Made in Italy Fund

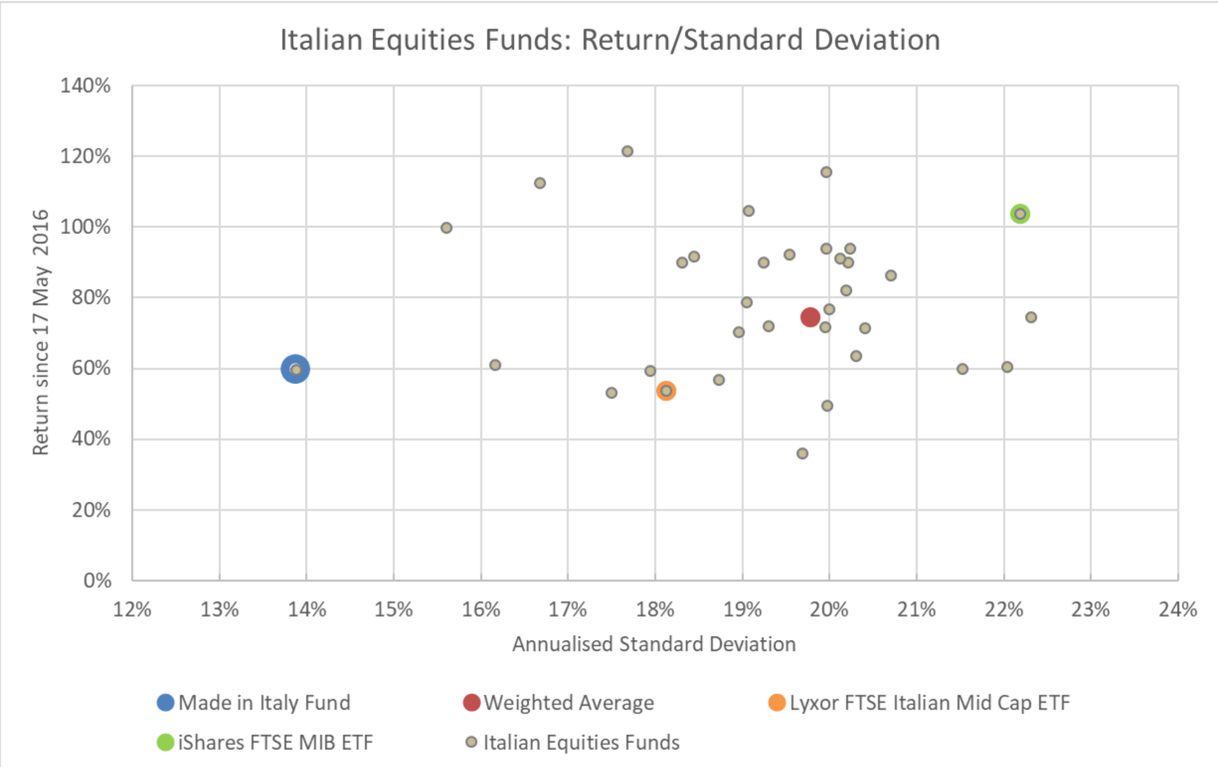
Bayes Investments

Investor letter – Second Quarter 2023

Dear Fellow Investors,

The Made in Italy Fund (MIF) had a return of -8.8% in the second quarter of 2023. The return since inception (17 May 2016) is 59.7%. Returns are net of fees and all administration costs.

Following the negative quarter, the MIF has fallen behind the Italian Equities fund universe, whose weighted average return since our inception is 74.4%:



Source: Factset

The MIF return remained above the 53.8% return of the most comparable ETF – the Lyxor Mid Cap Fund – but has fallen further behind the 103.9% 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 13.9%, compared to 19.8% for the weighted average fund, 18.1% for the Lyxor ETF and 22.2% for the iShares ETF.

Second Quarter 2023

Our -8.8% return for the quarter compares with a weighted average return of 3.2% for the Italian Equities universe, -0.5% for the Lyxor ETF and 7.0% for the iShares ETF.

For the first half of the year, the MIF return is -1.5%, versus 14.7% for the weighted average fund, 10.3% for the Lyxor ETF and 23.0% for the iShares ETF.

