Made in Italy Fund

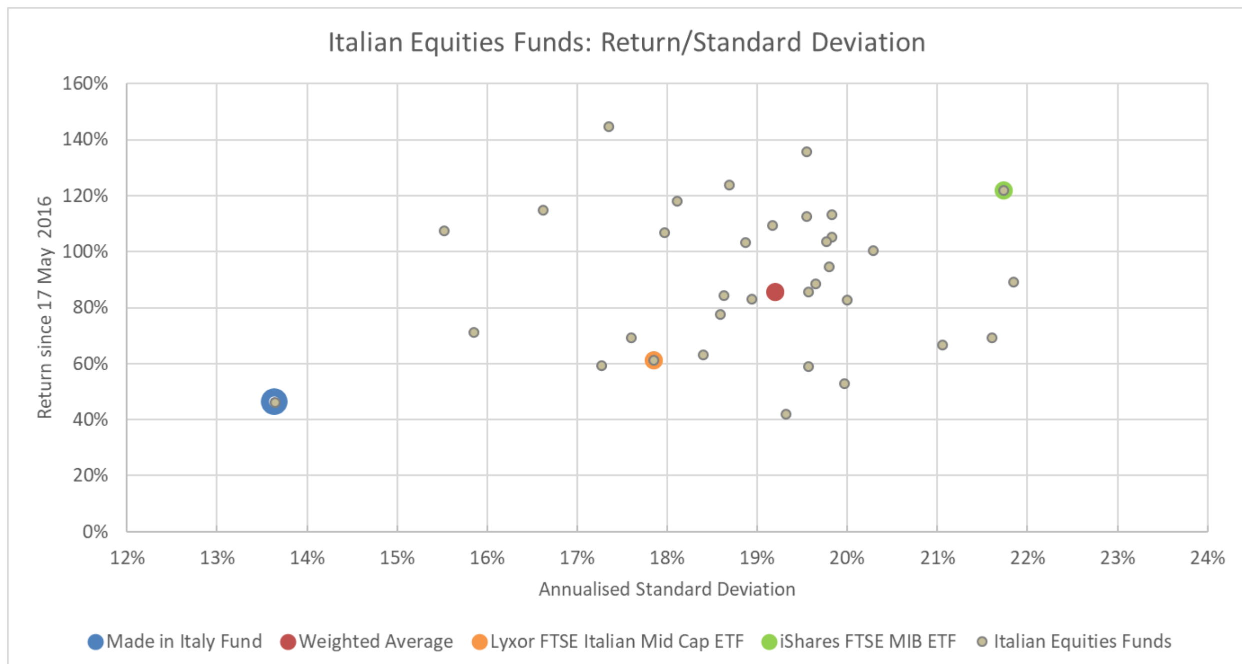
Bayes Investments

Investor letter – Fourth Quarter 2023

Dear Fellow Investors,

The Made in Italy Fund (MIF) had a return of -1.0% in the fourth quarter of 2023. The return since inception (17 May 2016) is 46.3%. Returns are net of fees and all administration costs.

During the quarter the MIF has fallen further behind the Italian Equities fund universe, whose weighted average return since our inception is 85.7%:



Source: Factset

The MIF return has also fallen behind the 61.3% return of the most comparable ETF – the Lyxor Mid Cap Fund – and is further behind the 121.8% 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 13.6%, compared to 19.2% for the weighted average fund, 17.8% for the Lyxor ETF and 21.7% for the iShares ETF.

Fourth Quarter 2023

Our -1.0% return for the quarter compares with a weighted average return of 9.1% for the Italian Equities universe, 12.2% for the Lyxor ETF and 8.3% for the iShares ETF.

The MIF ended 2023 with a return of -9.8%, versus 22.3% for the weighted average fund, 15.7% for the Lyxor ETF and 33.8% for the iShares ETF.

