Made in Italy Fund

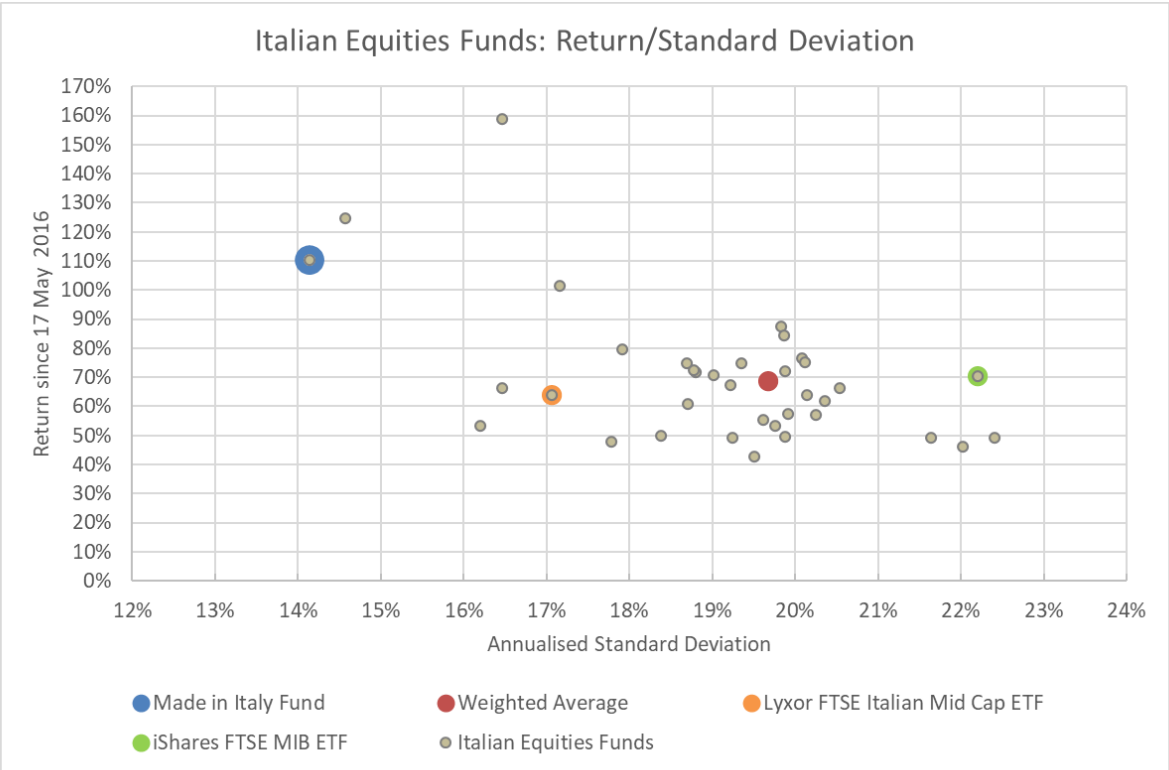
Bayes Investments

# Investor letter – Third Quarter 2021

Dear Fellow Investors,

The Made in Italy Fund (MIF) had a return of 19.4% in the third quarter of 2021. The return since inception (17 May 2016) is 110.4%. Returns are net of fees and all administration costs.

In the quarter the MIF was again ahead of the Italian Equities fund universe, whose weighted average return since MIF's inception is 68.8%:




Source: Factset

The MIF return is significantly higher than the 64.0% return of the most comparable ETF – the Lyxor Mid Cap Fund – as well as the 70.4% 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 14.1%, compared to 19.7% for the weighted average fund, 17.1% for the Lyxor ETF and 22.2% for the iShares ETF.

**Third Quarter 2021**

Our 19.4% return for the quarter compares with a weighted average return of 3.7% for the Italian Equities universe, 2.3% for the Lyxor ETF and 2.9% for the iShares ETF.

Since the beginning of the year, the MIF has returned 62.6%, versus 23.0% for the Italian Equities universe, 28.9% for the Lyxor ETF and 17.9% for the iShares ETF.

After a strong first half, our upward move accelerated in the third quarter, ending markedly ahead of the Italian Funds average and all market indices. Our NAV is now above the 200 mark in all three original Fund classes – we have doubled the initial 100 euro NAV – and close to 150 in the new IX class.

Again, most of our stocks had strong advances in the quarter. As we did in the last two quarterly letters, we highlight the top three.

