Made in Italy Fund

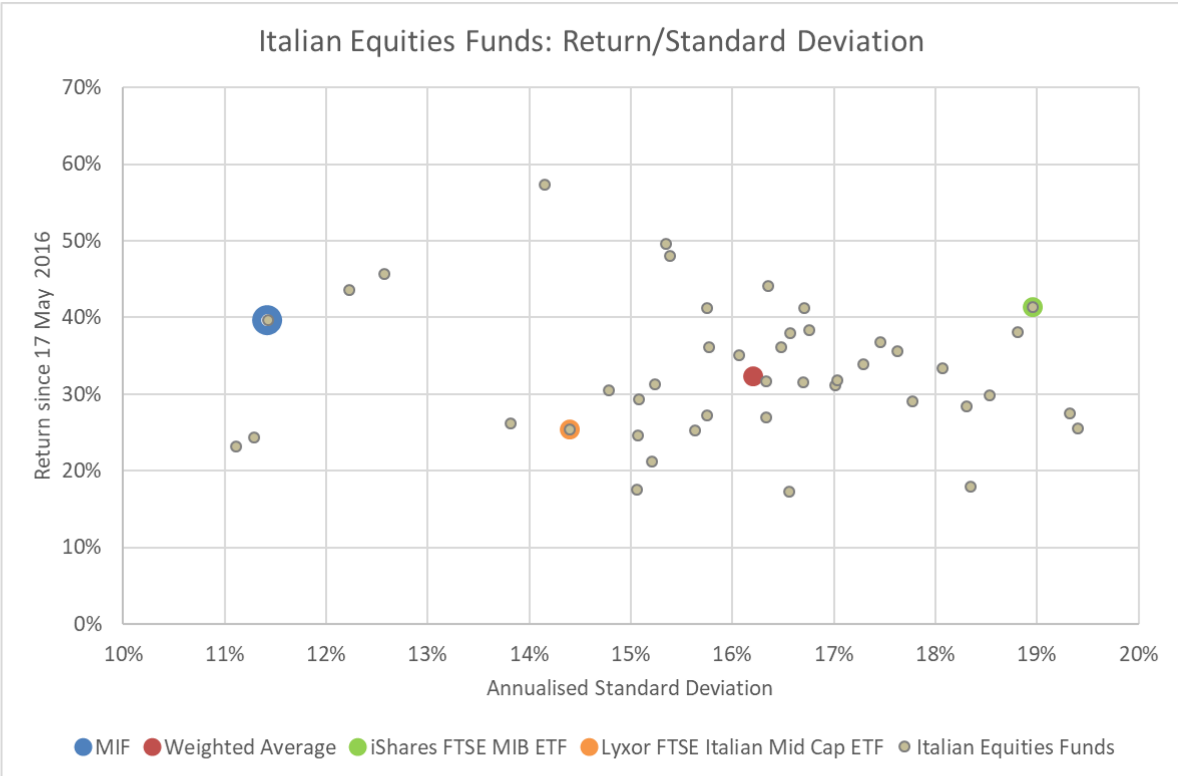
Bayes Investments

Investor letter – Third Quarter 2019

Dear Fellow Investors,

The Made in Italy Fund (MIF) had a return of 0.1% in the third quarter of 2019. The return since inception (17 May 2016) is 39.6%. Returns are net of all fees and administration costs.

During the quarter, the MIF reduced its advantage over the Italian Equities fund universe, whose weighted average return since MIF's inception is 32.3%:



Source: Factset

The MIF return remains well above the 25.4% return of the most comparable ETF – the Lyxor Mid Cap Fund – but is now slightly below the 41.4% return of the main Italian Equities ETF – the iShares FTSE MIB.

