Made in Italy Fund

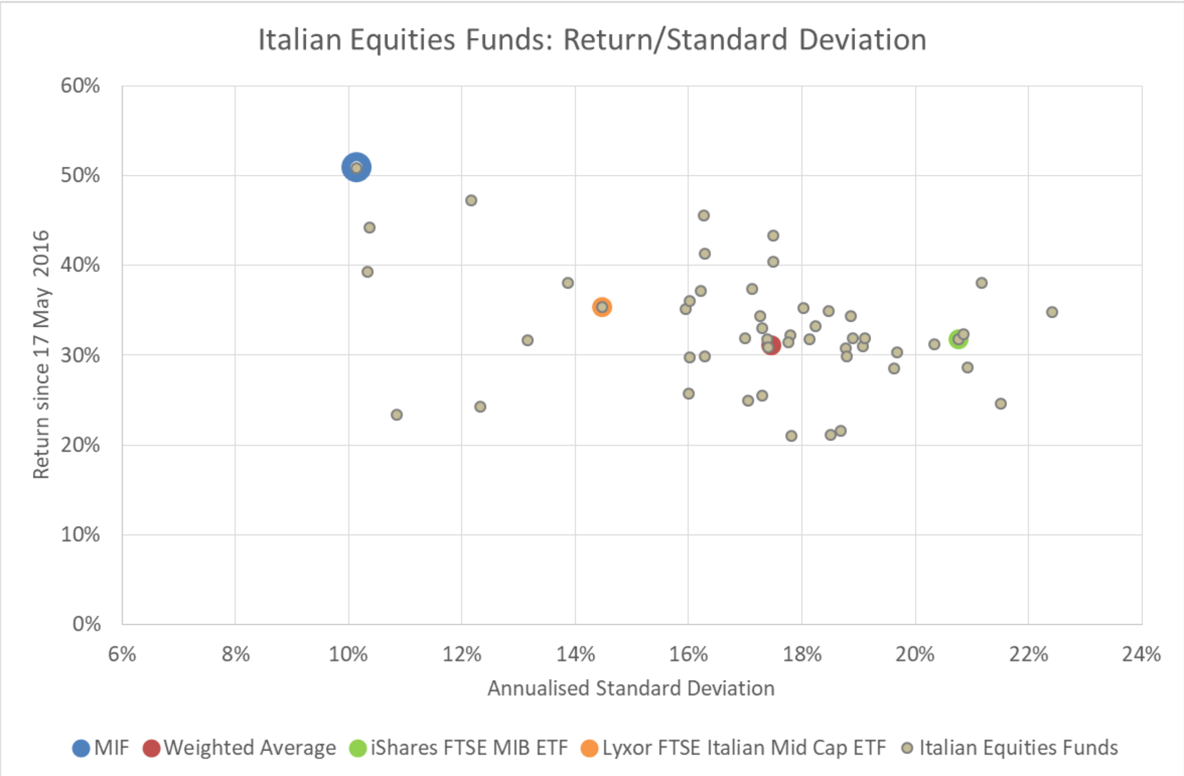
Bayes Investments

# Investor letter – Fourth Quarter 2017

Dear Fellow Investors,

The Made in Italy Fund (MIF) was down -2.5% in the fourth quarter of 2017. The return since inception (17 May 2016) is 50.9%. Returns are net of all fees and administration costs.

During the quarter, the MIF maintained its advantage over the Italian Equities fund universe, whose weighted average return since MIF's inception is 31.1%:




Source: Factset

The MIF return is also well above the 31.8% return of the main Italian Equities ETF – the iShares FTSE MIB – as well as the 35.4% return of the ETF most comparable to the MIF – the Lyxor Mid Cap Fund.

The MIF's highest return continues to be accompanied by the lowest volatility. The annualised standard deviation of its daily returns is 10.1%, compared to 17.5% for the weighted average fund, 20.8% for the iShares ETF and 14.5% for the Lyxor ETF.

**Fourth Quarter 2017**

Our -2.4% return for the quarter compares with a weighted average return of -2.2% for the Italian Equities universe, -3.5% for the iShares ETF and 0.5% for the Lyxor ETF.

For the whole year, the MIF returned 35.9%, versus 20.8% for the weighted average fund, 16.5% for iShares ETF and 33.9% for the Lyxor ETF.

