Made in Italy Fund

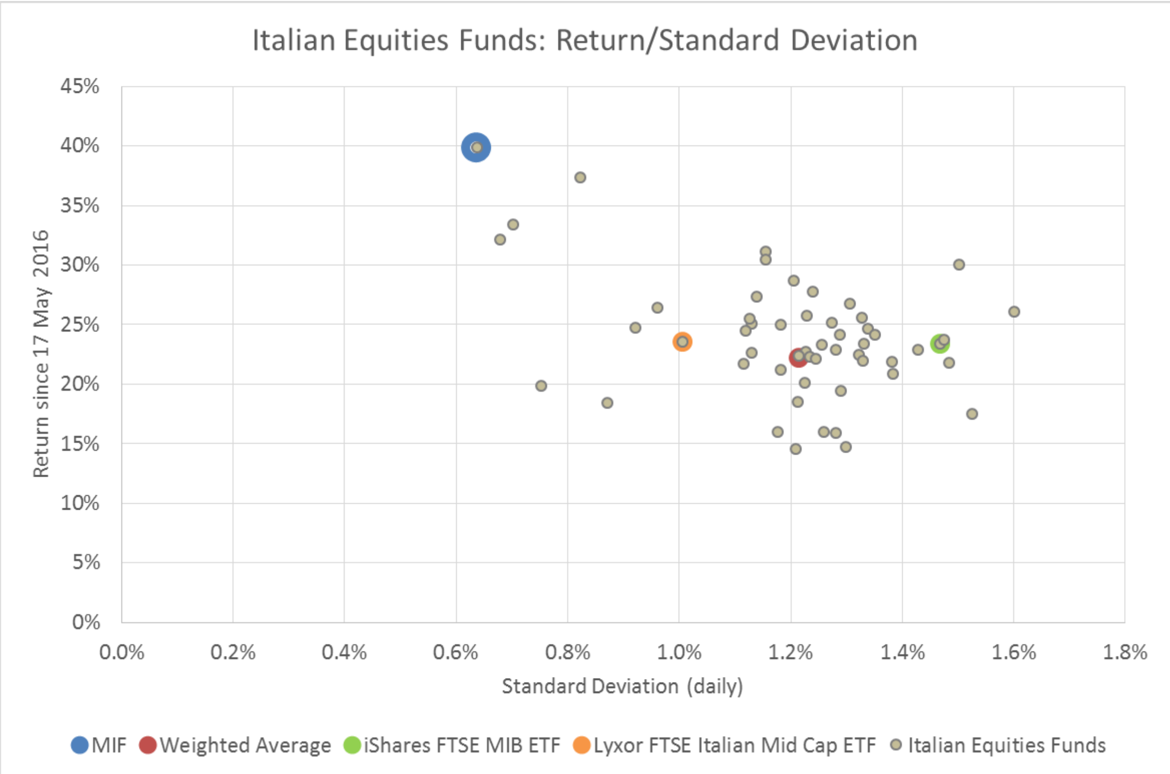
Bayes Investments

Investor letter – Second Quarter 2017

Dear Fellow Investors,

The Made in Italy Fund (MIF) returned 4.6% in the second quarter of 2017. The return since inception (17 May 2016) is 39.9%. Returns are net of all fees and administration costs.

During the quarter, the MIF continued to outperform the Italian Equities fund universe, whose average return, weighted by size, was 22.3% since MIF's inception:



Source: Factset

As shown in the graph, the weighted average fund return was slightly below the performance of the main Italian Equities ETF – the iShares FTSE MIB – which was up 23.4% over the period, and of the ETF most comparable to the MIF – the Lyxor Mid Cap Fund – which returned 23.6%.

The MIF's advantage is further strengthened by lower volatility. The standard deviation of daily returns is 0.6% for the MIF, compared to 1.2% for the weighted average fund, 1.5% for the iShares ETF and 1.0% for the Lyxor ETF.

