Made in Italy Fund

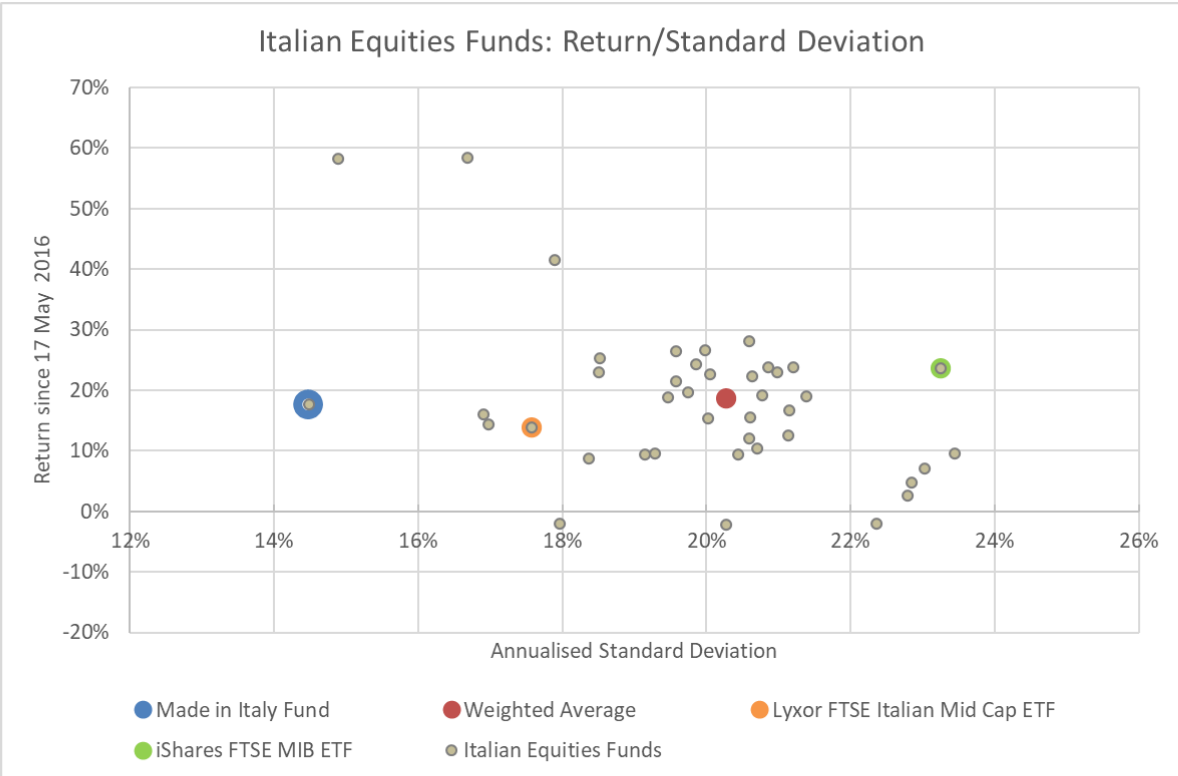
Bayes Investments

Investor letter – Third Quarter 2020

Dear Fellow Investors,

The Made in Italy Fund (MIF) had a return of -5.9% in the third quarter of 2020. The return since inception (17 May 2016) is 17.6%. Returns are net of fees and all administrative costs.

During the quarter, the MIF lost its advantage over the Italian Equities fund universe, whose weighted average return since MIF's inception is 18.8%:



Source: Factset

The MIF return remains above the 13.8% return of the most comparable ETF – the Lyxor Mid Cap Fund – but is below the 23.6% 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 20.3% for the weighted average fund, 17.6% for the Lyxor ETF and 23.2% for the iShares ETF.

Third Quarter 2020

Our -5.9% return for the quarter compares with a weighted average return of 1.1% for the Italian Equities universe, 3.8% for the Lyxor ETF and -1.5% for the iShares ETF.