It was again a positive quarter for world equities, and in particular for US equities, with the S&P 500 index up 9% and the Nasdaq index up 13%, bringing their first-half returns to 17% and 32% respectively. European markets were also up, with the Euro STOXX index returning 3%, on top of its 12% return in the first quarter. Again, Italian equities did better, with the main market MIB index up 7%, on top of its 15% first-quarter return. For the fourth quarter in a row, however, Italian small cap stocks lagged substantially behind, with the Italia Small Cap index actually falling -7% this quarter.

As pleased as we are with the persistence of the equity market recovery we envisaged in last year's Q3 letter, we are disappointed that it has failed so far to extend to the Italian small cap universe and to our portfolio. The sustained small cap underperformance we discussed in the Q4 letter, likening it to a similar phase we experienced between 2019 and 2020, had seemed to change direction in the second half of last quarter, thus encouraging us to anticipate the beginning of an overdue catch up with large caps. We were wrong. The small cap underperformance resumed mightily in the second quarter, this time with inverted signs.

The downward move was particularly fierce for a number of our companies, with Farmacosmo down -51%, Tecma Solutions -48%, Solid World Group -31%, Matica Fintec -27%, Datrix -25%, and Giglio.com -23%. This was in sharp contrast with their strongly positive business trends.

Farmacosmo, a company we bought at IPO in Q1 2022, is an e-commerce player specializing in the online sale of pharmaceutical and wellbeing products. The business has expanded into Q-commerce, opening physical pharmacies in strategic locations throughout Italy. Additionally, the company has been strengthening its online presence through acquisitions, including the recent purchase of ProfumeriaWeb, an e-commerce platform specializing in perfumes and make-up products, and BAU Cosmesi, which focuses on wellbeing products for pets. Furthermore, it is investing in innovative services in the wellbeing sector, with a particular emphasis on telemedicine and leveraging online platforms to improve access to healthcare services, as evidenced by the recent launch of ContactU, a digital platform offering psychology and psychotherapy services. The business has been growing well. In the first semester of this year, revenues were up 17% from the same period last year, driven by the online retail channel, up 33%. Orders were up 35% and total customers up 45%, with the average cart value reaching 108 euro. Italian speakers may want to listen to the recent Class CNBC interview of Farmacosmo's CEO Fabio de Concilio. We have taken the opportunity of the unwarranted fall in the stock price to increase our position.

Tecma Solutions, which we bought at IPO in Q4 2020, is a technology company specializing in digital transformation for the global real estate industry. It offers a fully digitalized technological platform, which aims at increasing customer revenues, reducing costs, and expediting sales and rentals for real estate players. Tecma has established a leadership position in Italy, supported by its track record, reputation, and relationships with key developers. 80% of its 2022 sales were generated in Italy's growing market of new residential buildings, with Milan as the main reference market. Through the increasing adoption of proptech in the real estate market and its international expansion into new market segments, the company has achieved substantial top-line growth, with over 400 active and completed projects. While growth in 2022 was adversely impacted by a shift in the business model and project delays in the Italian market, we expect the business to resume growth this year, driven by penetration into new market segments, international expansion, the introduction of new products, and the development of its distribution channel. The company aims to consolidate its international presence and offer software solutions as well as a marketplace for design and fintech. The strategic shift will allow Tecma to provide recurring revenue streams and transform itself into a tech player with software-as-a-service offerings. We also increased our position during the quarter.

Solid World, which you will remember was 232% last quarter, had a partial and seemingly physiological retrenchment this quarter. But at 7 euro per share the company had a market cap of 81 million, 13.5 times the 6 million EBITDA expected in 2023 – decidedly cheap in absolute and relative terms. Now that the market value has been cut to 51 million the stock is even cheaper and again we have taken the opportunity to increase our position – and so has the company, which at the end of May has initiated a share buyback program.

Matica Fintec will report first-half results in the first week of August, which will likely continue to show the strong progress seen in 2022, with a 20% revenue growth on a 25% EBITDA margin. **Datrix** (which was *up* 24% last quarter) has been releasing a string of updates on important new contracts and collaborations, building on a 46% increase in revenues in 2022. **Giglio.com** reported a 32% year-on-year increase in revenues in the first quarter and is on its way to EBITDA profitability.