Second Quarter 2017

Our 4.6% return for the quarter compares with a weighted average return of 3.2% for Italian Equities universe, 2.1% for the iShares ETF and 4.2% for the Lyxor ETF.

For the first half of the year, the MIF returned 26.0%, versus 12.8% for the weighted average fund, 9.1% for iShares ETF and 22.3% for the Lyxor ETF.

The quarter started strongly in April, in the wake of the PIR-related enthusiasm of the first quarter, slowed down in May, though the fund managed to make some further progress, while June was a negative month – the first after November 2016 – in line with most European markets. As typical in such circumstances, commentators were quick in labelling this as ‘profit taking’ in an ‘overextended market’. But our outlook remains unaffected. Stocks in the portfolio are attractively priced compared to their intrinsic value. Volatility is part of normal market physiology and not in itself a cause for concern.

During the quarter, the fund has taken a position in three new companies and sold out of one position. Two of the new stocks are IPOs. The first is Indel B, a manufacturer of mobile cooling appliances for the automotive, marine/recreational and hospitality sectors. The second is Finlogic, a producer of adhesive labels for the food, logistic, pharmaceutical, healthcare and cosmetic sectors. (check out pictures from our recent company visits at Indel B’s plant in Sant’Agata in Feltre, near Rimini, and Finlogic’s plant in Acquaviva delle Fonti, near Bari, on our brand-new Instagram account).

In this respect, the arrival of new companies, quoted at reasonable initial prices and keen to establish a fresh presence, is a positive and promising development for the Italian stock market. A continuous flow of new IPOs will be an important measure of long term success of the recent PIR legislation.

Besides new IPOs, we have been studying, visiting and evaluating more companies, with a view to adding them to the portfolio. We have identified a few excellent candidates and are planning to include them in the coming months. This is much more important to us than the additional positives of an improving European and Italian macro outlook and the recent resolution of uncertainty in the intricate domain of Italian banking. These, along with the humdrum shenanigans of Italian politics, are unlikely to affect our expected returns, which, as ever, will be primarily driven by the specific performance of our companies.

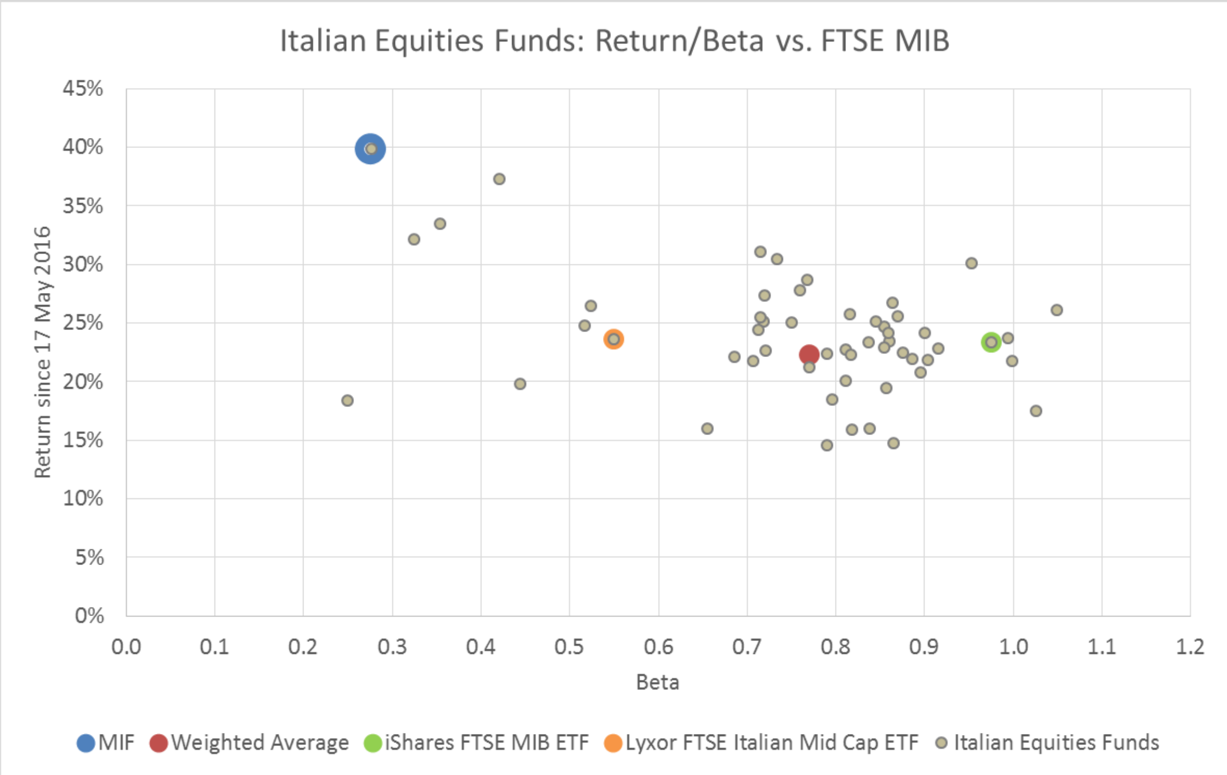
The sector composition of the MIF is currently the following:

