Made in Italy Fund

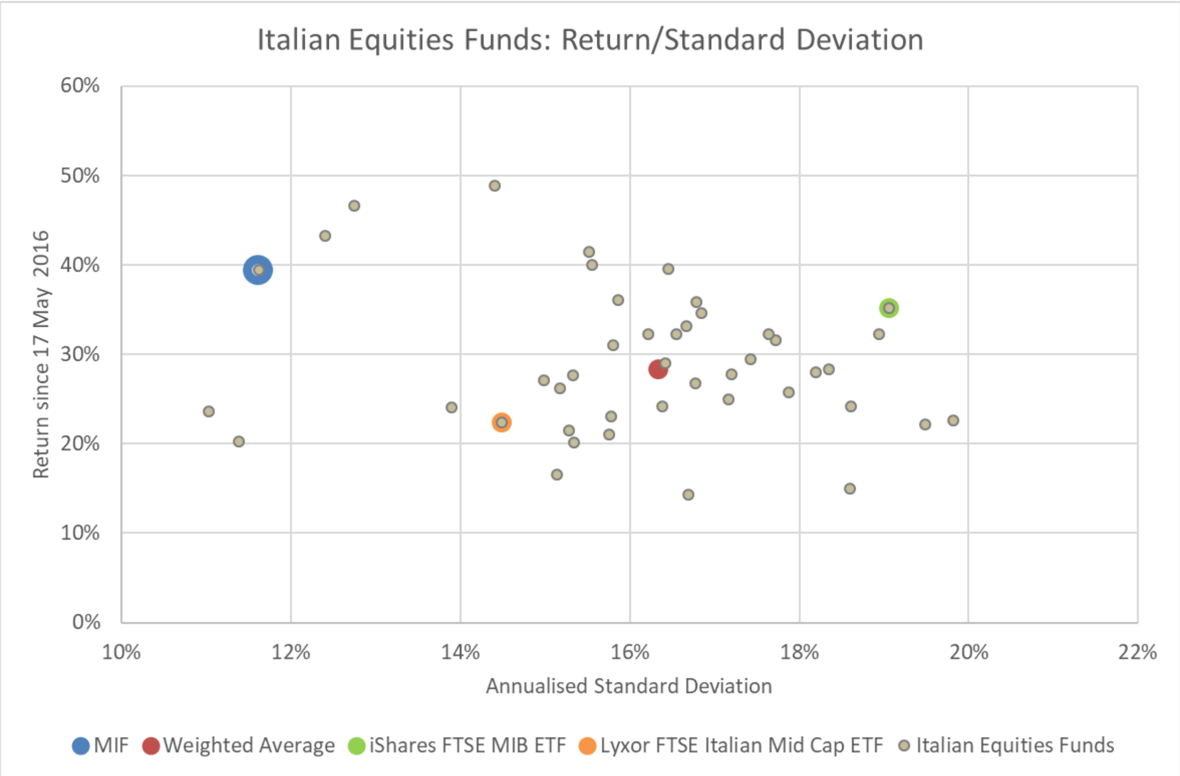
Bayes Investments

Investor letter – Second Quarter 2019

Dear Fellow Investors,

The Made in Italy Fund (MIF) had a return of 2.3% in the second quarter of 2019. The return since inception (17 May 2016) is 39.4%. Returns are net of all fees and administration expenses.

During the quarter, the MIF increased its advantage over the Italian Equities fund universe, whose weighted average return since MIF's inception is 28.3%:



Source: Factset

The MIF return is well above the 22.3% return of the most comparable ETF – the Lyxor Mid Cap Fund – as well as the 35.2% 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 11.6%, compared to 16.3% for the weighted average fund, 14.5% for the Lyxor ETF and 19.1% for the iShares ETF.

Second Quarter 2019

Our 2.3% return for the quarter compares with a weighted average return of 0.8% for the Italian Equities universe, -1.5% for the Lyxor ETF and 2.3% for the iShares ETF.

Stock markets continued to do well in the second quarter, despite a dip in May, which they quickly recovered the following month. The MIF did particularly well against the Lyxor ETF, more than recouping the underperformance of the first quarter. For the first half of the year the MIF returned 13.3% versus 10.6% for the Lyxor ETF, whose return coincided with the first half return of the FTSE Small Cap index.

By far our best performer in the quarter was **Expert System**, whose 30% jump in the first quarter to 1.5 euro we highlighted in our last letter, where we remarked that it looked as if our patience – we have held the stock since inception at an average cost of 1.96 euro – was finally being rewarded. Indeed it was, as the stock price proceeded to increase a further 140% in the second quarter to 3.6 euro, thus bringing the first half return to more than 200% and taking the company's market value from 55 to 140 million euro.

