Made in Italy Fund

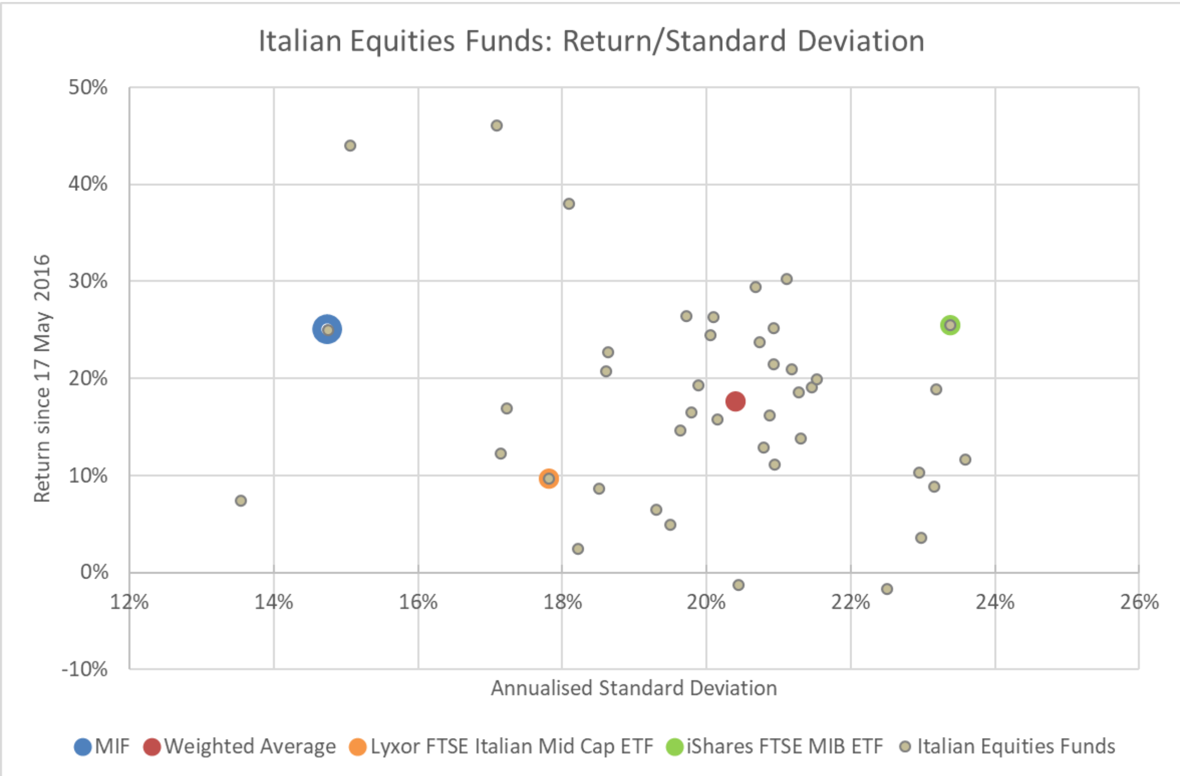
Bayes Investments

Investor letter – Second Quarter 2020

Dear Fellow Investors,

The Made in Italy Fund (MIF) had a return of 17.3% in the second quarter of 2020. The return since inception (17 May 2016) is 25.0%. Returns are net of fees and all administrative costs.

During the quarter, the MIF increased its advantage over the Italian Equities fund universe, whose weighted average return since MIF's inception is 17.7%:



Source: Factset

The MIF return is well above the 9.7% return of the most comparable ETF – the Lyxor Mid Cap Fund – and approximately at par with the 25.5% 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 14.7%, compared to 20.4% for the weighted average fund, 17.8% for the Lyxor ETF and 23.4% for the iShares ETF.

Second Quarter 2020

Our 17.3% return for the quarter compares with a weighted average return of 14.2% for the Italian Equities universe, 14.0% for the Lyxor ETF and 14.7% for the iShares ETF.

For the first half of the year, the MIF is down -13.5%, versus -16.7% for the weighted average fund, -17.8% for the Lyxor ETF and -16.6% for the iShares ETF.

After powering on in April – as documented in our Q1 letter – the Fund's recovery from the mid-March lows continued in May and June, albeit at a slower pace. Performance was in line with the main market in May but below in June, as large caps recouped some of the performance gap versus small cap and AIM stocks accumulated in the previous two quarters.

We continued to see strong rebounds in many of our positions – most notably those that had seen the heaviest falls in the first quarter. **Openjobmetis** kept recovering from its -50% Q1 fall, closing Q2 up 47%. **Landi Renzo**, which had fallen -51% in Q1, was up 42% in May and 43% in the quarter. **Expert System**, down -29% in Q1, was up 39% in Q2. **EdiliziAcrobatica**, down -35% in Q1, had a 32% rebound in Q2. **Reno De Medici**, down -33% in Q1, was up 31% in Q2.

