Made in Italy Fund

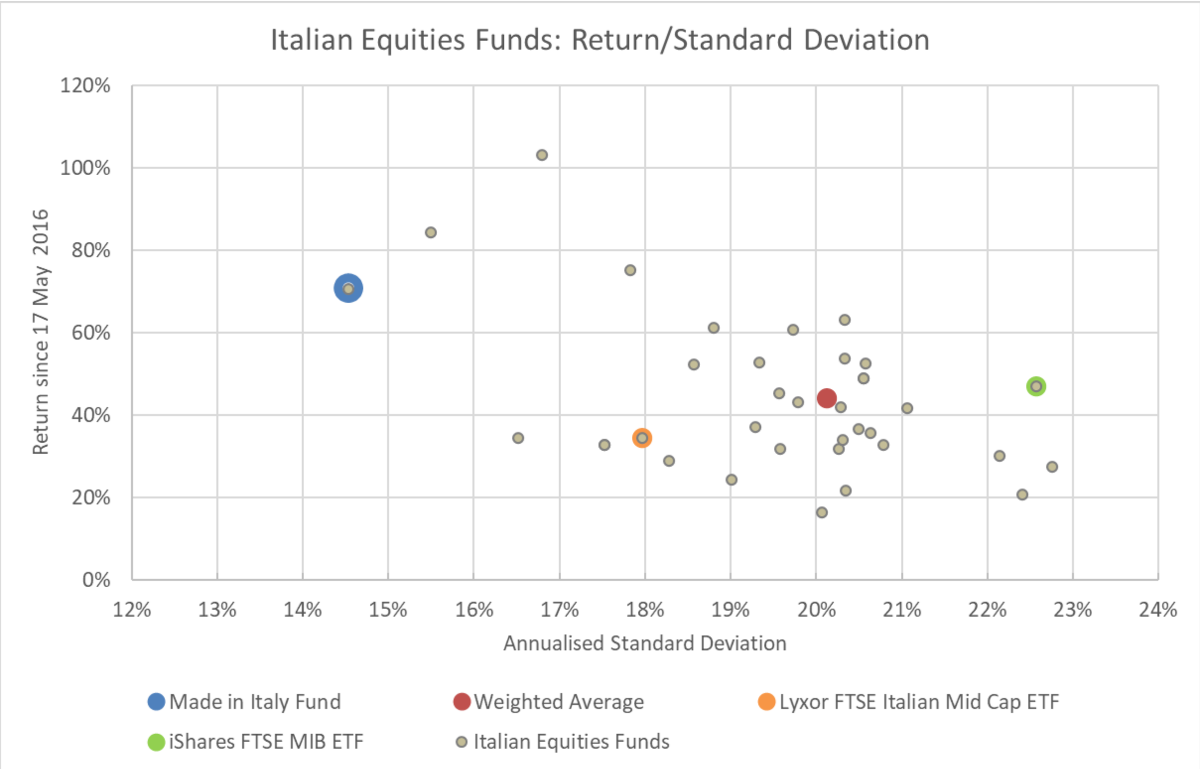
Bayes Investments

Investor letter – Second Quarter 2022

Dear Fellow Investors,

The Made in Italy Fund (MIF) had a return of -12.0% in the second quarter of 2022. The return since inception (17 May 2016) is 70.7%. 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 44.1%:



Source: Factset

The MIF return is significantly higher than the 34.5% return of the most comparable ETF – the Lyxor Mid Cap Fund – as well as the 47.1% 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 14.5%, compared to 20.1% for the weighted average fund, 18.0% for the Lyxor ETF and 22.6% for the iShares ETF.

Second Quarter 2022

Our -12.0% return for the quarter compares with a weighted average return of -11.5% for the Italian Equities universe, -10.4% for the Lyxor ETF and -12.6% for the iShares ETF.

In the first half of the year the Fund was down -20.4%, versus -19.7% for the weighted average fund, -21.3% for the Lyxor ETF and -19.8% for the iShares ETF.