The top performer was **Websolute**, up 131% in the quarter, on top of a 21% return in the first half, for a year-to-date performance of 180%:


We bought the stock at its IPO in Q4 2019, paying 1.5 euro per share, which became 1.36 euro after the distribution of 1 bonus share every 10 owned in October 2020. We subsequently increased our position at various points, lately in August and September. At the time of the IPO, the company – a digital communication and marketing service provider – had a market cap of 19 million, 12 million in revenues and 1.7 million EBITDA. Revenues this year will be around 19 million – the company reported 9.3 million in the first half, 56% ahead of H1 2020 – with EBITDA almost doubled at 3.2 million. The current market cap is 33 million and the stock price is 4 euro.

The second top performer was **Reti**, up 64% in the quarter, on top of an 83% return in the first half – a year-to-date return of 201%:


We bought the stock at its IPO price of 1 euro per share in Q3 2020 and increased our position through time – most recently in August. At the time of the IPO, the company – a provider of System Integration Services – had a market cap of 10 million, 21 million revenues in 2019 and 2.3 million EBITDA. This year's revenues will be around 25 million, with a 2.9 million EBITDA. The current market cap is 33 million and the stock price is 2.5 euro.

The third top performer was our top holding **EdiliziAcrobatica**, which was up again 48% in the quarter to 19.1 euro, on top of a 145% return in the first half – a year-to-date performance of 262%. We commented on our position in last quarter's letter. This quarter we exercised the warrants we received for free at the IPO, giving us the right to buy shares at 4.43 euro. The warrants were priced at 0.28 euro on the IPO date in November 2018. They expired at 15 euro at the end of the quarter – a 54-fold increase.


**Matica Fintec** was also strong, up 40% in the quarter to 1.9 euro, above its 1.71 euro IPO price in Q4 2019. **Vantea Smart** continued its progress, up a further 37% in the quarter and 275% above its 2.2 euro IPO price in January this year. So did **Doxee**, up a further 34% in the quarter and 254% since the beginning of the year. Last quarter's top performer **Portale Sardegna** had a pause, up just 1% this quarter, while the third top performer **Labomar** gave up some of its gains and ended the quarter down -22% – a move that does not concern us. **Sebino** – the second top performer in Q1 behind Doxee – also made further progress, up 22% this quarter and 164% year-to-date, and so did the third top performer **Intred**, up again 23% this quarter and 98% year-to-date.

During the quarter we exited one position and entered five new ones, four of which via IPOs.

The company we sold is **Reno de Medici**, after controlling shareholder Cascades announced the sale of its shares to Apollo Global Management, which will finalise the purchase of the whole company in the fourth quarter. We had been holding the stock since inception, when we first bought it at 0.34 euro per share (we first commented on it in our Q1 2018 letter). It then had a positive return in each of the following five years, until our final sale at 1.44 euro.

The new IPOs are:

**ID-Entity**. The company is a Marketing Technology Content Factory. It provides data-driven, omnichannel and multimedia content solutions for companies and public entities that enhance their communication strategies and optimize their brand management and advertising. Its tools generate online traffic and interactions to social media, e-commerce and online shops, thus increasing brand awareness and sales. The company has a market cap of 26 million euro, with 2021 revenues expected to be around 9 million with a 2.5 million EBITDA, which we expect to grow rapidly in the coming years. We paid 1.7 euro per share at the IPO in early July. The stock closed the quarter at 3.43 euro, up 102%.

**Giglio.com**. The company is a digital marketplace for the luxury fashion industry. It sells luxury products in the inventory of multi-brand boutiques, mostly but not exclusively Italian, and luxury brands to consumers around the world in exchange for a commission. It does so through an internally developed technological platform that enables the company to manage the complex logistical activities required to run the business. The company has a market cap of 51 million euro, with 2021 revenues of around 37 million. The company is currently loss-making, but we expect it to turn profitable within the next few years, as it rapidly grows alongside and above its UK-based, US-quoted, much larger competitor Farfetch. We paid 4.8 euro per share at the IPO in July and the stock ended the quarter at 4.3 euro. We have been increasing our position throughout the quarter and have recently presented our investment case at the annual MOI Global European Investing Summit.

**A.L.A.**. Advanced Logistics for Aerospace provides integrated logistics services and distribution of products and components for the civil and defence aeronautic and aerospace industries. It operates under two units: 1) The Service Provider unit supplies logistics services for Italian and foreign groups for the procurement, quality control, warehouse management, and transport of components and equipment. 2) The Stocking Distribution unit distributes components and products used to build and maintain engines, cells, equipment, systems, and interiors of commercial and military aircraft cabins, structures and other plants and machinery to operators in the aerospace and defence industry. It has a market cap of 92 million, 2021 revenues of around 140 million with an EBITDA of around 14 million and 6 million net income, expected to grow at a healthy pace in the coming years. We paid 10 euro per share at the IPO in July and the stock ended the quarter up 6% at 10.6 euro.

