Made in Italy Fund

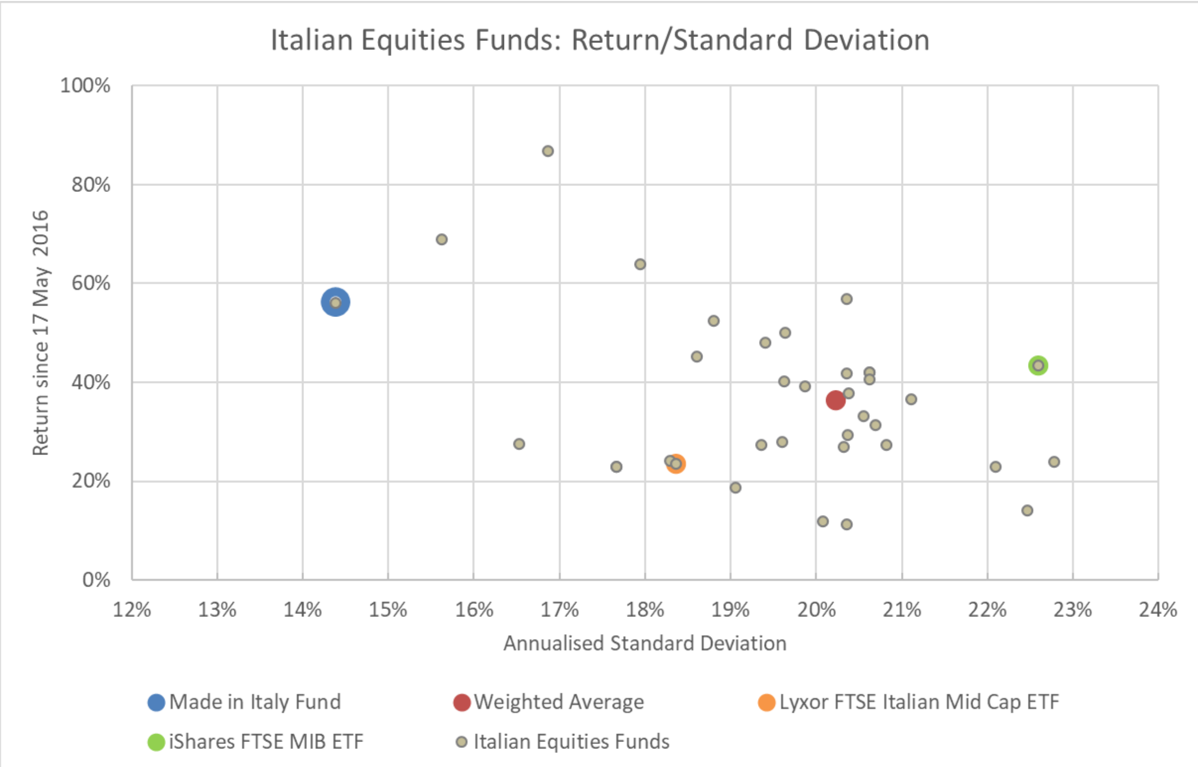
Bayes Investments

Investor letter – Third Quarter 2022

Dear Fellow Investors,

The Made in Italy Fund (MIF) had a return of -8.6% in the third quarter of 2022. The return since inception (17 May 2016) is 56.1%. 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 36.4%:



Source: Factset

The MIF return is significantly higher than the 23.6% return of the most comparable ETF – the Lyxor Mid Cap Fund – as well as the 43.5% 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 14.4%, compared to 20.2% for the weighted average fund, 18.4% for the Lyxor ETF and 22.6% for the iShares ETF.

Third Quarter 2022

Our -8.6% return for the quarter compares with a weighted average return of -4.8% for the Italian Equities universe, -8.1% for the Lyxor ETF and -2.5% for the iShares ETF.