Our sense of accomplishment is only tinged by a dose of regret for failing to buy more last year, as the price hovered between 1.4 and 1.2, eventually falling 19% in the year. As you will remember, however, there wasn't much scope for buying in 2018, amid declining markets and fund redemptions. If anything, we should be glad that Expert System was one of the few stocks that we managed to spare from redemptions-driven sales. In fact, we did not sell any Expert System in 2017 either, actually adding to the position despite the stock price falling 24% over the year, versus the fund's NAV growing 36%. We bought some more stock this year at the end of April, when the price was still at 1.9.

We draw three lessons from this:

1. When a stock sells at an ample margin of safety to its intrinsic value, the investment risk is small and the potential reward is large. Sooner or later, the price will catch up with value. Patience is a value investor's key virtue.

2. An investor should continuously test the validity of an investment case. But if the case holds up to the challenge, he should not be swayed by adverse price movements. As Seth Klarman bluntly puts it: Mr. Market knows nothing.

3. As we have been repeatedly stressing in our letters, the Made in Italy Fund is not a country fund. We do not invest in Italy as a country. We invest in Italian companies with a market capitalisation of less than one billion, quoted on the Milan Stock Exchange. We do so because Borsa Italiana is a good place to find great companies at attractive valuations, and because we have the experience and expertise to find them. The point is further expounded here.

Another strong performer in the quarter was **Intred**, up 30% to 5.1 euro. We mentioned the company in our Q3 2018 letter, as it closed that quarter at 3.1 euro, up from an initial IPO price of 2.3 euro in mid-July.

Unfortunately, unlike Expert System, we had to sell some Intred in order to finance redemptions. Nevertheless, the stock remains one of our largest positions.

EdiliziAcrobatica, mentioned last quarter as it rose 48%, continued its climb, growing a further 21% this quarter to 5.9 euro and bringing its year-to-date performance to 79%. **Renergetica**, mentioned in the Q4 2018 letter as it rose 92%, grew 21% in the second quarter to 3.7 euro, bringing its year-to-date return to 31% and 145% above its 1.5 euro IPO price in August last year. **MailUp**, also mentioned last quarter as it rose 36%, continued to grow 18% this quarter, bringing its year-to-date performance to 61%.

On the negative side, **Askoll EVA**, a producer of electric scooters and bicycles that came to the market in July last year at 3.5 euro per share, was down 25% to 2.4 euro. The company was founded in 2014 as part of the Askoll Group, a producer of electric motors for white goods and aquariums. 2018 revenues were 14 million euro, up from 4 million the year before, mostly in e-scooters, whose demand is growing rapidly in Europe, with 40,000 units sold in 2018 (mainly in France, Belgium and the Netherlands), up from 8,000 in 2014. Demand is expected to continue growing at a 30% annual rate to 2025. Askoll EVA is the market leader in Italy, with a 62% market share, and is one of the main players in France. Market cap is 38 million, and free float is 22%. The company is still loss-making, but after our visit in May to their headquarters near Vicenza in the Veneto region, we are confident that their strategic growth plan, driven by newly-appointed CEO Gian Franco Nanni and Askoll Group CEO Alessandro Beaupain, will bear fruit in due course.

Other weak stocks in the quarter were Emak (-21%), Panaria (-14%) and Longino & Cardenal (-12%). None of the moves were justified by substantial reasons. In mid-May we took the opportunity to increase our position in Emak.

Following our belated exit from Banca Ifis in the first quarter, in June we took a new position in the finance sector. **illimity** (lower case initial!) is a brand-new bank founded by CEO Corrado Passera, ex CEO of Intesa Sanpaolo and Poste Italiane, and a small number of other managers, including Andrea Clamer, who had left Banca Ifis as Head of the NPL Division in October 2017 – ominously coinciding with the peak in Banca Ifis' stock price – to take the same role in illimity.

Quoted on the main market since April after a merger between a purpose-built SPAC and a target regional bank, illimity is a no-legacy, fully digital bank specialised in three areas: credit to Small and Medium Sized Enterprises, Corporate NPLs and Direct Banking. Here is a link to a recent presentation.

Current market cap is 500 million and free float is over 80%. The management has ambitious plans: it expects net income to be around 55-70 million in 2020 with a ROE of 9-10%, growing to 280 million and 25% respectively in 2023. We think it is very likely that market cap will be much higher by then.

TIP

No stock in the MIF portfolio better exemplifies our investment approach as does **Tamburi Investment Partners**, an investment company founded by Giovanni Tamburi in 2000. The stock has been in our fund since inception, when we bought it at 3.2 euro. It closed the second quarter this year at 5.6. Before fund launch, in October 2015, we presented the company at the MOI Global European Investment Summit. Here is a transcript of the presentation.