After the Q3 retracement, Q4 was again a positive quarter for world equities, with the US S&P 500 index up 12% and the Euro STOXX and Italian MIB indices up 8%. Remarkably for our purposes, Italian small and mid cap indices reversed the underperforming trends we have been commenting on in the last several quarters, with the Italia Small Cap index ending the quarter up 10%, the Mid Cap index up 12% and the STAR index up 14%. A notable exception, however, was again the Italia Growth index, which ended the quarter virtually unchanged.

In line with the Growth index, where most of our stocks are quoted, the MIF was down -9% in October, but staged a significant recovery in November and December, up 2% and 6% respectively. December in particular saw a meaningful outperformance versus the MIB index.

During the quarter we exited three positions and at the end of December participated in two new IPOs:

Edizioni Simone. The company operates in the Italian publishing sector, offering own volumes and manuals in the legal-professional, scholastic, and children and teenagers publishing segments. Their customers include students at all levels, as well as professionals who wish to prepare for university exams and public competitions. The company represents a point of reference in the publishing sector, thanks to a large archive of proprietary content that is constantly updated by in-house editors and to a high-quality customer service, which guarantees a vast offer of volumes at a high level of specialization.

The company has a market capitalisation of 16 million euro, expected 2023 revenues of 18 million, with an 16% EBITDA margin, an 8% Net Income margin and a 20% ROE. The shares, which we bought at IPO at 2 euro, ended the year at 2.2 euro.

Lemon Sistemi. The company is active in the renewable energy sector. Its core business is the design, supply and installation of photovoltaic, thermo-hydraulic and storage systems. It also offers its customers design services for energy efficiency solutions. The company targets residential (B2C), corporate, medium-industrial and commercial (B2B) customers, offering them "turnkey" solutions. In the field of photovoltaic systems, the company specializes in the installation of small-sized systems (up to 10 MWp), benefiting from a simplified regulatory framework.

The company has a market cap of 19 million euro, expected 2023 revenues of 15 million, with an 18% EBITDA margin, a 9% Net Income margin and a 38% ROE. We bought the shares at 1.47 euro at IPO. They ended the year at 2.2.

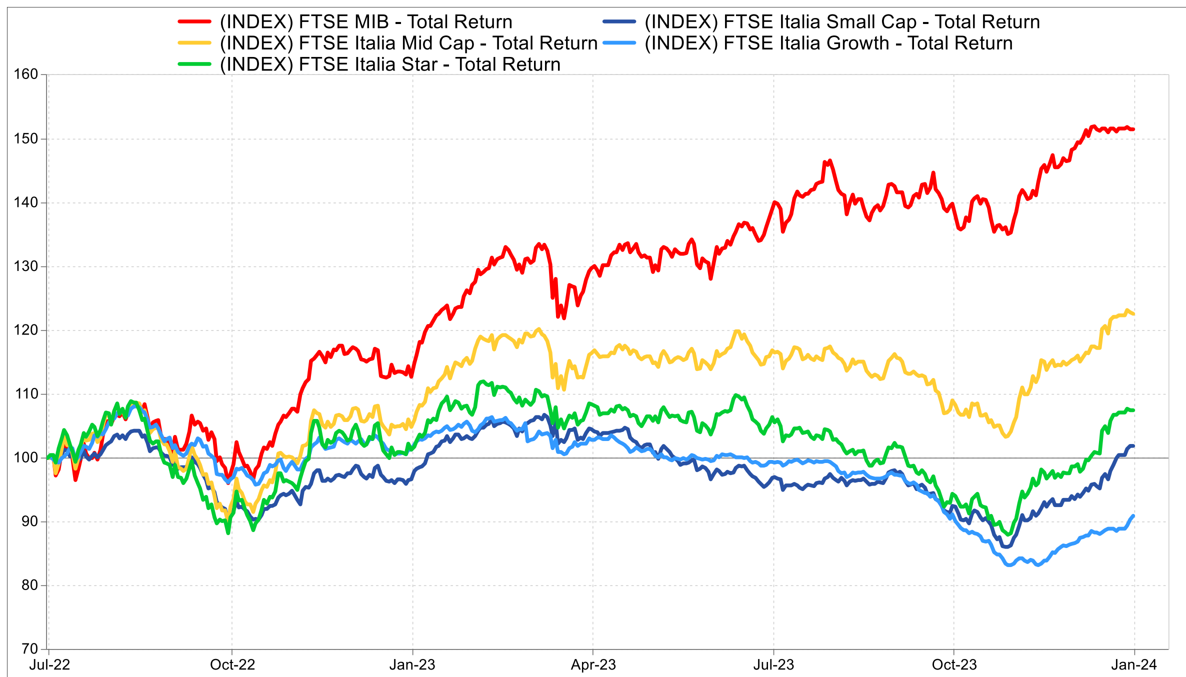
The current sector composition of the Fund is the following:

	Number of companies	% Weight
Producer Manufacturing	7	14.0%
Electronic Technology	2	3.6%
Process Industries	2	2.8%
Consumer Non-Durables	0	0.0%
Consumer Durables	6	15.9%
Industrial Services	1	1.7%
Commercial Services	4	10.3%
Consumer Services	3	6.0%
Technology Services	9	19.0%
Distribution Services	1	4.7%
Health Technology	1	1.9%
Retail Trade	1	3.5%
Communications	1	1.9%
Finance	4	7.3%
Utilities	2	3.5%
Warrants + cash		3.7%
Total	44	100.0%

An unfulfilled pledge

It is obviously too early to tell whether the overdue catch up between small and large caps that we have been waiting for throughout the year has finally started. But strong rebounds in some of our stocks in the last two months may well be a sign of an incipient turnaround. Just to mention those highlighted in the Q2 letter, Tecma Solutions and Datrix were up 47% and 32% in November, and Farmacosmo and Solid World Group are up 52% and 25% respectively so far in January.

There is a lot more to go. To reiterate, the performance gap between large and small caps that started in Q2 2022 and continued relentlessly to the end of this year is unprecedented. Over those six quarters, the large cap MIB index rose 52%, whereas the Small Cap index was up 2% and the Growth index fell -9%. In between them, the Mid Cap index rose 23% and the STAR index – the uncontested long-term winner – returned 7%:



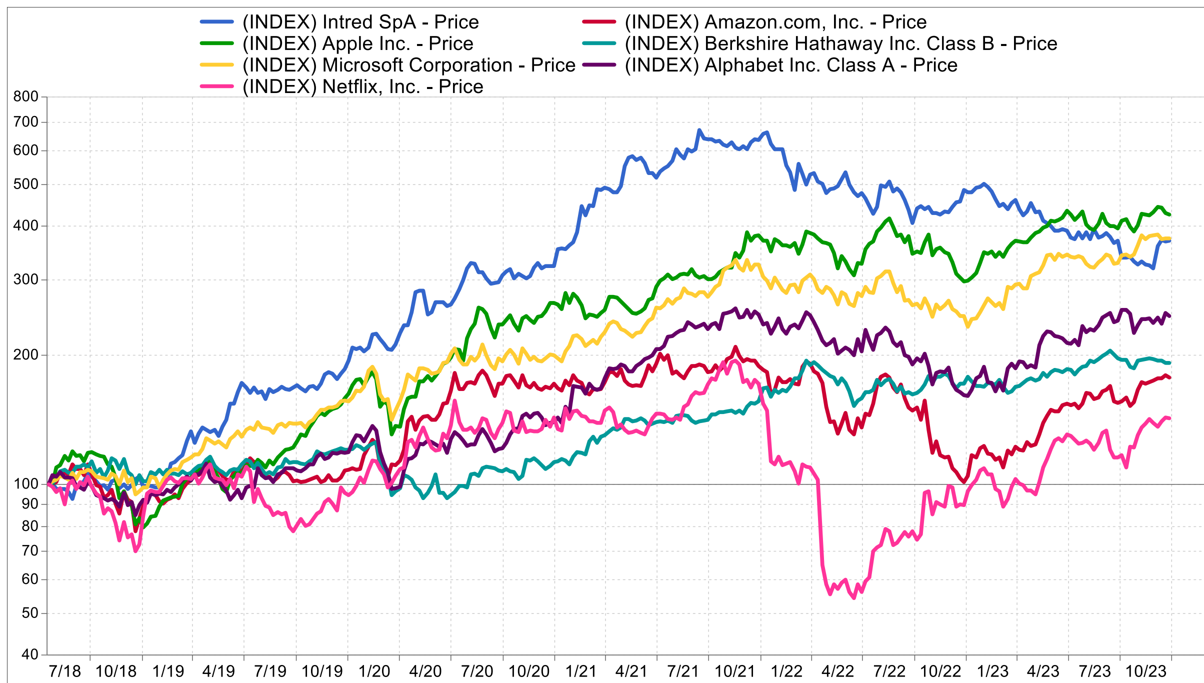
Source: Factset

We shall refrain from belabouring on the origins of this massive gap – amply covered in the last five quarterly letters. The point that is worth repeating, however, is that the gap that has opened between our Fund's performance and that of its usual comparisons – the weighted average fund in the Italian Equities universe, the Lyxor ETF and the iShares ETF – has no other explanation than what is shown in the above graph. Most Italian Equities funds are mainly invested in the large cap stocks represented in the MIB index. They include Ordinary PIR funds, which – as we showed in detail in the document reported in the Q3 letter – mostly contain large and mid cap stocks and have only a residual exposure to small caps – about 5% on average. The MIF, on the other hand, is an Alternative PIR fund, which must have a minimum 70% weight in non-MIB and non-Mid Cap stocks. In addition, it is the only Alternative PIR fund which is exclusively invested in quoted stocks – all others are mostly invested in private, non-quoted equities.

As our regular readers will remember, over the last several years we have progressively divested from mid-cap stocks and focused the portfolio towards smaller caps quoted on the Euronext Growth Market (EGM, ex AIM), mainly by participating in new IPOs. The move paid handsomely in 2021, and we justly celebrated it in the Q4 2021 letter.

Then in the Q1 2022 letter, reporting on the first negative quarter after five consecutive positive ones – on the back of the Ukrainian invasion and rising inflation and interest rates – we made a pledge: We shall not revert to the mean. And, to back our promise, we showed an updated version of the performance of one of our, by then, most successful investments – broadband provider Intred – against FAANGs. As long as we are able to find gems like Intred – we said – we shall continue to do well, in absolute and relative terms.

Alas, we were very wrong. What followed was two consecutive years of negative performance, for Intred and for the Fund. Intred fell -23% in 2022 and a further -23% in 2023, for a cumulative loss, including dividends, of -41%. Here is the updated Intred graph:



Source: Factset

What happened to Intred in the last two years to justify such a harsh rerating? At the end of 2021, with the stock price at 19 euro, Intred had a market capitalisation of around 300 million, with revenues of 41 million, EBITDA of 18 million (a 43% margin), a Net Profit of 8.6 million (a 21% margin) and an average Book Value of 36 million, equivalent to an ROE of 24%. Its valuation, while not cheap in standard terms, was entirely reasonable and not unusual, given past and prospective growth, high, stable and sustainable profitability and a strong management team. In fact, a year later, revenues had gone up to 46m, EBITDA to 20m, Net Profit to 8.7m and Average Book Value to 44m, resulting in an ROE of 20%. But the stock price had fallen to 14.5 euro and market cap to 230m. In the meantime, the company continued to report strong results, including the award of the Lombardy lot of a public tender to supply fibre optic connections to 5,200 schools, worth 60m over five years.

This is the typical scenario we had to endure in 2022 throughout our portfolio: strong and improving fundamentals vs. lower stock prices. Same story in 2023: Intred reported H1 revenues of 25m, on the way to 50m for the whole year, EBITDA was 11m (+12% year-on-year) and Net Profit 4m (-9% year-on-year, mainly due to a higher interest charge for debt incurred to finance investment for the school tender). Result: a further fall in the stock price to 11 euro by the end of the year, and a market cap reduction to 175m – this time, moreover, in the context of a mighty rebound in global equity prices and especially in Italian large caps.