After staging a sizeable rebound in July, world stock markets resumed their downtrend in the middle of August, which intensified in September. It was the third negative quarter in a row – a first in the history of our Fund and a rare event in the long history of equity markets. Needless to say, the drivers were the same: the trajectory of inflation and interest rates – the mid-August inversion was triggered by a higher-than-expected data point in US inflation – and the twists and turns of the Ukrainian war.

At the end of the quarter, the US S&P 500 index and the German DAX index were down -5%, the Euro STOXX -4% and the Italian MIB index -2.5%. European smaller capitalisation stocks fared worse: the German MDAX index ended the quarter down -13%, the Euro STOXX Small index -10% and the FTSE Italia Small Cap index -9%. The negative performance extended to bond markets: the US 10-year Treasury yield moved up 80 basis points to 3.8%, the German 10-year Bund yield rose 70 basis points to 2.1% and the Italian 10-year BTP went up from 3.3% at the end of June to 4.5% at the end of September, thus extending the spread over Bunds from 1.9% to 2.4%.

Italian general elections at the end of September resulted in an widely anticipated win for the 'centre-right' coalition, and in the appointment of the first female Italian Prime Minister, Giorgia Meloni. The new government vowed to continue in the wake of former PM Draghi's pro-Europe and pro-NATO agenda. Notably, the new Economics and Finance minister, Mr Giorgetti, was the Economic Development minister in the Draghi government.

Some of our stocks did well in the quarter: **Finlogic**, a company we bought at IPO in Q2 2017 at 3.6 euro per share, ended the quarter up 15% at 6.6 euro, above its year-end price. **Giglio.com**, which we bought at IPO in Q3 2021 at 4.8 euro per share, was up 13% to 3.4 euro. **Renergetica**, first mentioned in our Q4 2018 letter but in portfolio since August 2018 – when we first bought it at IPO paying 1.4 euro per share – was up 7% in the quarter to 7.4 euro, 6% above its year-end close. Also up 7% was **Racing Force**, bought at IPO in Q4 2021 at 4.5 euro per share, a level it regained at the end of the quarter.

Our largest position **EdiliziAcrobatica** (EDAC) was up 5% in the quarter. As we did for Giglio.com a year ago, we recently presented our investment case in the company at this year's annual MOI Global European Investing Summit. In it we made the point that, whereas the stock was down -13% year-to-date and -26% from its peak in August 2021, the company had just reported an 85% increase in revenues for the first half of 2022 compared to the first half of 2021, and a 6-fold increase in net profits from 1.6m to 10.7m.

Nothing like a fast-growing company epitomises the fact that, as its market price grows, thus closing the gap with the higher intrinsic value that originated the investment, so does the intrinsic value itself, thus reopening the gap at a higher level. EDAC's market capitalisation is currently around 130m. It was 25m when we first bought the stock in 2018. At 25m the company was priced at 1 time 2018 sales and 11 times earnings. At 130 million, it is now at 1.5 times 2021 sales and less than 12 times earnings and, as we have just seen, at a much lower multiple on what will certainly be much higher 2022 final numbers. In our valuation framework – which obviously goes well beyond PE ratios – EDAC is worth 2 to 3 times its current price.

To a different extent, the same is true for the other companies we mentioned. Finlogic reported a 22% increase in first-half 2022 revenues and a 23% increase in earnings. The same pair of numbers for Renergetica were 21% and 130%, and for Racing Force 35% and 93%. Giglio.com, which is at an early, loss-making development stage, reported a 47% increase in first-half revenues.

Overall, our companies reported an average increase in first-half revenues of 55% (35% median), and most of them also reported healthy increases in earnings, with exceptions explained by increases in internal and external investments for future growth.

Nevertheless, as in the past two quarters, the majority of our stocks were dragged down by the downward momentum, with the largest falls occurring in Landi Renzo (-36%), Estrima (-31%), Websolute (-26%) and Sebino (-22%) – which, as you may remember, was *up* 25% in Q2.