Some stocks that had fallen less or were even up in Q1 are now in positive territory year-to-date. **Intred** was up another 25% in Q2 after its 13% advance in Q1, closing the first half up 41%. **Renergetica**, up 2% in Q1, advanced 30% in Q2 and is 32% above its year-end level. **SeSa**, which had fallen -17% in Q1, rebounded 36% in Q2 and closed the first half up 13%. **Askoll EVA**, down -19% in Q1, was up 36% in Q2 and is up 10% year-to-date. **MailUp**, down -12% in Q1, gained 25% in Q2 and is now 11% up at half year. In addition, two of the three IPOs in which we participated in Q4 last year – **Websolute** and **Doxee** – and one of the three in which we invested in Q3 – **Pattern** – were above their IPO price at the end of the quarter, +16%, +8% and +17% respectively. About 30% of our Fund is invested in these eight stocks.

Most other stocks in the portfolio had a positive performance in the quarter and we expect their recovery to continue in the second half of the year.

During the quarter we trimmed the weight of some of our best performing stocks to increase positions in, among others, Askoll EVA, EdiliziAcrobatica, Openjobmetis and Landi Renzo.

In June we participated in two new IPOs:

Sebino, a supplier of fire protection and security systems. The company has a market cap of 31 million euro, 40 million revenues and 6.4 million EBITDA. The IPO was priced at 2 euro per share. The stock ended the quarter at 2.6.

Cy4Gate, a provider of cyber intelligence and cyber security services. The company has a market cap of 64 million, 7 million revenues and 3 million EBITDA, both expected to grow rapidly in the next few years. The IPO was priced at 3.15 euro per share. The stock ended the quarter at 3.95.

The current sector composition of the Fund is the following:

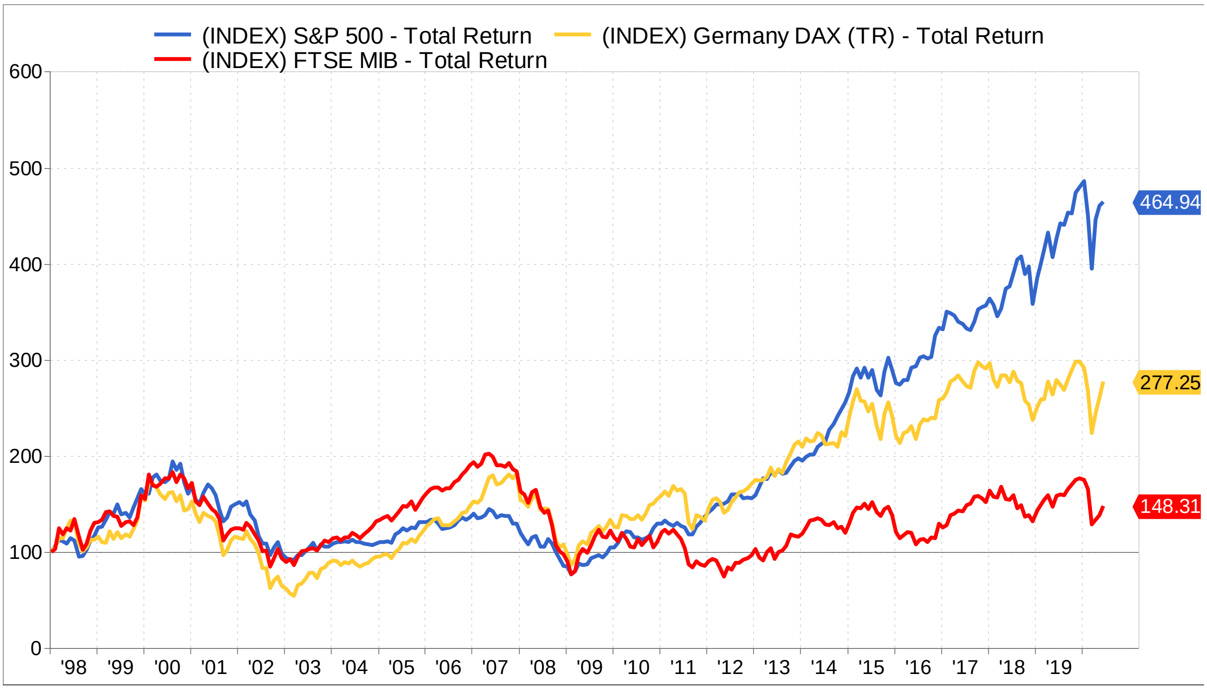
	Number of companies	% Weight
Producer Manufacturing	6	13.6%
Electronic Technology	2	4.3%
Process Industries	3	12.9%
Consumer Non-Durables	1	2.5%
Consumer Durables	2	8.6%
Industrial Services	1	6.1%
Commercial Services	6	17.7%
Consumer Services	1	3.2%
Technology Services	6	15.6%
Finance	1	3.1%
Health Technology	1	0.8%
Communications	1	5.4%
Utilities	1	4.2%
Total	32	98.0%
Cash		2.0%

American and Italian stars

The world continued to edge towards more normal conditions throughout the second quarter, and global stock markets reflected the move. Italian stocks performed broadly in line with the rest of Europe, with the MIB index up 15%, roughly halving the first quarter loss and bringing first-half performance to -16%, versus -12% for the STOXX Europe 600 index.