So: in the light of these impressive results, what explains the dismal stock price performance of these companies? Before we attempt to answer this question in the next section, let us highlight a few bright spots:

Last quarter's IPO **Reway Group** ended this quarter up 25%; **Expert.ai** – which had suffered mightily last year – continued its run, up a further 25% this quarter after advancing 11% in the first; **Sebino** – a company we bought at IPO at 2 euro per share in the middle of the pandemic in Q2 2020 – received in April a delisting offer by its controlling shareholders at 7.2 euro per share, 17% above its previous day close and 3.6 times its IPO price; the next month, **Labomar** – which we bought at IPO at 6 euro per share in Q3 2020 – received a similar offer at 10 euro per share, 14% above its previous day close and 67% above its IPO price.

During the quarter we sold Sebino and Labomar after their delisting offer as their price reached the offer level, exited another position and participated in two new IPOs:

Ecomembrane. The company is a specialized producer of PVC-coated membrane covers and technical systems used in various applications such as gasholders, biogas plants, digesters, odour control systems, and emerging fields like CO2 storage/capture and the hydrogen industry. The growing demand for clean gas, driven by international net-zero and environmental policies, technology advancements, replacement cycles for outdated infrastructure, and market concentration, is set to propel the industry forward. Forecasts indicate significant market expansion, especially in the European and US Biogas and Natural Gas markets. Ecomembrane occupies a key strategic position in this burgeoning industry, as its products represent a vital component, accounting for 7%-10% of the capex costs in biogas/biomethane projects. With an impressive track record of market expansion, experiencing strong growth since 2011, the company is in the position to capitalize on the transformative opportunities presented by the evolving energy market.

The company has a market capitalisation of 36 million euro, 2022 revenues of 14 million, EBITDA of 3.2 million and Net Income of 1.8 million, all expected to grow rapidly in the next few years. We paid 8.5 euro at the IPO in April. The stock ended the quarter at 8.8.

Italian Design Brands. The company is a group consisting of high-end furniture and design brands that operate in the luxury furniture, lighting, and kitchen sectors. Comprising ten companies, including renowned names like Gervasoni, Meridiani, and Davide Groppi, each brand within IDB holds a distinct reputation within the luxury and design industry. The group's growth strategy involves aggregating additional Italian design brands and capitalizing on synergies between the brands to foster organic expansion. IDB strategically positions itself within a resilient and expanding market, responding to the growing international demand for Italian design furniture. The substantial number of visitors, approximately 400,000, at the prestigious Salone del Mobile fair in 2023 further highlights the prominence of Italian design in the industry. Additionally, the ongoing "back to the office" trend has reinforced the global need for furniture and lighting solutions, contributing to IDB's growth in contract sales. With a structured presence in the US, UK, and Chinese markets, IDB is actively investing in digitalization efforts at both the product and organizational levels. This investment aims to leverage group synergies and enhance operational efficiency. IDB's emphasis on luxury and design, coupled with its ability to adapt to market trends, positions the group as a significant participant in the industry. In a notable development, Tamburi Investment Partners, the anchor investor of IDB's IPO, has recently raised its stake in the company, highlighting its strong commitment and confidence in IDB's future prospects.

