Made in Italy Fund

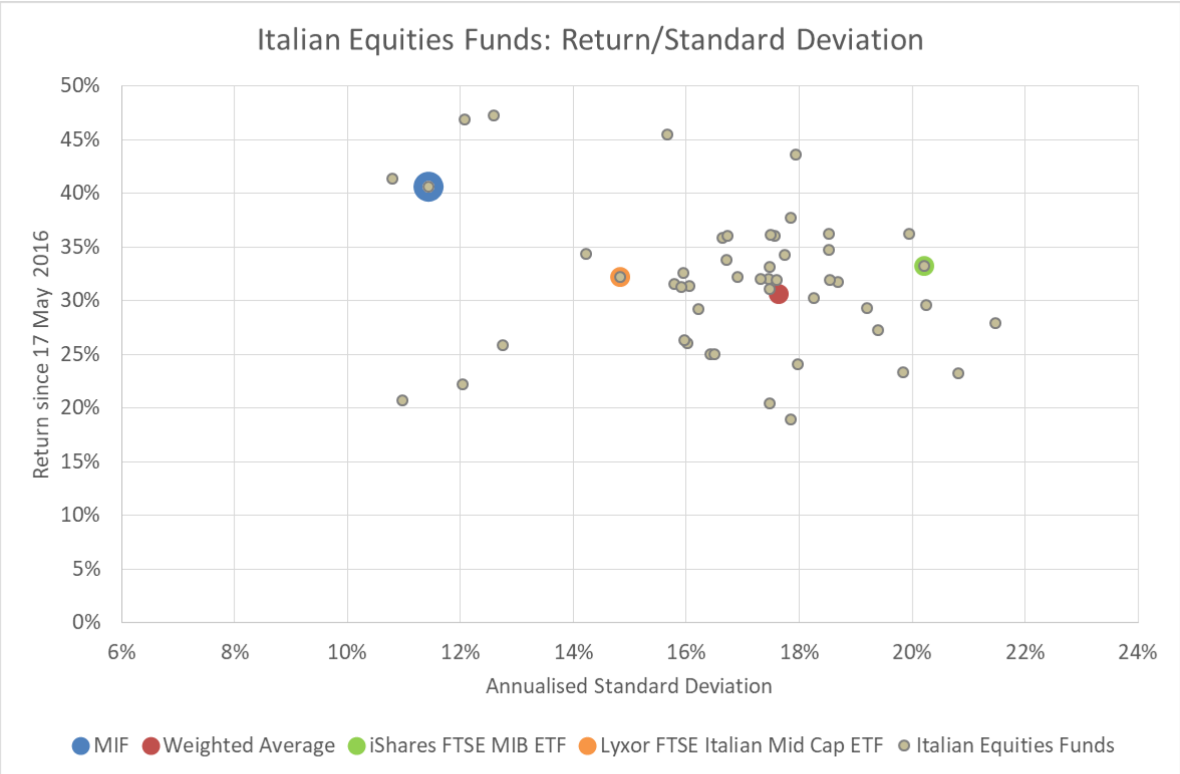
Bayes Investments

Investor letter – Second Quarter 2018

Dear Fellow Investors,

The Made in Italy Fund (MIF) was down -2.5% in the second quarter of 2018. The return since inception (17 May 2016) is 40.6%. Returns are net of all fees and administration costs.

During the quarter, the MIF maintained its advantage over the Italian Equities fund universe, whose weighted average return since MIF's inception is 30.5%:



Source: Factset

The MIF return remains well above the 32.2% return of the most comparable ETF – the Lyxor Mid Cap Fund – as well as the 33.2% 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 17.2% for the weighted average fund, 14.8% for the Lyxor ETF and 20.2% for the iShares ETF.

Second Quarter 2018

Our -2.5% return for the quarter compares with a weighted average return of -0.9% for the Italian Equities universe, -0.7% for the Lyxor ETF and -1.6% for the iShares ETF.

The Fund was up 1.8% in April, in line with FTSE Small cap index but below the main market MIB index, which, as we saw in January, had a strong rally, ending the month up 7.4%. The positive trend continued in the first part of May, with the Fund regaining its year-end level, but was brusquely inverted mid-month, following the turmoil around the formation of the new Italian government. As a result, the Fund ended May down -5.6%, ahead of the Small Cap index as well as the MIB index, which fell -7.5%. At the beginning of June we wrote a note summarising our take of the events and explaining the reasons why we were not changing our positive outlook. June was a positive month, with the Fund gaining 1.4% vs. -0.5% for the MIB index.