German stocks were strongest in Europe in the second quarter, with the DAX index up 24%, which, compounded to the -25% fall in the first quarter, brought first-half performance to -7%. This was almost as good as the performance of US stocks, where the S&P 500 index was up 21% in the quarter, thus recovering most of its -20% Q1 fall and ending the first half at -3% versus year-end. The NASDAQ index did even better and recorded a 31% advance in the quarter, driven by Apple (+45%), Microsoft (+29%), Amazon (+42%), Google Alphabet (+22%), Facebook (+36%) and, most spectacularly, Tesla (+106%). This erased the -14% Q1 loss and took the index to an all-time high, 13% above its year-end level.

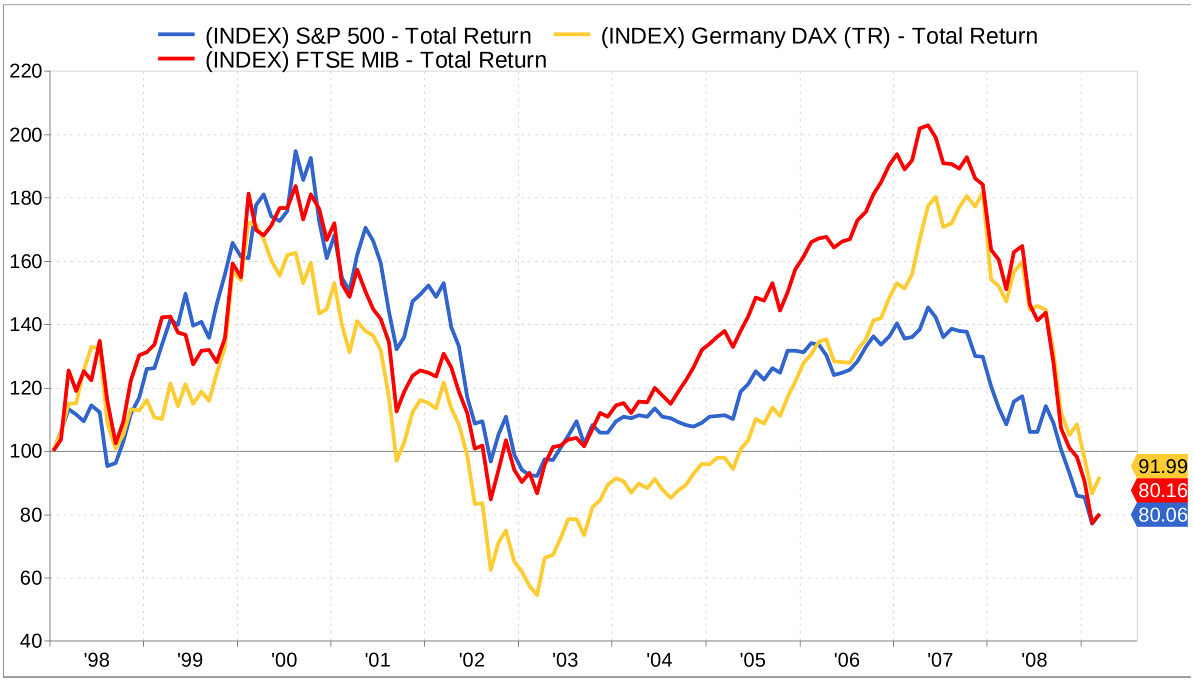
Looking at performance with such a short-term perspective would be insignificant per se, except that it reflects a much longer-term trend. This can be seen in the following chart, which shows the Total Return of the three main market indices for Italy, Germany and the US since 1998 (the S&P performance is in euro, but seeing it is US dollar would make little difference over such a long time span).



Source: Factset

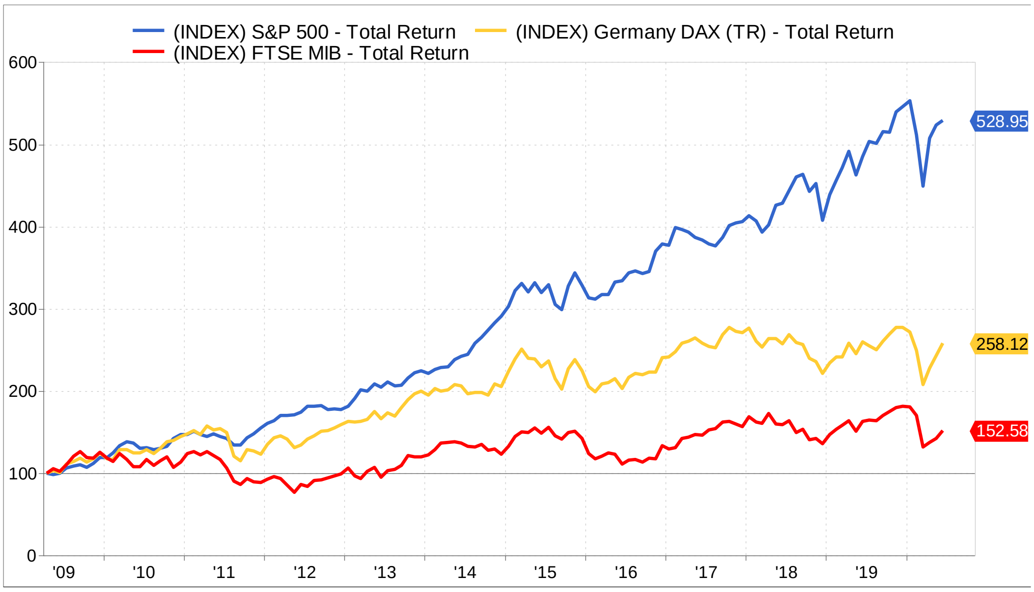
The superior performance of US stocks is eye-catching: 100 euro invested at the beginning of the period in the S&P 500 would have turned into 465 euro by the first half of 2020, compared to 277 euro if invested in the German DAX and a measly 148 euro if invested in the Italian MIB.