	Number of companies	% Weight
Producer Manufacturing	7	22.3%
Electronic Technology	4	14.7%
Process Industries	3	7.8%
Consumer Non-Durables	2	5.3%
Commercial Services	3	7.3%
Distribution Services	2	5.0%
Technology Services	5	12.9%
Consumer Durables	2	7.3%
Finance	5	14.9%
Total	33	97.5%
Cash		2.5%

Italian Equities Funds

As evidenced in the previous graph, Italian Equities funds are fairly tightly clustered around their average return. This reflects the fact that most of them are managed around the main Italian Equities index – the FTSE MIB – which, as we have seen in the previous letter, includes the first 40 large capitalisation stocks and is heavily skewed towards four economic sectors – Finance, Utilities, Energy and Consumer Non-Durables.

This is even more apparent when fund returns are plotted against their beta vs. the FTSE MIB index:



Source: Factset

Notice that while the iShares ETF's beta is – as it should be – close to 1, most funds have a lower beta – the average is 0.77. But as with the standard deviation, the range is quite narrow. A look at the funds' top holdings on www.morningstar.it explains why: most of them are the same, coinciding with the largest components in the FTSE MIB index. Unsurprisingly, then, their performance is quite similar – although there is some degree of variability – and their average return is, as is typically the case, below the return of the iShares ETF by an amount close to the difference in management fees. Also, about two thirds of the funds underperformed the FTSE MIB index, whose total return (dividends included) over the period was 25.0%.

Besides the MIF, only a handful of Italian Equities funds escape this logic. Five of them – including the Lyxor Mid Cap ETF – have a lower beta but similar middling returns (the one with the lowest beta is a fund of funds), while three funds are closer to the MIF. Of these, two turn out to be managed very closely to the FTSE Italia STAR index, which, as we have seen in the previous letter, has greatly outperformed the MIB index over the past several years. Their beta vs. the STAR index is 0.91 and 0.98, reflecting the fact – again easily verifiable on the Morningstar website – that their holdings mostly coincide with the largest components of the index. Similar to their MIB-benchmarked brethren, they are *de facto* STAR index funds charging a higher management fee than a declaredly passive ETF. They have just chosen a better index.

We have explained in the previous letter why the MIF is not benchmarked to any index. The fund owns many companies that are part of the STAR segment, but their inclusion has nothing to do with index presence. This is reflected in the MIF's beta vs. the STAR index, currently at 0.6.

Alphabeta

To summarize: after thirteen and a half months since inception, the Made in Italy Fund has had a return of 39.9%. This has been obtained with a daily standard deviation of 0.6% (10.3% annualised) and a beta of 0.28 vs. the general market index – the FTSE MIB – whose total return over the period has been 25.0%, with a daily standard deviation of 1.5% (23.9% annualised).