**Nusco**. The company manufactures and markets interior doors and window frames, shutters and gratings made out of wood, PVC, aluminium and iron. It has a market cap of 38 million, 2021 revenues of around 20 million with an EBITDA of 3.2 million and a net income of 1.2 million, expected to grow at a solid pace in the next few years. We acquired the stock at 1.2 euro per share at the IPO in early August and have been steadily increasing our position since then. The stock ended the quarter at 2.38 euro, up 98%.

Finally, in August we started building a position in Solutions Capital Management SIM, the wealth management company we have been advising since the beginning of the year on its new Alternative PIR investment line, which is in part directly invested in our Fund. The company has been quoted on the AIM Italia market since mid-2016. It has assets under control – partly direct management, partly advisory – of nearly 1 billion euro. Its current market cap is 8 million euro, which places the company at a very large discount versus its Italian and international peers, whose market value averages 2% to 3% of assets under control. While this can be explained by a history of poor growth and low profitability – which brought the stock price from 10.6 euro at IPO to the current 4 euro level – we believe that company is now at a turning point, as we have been able to witness throughout the year in direct contact with its top management and its 40-strong and growing network of financial advisors. We view SCM as striking the right balance between attentive care for clients' individual financial needs – which in other places regularly succumbs to wholesale product placement pressures – and a streamlined asset allocation approach, which preserves coherence across clients and avoids the accumulation of unmanageable idiosyncrasies. We believe this setup will help the company to resume growth in assets and increase profitability, as clients' portfolios are gradually migrated away from fixed income towards equities – a move we have been happily facilitating in our role as advisors to the SCM Alternative PIR line. Our investment – small, given the stock's current illiquidity – reflects our belief that a growing, profitable SCM should be able to bridge the current valuation gap versus its peers.

The current sector composition of the Fund is the following:

| | Number of companies | % Weight |
|---|---|---|
| Producer Manufacturing | 6 | 17.7% |
| Electronic Technology | 2 | 4.9% |
| Process Industries | 2 | 5.0% |
| Consumer Non-Durables | 1 | 2.2% |
| Consumer Durables | 1 | 1.9% |
| Industrial Services | 2 | 9.5% |
| Commercial Services | 5 | 13.5% |
| Consumer Services | 3 | 7.1% |
| Technology Services | 9 | 24.8% |
| Health Technology | 1 | 3.2% |
| Retail Trade | 1 | 2.7% |
| Communications | 1 | 3.8% |
| Finance | 1 | 1.0% |
| Utilities | 2 | 3.9% |
| | | |
| Total | 37 | |
| Warrants | | 2.8% |
| Cash + Warrants | | 1.4% |

Notice the number of stocks has gone up due to our new IPO participations. In the fourth quarter we will proceed to a gradual reduction of the number of positions in the portfolio.

**Don't say we didn't tell you**

We are clearly very pleased with our performance this year. As our regular readers know well, we have been expecting a valuation realignment of small caps versus the main market after a long period of underperformance dating back to 2018, and have been adjusting the portfolio accordingly, selling over time our mid cap holdings at a profit and buying smaller caps, often as they came to the market via IPOs.

We have been insisting on this point for the last two years, starting in our September 2019 note and the subsequent Q3 2019 investor letter. The note concluded: "We believe there is now an attractive opportunity to pick up Italian small cap pearls on the cheap." And the letter expanded on the point:

> "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."

