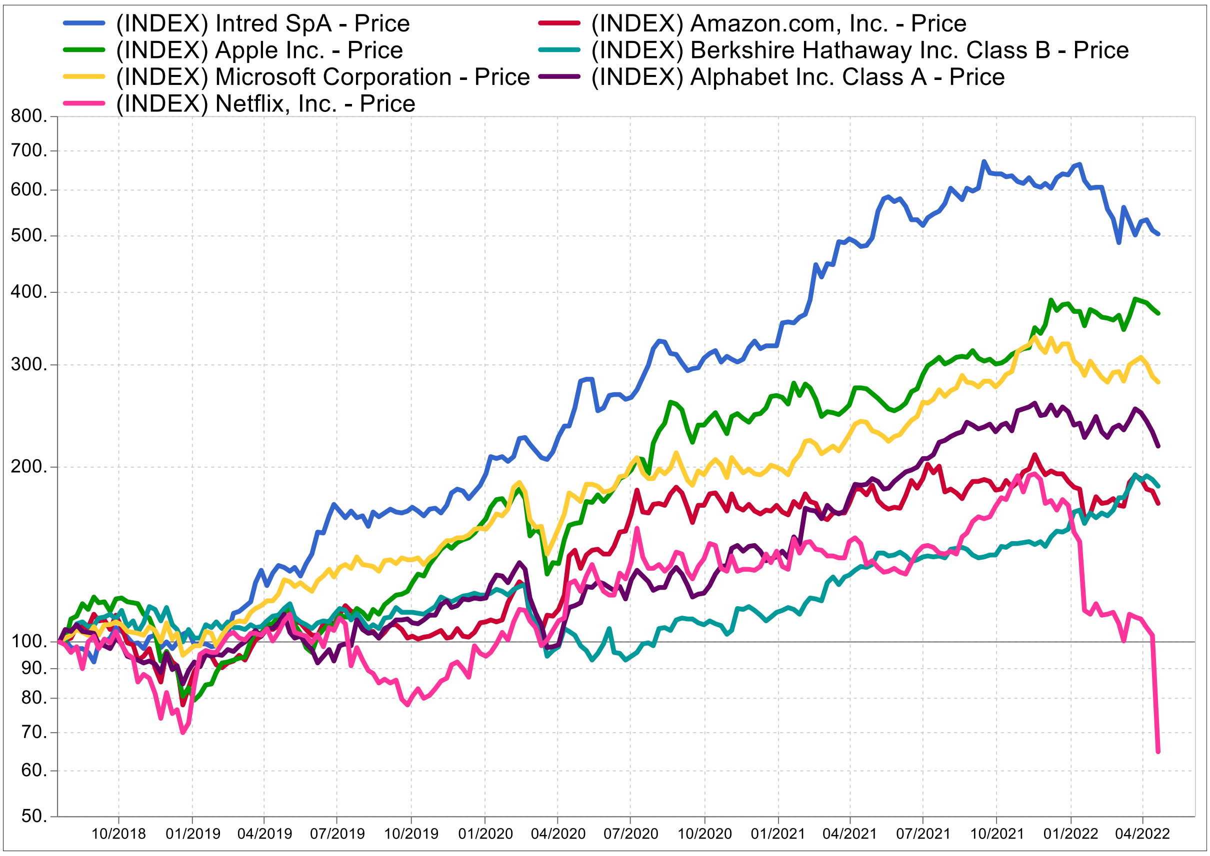
Clearly, it is a long-term indication: anything can happen in a month, a quarter, a year. But if a stock has done well in the last five years – i.e. it had a return significantly exceeding the market average – it is right to expect it to have a higher probability of doing so in the next five. Again, there is no guarantee: the next five years may turn out to be very different from the past five, or the current price level may already reflect future growth. But some stocks can do very well for a very long time – think of Amazon, Apple, Berkshire Hathaway. These are what value investors call Compounders: stocks that keep growing because the company keeps exceeding market expectations.

What is true for stocks is even truer for funds. If a fund has done well in the last five years – i.e. it had a return significantly exceeding the relevant comparisons – it is right to expect it to have a higher probability of doing so in the next five. No guarantee here either – many things can happen in the next five years. But, in principle, funds have an additional degree of freedom: they can move out of stocks that have reached their valuation potential and buy cheaper stocks with a wider valuation gap. In this sense, while no company can keep doing well forever, funds can.

At least those that try. Passive funds like ITAMID, by definition, don't. They just own everything that is included in the index they aim to track (or a large sample thereof). Other funds try half-heartedly: they aim to do better than the index but own many of the stocks therein, especially the larger ones. They may own more or less of those stocks compared to passive funds, but they do own them – not because they are attractive investments but just because they are in the index.

Not our Fund. The only reason why we own each stock in the Fund is that we think the company is worth much more than the current price, and that therefore the stock will do well in the future – better than the market average – as its price catches up with value.

We do it in a special place, out of the limelight and unfamiliar to most investors – Italian included – and, partly for that reason, rich with hidden gems. We made the point a year ago, in our [Q1 2021 letter](), where we showed the price of virtually unknown **Intred** against the ultra-famous FAANGs. Here is the updated graph, with illustrious Compounder Berkshire Hathaway included:



It is early days to call Intred a Compounder – the company came to the market in July 2018, less than four years ago. But we believe there is a good chance that it is. This is why we held on to it over time despite its powerful appreciation and will do so in the future, unless fundamental changes make us revise our outlook. The same is true with most of our companies, many of which are even younger than Intred. It is unlikely that all of them will turn out to be successful long-term Compounders, and we will replace them if and when we change our mind. We are also aware that excessive appreciations may drive some stocks out of line with fundamentals – Netflix in the graph above way well be a case in point – and are prepared to replace them beforehand with cheaper alternatives.

One thing is for sure though: smaller, younger, little-known companies have a better chance of multiple appreciation compared to giant, established and renowned corporations.

So yes, our past performance can be regarded as an indication of future performance. A repeat of last year’s return is unlikely, but our pledge is to continue to do well, and better than passive alternatives. We shall not revert to the mean.

Welcome Thomas

Looking forward to a bright future, in mid-February we welcomed Thomas Götsch.

Thomas collaborates with our partner SCM SIM, supporting SCM's advisors in their relationship with PIR line investors, also in order to develop new relationships with potential investors in the PIR line and in the Made in Italy Fund.

Thomas has dual Italian and German nationality, a BSc (Hon) in Psychology with Management from the University of Exeter and an MSc in Behavioural Economics from the City, University of London.

He has already been in touch with some of you and is eager to speak to all interested parties.

He can be reached at thomas.goetsch@scmsim.it and tg@bayesinvestments.com.

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