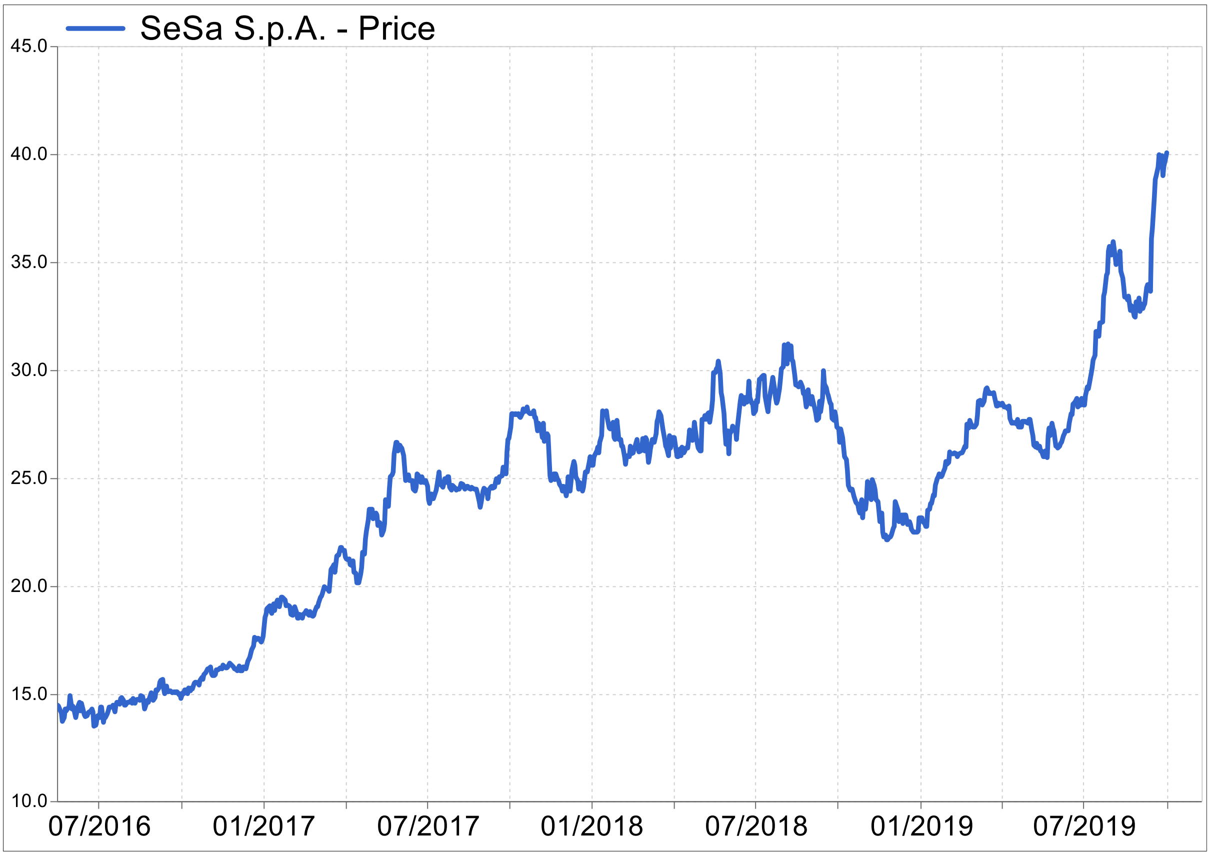
The MIF return continues to be accompanied by low volatility. The annualised standard deviation of its daily returns is 11.4%, compared to 16.2% for the weighted average fund, 14.4% for the Lyxor ETF and 19.0% for the iShares ETF.

Third Quarter 2019

Our 0.1% return for the quarter compares with a weighted average return of 3.0% for the Italian Equities universe, 2.5% for the Lyxor ETF and 4.6% for the iShares ETF.