Among notable moves in the quarter, we highlight a further 19% advance in Reno de Medici, coming on top of a 60% return in the first quarter and a 67% gain in 2017. Reply, a core holding since inception, was up 30% in the quarter and is up 27% year-to-date, on top of 58% gain in 2017. Cembre, another core holding, was up 17%, on top of an 8% return in Q1 and a 61% gain in 2017. Datalogic, whose -17% price drop we discussed in our Q1 2018 letter, had a strong rebound in Q2, up 26%. Not so for the other stocks mentioned in the letter – La Doria, Panaria, Banca Ifis and Gefran – whose declines continued in the second quarter. At the end of May, we substantially increased our position in Panaria, taking some profits on Reno de Medici.

The current sector composition of the Fund is the following:

	Number of companies	% Weight
Producer Manufacturing	7	23.0%
Electronic Technology	4	12.6%
Process Industries	4	13.1%
Consumer Non-Durables	1	3.6%
Commercial Services	4	9.9%
Distribution Services	1	3.0%
Consumer Services	2	6.4%
Technology Services	4	9.2%
Consumer Durables	2	5.4%
Finance	3	9.3%
Retail Trade	1	1.2%
Total	33	96.8%
Cash		3.2%

First half 2018 vs. 2017

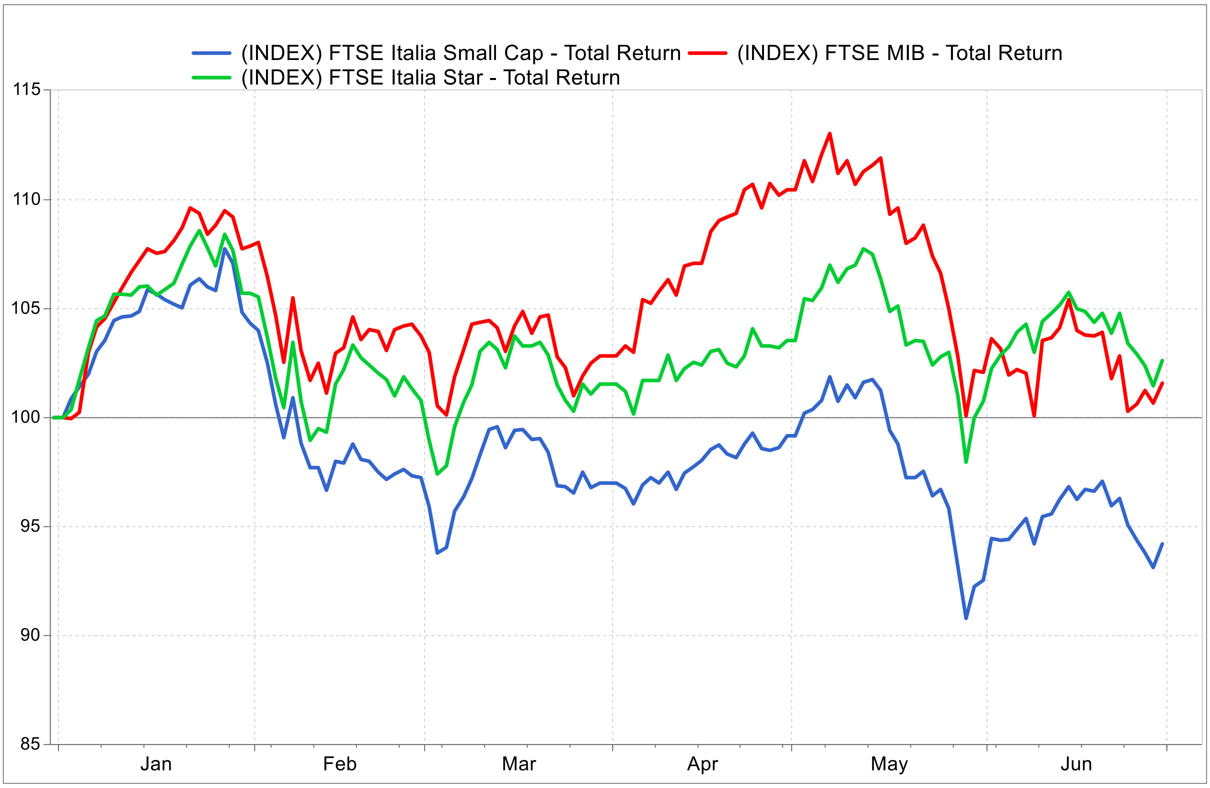
For the first half of the year, the Fund is down -6.8%, versus -0.5% for the weighted average fund, -2.3% for the Lyxor ETF and +1.1% for the iShares ETF.