Contrary to our expectations, extensive weakness in global stock markets intensified in the second quarter, fuelled by the same themes that had unsettled them in the first quarter: the Ukrainian war and the outlook for inflation and interest rates. On the first, hopes for some sort of resolution gave way to a resigned expectation of a prolonged conflict. On the second, the view that resurgent inflation in the US and Europe was due to temporary supply bottlenecks in a post-Covid recovery, exacerbated by war-related spikes in energy, raw materials and food prices, succumbed to the idea that the surge had been caused by excessive fiscal stimulus and aggravated by delayed central bank intervention, requiring sharper monetary policy tightening and increasing the risk of a significant slowdown in economic activity.

Equity and bond markets suffered a severe correction. The S&P 500 index in the US fell -16% in the quarter, which, compounded with the first quarter loss, resulted in a six-month drop of -20% – the worst first-half performance since 1970. The Nasdaq index fared even worse, falling -22% in the quarter and -29% in the first half. The 10-year US Treasury yield, which ended last year at 1.5%, doubled to 3% by the end of June, after touching 3.5% in the middle of the month. In Europe, the German DAX index fell -11% in the quarter and -19.5% in the first half, while the 10-year Bund yield rose from -0.2% at the end of last year to 1.4% at the end of June. The Euro STOXX index registered a similarly negative performance and so did the Italian main market MIB index, down -12.5% in the quarter and -19.6% in the first half. The Italian 10-year BTP yield rose from 1.2% at the end of 2021 to 3.3% at the end of June, thus extending the spread over Bunds from 1.4% to 1.9%.

The Fund's performance in the second quarter and the first half of the year was in line with the MIB index and the two reference ETFs, as well as the other two ETFs that were launched after our inception, ITAPIR and IPIR, down -19.7% and -20.2% respectively in the first half.

Defying the downward momentum, a few of our stocks did well in the quarter. We highlight two:

Sebino, a company we bought at its IPO in Q2 2020 at 2 euro per share, ended the quarter up 25% at 6.5 euro, thus recouping its -22% decline in Q1. The stock was up 138% in 2021.

Piteco rose 21% in the quarter, after receiving a take-out offer from its controlling shareholder in mid-June. We have held the stock since inception, buying it then at 3.8 euro per share and accumulating it over time. We commented on it in our Q3 2020 letter, after a 27% jump in that quarter to 8 euro. The stock continued to appreciate thereafter, until the June offer came at 11.25 euro, 24% above the previous day close but below the 12 euro level the stock had reached at the end of August last year. Like us, the controlling shareholder evidently thought the company was worth more than its current price and took advantage of market turmoil to place an offer at a convenient level – probably with a view to bringing to the market the larger group Piteco is part of. Seeing no further meaningful upside, we subsequently sold the stock at 11.1 euro in order to raise cash for new investments. This is almost three times what we paid originally, and 82% above the average price of 6.1 euro at which we had been accumulating the stock.

Source: Factset

The majority of our stocks, however, were unable to avoid the negative drift and lost further ground.

During the quarter we participated in two new IPOs:

Bifire. The company is a manufacturer of fire protection and thermal insulation products for building and industrial use. The Fire Protection segment produces fiber-silicate calcium-based sheets. The Thermal Insulation segment provides insulating plates applied to the walls of buildings. Both product lines are employed in the renovation of old buildings, increasing their safety and energy efficiency, improving living standards and decreasing CO_2 emissions. Products for industrial use include lift and fire doors, fire dampers, furnaces and dryers. The company has a market capitalisation of 53 million euro and 2021 revenues of 29 million (2/3 Building, 1/3 Industrial), expected to grow close to 40 million this year. 2021 Net Profits were 4.2 million, expected to increase to 5.4 in 2022. We paid 3.67 euro per share at the IPO at the end of May. Caught in the June mayhem, the stock ended the quarter at 2.83.

General Finance. The company operates as an intermediary in recourse (pro solvendo) and non-recourse (pro soluto) factoring. Its services include: 1) Credit and collection management of assigned debtors, allowing sellers to outsource activities otherwise carried out internally; 2) Financing of sellers of a part of the nominal value of the assigned receivables; 3) Insurance of the insolvency risk of the assigned debtors. The company has a market cap of 90 million and closed 2021 with revenues (intermediation margin) of 24 million, up an average 25% per year since 2016. Net profits were 9.5 million, up 37% a year on average since 2016. We expect such growth to continue, as the company expands its operations internally and via M&A. We paid 7.2 euro per share at the IPO at the end of June.

