Made in Italy Fund

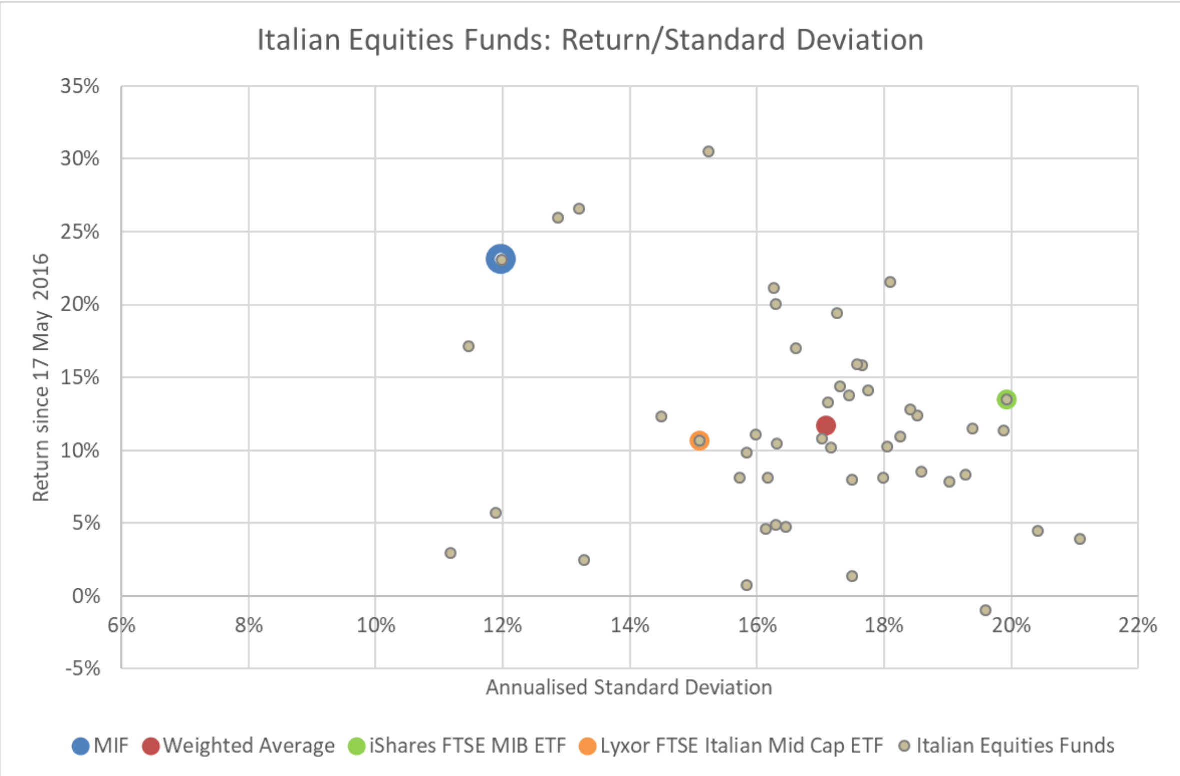
Bayes Investments

# Investor letter – Fourth Quarter 2018

Dear Fellow Investors,

The Made in Italy Fund (MIF) was down -13.6% in the fourth quarter of 2018. The return since inception (17 May 2016) is 23.1%. 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 11.7%:




Source: Factset

The MIF return is well above the 10.6% return of the most comparable ETF – the Lyxor Mid Cap Fund – as well as the 13.5% 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 12.0%, compared to 17.1% for the weighted average fund, 15.1% for the Lyxor ETF and 19.9% for the iShares ETF.

**Fourth Quarter 2018**

Our -13.6% return for the quarter compares with a weighted average return of -13.0% for the Italian Equities universe, -15.5% for the Lyxor ETF and -11.4% for the iShares ETF.

For the whole year, the MIF was down -18.4%, versus -15.3% for the weighted average fund, -18.3% for the Lyxor ETF and -13.9% for iShares ETF.

Q4 has been a ghastly quarter for world stock markets: S&P 500 down -14% and Nasdaq -18% in the US, Nikkei -17% in Japan, Euro Stoxx -13%, China Shenzhen -12%. The Italian MIB index fared marginally better, down -11%, but the FTSE Italia Small Cap index took a harder hit, down -16%, and even harder was the -18% fall in the FTSE STAR index.