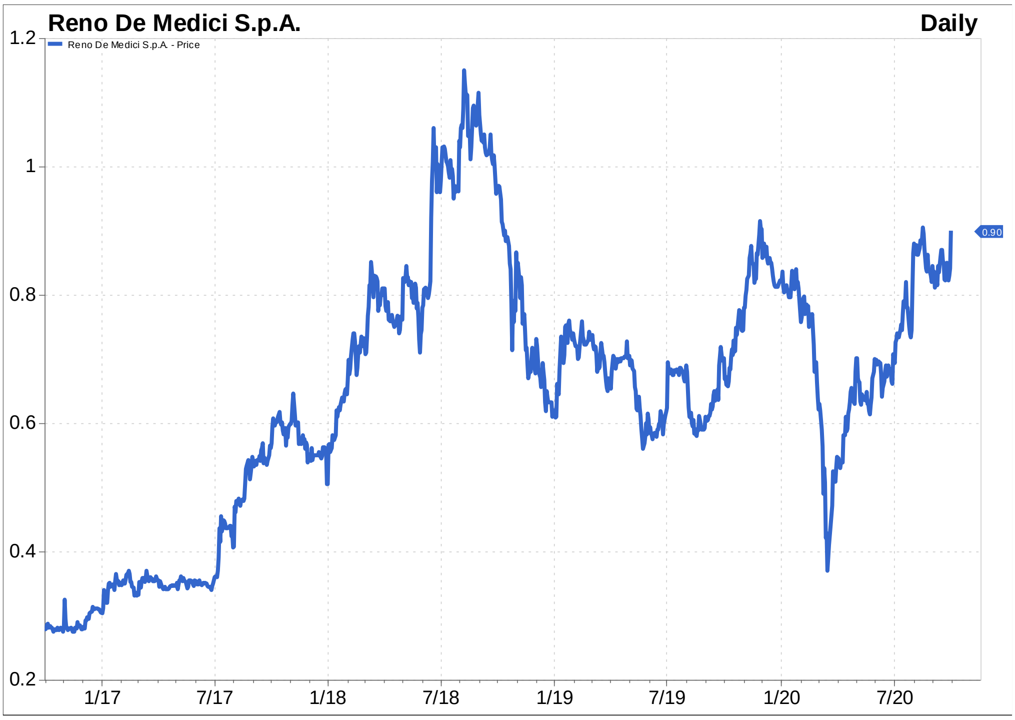
It has been a poor quarter for the MIF. After small declines in July and August, the Fund was down more than 4% in September, ending an eminently forgettable quarter behind all main indices.

A number of our stocks did well. Above all **SeSa**, a company we highlighted in our Q3 2019 letter. There we mentioned that the stock had ended the quarter at 40.1 euro, almost double our average purchase price. A year later, the price more than doubled again, ending the third quarter at 85.7 euro – an increase of 60% in the quarter and 80% year-to-date, and more than four times the average price at which we accumulated the stock since our first purchase in October 2016.

Source: Factset

Two other stocks that did well in the quarter were Reno de Medici and Piteco, both up 27%. Both companies are in the portfolio since inception.

Reno de Medici, first mentioned in our Q1 2018 letter, is the second largest European producer of coated recycled carton board, mainly White Lined Chipboard and Folding Boxboard paper. The stock ended the quarter at 0.9 euro, 2.6 times our average purchase price of 0.34 (to which it had briefly returned at the March bottom), after reporting a 50% increase in net profit for the first half of the year compared to a year earlier. The company has a market capitalization of about 400 million euro and has delivered 49 million operating income in the last twelve months. Here is a link to their latest presentation.



Source: Factset

Piteco is the leading Italian provider of financial software for corporate treasury management and financial planning, used by more than 650 national and international companies across all economic sectors. It recently launched into the US market by acquiring Juniper Payments, a software house offering solutions in digital payments and accounting clearance of interbank financial flows for about 3,000 US banks. It also owns Myrios, an Italian software house offering financial modelling solutions. The company has a market value of 150 million and has produced a 7.5 million operating income in the last twelve months. Here is a link the company's [latest presentation].