The current sector composition of the Fund is the following:

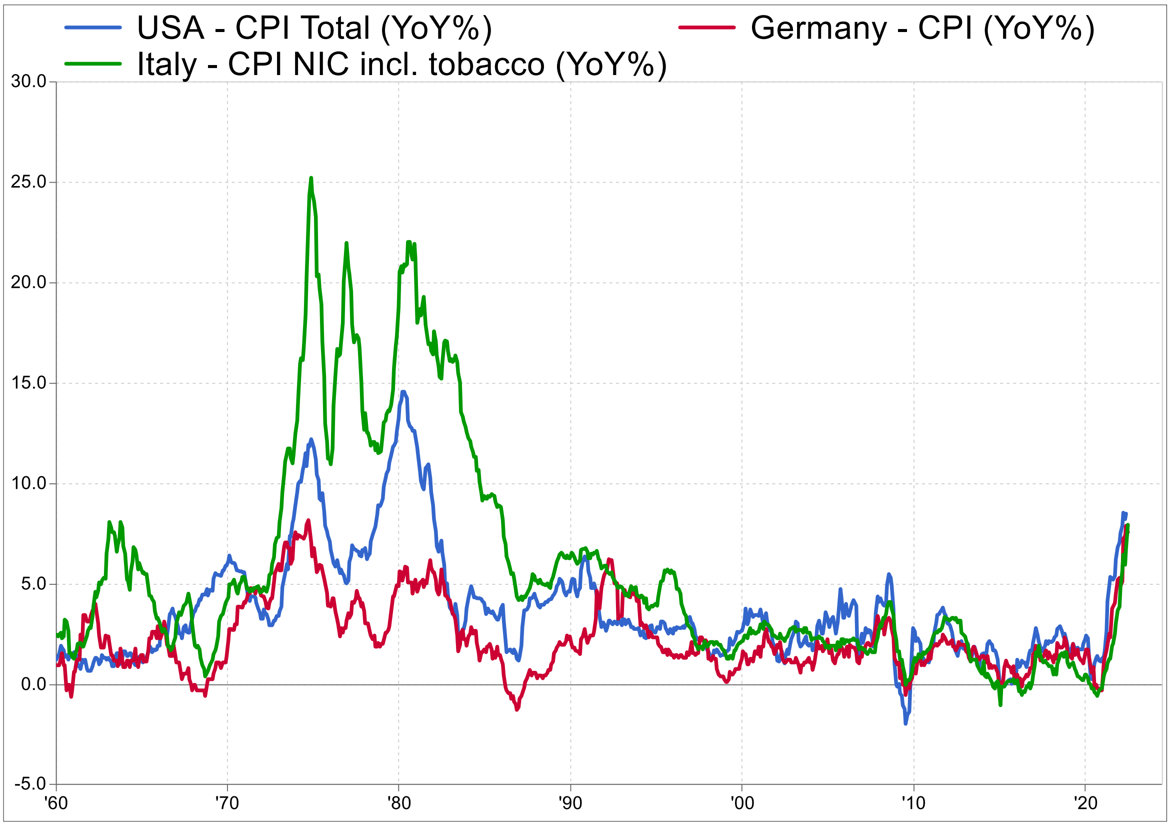
	Number of companies	% Weight
Producer Manufacturing	5	11.3%
Electronic Technology	3	5.5%
Process Industries	3	5.3%
Consumer Non-Durables	1	2.2%
Consumer Durables	3	6.2%
Industrial Services	1	5.9%
Commercial Services	6	13.0%
Consumer Services	3	6.8%
Technology Services	9	20.6%
Health Technology	2	5.2%
Retail Trade	1	2.7%
Communications	1	2.2%
Finance	3	4.0%
Utilities	2	4.5%
Total	43	95.5%
Warrants + cash		4.5%