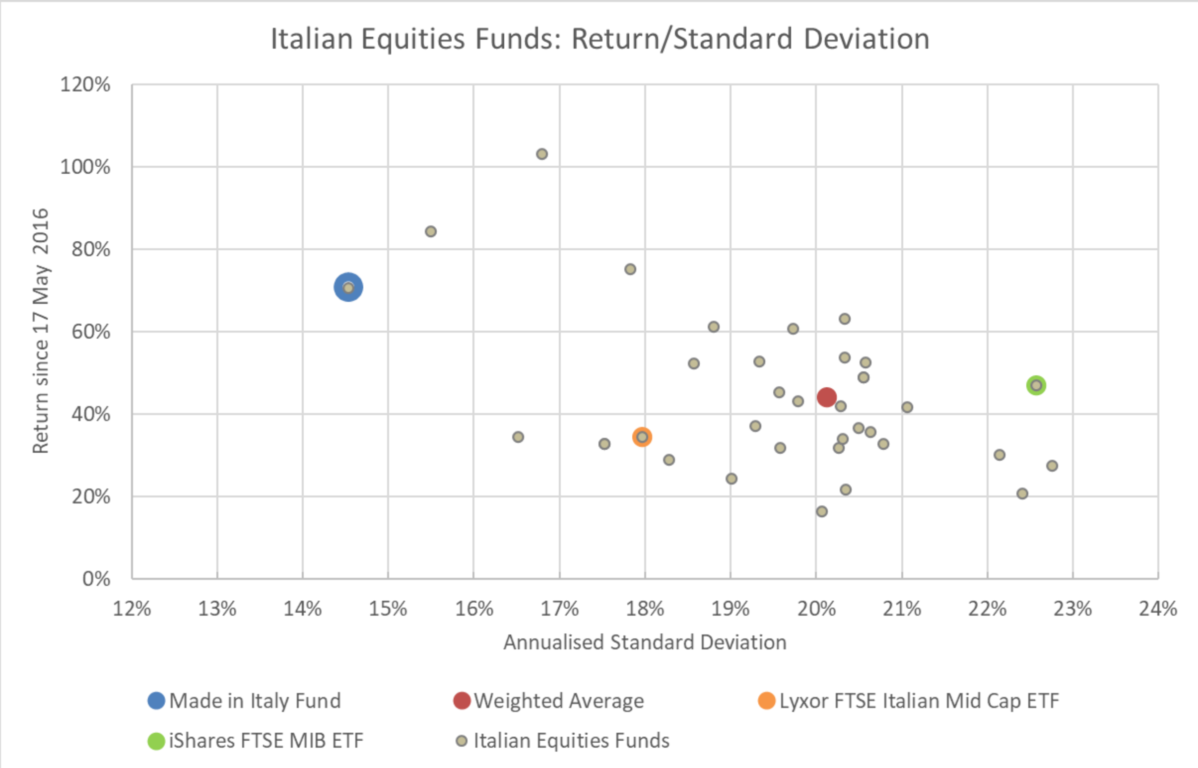
The company’s market cap is 310 million euro, with 2022 revenues of 270 million, EBITDA of 49 million and Net Income of 26 million. We paid 10.9 euro per share at the IPO in May. The stock ended the quarter at 11.2.

The current sector composition of the Fund is the following:

	Number of companies	% Weight
Producer Manufacturing	7	15.7%
Electronic Technology	3	5.0%
Process Industries	1	2.0%
Consumer Non-Durables	1	1.4%
Consumer Durables	6	16.6%
Industrial Services	2	3.5%
Commercial Services	4	11.2%
Consumer Services	3	6.1%
Technology Services	8	19.3%
Distribution Services	1	4.5%
Health Technology	1	2.6%
Retail Trade	1	2.6%
Communications	1	1.9%
Finance	3	4.0%
Utilities	1	1.4%
Total	43	98.0%
Warrants + cash		2.0%

Small Cap blues

The extensive underperformance of small cap stocks versus the main market MIB index has been lasting for four quarters in a row and is now larger than what we experienced in 2019-2020. This has dragged down our relative performance versus the Italian Equities fund universe, which is largely benchmarked against the MIB index. As our regular readers know, the chart on the first page of this letter has a highly atypical look. For comparison, this is how the chart appeared in the Q2 letter a year ago, and similarly in most of our quarterly letters since 2017:

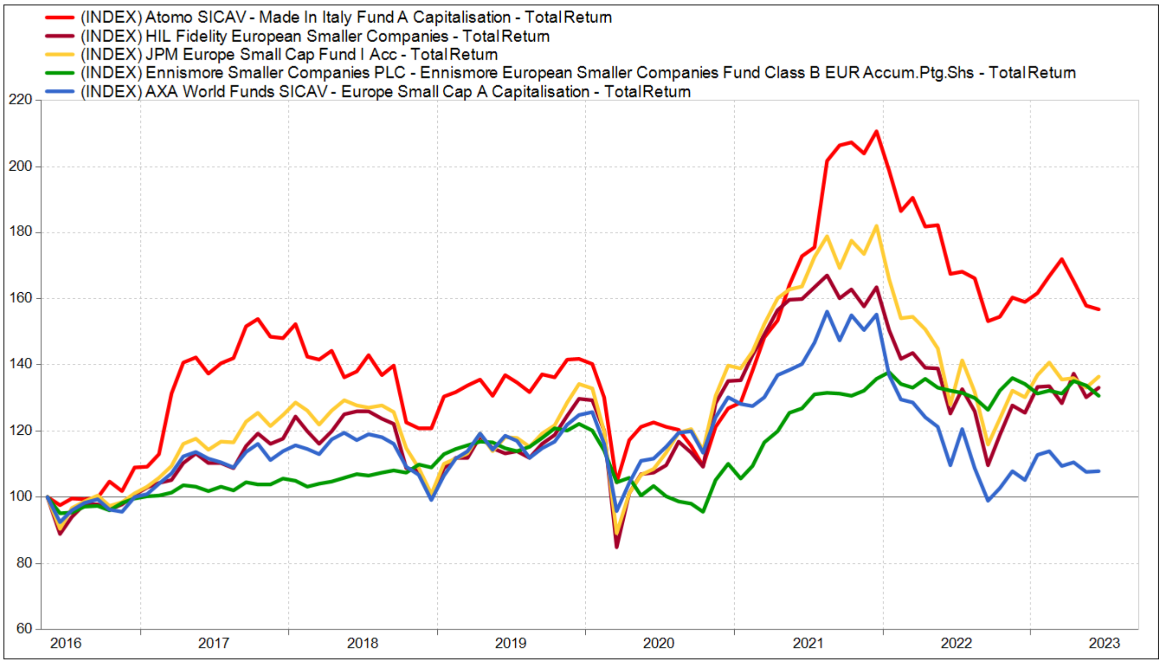


As we said earlier, and have stressed in our recent letters, this has nothing to do with the underlying performance of our companies, and more in general of the small cap universe, where a large majority of companies have been reporting good results over the period.

There are rather two main factors at work.

The first is that small cap underperformance in 2022 has been not only an Italian phenomenon, but it has affected most European markets. In Germany, for instance, the small cap SDAX index ended 2022 down -28%, versus -12% for the large cap DAX index. Likewise, the French CAC Small index was down -18%, versus -7% for the main market CAC index. The underperformance continued to a lesser extent in the first half of this year, where the SDAX and DAX indices were up 12% and 16% respectively, whereas the CAC Small was up 4% versus 17% for the CAC index.

The 2022 dip is evident in the following graph, which shows our performance since inception against the performance of four major Pan-European small cap funds:



Source: Factset. Charts indexed at 100 on 17 May 2016

Incidentally, the graph demonstrates the validity of our single-country approach, as discussed in the last Q1 letter. The first column in the following Table shows the annualised returns of our fund versus the other funds, from our inception to the end of this quarter:

Total Return, EUR - Annualised

	Jun 2016-Jun 2023	Jun 2016-Dec 2021
MIF	6.6%	14.3%
Fidelity	4.1%	9.2%
JPM	4.5%	11.3%
Ennismore	3.9%	5.6%
AXA	1.1%	8.2%