The largest downturn occurred in October, driven by the recurring themes that plagued markets throughout the year: a weakening global economy, tighter US monetary policy and US-China trade tensions. The move was exacerbated in Italy by the standoff between the government and the EU on the subject of the 2019 budget deficit provision, which we discussed in our Q3 investor letter. By the end of the month, however, the MIB index fell broadly in line with other markets. The Small Cap and the STAR indices, on the other hand, were more harshly affected, and the MIF was similarly hit. Markets remained weak in November, but some of our stocks showed sizeable rebounds. This relative move extended into December, when the global market downturn resumed but the MIF managed to end the month unchanged.

By year-end, the Italian government and the EU reached the sort of compromise we had envisaged right at the start of the sorry tale. And although the path was much more convoluted than we had expected, the volatility that came with it had much more to do with the global market downturn than with the specifics of the Italian impasse (although 'Italian uncertainty' was thrown into the big cauldron of 'global worries'). In fact, as we have seen, Italian equities fell a bit less than other markets in the quarter. It was small caps, though, that bore the brunt of investors' disgruntlement with the shenanigans of Italian politics, falling noticeably more than their Euro area counterparts – the Euro STOXX Small Cap index was down -13%, right in line with the Euro STOXX index. As we argued early in the quarter in our 5 November note, there was no fundamental explanation for such a broad and indiscriminate move. In the end, the only consolation was that the MIF managed to contain the quarterly loss close to the Euro area average.

During the quarter we entered three new positions, two of which were new IPOs, and exited four positions, three of which were larger and more liquid stocks that ended up being unduly caught in the October-November whirlwind. Our increased exposure to IPOs in the second half of 2018 actually helped us mitigate the impact of the Q4 downturn, as these stocks were largely spared the blanket sale pressure that affected their more liquid counterparts. For instance, the two companies we mentioned in the Q3 letter saw their stock price fall less than average: Longino & Cardenal ended the year at 4.35 euro, down -10% in the quarter but well above its July IPO price of 3.6 euro; Intred closed at 3.1 euro, down less than -2% in the quarter and again well above its July IPO price of 2.3. But by far the largest contribution to our performance came from Renergetica, a company that we bought at 1.5 euro per share at its August IPO and ended the year at 2.8, up +92% in the quarter.

Renergetica operates in the renewable energy sector, acting as Project Developer, Independent Power Producer, Asset Manager and Industrial Engineer for renewable energy plants, hybrid power generation systems and energy storage solutions. At the IPO, where it raised 2 million euro, the company had a market value of 11 million, with revenues of about 6 million, a 30% EBITDA margin, a 30% ROE, and free float of around 18%. Sales are expected to grow at a 25%-30% annual rate in the next few years, as the company expands its business from Italy and Chile, where it is already present and growing, to the US, Colombia, Africa and elsewhere, with returns to scale providing for further margin expansion.

The sector composition of the Fund at year-end was the following:

| | Number of companies | % Weight |
|---|---|---|
| Producer Manufacturing | 7 | 17.6% |
| Electronic Technology | 2 | 6.1% |
| Process Industries | 5 | 16.7% |
| Consumer Non-Durables | 1 | 3.4% |
| Consumer Durables | 3 | 8.9% |
| Industrial Services | 1 | 1.5% |
| Commercial Services | 5 | 12.2% |
| Distribution Services | 1 | 2.6% |
| Consumer Services | 1 | 3.1% |
| Technology Services | 5 | 9.8% |
| Finance | 3 | 6.5% |
| Communications | 1 | 2.8% |
| Utilities | 1 | 7.9% |
| Total | 36 | 99.0% |
| Cash | | 1.0% |