Explaining vs. justifying

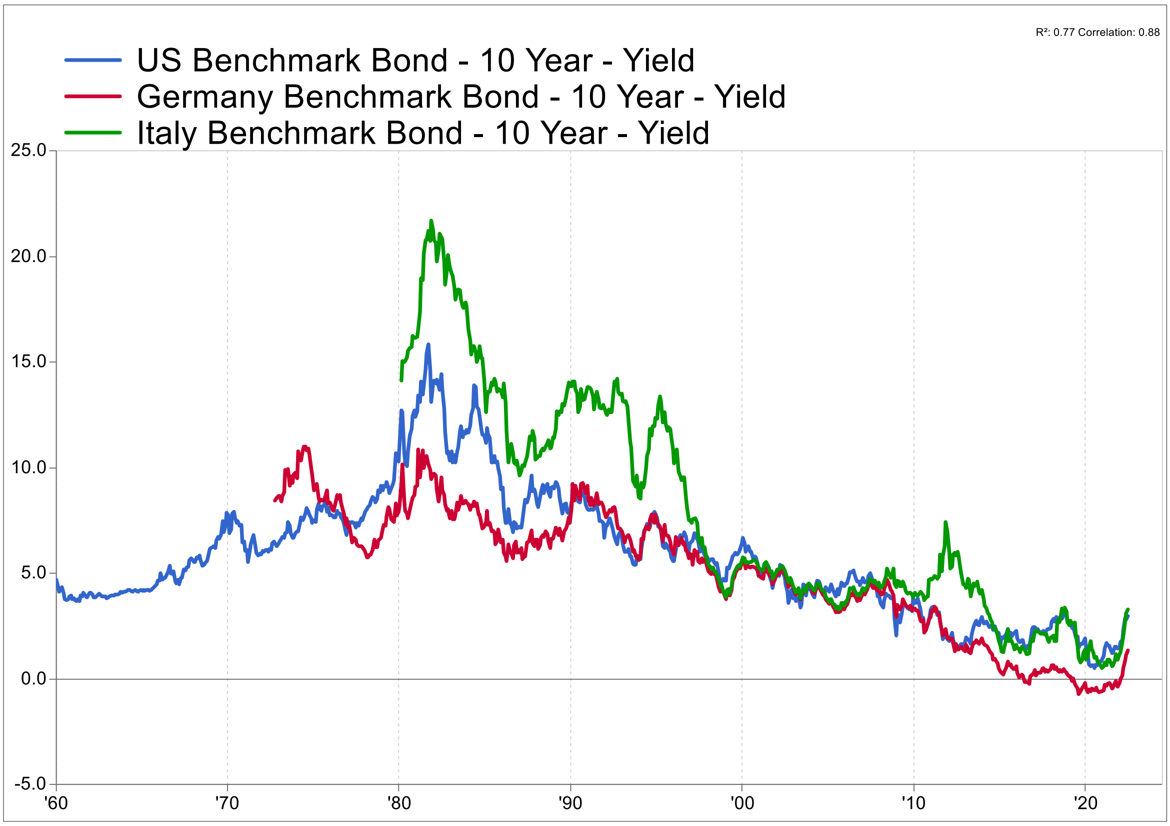
Why did stock markets take such a beating in this first half of the year? Are the Ukrainian war and the upsurge of inflation and interest rates sufficient reasons to explain it? There is no shortage of commentary on this. Most of it, however, is typically focused on the short term, whereas a long term perspective is much more useful to place current events in the right context.

The first chart on the next page shows Consumer Price Index inflation in the US, Germany and Italy since 1960. Let's focus first on the recent numbers. Year-on-year inflation was 1.3% in the US at the end of 2020, after touching 0.2% in May in the throes of the pandemic's first wave. Thereafter, however, it started a steady climb, and by the end of 2021 it reached 7.1%. Germany and Italy followed a similar path, but starting from a lower base: -0.3% and -0.2% at the end of 2020, climbing to 5.3% and 3.9% at the end of 2021. The upward move has continued this year: the June numbers are 9.0% in the US, 7.6% in Germany and 8.0% in Italy. These are considerably higher numbers than those we have been accustomed to in the new century, especially after the 2008 financial crisis. In fact, to see a number above 9% in the US we need to go back to the end of 1981, while the last time Bundesbank-guarded Germany had inflation above 7% was back in 1974, at a time when Italy's inflation ran above 25% and US inflation was above 12%.

Are we heading back to those days? We highly doubt it. And so does the bond market. As shown in the second chart (sorry for the truncation of the German and Italian lines – Factset is good but not perfect), and as we mentioned above, 10-year bond yields in the three countries have climbed considerably from the low levels of 2021 and from the even lower levels a year before – when 10-year Bunds yielded an unprecedented -0.6%. But while the move has been impressive in percentage terms – US yields doubling in six months, and three times as high as they were at the end of 2020 – their absolute levels are still a fraction of what they were in the '70s and '80. In fact, US yields were at today's level as recently as the end of 2018, while German Bunds and, more so, Italian BTPs were at higher levels until mid-2014.