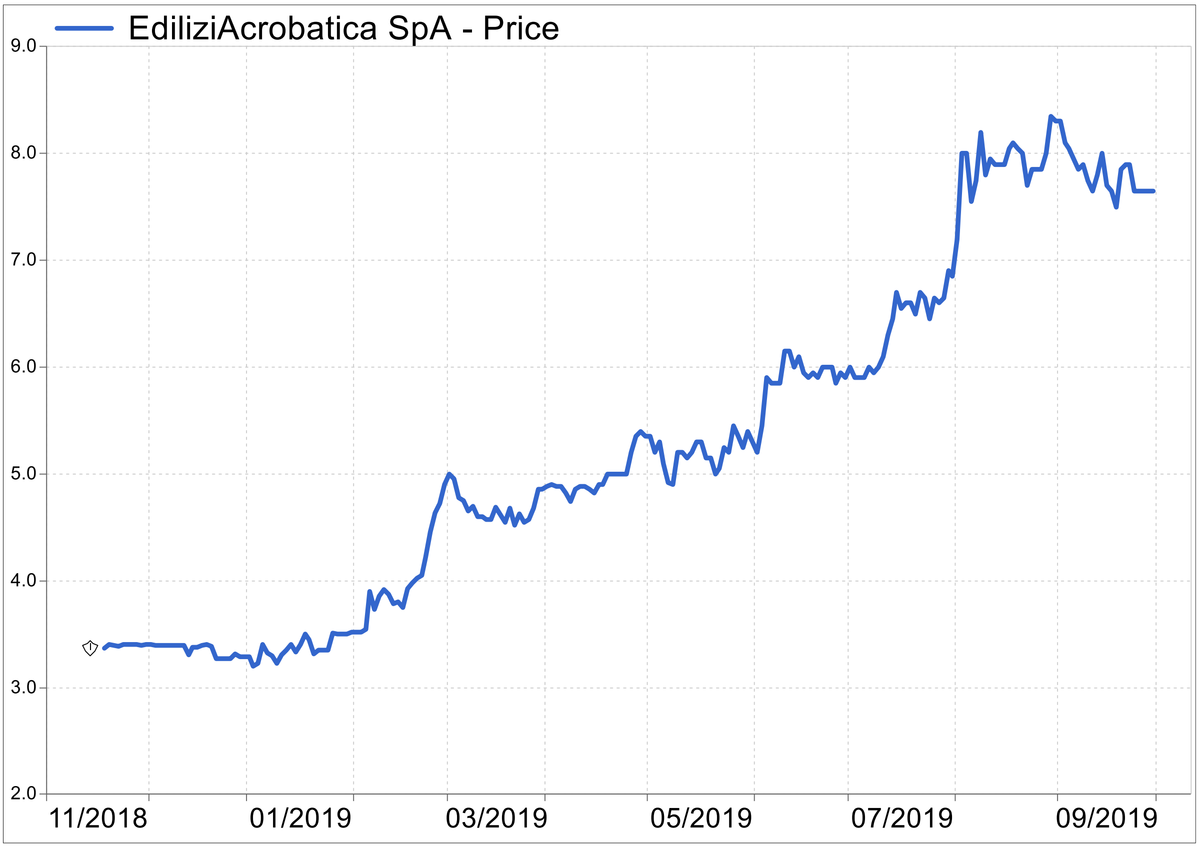
The quarter was characterised by two negative months, July and August, and a rebound in September, following the formation in mid-August of a new government supported by a 5Star/Democratic Party coalition. We wrote about it in our 9 September note, where we underlined the resulting strong positive effect on government bonds and the concurrent equity market rebound, which has been distinctly MIB index-driven. The rebound continued throughout September, with the MIF participating in equal measure.

Our strongest performer was **Sesa**, a service provider of IT solutions and system integration for small and medium sized enterprises, up 43% in the quarter and 76% year-to-date. The company, which we mentioned in the Q2 letter as **TIP** had acquired a stake in its controlling vehicle, has been in our portfolio since October 2016, when we bought it at around 15.8 euro per share. After further accumulation, its average booking price is currently 20.5 euro, about half the 40.1 euro reached at the end of the quarter:



The company is a market leader in Italy and has been growing steadily for 25 years (here is a link to a recent presentation). It has a market capitalisation of around 630 million and ended its last financial year (April year-end) with a 29 million net profit. It has a 41 million net cash position and an unbroken record of Free Cash Flow generation. Alas, we had to sell some shares in 2018 at between 25 and 31 euro in order to finance redemptions, but the company remains one of our core holdings.