A closer inspection, however, shows a more complex picture. Notice that the three indices were pretty much in the same place at the bottom of the Global Financial Crisis in March 2009, with Italian stocks actually outperforming for much of the intervening period. A zoom-in makes it clearer, and gives us a painful reminder of the noughties' rollercoaster:



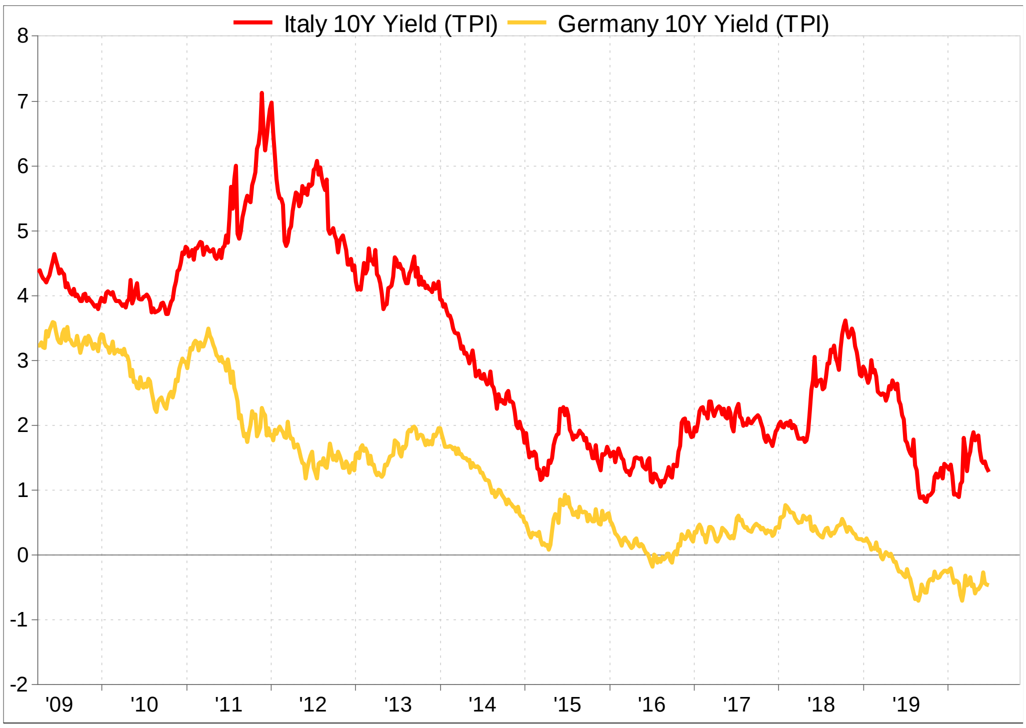
Source: Factset

The predominance of US stocks started to emerge after that turning point. The DAX kept pace until the first half of 2011 and, to a lesser extent, until the end of 2013, whereas the MIB underperformance started earlier in 2010 and intensified in the second half of 2011.