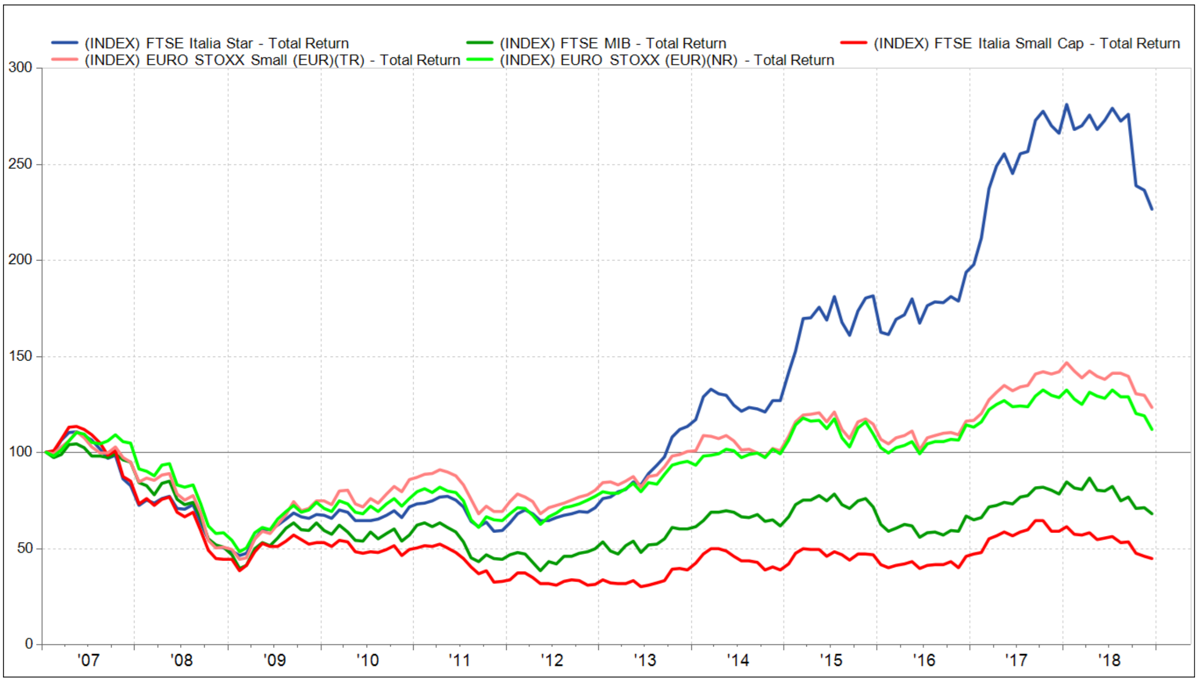
**Our fundamental principle**

Renergetica's performance epitomises the most important tenet underlying the management of the Made in Italy Fund:

Italian small caps can only be properly appreciated from a bottom-up perspective.

Political events, macroeconomic factors and market volatility have and will continue to have a transient influence on price dynamics. But the fundamental valuations of the more profitable, faster growing and better managed companies will eventually prevail. Therefore, we believe that, disregarding the background noise, holding significant positions in these companies, irrespective of their size or index weight, is the key to long term success.

No better picture illustrates this point than the performance of the FTSE Italia STAR index, which we have been referring to time and again since our first quarterly letter in Q1 2017. As shown in the graph below, the outperformance of the STAR segment vis-à-vis Italian large and small caps, as well as their Euro area counterparts, has been vast, has occurred through a variety of economic and political environments and long predates the introduction of PIR funds in 2017. As we have argued repeatedly in our quarterly letters, such outperformance does not imply overvaluation but reflects better fundamentals. Hence we believe that it is set to continue in the future.




**Taking stock**

As have seen, since its inception in May 2016 until the end of 2018 the MIF has returned twice as much as the weighted average Italian Equities fund, 2.2 times as much as the Lyxor ETF, and almost 10 percentage points more than the iShares ETF.

As explained in our Q4 2017 letter, we prefer to compare our performance to actual investment vehicles rather than uninvestable indices. For reference purposes, however, we notice that the MIF has returned three times as much as its most comparable index, the FTSE Italia Small Caps, and 7 percentage points more than the MIB index (notice the 2.5% difference between the theoretical return of the MIB index and the actual return of the iShares ETF). The MIF was also well ahead of the Euro STOXX index – which, interestingly, lagged behind the MIB index over the period – as well as the Euro STOXX Small Cap index, which instead outperformed its large cap counterpart and did much better than the Italian Small Cap index.

| | MIF Class A | Italian Equities Funds Weighted Average | Lyxor FTSE Italia Mid Cap PIR (DR) UCITS ETF | iShares FTSE MIB UCITS ETF EUR (Acc) | FTSE Italia Small Cap | FTSE MIB | FTSE Italia Star | Euro Stoxx | Euro Stoxx Small Cap |
|---|---|---|---|---|---|---|---|---|---|
| 17/05/2016 - 31/12/2018 | 23.1% | 11.7% | 10.6% | 13.5% | 7.7% | 16.0% | 31.7% | 10.5% | 15.0% |

Our legitimate gratification is tempered by the fact that the MIF is so far still trailing the STAR index. As we have said many times, the MIF is managed with an absolute return objective, irrespective of any benchmark. In particular, the STAR index is highly concentrated – the largest ten components representing 60% of its market value – and its top names far exceed our one billion market cap threshold. These are successful companies – Amplifon, Interpump, IMA – that have done very well over the years and since MIF's inception. But our Fund is geared towards the success stories of tomorrow, and we believe that, in due course and with the right choices, its performance will also be ahead of the STAR index.