EdiliziAcrobatica – first mentioned in our Q1 letter – had a third strong quarter in a row, up a further 30%, thus accumulating a 130% appreciation since its November 2018 IPO at 3.3 euro:



On the negative side, **Askoll EVA** had another down quarter, falling 25% to 1.7 euro. We took this as an opportunity to increase our position, as we share the company's expectations detailed in their recently revised industrial plan. Among last quarter's laggards, **Panaria** and **Longino & Cardenal** rebounded this quarter, both up 12%, while **Emak** was again weak, down a further 9%. Our first-half top performer, **Expert System**, shed some of its appreciation and ended the quarter down 19%.

During the quarter we participated in three new IPOs:

Marzocchi Pompe, a producer of high-performance external gear pumps and motors with a solid growth record and a strong competitive position. The company has a market cap of 30 million, 42 million revenues, EBITDA of 7.5 million (17% margin) and a 3 million net profit.

Pattern, a producer of clothing prototypes for the top luxury fashion industry, also with a high growth record and an asset-light business model in an attractive industry. Market cap is 48 million, with revenues of 44 million, a 5 million EBITDA and a 3 million net profit.

Friulchem, a manufacturer and distributor of pharmaceutical products for veterinary and human use. It has a market cap of 14 million, sales of 16 million and 1.8 million EBITDA.

The current sector composition of the fund is the following:

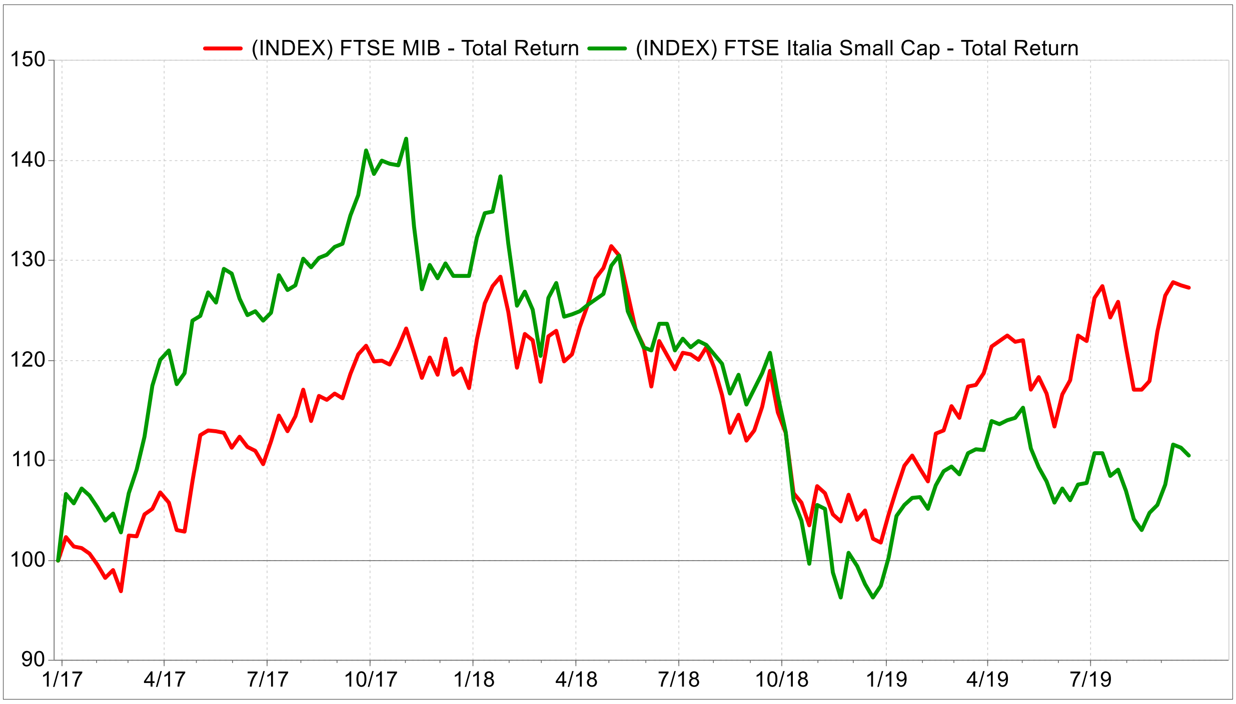
	Number of companies	% Weight
Producer Manufacturing	6	15.9%
Electronic Technology	2	5.9%
Process Industries	5	17.6%
Consumer Non-Durables	1	2.2%
Consumer Durables	2	5.3%
Industrial Services	1	4.4%
Commercial Services	4	10.8%
Distribution Services	1	2.0%
Consumer Services	1	3.3%
Technology Services	5	17.0%
Finance	2	3.4%
Health Technology	1	2.0%
Communications	1	4.1%
Utilities	1	4.9%
Total	33	98.8%
Cash		1.2%