Source: Factset

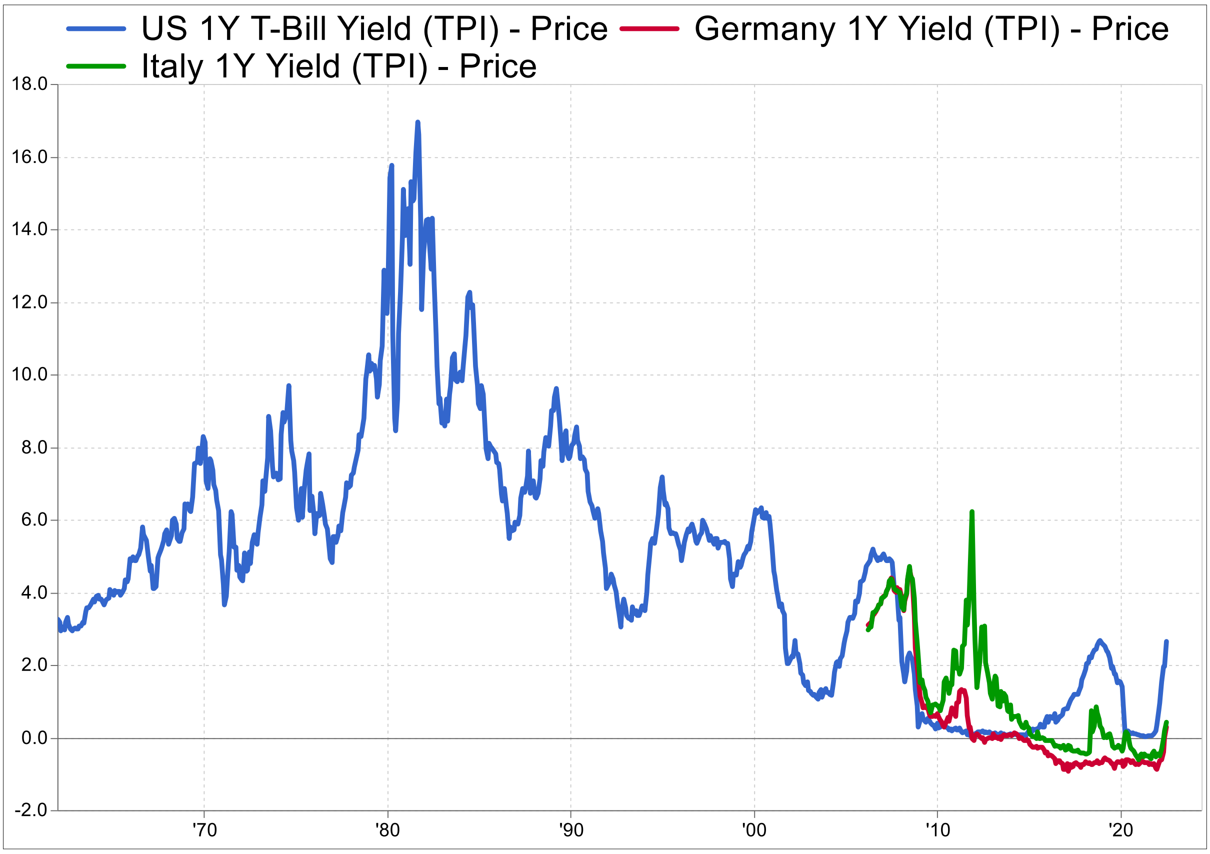


Source: Factset

We point this out because a popular explanation of the dismal performance of stock markets so far this year has been that higher interest rates imply higher discount rates of future earnings, and therefore justify lower valuations, especially for companies where value comes mostly from future growth opportunities. We think this is wrong on two counts.