This is notably different from the first half of 2017, when the Fund was up 26.0%, versus 12.8% for the weighted average fund, 22.3% for the Lyxor ETF and 9.1% for iShares ETF. Writing about these results in our Q2 2017 letter, we pointed out (see 'Alphabeta') that they were in contrast with standard finance theory, and indicated as a possible explanation that our performance might have been a short term aberration, destined to revert to the mean in due time. Clearly, this was not our belief, and still isn't. A fundamental tenet of our investment approach, and our preferred explanation, is that the standard theory is wrong and that a fund managed on the basis of a sound investment process can do consistently well over time. The MIF proceeded to do so in Q3, but that was followed by three negative quarters, where, curiously, performance was brought down in each period by a negative middle month – November, February and May. November saw a sharp selloff of Italian small caps, resulting in a -8.6% fall in the Small Cap index and a more limited -3.5% decline in the MIF, which ended Q4 well ahead of the Small Cap index as well as the main MIB index. The February decline was more generalised, mainly triggered by global trade tensions. The MIF fell in line with Italian small caps but more than the MIB index, which had already rallied sharply in January. Finally, as we have just seen, the May decline was due to the Italian election turmoil, where again the MIF did better than the Small Cap index as well as the MIB index, which had however registered another sharp rally in April.

Be that as it may, our first half performance was poor, both in absolute and relative terms. Many of our stocks are down year-to-date, most of them having done very well in 2017. Reversion to the mean? We don't think so. It is part of stock markets' normal physiology that strong performance might be followed by a retracement phase. It is in these circumstances that the advantage of an in-depth knowledge of each of our companies and a personal relationship with their managers comes in full light, keeping us confident in interpreting the downturn as a temporary pullback.

From a relative standpoint, after last year's underperformance the large cap FTSE MIB index is substantially ahead of the Small Cap index so far this year (see picture below), driven by great companies such as Moncler (+51%) and Ferrari (+34%), as well as Tenaris (+21%) Poste Italiane (+21%) and ENI (+18%). The FTSE STAR index is also doing relatively well, driven by companies we own, such as Reno de Medici, Reply and Cembre, as well as by bigger caps we do not own, such as Amplifon (+39%), IMA (+12%) and BB Biotech (+8%), which have a large index weight (24% in total). As a result, our Fund's advantage vis-à-vis the Italian Equities universe, which is largely indexed to the MIB, has been somewhat eroded, and we have lost our primacy in the performance ranking since inception, notably against a couple of funds that are closely managed around the STAR index.

We consider this a temporary setback and regard it as a good opportunity for investors who share our investment philosophy to initiate or increase their exposure at an advantageous NAV level.



Source: Factset

Positives and Negatives

On 17th May – right in the middle of the Italian political drama – the Made in Italy Fund completed its second year. With a return in excess of 40% since inception, we have cause for celebration. But the anniversary is also a good occasion to take stock of experience and look back at good and bad decisions.

Looking *ex post*, there are two kinds of good investment decisions: 1) True Positives: Buy a stock that does well 2) True Negatives: Not buy (or sell) a stock that does poorly. And there are two kinds of bad decisions: 3) False Positives: Buy a stock that does poorly 4) False Negatives: Not buy (or sell) a stock that does well.