A yawning performance gap

The third quarter index-driven equity market appreciation prolonged a key trend we documented in our September note: the significant outperformance of large cap stocks relative to small caps that has been occurring since 2018. Here is the return table we showed in the note, updated to the end of September:

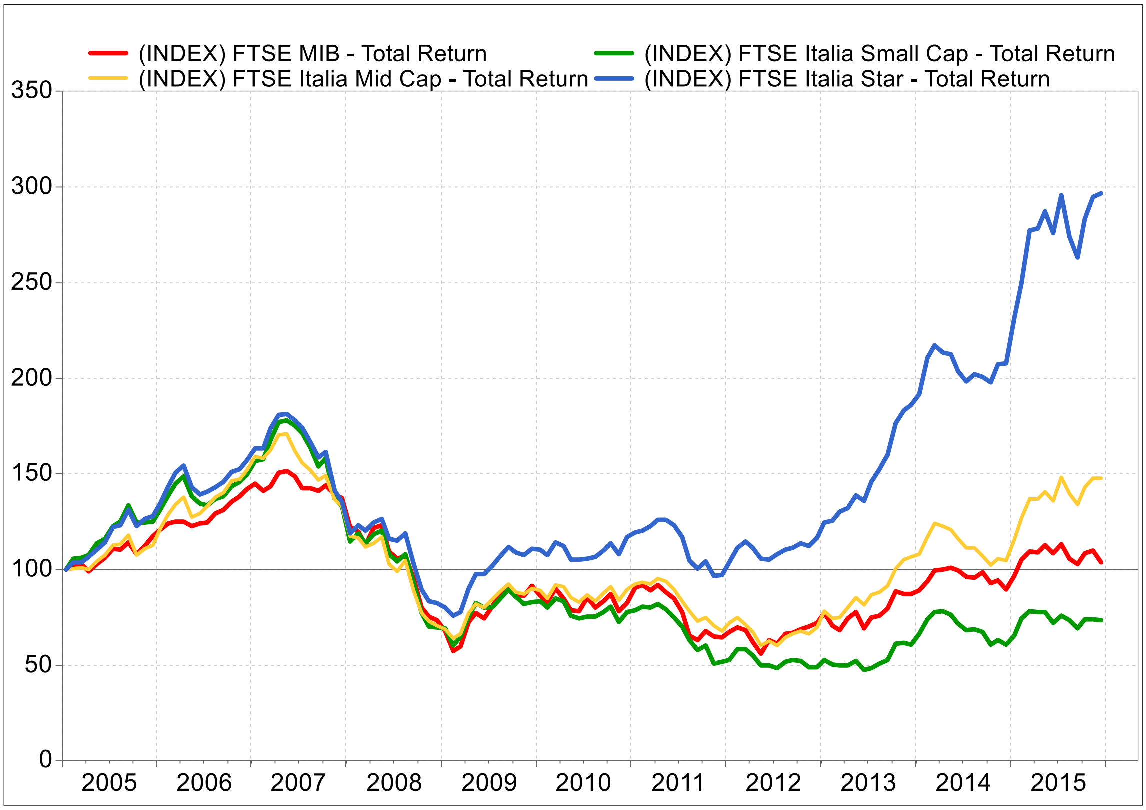
	MIB	**Small Caps**
YTD to September	25.6%	13.7%
Mid-May to end 2018	-22.5%	-25.0%
2018	-13.2%	-24.1%
2018 to September 2019	9.0%	-13.7%
2017	17.3%	28.5%
2017 to September 2019	27.8%	10.8%