Source: Factset

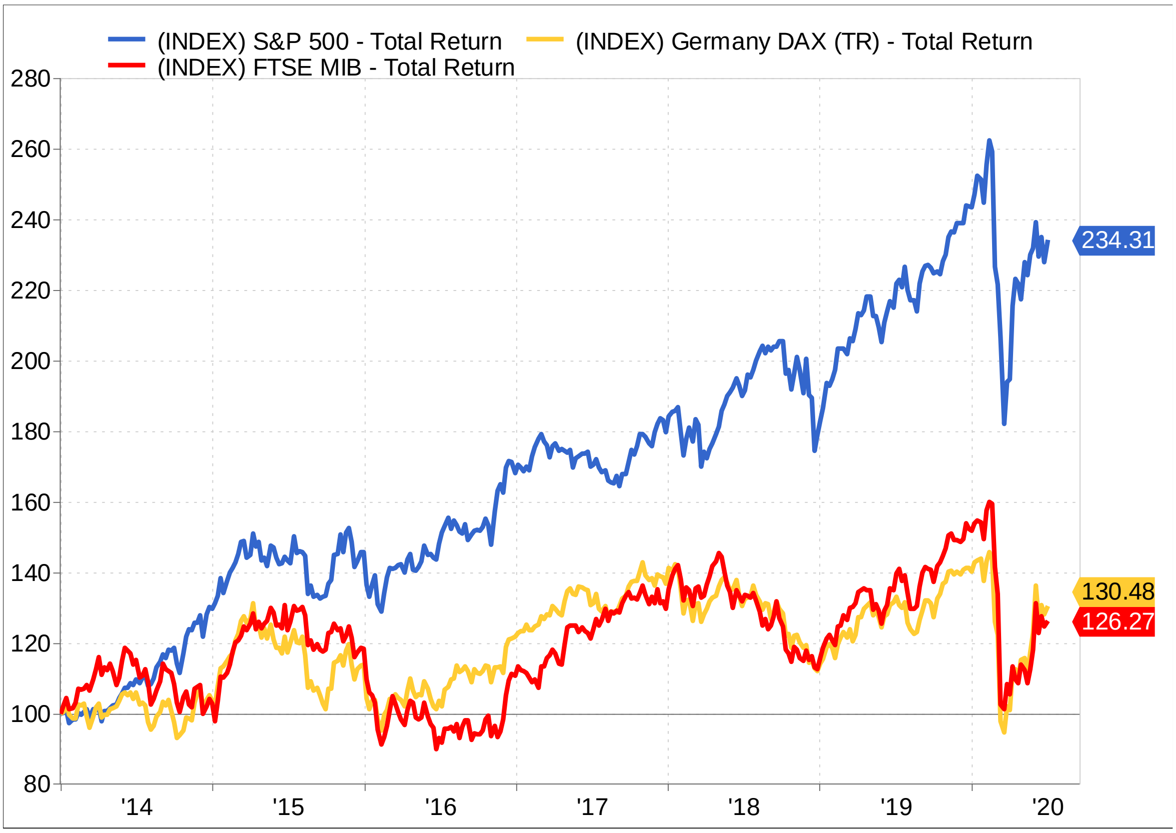
This coincided with the escalation of the European sovereign debt crisis, which had started in 2010 and by the autumn of 2011 ensnared Italy, causing a spike in Italian BTP yields – the 10-year jumping to 7% and opening a 5% spread versus the equivalent German Bund – and the eventual fall of the last Berlusconi government.



Source: Factset

Subsequent governments managed to defuse the risk of a sovereign default and to squeeze the spread to below 1% by 2015, then keeping it within 2% until 2018, when – as you will remember – a new spike to 3% followed the appointment of the 5Star-Lega government. This was also eventually reabsorbed in 2019 as 10-year Bunds drove into negative territory. The spread is now back to well below 2%.

Rebasing the chart to the beginning of 2014 highlights the period of US maximal outperformance and reveals the substantial equivalence of Italian and German equity total returns since then:

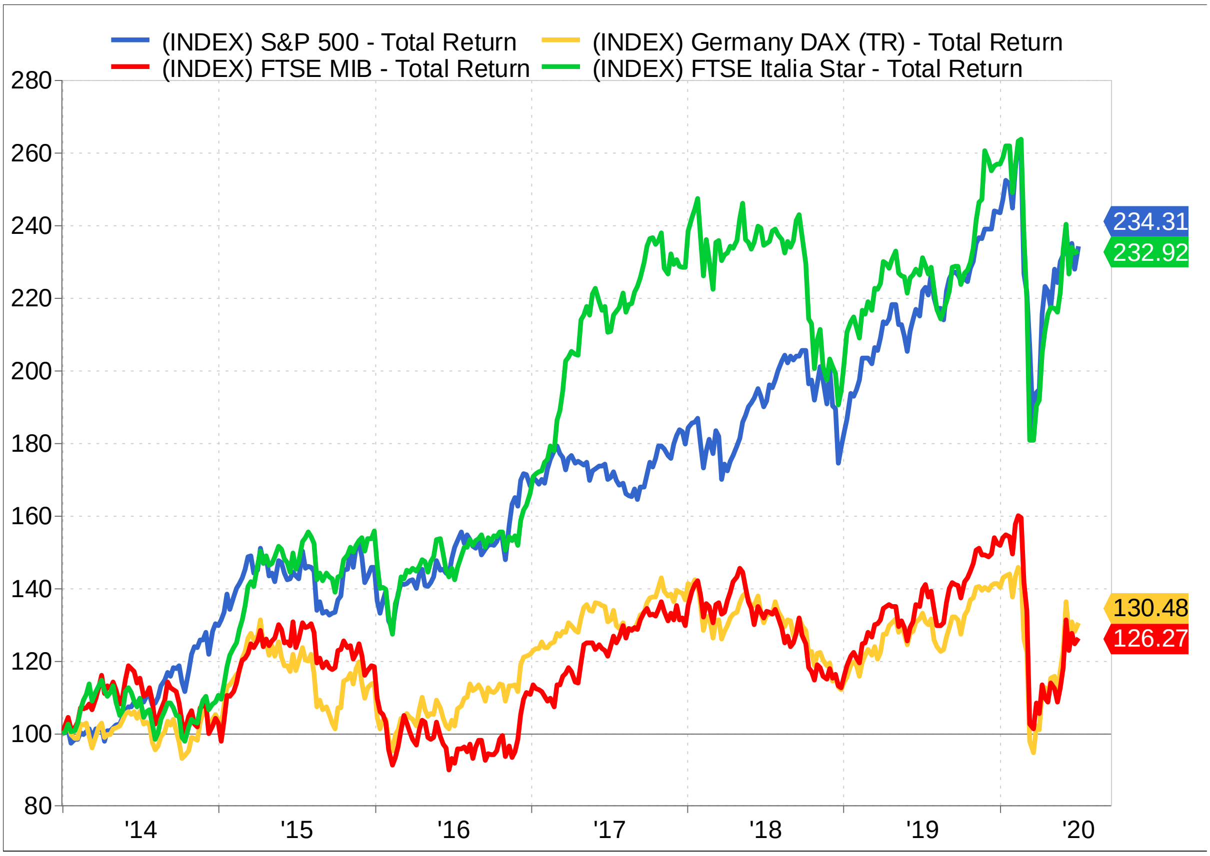


Source: Factset

The picture does not change much if we replace the DAX with the STOXX Europe 600 index or any other major country indices: the US stock market has been a peerless investment destination in recent years, and calls for its leadership to end in the name of mean reversion have so far been sorely disappointed. As a result, US stocks now weigh as much as two thirds of world equities.

This is not the place for us to comment on the outlook for the US stock market for the months and years ahead. It is the right place, however, to point out that we *can* get a different picture if we change perspective and instead of looking for countries we look for investment *spaces*.

Doing so exposes us to unexpected results. Such that, over the same period in which the US imposed its supremacy on other countries, the STAR segment of the Italian Stock Exchange delivered an uncannily identical total return:



Source: Factset

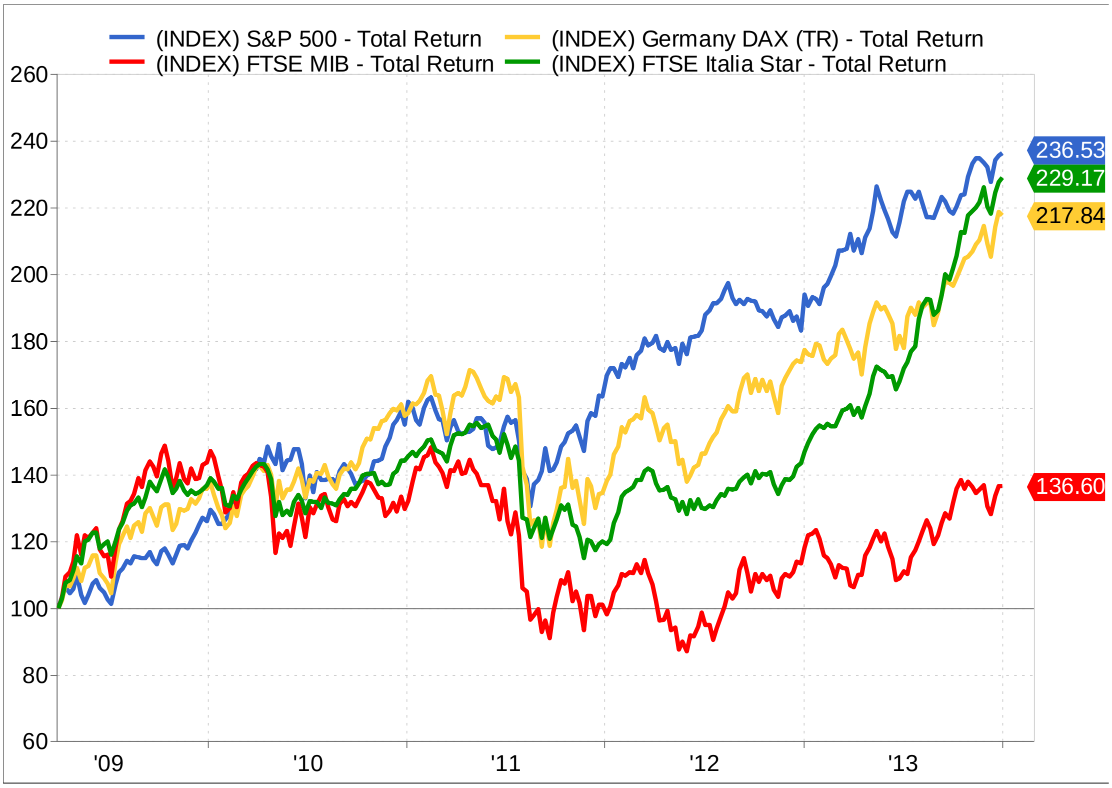
Our regular readers are familiar with this point, which we have been stressing repeatedly since our very first quarterly letter. It is the *raison d'être* of the Made in Italy Fund: the Italian smaller cap universe is a good hunting ground for attractive investments. But it remains hidden to investors unless they are prepared to overturn their perspective and realise that they do not buy countries – they buy companies.

So we say it again: The best way to look at Italian equities is not from a top-down country perspective, but from a bottom-up company perspective.