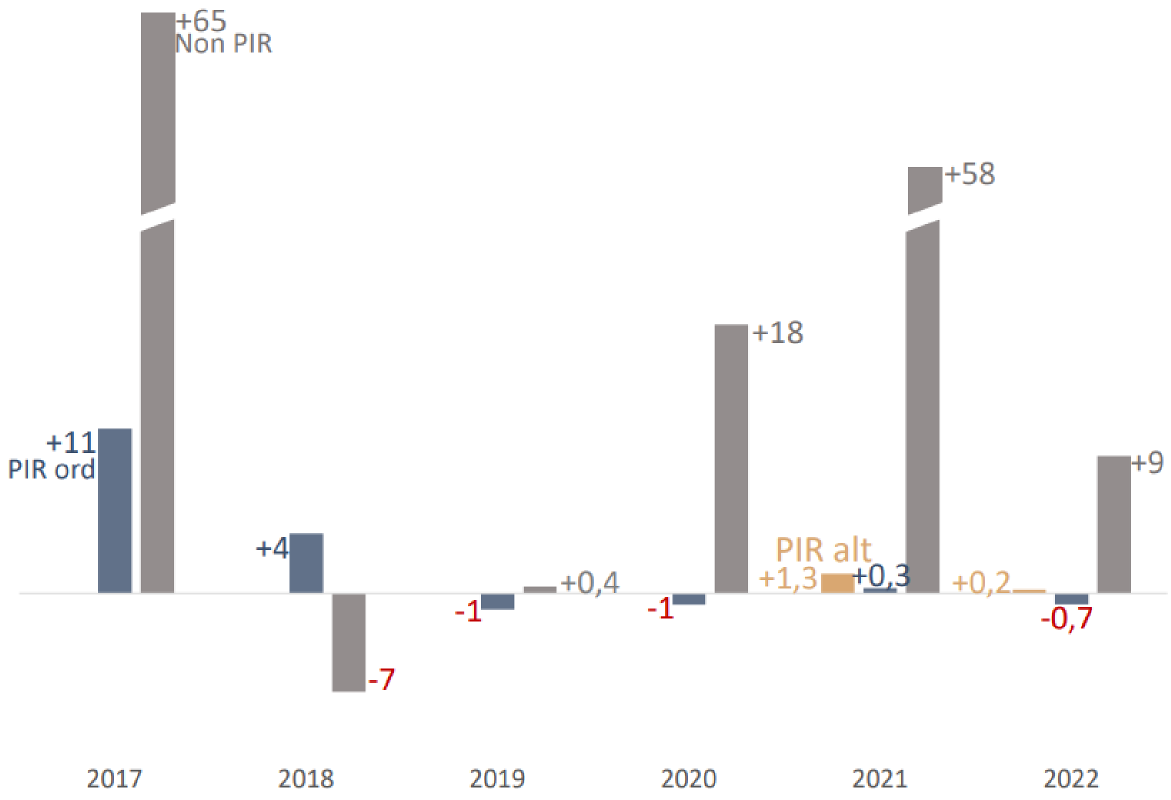
Source: Factset

Notice the dramatic impact of the 2022 downturn. For comparison, the second column in the Table reports annualised returns to the end of 2021 – a much healthier picture, which we have no doubt will be restored in due time.

The second factor to take into account is that Italian small cap underperformance – particularly evident this year, with the Italia Small Cap index flat and the Italia Growth index *down* -2% in the first half, versus +23% for the MIB index – has been exacerbated by an additional element: outflows from PIR funds.

Remember PIR funds were first launched in 2017 and require a five-year holding period in order to benefit from capital gain tax exemption. The following chart shows that the bulk of PIR inflows occurred in 2017 and to a lesser extent in 2018. Then, following some ill-conceived changes in PIR legislation, inflows came to a halt and never recovered, despite the repeal of those changes at the end of 2020. At the same time, Alternative PIRs were introduced, which saw small inflows in 2021 and 2022.

Net inflows – Ordinary PIR, Alternative PIR, and non PIR funds (in billion euro)



Source: Osservatorio PIR Assogestioni

Hence for most PIR accounts the five-year holding period expired in 2022 and 2023, causing an outflow from Ordinary PIR of 734 million in 2022, which the asset management industry has been unable to offset with new inflows. The outflows accelerated in the first half of this year, with 779 million out of Ordinary PIRs in the first quarter, and more estimated in the second quarter. This, combined with the fact that 82% of Ordinary PIR assets are in the hands of a small number of large funds managed by the top five asset management groups (see here, p. 20), may well have been a key factor in explaining the indiscriminate price falls in our and other stocks at the root of the year-long small cap underperformance.

There is no doubt that Ordinary PIRs have had positive effects on the Italian stock market. It is equally clear, however, that their effectiveness has waned over time and that they need to be revitalised and relaunched.

The primary objective of PIRs is to incentivise Italian savings to invest in SMEs, encouraging companies to go public and thus increasing the size and liquidity of the Italian stock market. But in reality – as shown in the Osservatorio PIR put together by Assogestioni on end-2022 data – out of the 17.5 billion euro in Ordinary PIRs, only EUR 861 million is invested in securities of listed SMEs, or

4.9% – slightly above the minimum of 3.5% required by the law. As a result, of the 8.3 billion invested in Italian equities, only 10.3% is invested in listed SMEs.

These numbers are clearly insufficient, and contrary to the spirit of the PIR law. A relaunch of PIRs cannot be conceived without raising the minimum percentage to be invested in SMEs to a significantly higher level.

Such change needs to be combined with the creation of new demand for small caps coming from long-term institutional investors, such as pension and social security funds. These currently invest very little in Italian equities and virtually nothing in quoted SMEs, despite benefitting from the same PIR tax advantages. Their investment could take the form of a **fund of funds**. Following the example of France, the existence of an adequate number of dedicated funds for domestic SMEs is a necessary condition for increasing and maintaining a healthy level of liquidity. A wider dispersion of ordinary PIRs in a larger number of smaller funds – as such more suitable for investing in SMEs – would increase diversification and liquidity, thereby benefitting the whole system.

We have recently taken the initiative of carrying these two proposals to the appropriate institutional levels, and will update you on the progress made in the third quarter letter.

Will the third quarter be as disappointing as the last four? We don't know. What we do know, however, is that prices do not stray from values indefinitely, and that the longer they diverge the faster they catch up. As at the end of 2019-2020, periods of maximum pain often turn out to offer the best investment opportunities.

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