During the quarter we exited one position and participated in a new IPO:

Solid World Group. The company is the leading Italian operator in the space of 3D Digital Manufacturing. It offers 3D printing services and related training to the design and production departments of companies in the automotive, aerospace, mechanics, mechatronics, sport system, home design and fashion sectors, as well as in the biomedical sector for the provision of consulting services, segmentation software, printers, and visors to hospitals and clinics. It provides software for the design, simulation and analysis of 3D systems, hardware – 3D printers and scanners and related consumables – and additive manufacturing for prototyping and printing services. The company has a market capitalisation of 29 million euro and 2021 revenues of 58 million, with a 4 million EBITDA. Recently reported first-half 2022 revenues were 32 million, expected to be around 65 million at the end of the year, with an expanded EBITDA margin of 8% and a net profit of 2 million. We paid 2 euro per share at the IPO in early July and increased our position at 2.2 euro shortly thereafter. The stock closed the quarter up 22% at 2.43.

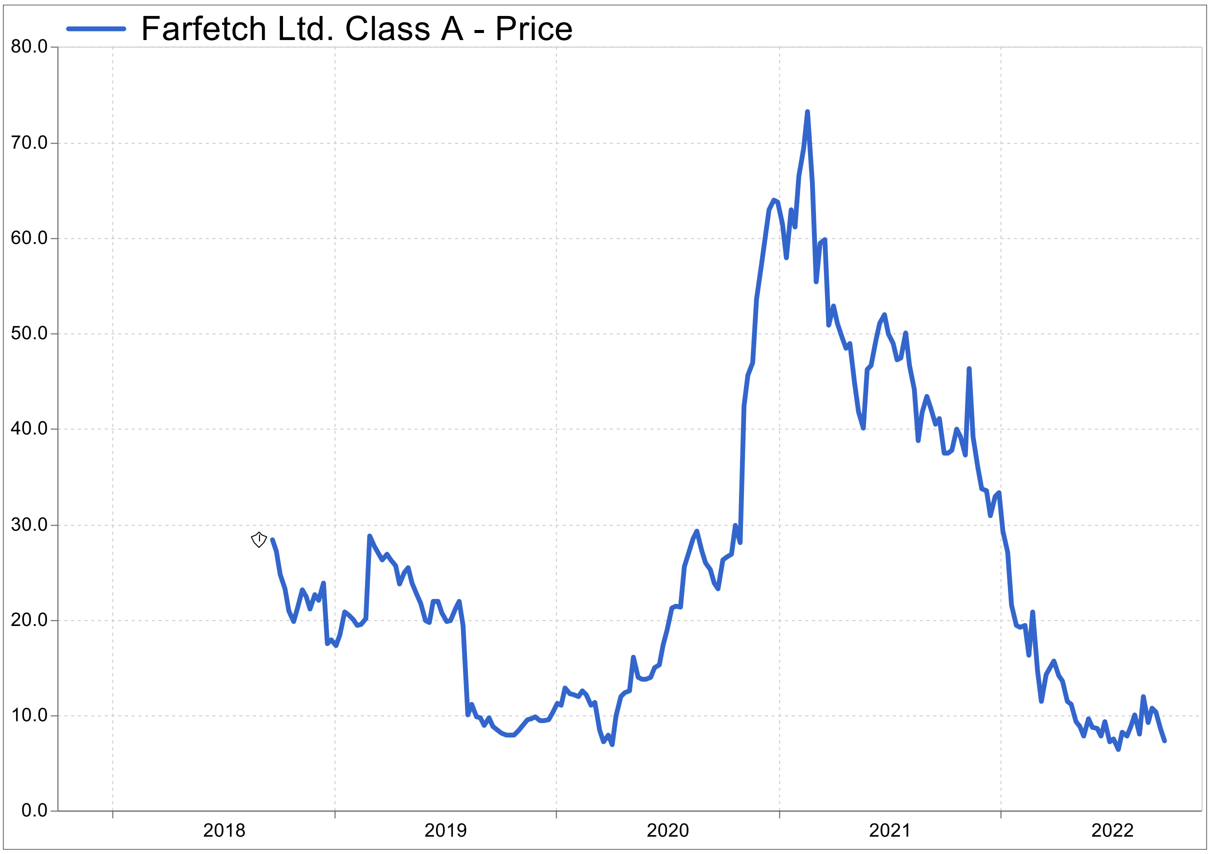
The current sector composition of the Fund is the following:

	Number of companies	% Weight
Producer Manufacturing	5	11.9%
Electronic Technology	3	5.9%
Process Industries	2	3.0%
Consumer Non-Durables	1	2.1%
Consumer Durables	3	5.9%
Industrial Services	1	7.3%
Commercial Services	6	12.7%
Consumer Services	3	6.6%
Technology Services	8	20.3%
Distribution Services	1	3.4%
Health Technology	2	5.1%
Retail Trade	1	3.1%
Communications	1	2.2%
Finance	3	4.0%
Utilities	2	4.4%
Total	42	97.8%
Warrants + cash		2.2%

Perma-bulls

We explained in last quarter's letter why we think this year's dismal equity markets performance cannot be justified by the rise in inflation and interest rates, except for some companies, especially in the US, that in the last few years had been priced at unreasonably low discount rates.

A case in point is Giglio.com's main competitor, US-quoted Farfetch:



At the end of 2020, at 64 dollars the stock was valued at 13 times sales of 4.9 dollars per share – this for a company with a perennial heavily negative EBITDA: -340m in 2020 on sales of 1.7bn. Farfetch proceeded to fall -48% last year and a further -73% this year, back to its pre-lockdown level of 9 dollars, equal to a much more sober 1.9 times last year's sales per share. Farfetch's graph is the epitome of a stock market bubble.

Now contrast that with Giglio.com. When we bought the company at IPO in July last year, we paid 1.4 times sales – a lower multiple than today's Farfetch. Still, despite this quarter's rebound, the stock is down 18% this year, and 21% from its price a year ago, on the day of our MOI Global presentation. This despite reporting, as we have seen, a massive increase in revenues and an even larger increase in gross margin, significantly ahead of the expected numbers we had showed in the presentation. As a result, the company – a smaller, better version of Farfetch, and much closer to reaching profitability – is now valued at 0.8 times sales, less than half than Farfetch.

Why? Because the equity market downturn has swept across most stocks indiscriminately, thus creating big opportunities for investors who are willing to go down to the level of individual companies rather than go along with lazy and unfocused macro considerations and the illusion of geographical diversification.

One more example: last quarter's IPO Bifire. Remember we bought the stock in May at 3.7 euro per share, paying 12 times 2022 expected earnings, and then increased our position in June. But by the end of the quarter the stock had dropped to 2.8 euro, or 9 times earnings. In the July rebound, the price had a suitable reaction, up 19%. But, as equity markets resumed their descent in mid-August, so did Bifire's price, ending the third quarter at 2.3 euro, despite the company reporting – in similar fashion to the others we mentioned – a 68% increase in revenues and a 38% increase in earnings for the first half of this year.

Value investors like us are usually portrayed, and often criticised, as being permanent bulls. This is wrong in a sense and right in another. It is wrong because we can, and at times we do have a negative market outlook over certain time periods. But it is right in the sense that the only reason why we own the stocks in our portfolio is that we think they are worth significantly more than their current prices. Therefore, as long as our value estimates hold, we expect those prices to, sooner or later, close the gap. We may be bearish about stocks, but we are always bullish about *our* stocks. As a result, we tend to see bear markets as opportunities to buy more of our favourite stocks at lower prices.