Source: Factset

illimity Bank, which we introduced in our Q2 2019 letter, also did well, up 23% in the quarter. After falling rapidly in February-March from a high of 11.2 euro to a low of 5.4, the stock ended the quarter at 9. **Intred**, a top holding our readers are familiar with, had yet another positive quarter, up 13%, and 59% year-to-date. **CY4Gate**, our second quarter IPO investment, was also up 13% in the third quarter, and 40% above its IPO price.

In contrast with such healthy advances, however, the Fund was negatively impacted by quite a few significant declines. Among them, **Askoll EVA** lost all its 36% rebound in Q2 and fell -32% in the quarter. **Longino & Cardenal** was down -29%. **Expert System** fell -24%, **Landi Renzo** -17%, **B&C Speakers** -15%, and our top holding **Finlogic** -10%.

Despite our best efforts, we are unable to find a valid reason for any of these drops, other than relating them to short term concerns about the adverse effect of the pandemic – obvious for a caterer such as Longino, or entirely imagined for a manufacturer such as Finlogic, which never closed its plants during the pandemic and produced almost as much operating cash flow in the first half of this year as it did in the same period last year.

Since the start of the virus mayhem, our primary engagement has been to make sure that our companies were able to withstand a possibly prolonged period of financial stress. We have had no major concerns so far, with the possible exception of Askoll EVA, which at the beginning of the year was counting on cash flow generation to finance its ambitious investment program and is now being forced to scale it back until revenue growth recovers to pre-pandemic levels. We are in regular contact with the management to monitor the situation and are offering our advice in the spirit of friendly activism.

During the quarter we sold out of four positions and entered three new ones. Two of the new positions are IPOs:

Reti is a provider of System Integration Services along three business lines: IT solutions, Business Consulting and Managed Service Provider. The company has a current market capitalisation of 10 million euro, 2019 revenues of 21 million and 2.3 million EBITDA. It is a much smaller version of Reply, with higher profit margins and faster expected growth. The September IPO was priced at 1 euro per share but, adding to the month's doldrums, it ended the quarter at a price of 0.8, around which we increased our position, as we think the stock is worth at least twice as much.

Labomar is a Contract Development Manufacturer providing R&D and production of food supplements, medical equipment, and cosmetics for third parties. The company has a market value of 130 million euro, 2019 revenues of 57 million and 12.2 million EBITDA. It is a very profitable firm in a high growth sector. The IPO, which took place right at the end of the quarter, was priced at 6 euro, with the price jumping to 7.15 on the first day of trading.

The third company is the smallest in our portfolio – a 4 million market cap – but we think is on the way to a great future:

Portale Sardegna is a traditional and online travel agent offering highly customised tourist packages through an innovative and proprietary software. The company is based in Sardinia and has so far been focused on local tourism, which has obviously been heavily impacted in the first half of the year. However, it has recently created a new business unit, called Welcome to Italy, with which it entered a partnership with Welcome Travel Group – a travel operator with more than 1300 agencies throughout Italy, jointly owned by Alpitour and Costa Crociere – with the aim of extending its unique business model to the whole country. Thanks to this partnership, the company expects to at least double its 2 million 2019 revenues by 2021.

With the latest insertions, about two thirds of the Fund is now invested in companies quoted on AIM Italia, up from about 60% at the end of last year.