**Performance fees**

Our absolute return objective is reflected in our performance fee structure. The Fund collects a 15% performance fee only if its annual return is above 4% and its year-end NAV is above the High Watermark – the level at which the last performance fee was paid. This means that, unlike 2016 and 2017, there will be no performance fee in 2018.

Performance fees are a contentious topic, with no optimal or generally agreed solution. Some investors refuse to pay them and only buy fixed-fee funds. On the other side of the spectrum, other investors don't mind – or pay no attention to – buying funds that collect monthly performance fees with no High Watermark. The MIF's solution is, we think, a good middle ground between meeting investors' ultimate objective – a positive return – and rewarding managers' success in achieving it.

A common alternative to our solution is a performance fee calculated on the fund's return relative to an appropriate benchmark, typically an index that best reflects the investment universe within which the manager makes his choices. In our case, that would be the FTSE Italia Small Cap Index, or perhaps one of the newly introduced PIR-related indices. Had we adopted such a solution at inception, investors would still have paid a performance fee in 2016 and 2017, as in both years the MIF's return exceeded the index, but the fee would have been lower, as it would have applied to the relative rather than the absolute return (although the fee percentage would likely have been higher, typically 20% or 25%). By contrast, however, investors would have also paid a performance fee in 2018, as the -18.4% MIF return was well in excess of the -24.1% index return.

Our absolute return solution rests on the assumption that investors are happier to share a higher portion of a positive return than to aggravate the pain of a negative return by paying a performance fee on top of it. In addition, our annual horizon and High Watermark make sure that investors are rewarding genuine success rather than amplifying the cost of market volatility.

**Hedging**

It is no secret that, while extolling the virtues of long-term serenity, even the staunchest value investors would gladly do without sharp market downturns.

The MIF is normally fully invested and does no market timing. But it reserves the possibility of using futures and other derivative contracts for the purpose of hedging market risk. This is not an option we would use lightly, and so far we never have. Looking back at 2018, though, there are a few times when we wish we did. But of course hindsight is a wonderful thing. The first time was in February, with the first global market downturn, which caused a completely unrelated and to us unforeseeable markdown of many of our stocks. The second was in May, when, after recovering its 2017 year-end level in the first half of the month, the MIF was again brought down by the first bout of political tensions, after the March elections resulted in the formation of the Lega/5Star government. We came close to pulling the hedging trigger over those couple of weeks and considered buying credit default swaps. But we eventually gave up, and explained why in our 4 June note. In fact, by the end of July the MIF moved up again close to its year-end level. The third time, though, was August, when the second bout of political tensions resulted in a hike in BTP rates and another sharp drop in the

MIB index. This time the MIF managed to soften the blow, falling half as much as the MIB. Over the month, we also became more confident that, as we wrote in our August Factsheet comment: "September will see a resolution of uncertainty as the Budget Law is presented at the end of the month. Our central scenario is that an acceptable compromise will be reached." In fact, September was a positive month, allowing the MIF to end the third quarter with a small positive return. It was however a short respite, as the third act of the Italian political drama started to unfold in the last day of the quarter. Once again we were tempted to pull the hedging trigger, but again we desisted, and explained why in our Q3 letter. And here comes a double irony. We were eventually proven right: the Italian government did reach our envisaged compromise with the EU and managed to avoid sanctions, and Italian equities ended up losing less than other markets in the quarter. But hedging at the beginning of October would have done us a lot of good! It's called Heterogony of Ends.

Will 2019 reserve us more thrilling trigger moments? We sure hope not.

**Happy New Year**

We join the rest of the investor community (and the rest of humankind) in bidding farewell to 2018.

After big stock market drops, we are reminded of Warren Buffett's counterintuitive remark: we should not fear but welcome them, since, as savers, we are net buyers of equities over time, and each drop gives us the opportunity to buy more at lower prices.

We certainly feel this way about the MIF. Although we managed to somewhat limit the damage, some of our favoured stocks saw violent price drops: great companies like Datalogic, El.En., Biesse, Banca Ifis, La Doria came down more than 50% in the year. If they were attractive at the beginning of 2018, they are now downright cheap.

After 2018, wisdom would suggest prudence in the new year. But, as a famous Italian song goes:

*Troppo spesso la saggezza è solamente la prudenza più stagnante*
*E quasi sempre dietro la collina è il sole*

Too often wisdom is only the most stagnant prudence
And almost always behind the hill is the sun

(Mogol-Battisti, La collina dei ciliegi)

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