The quarter got off to a good start in October, in the wake of the previous month's strong performance, with the MIF reaching its all-time high on 3rd November. During the month we exited two positions and bought a new one. This was followed, however, by a sharp market decline, which lasted until mid-November and was concentrated on small capitalization stocks, whose index – the FTSE Italia Small Caps – ended November down -8.6% (versus -1.6% for the main market FTSE MIB index). Confirming one of the MIF's guiding principles – the need for careful selectivity in the highly heterogeneous small cap universe – our Fund limited its November decline to -3.5%. In addition, price volatility offered us the chance to start a position in a new stock at a 30% discount to its third quarter-end price. The company is Emak, a producer of tools and hardware for gardening, agriculture and industrial use. Emak had been one of our 'misses' – a company we had studied, evaluated and twice visited in their headquarters in Bagnolo in Piano, near Reggio Emilia in the Emilia Romagna region – but declined to invest at what, at fund's inception, would have been a very good entry price of around 0.75 euro. Instead we saw the stock climb all the way to 2 euro, until the November downturn gave us the opportunity to buy it at around 1.4 – almost twice as much as what we would have paid at inception, but still an attractive price for a company with a market value of 250 million, sales of 390 million, a net profit of 18 million and a book value of 180 million. The company has a conservative balance sheet, strong free cash flow generation, a capable and motivated management team and has been growing steadily, organically as well as through acquisitions – the last one completed in mid-2017.

After a flat December, over which we mainly raised some cash at the margin, the MIF ended the quarter with a negative return, but well ahead of the Small Cap index (-8.9%) and ahead of the main MIB index (-3.5%, in line with the iShares ETF).

The sector composition of the fund at year-end is the following:

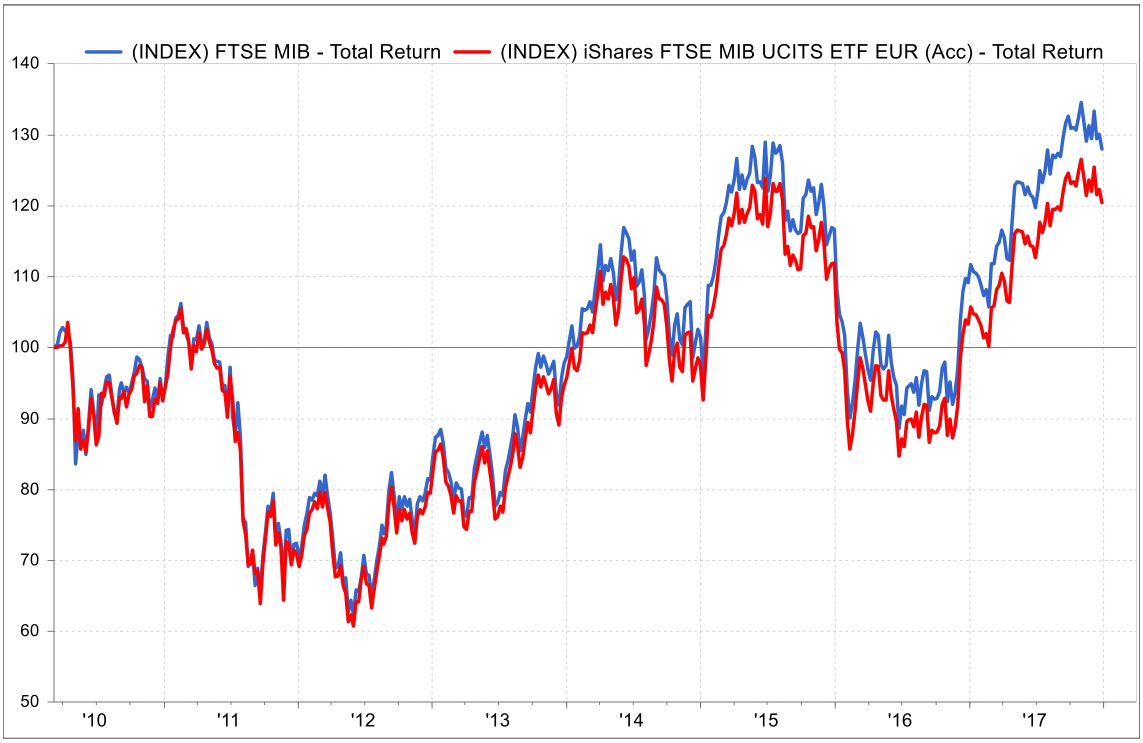
| | Number of companies | % Weight |
|---|---|---|
| Producer Manufacturing | 7 | 23.2% |
| Electronic Technology | 4 | 13.3% |
| Process Industries | 4 | 10.6% |
| Consumer Non-Durables | 1 | 3.6% |
| Commercial Services | 4 | 11.9% |
| Distribution Services | 1 | 2.9% |
| Technology Services | 4 | 9.6% |
| Consumer Durables | 3 | 8.7% |
| Finance | 3 | 10.3% |
| Retail Trade | 1 | 2.0% |
| Total | 32 | 96.0% |
| Cash | | 4.0% |