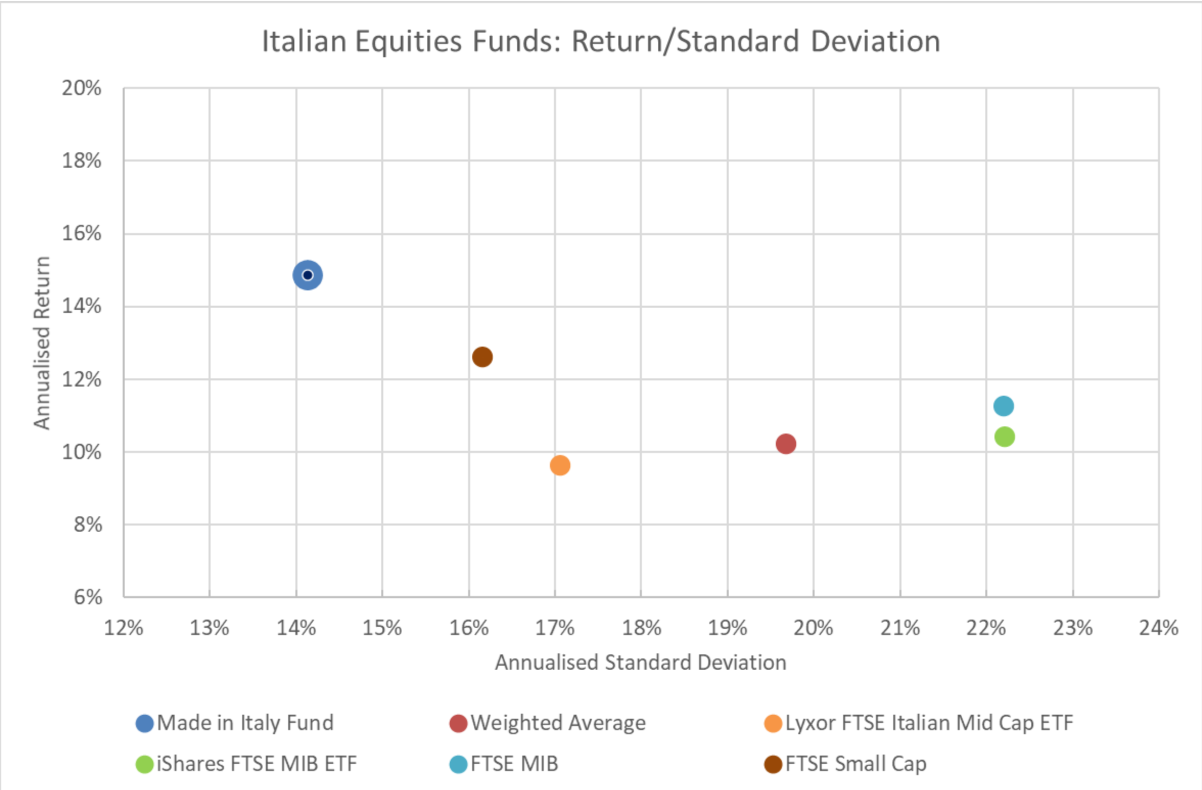
The Covid pandemic wreaked havoc on our forecast (and much else). Nevertheless, we stuck to our guns and, at the end of the *annus horribilis*, in our Q4 2020 letter renewed our call:

> "We started 2020 with the expectation that it would have been a good year for smaller capitalisation stocks, after two years of underperformance that had just started to reverse, and before the resumption of PIR investments in the wake of the new PIR law that had just been approved. The pandemic forced upon us a major reset. But at the beginning of 2021 we believe at least as strongly that conditions are again in place for a significant move. In fact, the sluggish second half performance increases our confidence for the new year and bodes well for our recent SCM alliance."

The new year proved us right, with a vengeance. The Small Cap index has so far returned 39.3% and the AIM index (renamed Italia Growth, after Borsa Italiana's merger with Euronext) is up 48.4%, well ahead of the 18.2% return of MIB index and the 28.7% return of the Mid Cap index.

On top of that, as we have just seen, our 62.6% return is substantially above all indices. As a result, our return since inception – which, while always staying above its direct competitor, the Lyxor ETF, had fallen behind the iShares ETF for most of the last two years, and in the second half of 2020 had even lagged behind the weighted average return of the Italian Equities universe – is now firmly ahead of all three.

This is as it should be. It is our stated objective: obtain a positive return above relevant market indices over the long term. Our early investors now have more than doubled their capital, earning an annual average return of 14.8% since inception, versus 11.3% for the MIB index and 12.6% for the Small Cap index:



The comparison is even more favourable when the MIF return is contrasted to the return of viable alternative investments: the annualised return of the Lyxor ETF over the period is 9.6% – significantly below the return of the Small Cap index and more in line with the 11.1% return of the Mid Cap index that it tracks – while the iShares MIB ETF has an average return of 10.4% per year, 0.75% below the return of the MIB index (amounting to more than twice its stated Total Expense Ratio). Finally, the annualised weighted average return of the Italian Equities universe is 10.2%, below the MIB index – as expected – and close to the iShares ETF.

Incidentally – and in line with our remarks in last quarter's letter about the illusion of European country diversification – Italian equities performed in line with the Euro area over the period: the Euro STOXX index had an annualised return of 9.4% and the Euro STOXX Small Cap index returned 12.1%.