Over the 7 quarters since the beginning of 2018, the MIB index had a *positive* return of 9.0%, while the Small Cap index had a *negative* return of -13.7%. This large divergence swamped the small cap outperformance of 2017. Over the 11 quarters since the start of 2017, the MIB index returned 27.8% vs. 10.8% for the Small Cap index:



Why do we draw attention to such index comparison? We have stressed many times (notably in the Q4 2017 letter) that the MIF is not managed against any index. Its objective is to obtain over time a high positive return, ahead of other funds in the Italian Equities universe. That includes, however – and this is the point of the comparison – passive funds that track the performance of relevant market indices. We want to be ahead of those too – there would otherwise be no point buying the MIF rather than a cheaper tracker fund. This is why we compare our performance to the weighted average return of Italian Equities funds, as well as to the return of the Lyxor Mid Cap Fund – the passive fund most comparable to the MIF – and the iShares FTSE MIB ETF – the passive fund that tracks the performance of the main market index.

The MIF is built on the assumption that the best way to pursue our objective is to invest in a selected portfolio of small cap stocks – companies with a market capitalisation of less than one billion euro. What is the rationale behind this assumption? Before launching the fund in 2016, the previous eleven years of market performance looked like this:



Large caps – represented by the FTSE MIB index, composed of the largest 40 stocks by market cap – had been fluctuating around their initial level and were barely above it. Mid caps – represented by the FTSE Mid Cap index of the next 60 largest stocks – had broadly tracked large caps until 2012 but had done much better in the last three years, up 48% from their initial level. Small caps, however – represented by the FTSE Small Cap index, composed of a sample of stocks smaller than the first 100 – had done considerably *worse* than large caps, down -26% from their initial level. The fund's small cap focus, therefore, was not based on any evidence that it would provide a structural advantage versus large caps – quite the opposite in fact. Our rationale was that meticulous stock picking within the highly heterogeneous small cap universe could generate superior results over time. Our hypothesis was strongly supported by the stellar performance of the STAR segment, which can only be accessed by companies with a market cap of less than one billion. As we said many times, we set our objective as that of investing in future star performers.

In fact, we have done well since then, vastly outperforming the Small Cap index:

	MIF	Small Caps
YTD to September	13.4%	13.7%
2018	-18.4%	-24.1%
2017	35.9%	28.5%
2016 (from 17 May)	11.0%	10.5%
2017 to September 2019	25.8%	10.8%
Since inception	39.6%	22.5%

We are also well ahead of the most comparable ETF – the Lyxor Mid Cap Fund – which returned 25.4% since our inception, only marginally ahead of the Small Cap index but well below the 34.0% performance of the Mid Cap index that it is intended to track.

But the mighty headwind we have been sailing against since 2018 made the iShares FTSE MIB ETF finally catch up with us – although we are still well ahead of the weighted average performance of Italian Equities funds, most of which are managed around the MIB benchmark and typically underperform it as a group.

In our September note we made the case for believing that the headwind against small caps will soon abate and may well turn into a tailwind, as more discerning investors return to the market. The case is likely to be reinforced by a resumption of PIR-related investing, as the new government is working on a pull back of the previous government's changes to PIR legislation, which resulted in blocking the openings of new PIR accounts since the beginning of the year.

We therefore confirm our positive outlook for our Fund, in the fourth quarter and into next year.

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