	Stock does well	Stock does poorly
Buy	1. True Positive	3. False Positive
Not Buy/Sell	4. False Negative	2. True Negative

Here are a few highlights for each of the four quadrants:

1) **True Positives.** There is plenty to be happy about in the first quadrant. Besides the aforementioned Reno de Medici (first bought at inception at 0.33 euro, accumulated over time at an average price of 0.34, closing Q2 at 0.96 for a +184% money-weighted return including dividends), Reply (first buy at 31 euro, average at 31.3, close at 58.2, +88%),

Cembre (13.4, 15.1, 26.5, +85%) and Datalogic (15.1, 15.7, 31.7, +107%), we can highlight among others Biesse (11.5, 18.2, 33.4, +89%), El.En. (11.9, 18.1, 28.0, +93%), Gruppo MutuiOnline (7.4, 9.4, 14.2, +55%) and B&C Speakers (7.1, 9.4, 12.9, +49%). Looking at these numbers, a natural question comes to mind: why do we still hold these stock after such strong appreciations? The answer – as we wrote in our Q4 2017 letter – is: we keep a dynamic perspective on company valuations. Much damage to long term performance comes from selling good stocks too early.

2) **True Negatives.** In this obscure but as important quadrant there are companies we studied, valued and in some cases visited and met with management, but eventually decided that their valuation did not justify a purchase. Among the companies that we rightly passed up, we can mention, among many others, Orsero (10.7 euro when it started trading in February 2017, Q2 closing at 7.5), OVS (5.0 when we met with management in November 2016, 2.8 at Q2 closing), Safilo (7.6 at meeting in November 2016, 4.5 at Q2 closing) and Tesmec (0.5 at fund inception, 0.5 at Q2 closing).

   Among companies we bought and subsequently sold, we can highlight Sogefi, first bought at 2 euro in October 2016, accumulated at an average of 2.3 and sold in August 2017 at 4.2 euro for a 79% return. Our judgement at the time was that, unlike the stocks in the first quadrant, Sogefi's appreciation had taken its price beyond an appropriate margin of safety – dynamic perspective included. Selling is justified in this case. And we were right: the stock closed Q2 this year at 2.6 euro. An earlier case was Cairo Communication, which we bought at 4.6 euro at fund inception, accumulated at 4.3 and sold in May 2017 at 4.6, as we reconsidered our valuation following disappointing results. The stock ended Q2 this year at 3.4.

3) **False Positives.** This is the dreaded quadrant of Warren Buffett's Rule no. 1: Never Lose Money. Savvy investors strive to have as few stocks as possible in this quadrant. But no matter the brilliance of an investor's track record, it is bound to be dotted with a number of False Positives. A good investor is not one who does not make mistakes, but one who is able to recognise them early and act accordingly.

   That said, we are happy to report only two sizeable mistakes in our Fund so far. The first is Esprinet, a stock we bought in June 2016 at 5.9 euro, accumulated at 6 and sold in October 2017 at 4.9 for a 16% loss (we earned a 2% dividend in May). In retrospect, the mistake was made in October 2016, when we bought Sesa, a company in the same sector – Information Technology distribution and related services – but, unlike Esprinet, geared towards the higher value-added enterprise market. Sesa proceeded to do well – first purchased at 15.8 euro, accumulated at 20.5 and closing Q2 this year at 28.2 for a +40% return. Our mistake was to keep both stocks in the Fund, rather than switching out of Esprinet. A year later, the company, exposed to the retail mass market, suffered an erosion in profit margins, which, in revising our numbers, we judged to be a persistent downshift rather than a temporary blip. Hence we decided to sell the entire position – a right decision, as Esprinet continued do poorly after our exit, ending Q2 this year 21% below our sale price, at 3.9 euro.

   The second mistake is Electro Power Systems, a producer of hydrogen-based systems for energy storage. We bought the stock in October 2017 at 13.1 euro and sold it in April this year at 10 euro for a 24% loss. This was shortly after the company, quoted in France but with an Italian management and imprint, revealed that French utility Engie had acquired a 51%

stake and that, as a result, the previously announced plan to seek quotation on the Italian Stock Exchange had been shelved. Our mistake in this case was to buy the stock before a better assessment of the company's long term strategy. The stock ended Q2 this year at 10.9 euro.

To be complete, this quadrant should also contain a couple of stocks that are still in the Fund but so far have had a disappointing performance. Hanging on to bad stocks is as much a mistake as selling good stocks too early. We have decided to give these companies more time to express their value. But there is a time limit beyond which we shall replace them.