Our market outlook remains unchanged, for the reasons presented in our third quarter letter. The only development of note since then has been the calling of the Italian general elections, which will take place on 4th March. With no intention of getting lost in the perpetual convolutions of Italian politics, we observe that the central and most probable outcome appears to imply some form of continuity with the current government, possibly enlarged to a wider party coalition. This would be a positive event. A negative event would be a larger than expected electoral success for the Five Star Movement and the formation of a new government led by them, possibly in coalition with a newly formed leftist party. While at the moment this seems to be an unlikely scenario, it represents the main risk to watch over in the next couple of months.

**ETFs versus indices**

The MIF's objective is to obtain over time a positive return in excess of the main Italian equity market index. At the same time, however, we emphasise that the fund is not managed against any index and that index weights play no part in our investment decisions. This is because we believe that, by selecting good companies and buying their shares at attractive prices, the MIF should do better than indices which, by construction, include a disparate variety of stocks, weighted by market capitalisation.

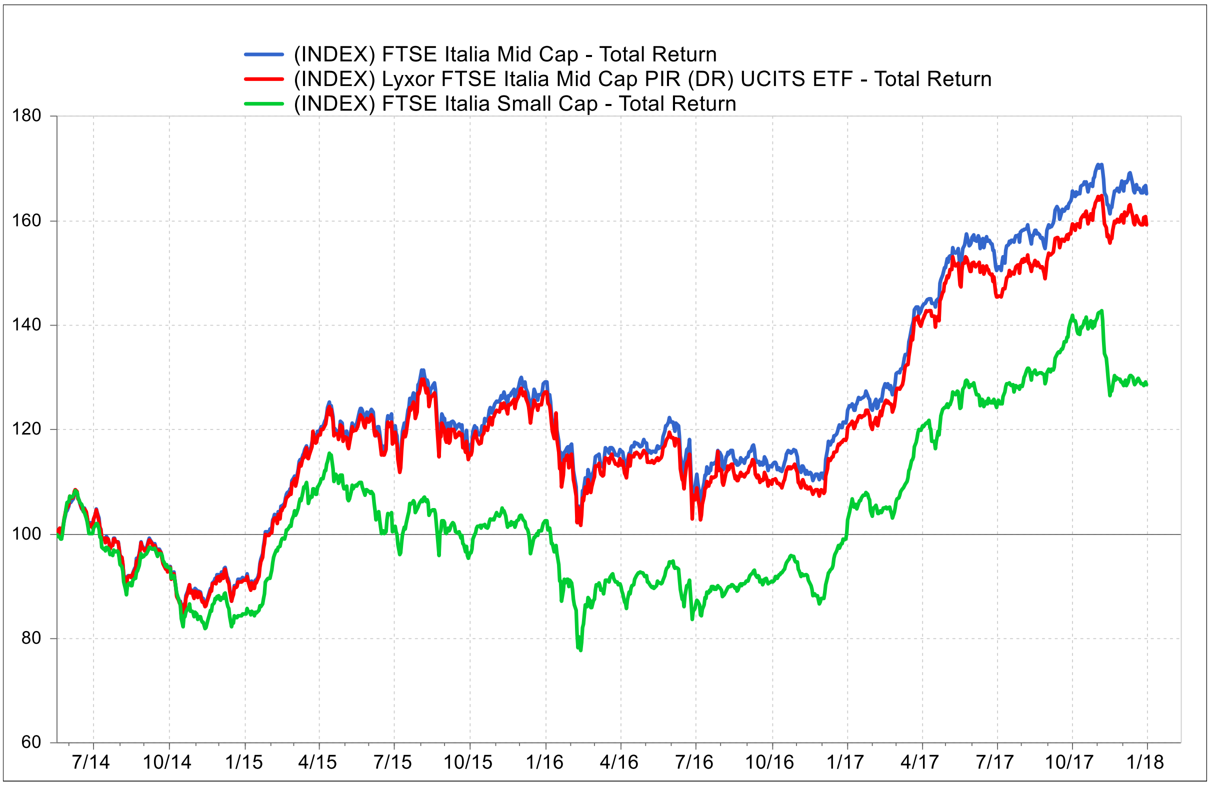
It is important to notice that indices as such are not viable investments. Although there is a futures contract on the FTSE MIB index and, since last December, a FTSE Italia PIR Mid Cap Futures contract, the practical choice for an investor who wants to buy Italian equities is to select one of the funds in the Italian Equities universe, which are typically managed around the FTSE MIB index, or to buy an explicitly indexed ETF. This is the rationale for comparing our performance to the weighted average Italian Equities fund and to the iShares ETF. The latter (available since March 2010) does a good job tracking the MIB index, although management fees, while much smaller than typical fund fees, create a cumulative performance gap over time:




Source: Factset

Comparing the MIF to the weighted average fund and the iShares ETF answers the question: how did a MIF investor fare relative to other investors who chose other funds, or declined the choice and went straight for the passive route? The answer so far is: much better. The MIF is the only Italian Equities fund which, since our inception, has had a net performance above 50%. In particular, in 2017 the MIF return was 15 percentage point above the return of the weighted average fund and almost double the return of the iShares ETF. As a reference, the 2017 total return (dividends included) of the FTSE MIB index was 17.3% and the total return (net dividends included) of the MSCI Italy index – most commonly used for international comparisons – was 12.8%.

A different question is: how did our fund, which invests exclusively in small capitalisation stocks and therefore in none of the companies contained in the MIB index, fare compared to a similarly focused ETF? This is the rationale for comparing the MIF to the Lyxor Mid Cap ETF, which is the only non-MIB ETF with some history (it started in May 2014. A couple of other PIR-based ETFs were launched in 2017). The Lyxor ETF does a good job tracking the FTSE Italia Mid Cap index:




Source: Factset

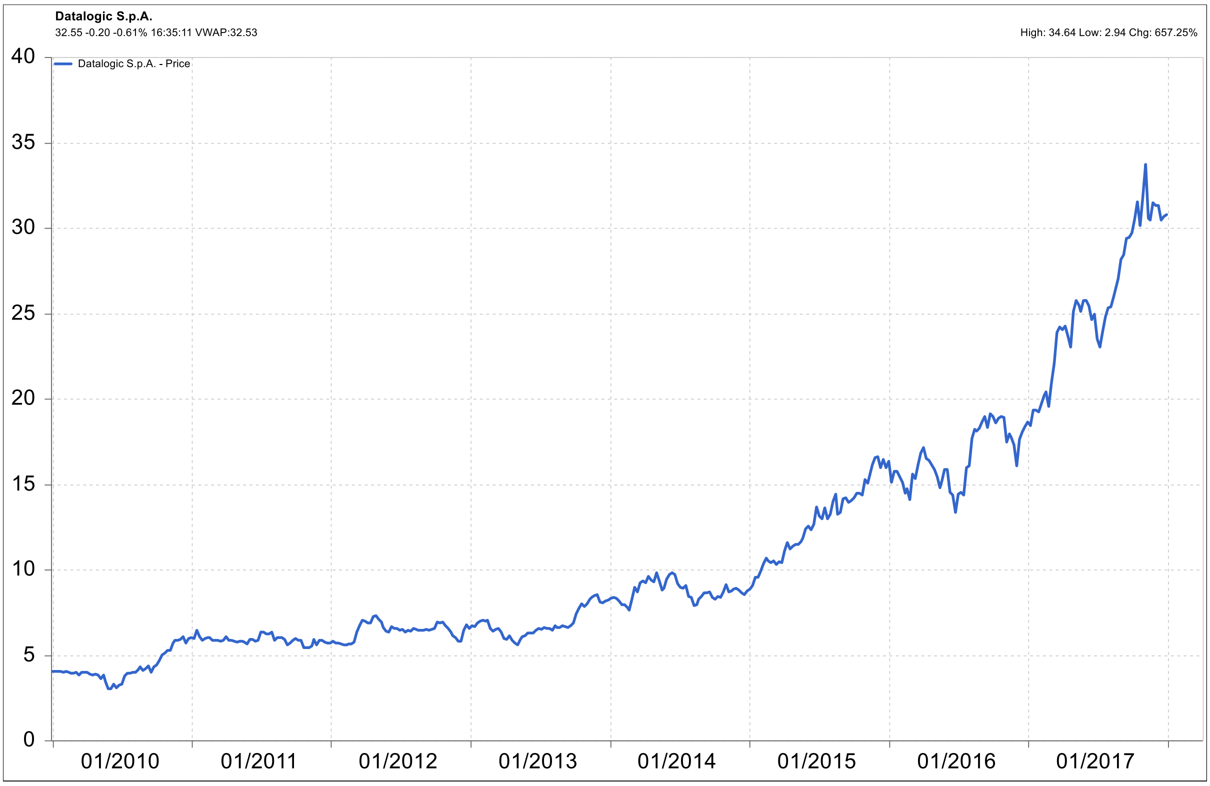
But the Mid Cap index – which contains the next largest 60 stocks after the 40 contained in the MIB index – includes many stocks whose market capitalisation is way above the MIF's one billion top range. A more comparable index to our range is the FTSE Italia Small Cap index, but there is no ETF tracking it at the moment. Notice however that the Mid Cap index and the Lyxor ETF have done much better than the Small Cap index, especially in 2017. Consequently, by outperforming the Lyxor ETF our fund is also comfortably ahead of the Small Cap index.