Italian large caps: Not as bad as they look

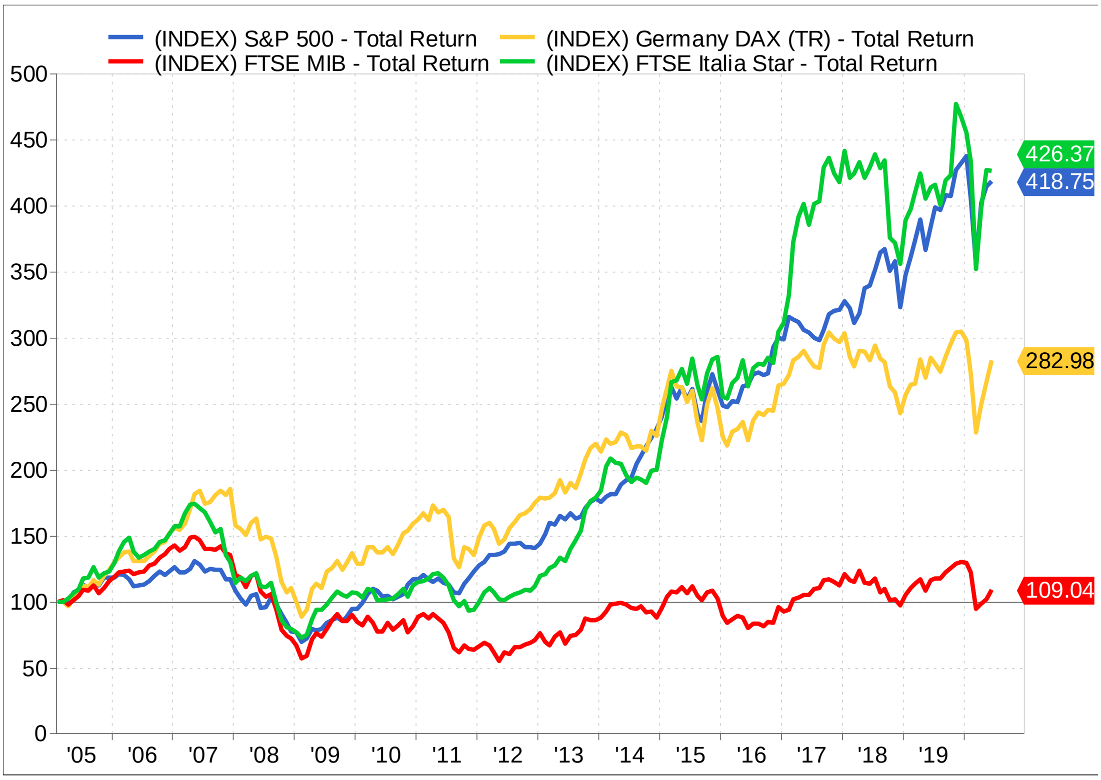
That said, however, we also like to highlight the other insight that emerges from a closer look at the graphs: what seems at first glance a chronic underperformance of the Italian MIB index can really be circumscribed to a specific period – 2010 to 2013 – in which Italy was embroiled in the European debt crisis. Before then, the MIB had performed in line or better than other indices, and thereafter it has been in line with the DAX and the rest of Europe behind the US. Indeed, you will remember that last year Italy was one of the best performing equity markets in the world, well ahead of Europe as well as the US.

A zoom-in on the period from March 2009 to the end of 2013 makes our point clearer. But it also shows that the underperformance was confined to the MIB index and did not include the STAR segment, which continued to perform in line with the US and Germany:



Source: Factset

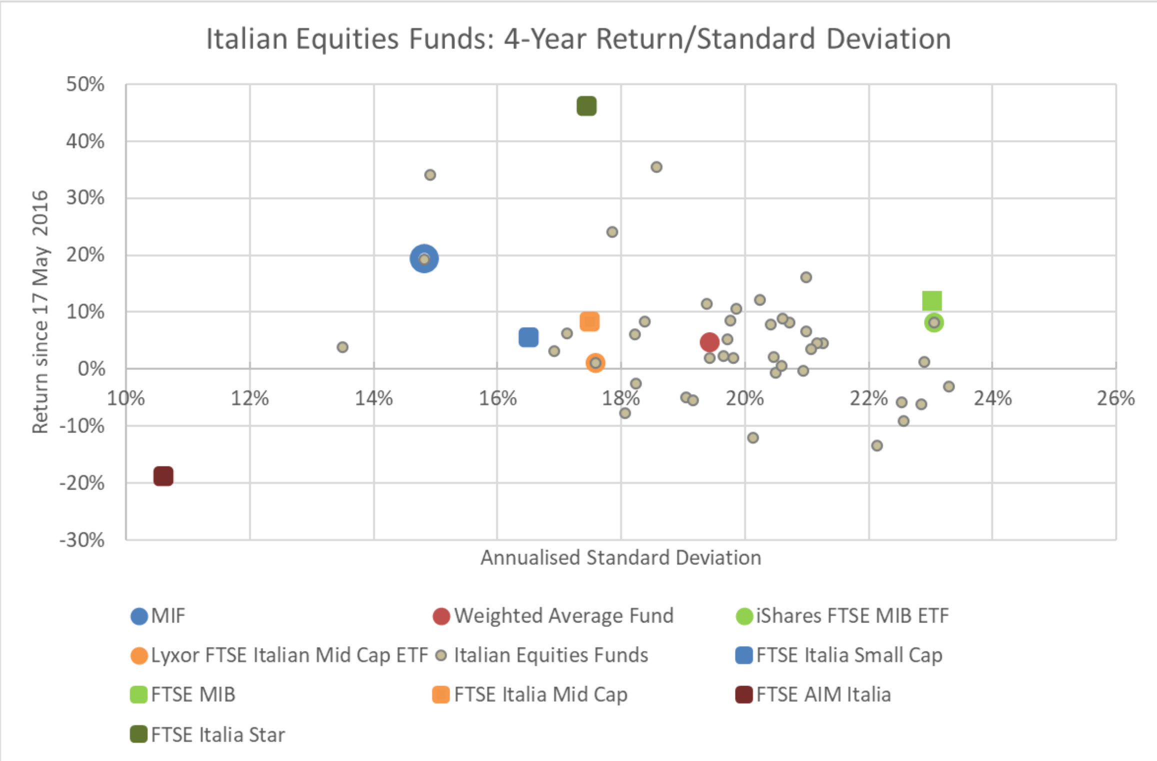
One last graph shows that the even match between the S&P 500 and the STAR segment holds over a much longer period (the first date for the STAR Total Return index on Factset is 1 February 2005):