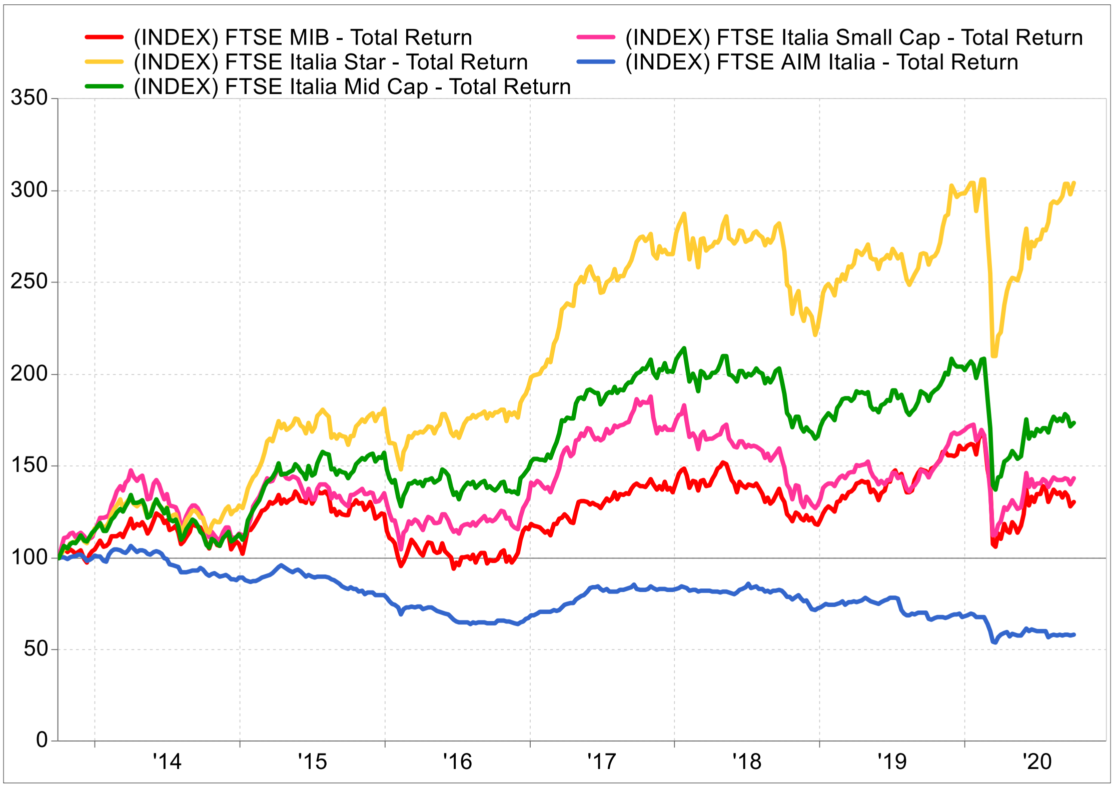
The current sector composition of the Fund is the following:

	Number of companies	% Weight
Producer Manufacturing	5	11.3%
Electronic Technology	1	1.8%
Process Industries	3	13.7%
Consumer Non-Durables	1	2.4%
Consumer Durables	2	4.9%
Industrial Services	1	5.3%
Commercial Services	5	16.9%
Consumer Services	2	5.0%
Technology Services	7	19.6%
Finance	1	3.2%
Health Technology	1	0.6%
Communications	1	5.0%
Utilities	2	8.2%
Total	32	97.9%
Cash		2.1%