TIP is to an Italy-based fund what Berkshire Hathaway is to a US-based fund – a core holding and a source of inspiration. Through TIP, the MIF is exposed to great companies whose market caps are beyond our scope – such as Prysmian, Ferrari, Moncler, Amplifon, Interpump – as well as to non-quoted companies such as Eataly and Azimut-Benetti. We have one stock in common – **BE TSE** – and very recently TIP has invested in the controlling vehicle of one of our companies, **Sesa**.

Bought at a market cap of around 500 million, TIP itself is now worth around 1 billion.

Having done better than many of our holdings, TIP has done better than the MIF itself since inception – it has even outperformed the STAR index, of which it is part. Although it was down 2% in the first half of this year, it managed to end 2018 *up* 5%, and it grew 56% in 2017.

Like the MIF, TIP is essentially a portfolio of businesses, but in the form of a closed-end public company rather than an open-end mutual fund. Thus, whereas the MIF's NAV is simply the weighted average of the quoted prices of its holdings, TIP's price is determined by demand and supply of its shares, based on the price of its quoted holdings as well as the market's assessment of the value of the unquoted holdings and any discount or premium that is deemed appropriate to apply to the total, in view of the company's future prospects.

Like Expert System and other top performers, TIP would be entirely missed by investors who, taking a grim view of Italy as a country, choose to avoid Italian companies altogether. Mr Tamburi wholeheartedly shares our view that investing in great Italian companies has little to do with investing in Italy as a country.

Italian readers can learn more about Mr Tamburi here.

Right and Wrong

It was in the second quarter last year, in early May, that we saw the start of the Italian psychodrama following the formation of the new national government, as reflected by the spike over that month of the 10-year BTP yield from 1.8% to above 3%.

As you will remember, it has been our view since then and throughout the period that, despite the posturing and commotion, the Italian government and the EU would avoid coming at loggerheads on budgetary plans and would eventually find a mutual face-saving compromise.

We were right, as is graphically reflected by the 10-year yield plunging past 1.8% in the first week of July all the way down to 1.6%, a level last reached in December 2017. Unfortunately, being right was not enough to prevent investors from taking 4.6 million euro out of the fund over the period, only partially offset by a 2.2 million inflow from more level-headed investors. The 2.4 million net outflow, combined with a declining market, caused the fund's assets to drop from 8 million at the end of April last year to 4.9 million at the end of this year's first half – a 39% drop.

In partial consolation, this was less than the 58% drop in the assets of the Lyxor ETF, from 532 million to 225 million over the same period. On the other hand, the Lyxor Fund had seen its assets explode from 42 million at the end of 2016 to 599 million at the end of 2017, reaching a peak of 633 million in January 2018. As we showed in our Q4 2017 letter, the Lyxor Fund closely tracks the FTSE Mid Cap index, which comprises the next largest 60 stocks after the 40 contained in the FTSE MIB index. We saw in our first Q1 2017 letter that the upsurge coincided with the launch of the Piani Individuali di Risparmio (PIR). But the reason why most investors bought the Lyxor Fund in 2017 was not to include it in a PIR account – in fact its designation as a PIR-compliant fund came after most of the surge had already occurred – but because they anticipated that PIR demand would boost mid caps' performance. Hence, the subsequent deflation of the fund's assets in 2018, which is continuing this year – year-end assets were 281 million – should not be interpreted as investors giving up their tax advantage by taking money out of their PIR accounts. In fact, while PIR openings slowed down in 2018 and came to a halt in 2019 after the introduction of new PIR legislation, actual outflows from PIR accounts have been minimal. Investors have taken money out of the Lyxor Fund for the same reason they did so out of the MIF: country-related fears. Our investors were relatively more in control in the downturn. But we only wish they had been as enthusiastic in the 2017 upturn, as our assets reached a peak of 11.8 million in September 2017. This was more than double the 4.9 million at year-end 2016, but nothing compared to the Lyxor Fund's 14-fold explosion.

Alas, Lyxor investors would have been much better off investing in the MIF. As we have seen, the MIF is ahead this year – 13.3% vs. 10.6% – and, more so, since the MIF's launch: 39.4% vs. 22.3%, a vast 17.1% difference after all costs (14.0% compound). Comparing Q2 2018 to Q2 2019, the MIF's return since inception is back to almost the same level (39.4% vs. 40.6%), whereas the Lyxor ETF's return is still significantly lagging (22.3% vs. 32.2%). In other words, in the 12 months rollercoaster from June 2018 to June 2019, the MIF got back to where it started, but the Lyxor ETF is still 10% behind (7.5% compound).

Incidentally, the FTSE Small Cap index has done even worse: it is up 19.1% since MIF's inception – less than half our return – and is still 14.6% behind its June 2018 level (10.9% compound).

Funds are not all the same: what ultimately matters to investors are not the costs they pay but the after-cost returns they earn. PIR investors should keep this in mind once they will again be able to open new PIR accounts – here are our three proposals to facilitate that goal.