4) **False Negatives.** Finally, the fourth quadrant contains companies we studied and visited but eventually declined to purchase, subsequently regretting the decision as their stock price did well. Striving to minimise the number of these companies is what we can call Rule no. 2, which is almost as important as Rule no. 1. Naturally, False Negatives are likely to outnumber False Positives, especially in concentrated funds like the MIF, where we want to keep no more than 30-35 positions. That said, we are not happy about quite a number of missed opportunities – stocks whose price we judged not low enough to encompass a suitably wide margin of safety, but subsequently proved that our valuation was too conservative. Examples include great companies such as Prima Industrie, Retelit and Saes Getters, among others.

   There is a natural tendency in these cases to worry about being 'too late' and drop these companies from the radar screen. But it is mistake. In the same way that past performance *per se* should not influence the decision to keep a stock, it should not influence the decision to buy a new one. In this sense, an investor is 'buying' his portfolio every day, i.e. holding stocks he would buy today at the current price. It is never too late to buy a stock, as long as its valuation is attractive, be it because of a price drop or a valuation upgrade.

   To be complete, this quadrant should include companies that have done well but we had not managed to analyse. The larger the sample space, the larger will be the number of overlooked companies. We cannot follow everything. But in the relatively small universe of Italian small caps we regret and learn from every big missed opportunity.

Italy: Top-down vs. Bottom-up

Despite our conclusion that the new Italian government did not warrant a change in our positive outlook, it evidently made it no easier to 'like' Italy from a top-down investment point of view. But this would be the wrong perspective to take for a value investor, particularly in Italy, which for many years has been burdened by a sluggish economy, high public debt and tortuous politics. These macro issues can perhaps be used to justify Italian equities' underperformance versus European equities over the last ten years. But, as illustrated in our Q3 2017 letter, they are an intellectual obstacle to realising and making sense of the outstanding advantage of investing in the best breed of Italian smaller capitalization stocks, as embodied in the stellar performance of the STAR segment.

MIF investors know well by now that the Fund owns many STAR companies but is not benchmarked to the highly concentrated STAR index, where the first 12 companies, each with a market value of more than one billion euro, account for more than 60% of its 44 billion capitalisation. As we have seen above, in the first half of the year the STAR index has kept pace with the MIB index, unlike the Small Cap index and the MIF, which have trailed behind.

A common interpretation of this relative move is to see it as a redressing of last year's small cap outperformance, which in turn is explained as the effect of the launch of PIR funds at the beginning of the year. We regard this as a misleading reading, based on the short-circuited equivalence PIR=Small caps.

This is wrong. PIR funds must hold at least 70% in Italian assets, and 30% of these – 21% of total – must be invested in non-MIB companies. For a start, this means that almost half of the assets in a PIR fund can be invested in large caps. Second, non-MIB is not the same as small cap. There is a large number of companies with a 3 to 5 billion market cap – e.g. the top names in the STAR index, as well as companies like Diasorin, De' Longhi, ERG, SIAS, Autogrill, Fincantieri and many others – which are neither MIB nor small caps. It is in these larger and more liquid stocks, much more than in actual small caps, that PIR funds have invested the bulk of their non-MIB assets. Third, about 40% of the circa 18 billion assets invested in PIR funds as of June 2018 is in Balanced funds, mainly 'low risk', i.e. with a large non-equity component, and 25% is in 'Flexible' funds with a variable equity exposure. This leaves 35% – about 6.3 billion – in Equity PIR funds, 21% of which is 1.3 billion. Including the equity component of Balanced and Flexible PIR funds, and accounting for the possibility that some funds may have invested more than the required minimum in non-MIB stocks, we can estimate the total non-MIB investment in PIR funds at no more than 2 to 3 billion. Under the generous assumption that a quarter of this went into actual small caps – stocks with a market cap of less than one billion – we can estimate the total PIR-related small cap investment at around 0.6 billion, i.e. 1.3% of the circa 46 billion of total small cap capitalisation at current prices, or 4% of average free float (assuming it is 1/3 of outstanding shares).

As often happens, then, going through the actual numbers shows that the size of an effect can be very different from the outcome of simplistic impressions. If anything, it is the larger mid-cap stocks that might have benefitted at the margin from PIR-related demand, which might perhaps contribute to explain the rich valuations of some of them. But the good performance of Italian small caps in 2017 – and of the MIF *a fortiori* – had little to do with PIRs. The same is true for this year's underperformance, which we expect to be reversed in the second half.

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