As it turned out, then, not only we did not maintain our pledge, but in fact did a lot worse than the mean, underperforming since Q3 2022 and ending this year at the bottom of the pile.

At the end of a disappointing year, in the Q4 2022 letter, our headline read: We have been there. We presented a graph of the MIF return since inception against the two ETFs and the weighted average of the extant Italian Equities funds. The graph showed that:

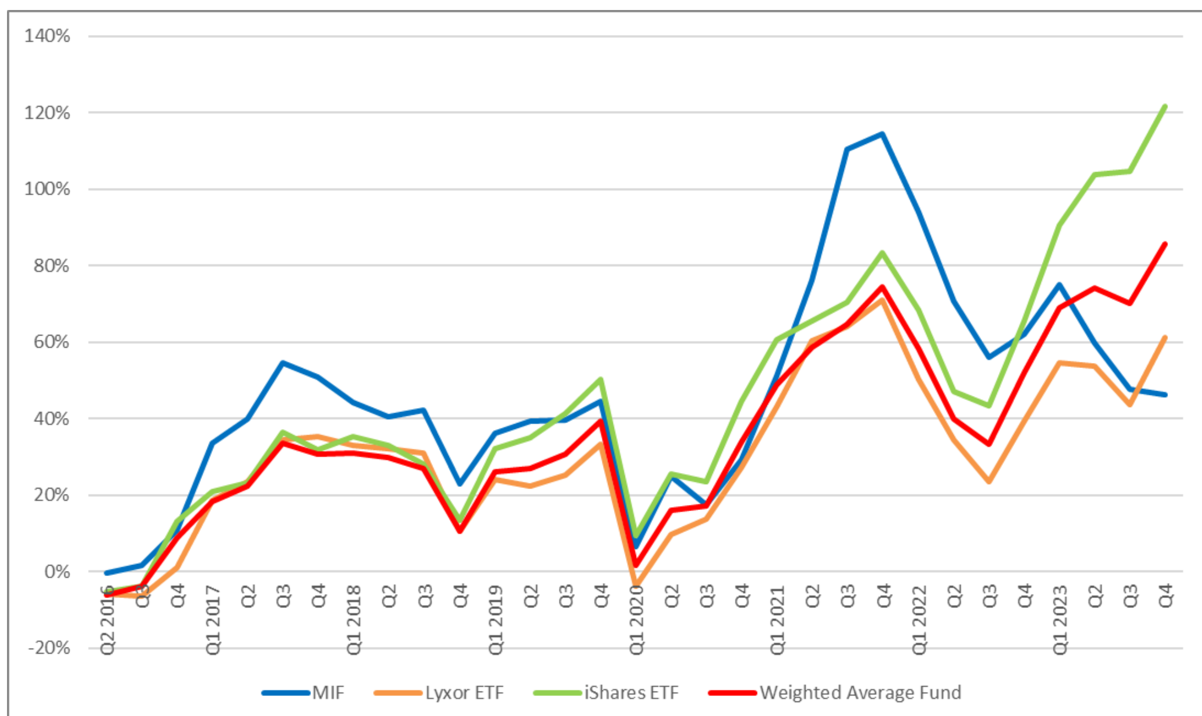
1. Our cumulative return had always been above the equivalent return of the Lyxor ETF, thus achieving our primary goal.

2. Except for two quarters in the middle of the 2020 pandemic, the MIF had also achieved our secondary goal: to have a cumulative return above the equivalent return of the weighted average Italian Equities fund.
3. The MIF had largely achieved its third goal: being above the MIB ETF, except for a period, between 2019 and 2020, in which our long-term return temporarily fell behind as a result of a yawning performance gap between large cap and small cap stocks that had started in 2018 and continued in 2019.

Hence we asked:

> Our second-half underperformance versus the MIB index was large enough to drive our long-term return slightly below the iShares MIB ETF, as it happened in Q3 2019. Is this a one-off episode or the beginning of a new period of small cap underperformance? We do not know.