An analogous issue holds for the FTSE Italia STAR index, discussed in our previous letters. Also the STAR index has no ETF tracking it – a missed opportunity for ETF providers. But there are a few funds – those trailing the MIF in the graph on page 1 – that are closely managed around it and are therefore highly concentrated in the largest components of the index, whose first ten stocks represent more than 50% of total value. In fact, after Brembo exited the index last May, its largest component has become BB Biotech, a Swiss closed-end fund invested in global biotech companies, which has nothing to do with Italy. Nonetheless, with a market cap close to 4 billion euro, the fund has an 8% weight in the STAR index, and therefore a similar weight in the STAR-tracking funds – an awkward idiosyncrasy that Borsa Italiana should find a way to remedy.

The MIF is invested since inception in three of the current top ten stocks of the STAR index: Banca Ifis, Datalogic and Reply. At the time, all three had a capitalisation of less than a billion, but through powerful appreciation their market value has now reached around two billion. Along with Biesse and Technogym – also bought below a one billion valuation and now worth 1.3 and 1.8 billion respectively (though the latter is not part of the STAR index) – they represent the exceptions to our one billion threshold. Other companies are approaching it, but we have no automatic rule to cut their weight. The urge to sell a stock prematurely to 'cash in' a large gain is a common temptation, and often a mistake. Past performance – positive or negative – is never a good indicator of value. What matters is the valuation gap.

**Dynamic perspective**

Our investment decisions are based on the existence of a large gap between the fundamental value of a company and its market price. As the latter grows, the gap is reduced. But fundamental values have their own dynamics. As the company evolves, generates cash flow and reinvests it in the business, its book value grows with it and sets a higher valuation base. At the same time, a growing and successful company may deserve higher valuation parameters, and therefore a reopening of the valuation gap. Only by maintaining such a dynamic perspective it is possible to understand and rationalise, for example, the progression of Datalogic's share price:




Source: Factset

Datalogic entered the paper portfolio of what was then the MIF project in late 2014 at 9 euro. It then entered the actual MIF portfolio at inception in May 2016 at 15 euro. The position was subsequently incremented several times, often taking advantage of temporary price declines, which helped keeping the average acquisition price below 16 euro. The stock ended 2017 at 31 euro, up 67% in the year, including a 0.3 euro dividend per share distributed in May. It is still in the MIF portfolio and we have no plans to sell it, as we think the company and its stock price will continue to do well (here is a recent FT article on Datalogic).

At the same time, we will continue in the new year to do what we did in 2017: looking for new, smaller stocks that we think have the potential to grow into the success stories of tomorrow.

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