According to standard finance theory, this makes no sense. A higher-than market return is supposed to be associated with higher-than market volatility and a beta higher than 1. The excess return – so runs the theory – can only be achieved as compensation for bearing higher risk. The theory predicts that the extra return – known as alpha – is 'explained' by a higher beta and that, once compared to the beta-adjusted market return, alpha disappears.

In contrast to the theory, the MIF has an alpha of 32.9% (= 39.9% - 0.28 x 25.0%, assuming for simplicity a zero risk-free rate – fair, given current interest rates). This compares to 3.1% for the weighted average fund, -1.0% for iShares ETF and 9.8% for the Lyxor ETF. Notice that, while about two thirds of Italian Equities funds underperformed the FTSE MIB over the period, only about a third did so on a beta-adjusted basis, given that most of them had a beta lower than 1 – a result again in contrast with standard theory.

Faced with such evidence, one can draw different conclusions:

1. The theory is right: the data are wrong. This is not the case. Data are public and calculations are available upon request.
2. The theory is right: the MIF performance is due to its small size and would not be possible in a larger fund. This is wrong. The fund has minimal turnover and could and would be managed in exactly the same way even if it were a large multiple of its current size.
3. The theory is right: the period is too short and performance will revert to the mean over time. This is entirely possible, and is the reason why some investors require more time to exclude the possibility that short-term results are the product of random luck. Some prefer to wait for a year, some other for five years and the ultra-sceptics – especially those who can get blamed for wrong choices but not for missed opportunities – for longer.
4. The theory is wrong: the MIF is managed according to a sound investment process and its good results suggest (but do not guarantee!) that it will continue to do well in the future.

As fellow investors in the fund, you have chosen to take the last view. We are very grateful for your vote of confidence and would like to take this opportunity to assure that we will continue to do our best to deserve and reward your trust.

MIF and PIR

As you know, Bayes Investments is an advisor of the Made in Italy Fund, which is a sub-fund of the Luxembourg-based Atomo Sicav, managed by Casa4Funds. We are pleased to inform you that Casa4Funds have now created a webpage dedicated to the MIF on their website http://www.atomosicav.com/made-in-italy/. This contains monthly Factsheets about the Fund's three classes, as well as operational indications on how to subscribe.

In this respect, we would like to point out that, besides the Institutional Class, reserved to institutional and professional investors, and the Retail Class, distributed by a number of intermediaries, the Listed Class allows anyone to buy the MIF directly on the Italian Stock Exchange. This can be done through any bank account as easily as buying shares. As this is a relatively new facility, with still little investor demand, banks may be unprepared or unwilling to provide the service. But it is important to know that, contrary to the arguments that many of them may use to decline the request, there is no actual impediment.

This is even more relevant as the MIF will soon be registered as a PIR-compliant fund, thus allowing any Italian resident to invest in it up to 30,000 euro a year through a PIR account and benefit from capital gain tax exemption after five years.

PIR legislation has created an important incentive to invest in Italian companies and, in particular, smaller capitalization stocks not included in the FTSE MIB index. The second leg of its impact will be a steady flow of new IPOs to increase the size of the investable universe. But a third leg is as important: the launch of more funds that, like the MIF, are specifically focused on Italian small caps. For this to happen, it is necessary to facilitate fund investment. Italy is behind other European countries in this respect. It has long been a feature of the Italian financial system that banks, promoters and other intermediaries limit the list of funds made available to their clients to their own in-house funds or to funds from which they receive a management fee rebate through a distribution agreement. Direct fund listing on the Italian Stock Exchange has been an important step to open up this restrictive arrangement. Listed funds, like the MIF, are managed and advised by European regulated investment firms and are registered and approved by the Italian market regulator CONSOB. There is therefore no reason why an Italian investor – who can easily buy all sorts of stocks, bonds, ETF and other financial products – should find it hard to buy a listed mutual fund.

Bayes Investments will seek to be at the forefront of the effort to remove this impasse in the coming months.

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