Notice, as we do each quarter, that our return has been obtained with a significantly lower standard deviation relative to its comparisons. We do not regard the standard deviation of returns as a proper measure of risk: we think it is a backward-looking, time-dependent and virtually meaningless number, which, contrary to the precision it pretends to convey, has only the vaguest relation to anything resembling what it purports to measure. But since, despite its drawbacks, it is still widely used as a standard measure of investment risk, it is worth pointing out that, contrary to the tenets of the Efficient Market Theory – where its use comes from – Italian small caps have a much lower standard deviation than the large caps in the MIB index, and that the MIF standard deviation is even lower. In addition, the Beta of the MIF versus the MIB index – which, according to the EMT, should be higher than 1 – is steady at 0.4. Food for thought for those Pavlovian-conditioned investors who keep dubbing small caps as 'very risky'.

**Rear-view mirror Stars**

While we are on the subject of misleading EMT-derived numbers, right before the start of our commentary on small cap underperformance in the Q2 2019 letter we welcomed the achievement in June of a 5-Star rating from Morningstar, having just completed the required minimum 3-year track record with a performance well ahead of the average fund in the Italian Equities category.

It was a brief celebration, however, as already in July our stars had fallen down to 3. Upon investigation, we figured out that Morningstar's calculations are very sensitive to one-month variations, which can have a sizeable impact on a scarcely populated category such as Italian Equities. We didn't make much of it and advised our investors to ignore stars and focus on our great companies' portfolio.

In fact, as our relative performance deteriorated in 2019 and 2020, our stars dwindled, down to 2 and then to 1 in the second half of 2020. Where are we now? You guessed it: back to 5 Star.

So here is more food for thought. On the one hand, we have the Efficient Market Theory telling us that no 'active' fund can beat the average of its category in the long run, and that investors are therefore better off buying 'passive' and cheaper funds like ETFs. On the other hand, we have investment advisors, such as Morningstar, ranking funds based on their track records and pointing investors towards their 5-Star top performers. Then we have fund managers themselves, beating their chest if they make it to the 5-Star club, only to fall silent if they slip down the ranking.

What should an investor do with such information? Should they buy 5-Star funds, on the assumption that they will carry on delivering top performance, or should they avoid them, on the assumption that their top performance is fluky and therefore bound to sooner or later revert to the mean?

Our answer is: neither – investors should simply ignore Morningstar ratings. Let's look at our fund: we had 5 stars just before entering a period of underperformance, and 1 star at the end of last year. A perfect contrarian indicator! Does it mean that the EMT is right and we will soon start underperforming again? No. Morningstar ratings are not contrarian indicators – they are rear-view mirror indicators: they only tell us what a fund has done in the past, not what it will do in the future. And, as every fund's legal disclaimer – including our own at the end of this letter – rightly says: "Past performance is not an indicator of future performance."

Morningstar more or less agrees: "The Morningstar Rating is a purely quantitative, backward-looking measure of a fund's past performance". "The Morningstar Rating helps investors assess a fund's track record relative to its peers. It's intended for use as the first step in the fund evaluation process." In order to "form expectations of how a fund will perform over a full market cycle", Morningstar invites investors to use "the Analyst Rating, Morningstar's forward-looking analyst-driven rating system, denoting the analyst's conviction in a fund's investment merits." "Morningstar assigns the Analyst Rating to funds that analysts qualitatively assess, typically through interviews and other sources". But Morningstar analysts cannot interview all managers – in fact, in the Italian Equities category only Fidelity and AXA have had the privilege. So the company has come up with a "Quantitative Rating, created by a machine-learning statistical model". "Investors can use the Quantitative and Analyst Rating the same way. The quantitative approach provides a forward-looking assessment of a much broader group of funds than the Analyst Rating".

How does the Quantitative Rating work? It's not for us to know. All we are told is that it is based on a machine learning algorithm – the new catchphrase that has replaced 'proprietary models' in the age of Artificial Intelligence – and that 'it works': Medalist funds – Gold, Silver and Bronze – outperform and funds with a Negative underperform.

The other thing we know is that our Quantitative Rating has been for a while and is still Negative – last year when we had 1 Star as well as today with 5 Stars. Maybe Morningstar's machine knows something we don't know. Or maybe it is the other way around.

The managers at SCM SIM have been wiser when they chose us as advisors to their Alternative PIR investment line at the end of last year. Investing in funds is not that different from investing in stocks: in both cases what matters is assessing future value. A company's future value depends on its strategy, competitive advantage and the strength of its management. The same is true for a fund. With a key difference: a stock can become overvalued, but a fund can sell overvalued stocks and replace them with undervalued stocks.

Buying undervalued stocks is our sole aim. It is a job that often requires time and patience – just look at the graphs in the first part of this letter. Investing in our fund requires a similar kind of patience. We have gone and will go through periods of adverse performance – absolute and relative. But investors who stick with us for the long run eventually earn their deserved reward.

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