Well, we know now. This is the updated graph:



The small cap underperformance not only continued but accelerated in 2023, as the MIB ETF zoomed up from the start, the weighted average fund overtook us in Q2 and the Lyxor ETF did so in Q4.

At the end of the last year-end's letter we asked: What now?

> Expecting 2023 to be a better year than 2022 does not require a huge flight of imagination. We certainly believe it will be. Inflationary pressures took longer to be repressed than originally thought, but they do seem to be reducing in most countries – as we predicted in the Q2 letter – while interest rates are back to more normal levels. Economic growth may be slower, and some countries may flirt with a mild recession, but the likelihood of the dire stagflationary scenarios bandied about earlier on appears more remote. […] On the whole, it seems quite safe to say that 2023 will at least be a more stable year than 2022, and

> therefore more conducive to a better market environment, where investors who so far have preferred to remain on the side lines may take a more constructive attitude.

We were right. Except for the last sentence:

> In this environment our stocks will have a much better chance to express their appreciation potential.

2023 has been a good year for equity markets around the globe, especially for large caps but also, to a lesser extent, for small caps. In the US, the S&P 500 index ended the year with a total return of 26% and the Nasdaq was up 45%, but the S&P Small 600 was also up 16% and the Russell 2000 +17%. In the Euro area, the Euro STOXX index was up 19% and the Euro STOXX Small +14%. In Germany, the DAX index was up 20% and the SDAX index +17%. Interestingly, as an exception, the French CAC 40 index was also up 20%, but the CAC Small ended the year down -1%. But the biggest exception was Italy, where the MIB 40 index rose as much as 34%, powered by the banking sector (Unicredit +95%, BPER +65%, BPM +51%, Intesa +40%) as well as, among others, Leonardo +88%, Stellantis +74%, A2A +58%, and Ferrari +54%, whereas the Small Cap index ended the year up just 5% and the Italia Growth index was, like the MIF, down -10%.

We wrote at length in our last letter about the market dysfunction at the root of such glaring disconnection, and about the initiatives we have promoted in order to resolve it. In this respect, we are glad to report the appearance of the Manifesto Mercato Capitali, a document prepared by Borsa Italiana, Equita Sim and Bocconi University and signed by more than 130 prominent participants in the Italian financial community – us included. It contains ten proposals for the development of Italian capital markets, the first few of which closely resemble our own two proposals:

- A systematic effort of the main Italian players, including banks, insurance companies, foundations, pension funds and social security funds in the promotion and implementation of a project, called "Italian Capital – Financial markets for Businesses", sponsored by authorities and the Government, which involves the creation of 20-25 portfolios or investment funds specific for Italian listed SMEs of 100–200 million euro each, for a total investment of 3–5 billion euro.
- Creation of a fund of funds financed for 1 billion euro which selects 10 managers of 100 million euro each for investments in Italian listed SMEs through alternative PIR funds.
- Amendment of the regulation on Alternative PIRs, increasing the potential allocation to listed mid-caps (companies included in the FTSE Italia Mid Cap index) to make the regulation more flexible for funds fully invested in listed securities.

Increasing the presence of long-term institutional investors in quoted SMEs is a necessary condition for expanding the size and liquidity of the Italian stock market. Low trading volumes are an important reason why stocks like Intred can become so detached from company fundamentals. The average volume in Intred shares in the last 52 weeks is currently less than 4,000 a day, down from 9,000 since the shares began trading in 2018. More investors would create more liquidity, which in turn would bring in more and larger institutional investors who would otherwise stay away. Such virtuous cycle would be further enhanced by encouraging controlling shareholders to release some of their holdings and increase free float.

Interest in our proposals is mounting and we are working hard to turn them into reality. Will 2024 be the year of the turnaround? After one and a half year of pathos we won't venture into a forecast. We shall confine ourselves to reminding that after 2019-20 came 2021, and that by the third quarter of that year our headline became: Don't say we didn't tell you.

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