First, a well-known property of any equity valuation model requires that the cost of capital R – the rate at which future cash flows are discounted to the present – must be higher than the terminal growth rate G – the rate at which the company is assumed to grow in the very long run. A robust valuation model must have an adequately wide R-G gap: narrow the gap towards zero and one can obtain any desired valuation level – in fact infinite as R nears G. R is commonly determined as the sum of a ‘riskless’ rate and a ‘premium’ reflecting the company’s ‘riskiness’. Therefore, lowering R in a world of low interest rates may be a tempting perspective, with a view to justifying higher valuations. But it would be a mistake. The ‘riskless’ rate component of R cannot be anything like the low yields that have prevailed in recent times. Just like G, R must be a *normalised* long-term rate, impervious to interest rate fluctuations.

Second, interest rates are going up because they have been very low – and negative in real terms – for a long time. They are normalising to appropriately higher levels, consistent with positive real rates, as they should be. But clearly they are not catching up with current high inflation. The reason is that current inflation is expected to be a temporary phenomenon, albeit protracted by supply disruptions caused by the Ukrainian war. Headline US inflation is at 9%, but the 1-year Treasury bill has moved from 0.4% at year-end to 2.7% at the end of June. It was at this level as recently as the first quarter of 2019. But it was 5% in 2007 and 17% in 1981!



Source: Factset

Obviously, it is possible that bond markets are wrong and high inflation is here to stay. But a suitably long historical perspective suggests this is a highly unlikely outcome. The world today is very different from that of the ’70s and ‘80s, when inflation was firmly entrenched in expectations and could only be subdued by massive monetary tightening and a hard recession.

Conclusion: the rise of inflation and interest rates does *not* justify the dreadful equity markets performance in the first half of the year. Still, as it is by far the main if not the only topic of conversation in market commentary, it does explain it. This is nothing new. That’s how stock markets behave. Robert Shiller wrote it more than forty years ago, in a paper that earned him the Nobel Prize in Economics in 2013: Stock prices move too much to be justified by subsequent changes in dividends.

This is not to deny that there are many companies, especially in the US, that may have been priced at too narrow an R-G gap, thus reaching unsound valuations that would have emerged as such if an appropriately wider gap had been used. In this respect, higher interest rates may well have the beneficial effect of facilitating a realistic reassessment of their true values at lower levels. But the blanket reassessment we have been experiencing in the last six months makes no sense. We can explain it, but we can’t justify it.

Just look at Bifire. When we bought the stock at IPO in May we paid 3.67 euro per share, valuing the company at 11.9 times 2022 expected earnings. By the end of June, the price dropped to 2.83, i.e. at 9.2 times. This for a company with a 19% operating margin and a Return on Equity of at least 25%, and which is expected to grow revenues, earnings and free cash flow at more than 10% a year in the foreseeable future. Who in his right mind would sell the stock at this level, moreover after buying it at IPO a few weeks earlier? Yet they do, including professionals who, under the influence of the prevailing narratives, succumb to the pressure of ‘doing something’ to ‘de-risk’ their portfolios. We did just the opposite: we increased our position in June. According to our valuation model – which goes well beyond a simple PE ratio – the company is worth more than twice the current price. Hence we see owning it at these levels as a very safe bet.

It is not long ago, at the end of 2018, that we faced a similarly sized downturn. In fact, what we wrote in our Q4 2018 investor letter has a close sounding resemblance to what we are writing today: ‘a weakening global economy, tighter US monetary policy and US-China trade tensions’. On top of that, we were dealing with the convolutions of Italian politics – an unsavoury drudgery that the Draghi government has spared us since February 2021 but may well come back to haunt us following the Prime Minister’s recent resignation.

We ended the Q4 2018 letter wishing our readers a

> **Happy New Year**
>
> We join the rest of the investor community (and the rest of humankind) in bidding farewell to 2018.
>
> After big stock market drops, we are reminded of Warren Buffett’s counterintuitive remark: we should not fear but welcome them, since, as savers, we are net buyers of equities over time, and each drop gives us the opportunity to buy more at lower prices.
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> […]
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> After 2018, wisdom would suggest prudence in the new year. But, as a famous Italian song goes:

Troppo spesso la saggezza è solamente la prudenza più stagnante
E quasi sempre dietro la collina è il sole

Too often wisdom is only the most stagnant prudence
And almost always behind the hill is the sun

(Mogol-Battisti, La collina dei ciliegi)

Sure enough, global equities and our Fund had a strong rebound in the first quarter of 2019 and continued to do well throughout the year.

Until a new drama, of a different nature, started unfolding in Q1 2020. An investor's life is never boring.

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