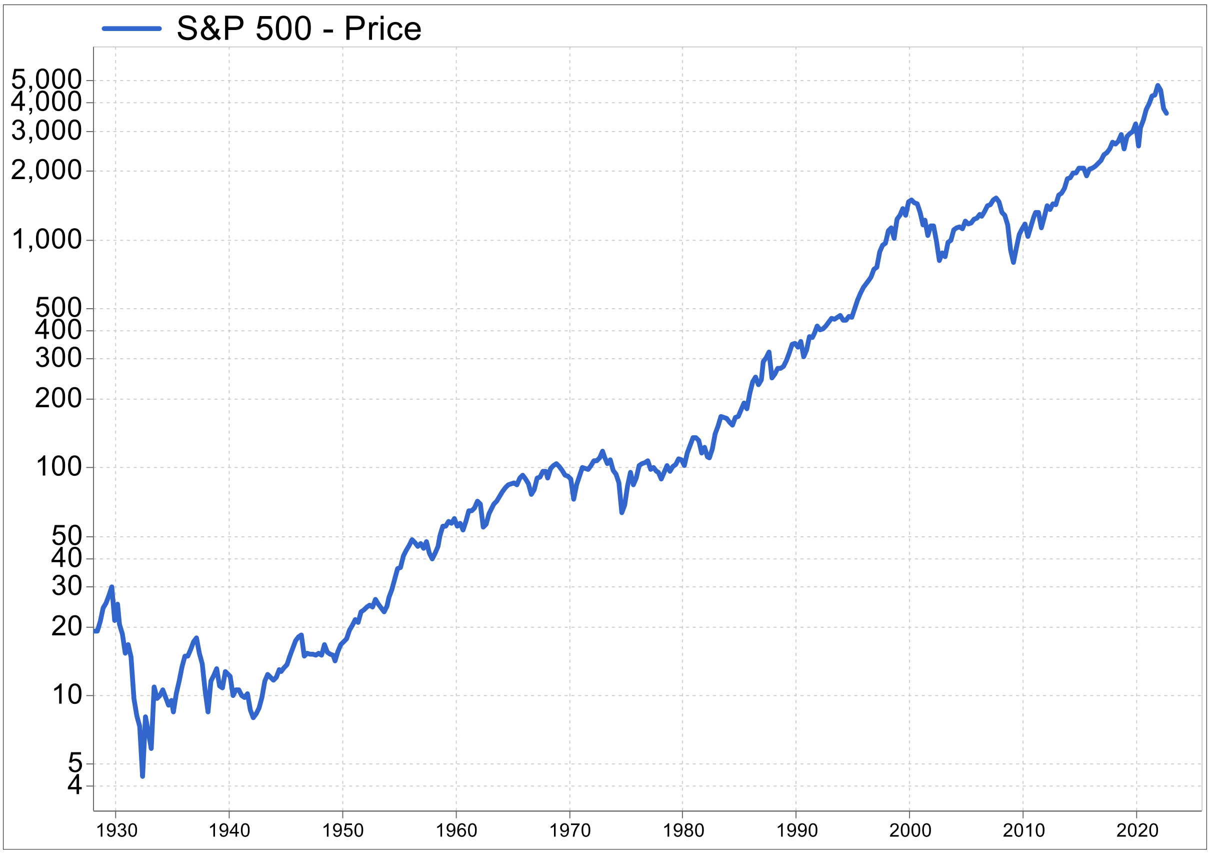
For a very good reason: valuable stocks go up over time. Take **Cembre**, a stock that has been in our portfolio since inception, and still is. The company – a producer and distributor of electrical connectors and related tools – went public almost 25 years ago, in mid-December 1997, at an IPO price of 5,800 lire, that is about 3 euro. It is now worth 24 euro. This corresponds to a compound annual price return over the whole period of about 9%, and to a total return, including reinvested dividends, of about 12% per year. It is pretty much what Cembre's controlling shareholders, the Rosani family, has been earning since the quotation:

As the graph clearly shows, however, such an attractive return did not come in a straight line. To better appreciate percentage changes, the graph is in logarithmic scale – meaning that the distance between e.g. 2 and 4 is the same as between 4 and 8, 8 and 16 etc. This makes it easier to see the wild gyrations the stock has gone through over its long life: from 4 to 2 in 1998-2002, from 2 to 9 in 2003-2007, from 9 back to 3 in 2007-March 2009, from 3 all the way up to 16 by April 2015, and so forth. We first bought the stock at less than 14 euro in May 2016. Since then, the price went up to 24 by the end of 2019, only to plunge to 15 over the Covid panic of Q1 2020 – a fall of 37% – therefrom rebounding 127% to 34 euro by the end of 2021. Unsurprisingly, this year the stock is down almost 30%, back to 24 euro, whereas the company – you guessed it – reported first-half revenues up 23% and profits up 21%.

What does this mean? First, it means that holding a valuable stock with the same long-term poise of a business owner pays a handsome return. Second, it means that such return can be further enhanced by buying more of the stock in periods of market decline. This, however, presupposes having cash available, which is not what a value investor, fully invested in his valuable stocks, usually has. Should we have sold Cembre at the beginning of the year at 34 euro to buy it back now at 24? With hindsight, yes. But hindsight – as the saying goes – is a wonderful thing. In reality, we thought Cembre was still an attractive stock at 34 – let alone at 24. Therefore, even if we had a negative market outlook at the beginning of the year – which we didn't – we would not have raised cash by selling Cembre, or indeed any other of our valuable stocks. A negative market outlook is better dealt with other means – hedging with futures and options – which is something, as we have said a few times in our letters, we are reluctant to do and have rarely done. Our job is not to time the market according to what we think about inflation, interest rates, the Ukrainian war, the Covid pandemic or any other external issue. Our job – and what our investors expect us to do – is to select valuable companies and hold on to them as long as their investment case holds. As you know, we regularly do a bit of trading at the margin, taking some money out of stocks that have done well and putting it into stocks that have lagged behind: this is a major reason why, as shown in the graph on the first page, the volatility of our returns is lower – in fact, the lowest of the group. But net cash in the Fund can only come from external sources: investors – old and new – taking the opportunity to acquire units of the Fund at a lower price.

Investors have been hesitant to do so this year – and rightly so, as the Fund, along with all equity markets around the world, has had three negative quarters in a row. And we have been flatly wrong in advocating better prospects ahead in each of the last three quarterly letters. But, at the cost of sounding like a broken record, we are going to do it again.

Three consecutive negative quarters of equity returns is a rare event. The graph on the next page – again in logarithmic scale – shows the quarterly progression of the S&P 500 index since 1928. Of 791 quarters since then, only 29 of them – or 3.7% – have been negative three times in a row, and only 13 – or 1.6% – have been negative four times in a row. The last time this happened was in 2007-2009, where – as many will painfully remember – the index had *six* consecutive negative quarters, from Q4 2007 to Q1 2009, for a cumulative fall of -47.7%. Before that, there were three consecutive negative quarters in 2002, for a cumulative fall of -29%, and four from Q2 2000 to Q1 2001, for a cumulative fall of -22.6%. There were a few other episodes in the further past, back to the mother of all bear markets in 1929-1932, but not many.



Of course, these are just statistics, which should be relied upon even less than our market outlooks. The S&P 500 was down -24.8% in the last three quarters, but nothing prevents Q4 2022 from being another negative quarter. Dangers abound: more inflation and interest rate hikes, recession, war escalation and more.

But, as Warren Buffett is fond of saying, never bet against America: after each decline, the US stock market has always come back with a vengeance. More modestly, we say: never bet against Cembre, and the other valuable companies we select for our Fund, many of which have shorter histories than Cembre, but at least as attractive futures. Of course, we can be wrong with some of them. But, in its shorter but not so short history, our well diversified portfolio has never failed to recoup its declines and proceed to reward its investors.

Now is the time to put more cash at work.

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