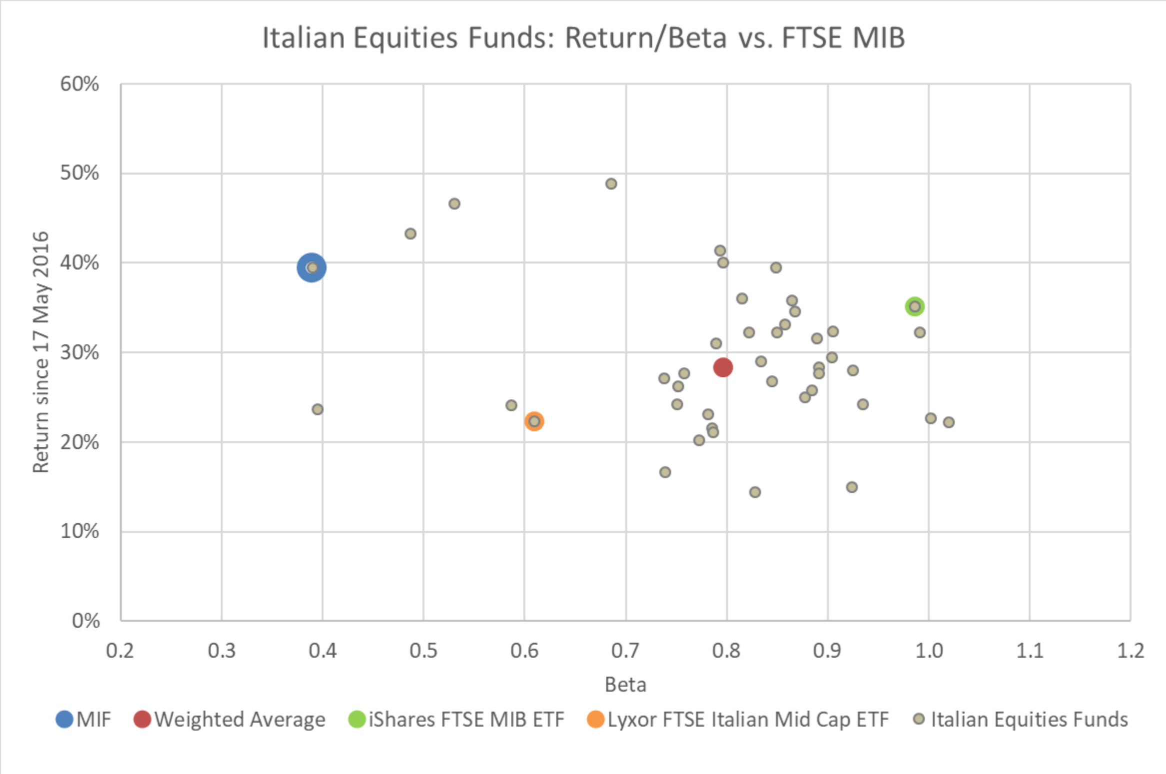
Three years, Five Stars

On 17th May 2019 the MIF had its three-year anniversary. This was particularly important because three years is the minimum period required by Morningstar to assign its coveted performance Stars. So we were pleased – but, given our numbers, not surprised – to find out that in June the MIF received the maximum 5-Star rating, which is automatically assigned to funds at the top decile of each category – Italian Equities in our case – ranked by what they call MRAR (Morningstar Risk Adjusted Return).

It was a proud moment for us and a welcome recognition of our effort.

We were more than a little surprised, therefore, to discover that in July – the calculations are done at the beginning of each month on three-year rolling monthly data – our stars went down to three. On closer inspection, we realised that MRARs are very sensitive to one-month variations. June 2016 was a particularly good month for the MIF relative to the other funds – we had just started to invest and had kept a large amount of cash ahead of the UK Brexit referendum on 23 June – while in June 2019 we were slightly below average.

Such sensitivity is not a good testament to MRAR's robustness. Its risk adjustment is rudimentary: it just corrects excess returns to cash by a coefficient of risk aversion, without taking into account either the standard deviation of returns or the beta of the fund versus an appropriate market benchmark. As you know, the MIF's standard deviation is and has always been lower than other funds. So is its beta versus the MIB index, which has been steadily around 0.4:



So the MIF's Sharpe ratio – annualised excess return to cash divided by annualised standard deviation – is high, and so is its Alpha – annualised excess return to cash minus beta times annualised benchmark return. Both measures are much more stable than MRARs.

We do not regard any of these numbers as a reliable measure of investment risk. For us risk is the danger of a permanent loss of capital, which we think is minimal for level-headed long-term investors in our fund. We expand on this subject in this presentation.

So we leave it at that. Just be ready to see our Morningstar rating jump around month to month and focus instead, as we do, on our great companies' portfolio.

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