AIM high

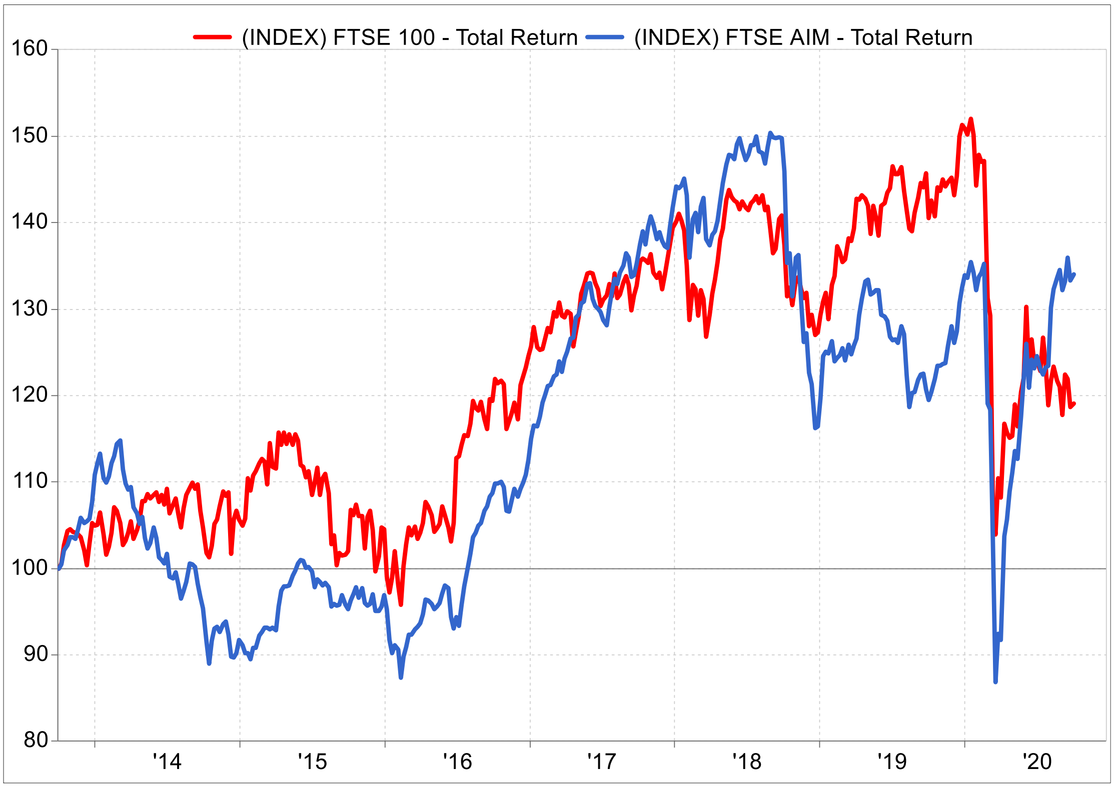
Our move towards smaller capitalisation stocks has been motivated by the underperformance of small caps versus large caps since 2018, as documented in our Q3 2019 letter, where we made the case that such headwind was likely to turn into a tailwind. So it did: in the following quarter, small caps proceeded to close much of the accumulated gap. As we wrote in the subsequent Q4 2019 letter, however, the move did not follow through to AIM stocks, where many of our new investments had been concentrated, mainly through participations in IPOs. We interpreted this as the adverse fallout of the Bio-On debacle, which had played out in the second half of the year, and thus grew more confident in AIM performance for 2020. In fact, the gap between small caps and smaller AIM caps did close considerably in Q1 2020, albeit – in the midst of the pandemic – only in relative terms, with the AIM index falling ‘only’ -15.5%, versus a -29% fall in the Small Cap index. Disappointingly, however, the move did not persist in the second quarter, with the AIM index rebounding only 5.4% versus 16.6% for the Small Cap index. Nor did it resume in the third quarter, where the AIM index actually fell -4%, versus a 2.4% gain in the Small Cap index.

In fact – as the following graph, starting in October 2013, makes clear – the sluggish performance of AIM Italia versus the rest of the market is not a recent phenomenon, but goes a long way back beyond the 2019 Bio-On fiasco:



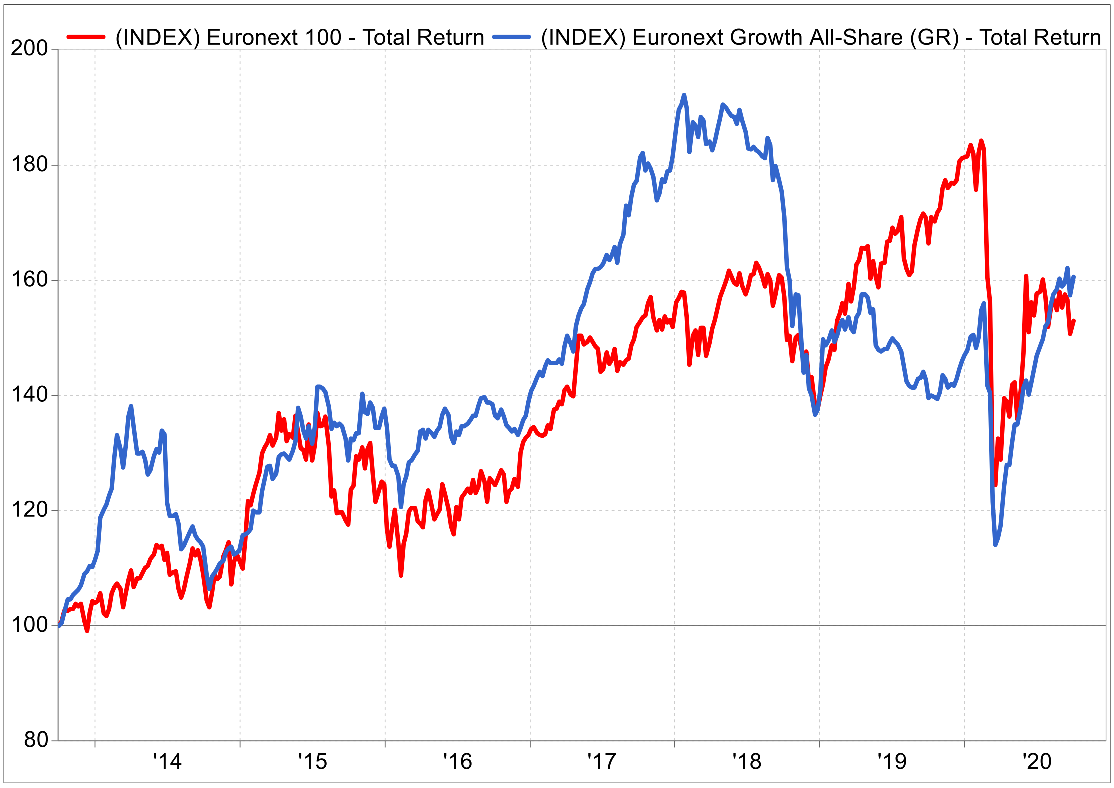
Source: Factset

This is in sharp contrast with the AIM UK experience, which Borsa Italiana – part of the London Stock Exchange since 2007 – intended to mirror. Unlike AIM Italia, AIM UK has kept pace with the main market over the same period:



Source: Factset

So did the AIM equivalent Euronext Growth market relative to the main Euronext market, which Borsa Italiana will join in 2021:



Source: Factset

As we have seen in our previous Q2 letter, exposure to STAR, mid and small cap stocks, as well as to many of the best companies on the AIM parterre, allowed the MIF to vastly outperform the AIM index: in our first four years, the Fund had a positive return of 19.2% over the period, versus a negative return of -18.7% for the AIM index. Confining our selection to AIM stocks would have certainly damaged our performance. And, indeed, increasing AIM exposure over the last few quarters has so far harmed our relative return versus the other indices – not a great occurrence in the middle of an ongoing public relation initiative.

Nevertheless, it is in smaller AIM stocks that we continue to see the best value opportunities and will continue to position the portfolio accordingly. As mentioned in our recent letters, we expect the reabsorption of this substantial value gap to be greatly facilitated by the long-awaited resumption of PIR-related investments following the revamping of PIR legislation at the end of last year. Among its assorted devastations, the pandemic has caused a deferral of the expected inflows. But it is only a matter of time. PIR inflow estimates from 2021 onwards run into several billions, with a large portion going into so-called Alternative PIR accounts, where allowed contributions are ten times larger than for traditional PIRs (300k euro per person per year for five years, versus 30k) and where at least 70% of assets need to be invested in companies which are not only outside the MIB index – the largest 40 stocks by capitalisation – but also outside the Mid Cap index – the next largest 60 stocks. This is a much greater portion than in traditional PIRs, where the minimum requirements are 17.5% for non-MIB stocks and 3.5% for non-MIB and non-mid cap stocks.

It is a material change compared to the first wave of PIR-related investments in 2017, where – as we first pointed out in our Q2 2018 letter – the main beneficiaries of PIR inflows ended up being MIB and mid cap stocks more than the small cap and AIM stocks that were intended as the primary targets of the PIR law. New PIR investments will surely increase demand for small cap and AIM stocks in the next few quarters and will help bring out the appreciation potential built into their attractive valuations. This is precisely the universe of choice from which we select most of our investments in the Made in Italy Fund. We shall see in the next few quarters whether our contrarian investment stance will bear its fruits.

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