Source: Factset

Our four-year anniversary

Investing in the best companies in the fertile Italian smaller cap universe is what we set out to do in our Fund since its inception in May 2016. Our four-year anniversary came in the middle of the quarter, as global equities were recovering from their dismal mid-March lows. This is our battered but proud birthday picture:



And these are the numbers, inclusive of five market indices, represented by squares in the picture:

17/05/2016 -15/05/2020	Total Return	Annualised Standard Deviation
MIF	19.2%	14.8%
Weighted Average Fund	4.6%	19.4%
Lyxor FTSE Italian Mid Cap ETF	1.1%	17.6%
iShares FTSE MIB ETF	8.2%	23.1%
FTSE Italia Small Cap	5.7%	16.5%
FTSE MIB	11.8%	23.0%
FTSE Italia Mid Cap	8.4%	17.5%
FTSE AIM Italia	-18.7%	10.6%
FTSE Italia Star	46.3%	17.4%

Our goal from the start has been to obtain a good return for our investors, ahead of the average return of the other funds in the Italian Equities universe – in particular the Lyxor and the iShares ETFs – as well as the main market indices.

We are glad to say we have done well. At the four-year mark, we have a significantly higher Total Return and a much lower Standard Deviation than most of our competitors. We are well ahead of the average Italian Equities fund and, more so, of our most comparable ETF. We are also ahead of our most comparable market indices: the Small Cap index, the Mid Cap index (which the Lyxor ETF is designed to track) and, most notably, the AIM index. In addition, despite the substantial underperformance of mid and small caps versus large caps since 2018, documented in our Q3 2019 letter, we are also ahead of the iShares ETF as well as the MIB index it is designed to track.

Our only disappointment is that we have not been able to keep pace with the STAR index. The largest components of this highly concentrated index – Amplifon, BB Biotech, IMA, Interpump – have done very well in these four years but are too large for our mandate to invest most of our fund in small companies, which we define as companies with a market capitalisation of less than one billion euro. We have or had STAR companies in the fund – Reply, TIP, SeSa, MutuiOnLine, Datalogic, Banca IFIS, FILA, El.En. and many others – but our investments have nothing to do with their being part of the STAR index.

With hindsight, we must acknowledge that a larger cap focus would have benefited our performance, as it has for those few funds that are invested around the STAR index and therefore show better returns. But we stand by our mandate: we want to invest in the Amplifon of tomorrow. Smaller caps and especially AIM stocks have had a tough time relative to larger caps in the last couple of years. But this is for us an added attraction, and the reason why we have been increasing our exposure to smaller capitalisations and participating in several IPOs of new companies mainly listed on AIM. We expect the smaller cap catch-up that we have seen in the last few quarters to continue in the quarters and years ahead, also aided by renewed interest in PIR investments. This should help our fund to catch up with the STAR index.

Our public relation initiative

In launching the Made in Italy Fund four years ago we had two objectives:

1. Give global investors exposure to an attractive but relatively unknown pot of value, replete with interesting companies that often remain hidden under the broad brush strokes of top-down country allocations.

2. Offer Italian investors an effective way to combine smart investing with a dose of healthy patriotism and participate in the success stories of their country. These are mostly represented by smaller companies that find little or no space in mainstream, MIB-driven domestic funds, and are most in need of resources to finance their growth.

It is with this second goal in mind that we have recently launched a public relation campaign in Italy, with the support of The Van Group and L45. Articles, interviews and related initiatives are summarised in the Media page of our website.

The vital objective in our fifth year that has just started is to attract investments in the Made in Italy Fund. We hope to deserve, maintain and elicit your interest.

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