

Heptagon Kettle Hill US L/S Equity Fund

Q4 2023 Commentary

Portfolio Management



Andrew Kurita

Opinions expressed whether in general or in both on the performance of individual investments and in a wider economic context represent the views of the contributor at the time of preparation.

The **Heptagon Kettle Hill US L/S Equity Fund** (the “Fund”) is a sub-fund of Heptagon Fund ICAV which is an open-ended umbrella type investment vehicle authorised pursuant to UCITS regulations. Heptagon Capital Limited (“Heptagon”) is the Investment Manager and Kettle Hill Capital Management, LLC (“Kettle Hill”) is the Sub-Investment Manager, meaning Kettle Hill exercises discretionary investment authority over the Fund.

Investment Objective

The Fund aims to achieve long-term capital growth through investing primarily in US small-capitalization stocks. The Fund’s Sub-Investment Manager, Kettle Hill Capital Management, is a long/short equity fund manager, established by Andrew Kurita in 2003 and is in New York, USA.

The Fund was launched on October 5, 2017 and had AUM of USD 94m as of December 31, 2023. Since launch to the end of Q4 2023, the Fund has returned 5.7% (Y USD share class) compared to 3.5% for the HFRX Equity Hedge Index, on an annualised basis. During the fourth quarter of 2023, the Fund returned 8.7% compared to 3.6% for the HFRX Equity Hedge Index.

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For the quarter ended December 31, 2023, Kettle Hill Partners, LP had a gain of 7.3%, net of all fees. Longs contributed 8.9%, and shorts subtracted 1.6%. For the year ended December 31, 2023, Kettle Hill Partners, LP had a gain of 11.9%, net of all fees. Longs contributed 16.3%, and shorts subtracted 4.4%. Ending exposure was 84% gross and 22% net, 53% gross long and -31% gross short, resulting in a long/short ratio of 1.72:1.

4Q23 Winners and Losers

Best-Performing Long—SentinelOne, Inc. (S)

SentinelOne is a security software company based in Mountain View, CA. The stock sold off in late 2022 after reporting a slowdown in growth and a change in revenue recognition policies. Based on a comprehensive analysis of the company, we concluded that the guidance was conservative, the restatement was understandable and not troubling, and the company continued to gain share in a robust security software market. The stock rose after reporting better than expected earnings. We believe they are continuing to execute well and continue to hold the stock, as we think it is still undervalued.

Worst-Performing Long—Morgan Stanley (MS)

Morgan Stanley is a global securities and asset management business based in New York, NY. We purchased the stock at a

price that recently served as the bottom of the trading range. With high rates available in the market, more customers opted to move their cash to higher-yielding instruments. We underestimated the high amount of earnings derived from the company's cash sweep on customer balances. We sold the stock for a loss after reviewing the impact of sharply reduced cash sweeps on balances.

Best-Performing Short—iShares Russell 2000 ETF (IWM)

We actively manage the net and gross exposure for the fund, and we will use ETFs to change exposure expeditiously in anticipation of future market moves in the short term.

Worst-Performing Short— Snap Inc. (SNAP)

Snap is a social media company based in Los Angeles, CA. We shorted the stock after the price increased in November. Our research on their position in the advertising market suggested that the move was unwarranted and related to a short squeeze. We covered the position for a loss after continued research uncovered a sudden improvement in their ad pricing.

I 2023 Review

Fear creates opportunity in the market. For most of the year, concerns about interest rates, inflation and recession weighed on the market. Seeking safety, many investors funnelled money into large technology companies and fled areas of the market that were perceived to be riskier. This created a very attractive potential opportunity set in small caps. In October, many small caps were trading at prices that implied the worst-case scenario of weaker earnings and low valuations, while our fundamental research indicated more positive outcomes.

We found the most attractive potential risk-rewards in software, social media, investment banks and brokers, and REITs. Our research team attempted to answer the key questions about potential investments through fundamental, bottom-up research including channel checks. We used the insights from this research to build proprietary earnings models in support of non-consensus investment theses, many of which paid off as value was later recognized by other market participants. We also took advantage of market volatility to actively trade around core positions, when appropriate.

From a top-down basis, we correctly forecast a turning point in inflation and surmised that cooling inflation would allow the Fed to lower rates in 2024. The Fed signalled this change in December, much earlier than we expected, which led to a profitable fourth quarter for the portfolio as equity markets reacted favourably.

Overall, the fund enjoyed a profitable 2023 due to a combination of factors including stock picking, active trading, thematic positioning and investment discipline. We strive to be flexible and aim to be quick to adapt to changing market conditions. We are proud of our accomplishments and hope to carry forward our momentum into 2024.

I Investment Outlook

We'd like to preface this by mentioning that top-down opinions can change rapidly based on incoming data and, therefore, we attempt to maintain liquidity and exercise individual and portfolio level risk guidelines and discipline. This is a major election year with numerous geopolitical events at present.

Individual company catalysts tend to be more durable and predictable, yet, due to our experience in the market, we view all things in the context of the overall macro landscape. That does not imply that we are a macro fund, but we do use top-down views as an important and integral part of our investment toolkit.

As of now, we will not try to fight the Federal Reserve. Chairman Powell has announced his intentions, we think inflation is likely to continue to subside, QT is likely to end in the summer, and the Fed will probably be reluctant to change course in an election year. There may be monthly inflation reports that will generate fear or euphoria, based on small variations from expectations. We think that equates to noise.

Past performance is no guide to future performance, and the value of investments and income from them can fall as well as rise

Our current view is that there is little risk of permanently high structural levels of inflation for the following three reasons: Covid-era supply chain disruptions have been resolved, looser immigration policy is reducing the structural labour shortage, and artificial intelligence will create a productivity boom over the next few years.

There is an intense debate on Wall Street about the timing and number of rate cuts that will happen in 2024. In our opinion, it is impossible to know for sure. We aren't fixed-income investors, and we don't need to be microscopically precise. We are individual stock pickers, and what matters most to us is stability. If rate volatility declines, we can invest in individual fundamental catalysts without worrying too much about significantly higher rates damaging our investment thesis.

Our research indicates that there continue to be great potential opportunities in software. We are taking a barbell approach, investing in both value and growth software companies. Value software stocks trade at steep discounts to private market valuations and provide very attractive potential risk-reward ratios. They can also be effective trading stocks in the intermediate term because of their valuation backstops. We also invest in software stocks that have the potential to grow at higher rates, and we can buy them for reasonable prices, due to the reset in valuations over the last two years. Artificial intelligence, gaming and security are examples of some growth drivers.

Management change is a theme in the portfolio. Our opinion is that years of zero-interest-rate policy created many poorly run companies. When capital is near-free, there is little incentive to manage expenses carefully. We anticipate this change sweeping board rooms as smaller companies take longer to implement the cost-management changes that companies such as Twitter and Meta were quick to implement. We invested in multiple companies where new CEOs with great pedigrees replaced ineffective CEOs. Many of these companies have incredible assets and competitive advantages that now have the potential to be revalued as better sales execution combines with expense discipline to grow profitability.

We think there are significant opportunities in REITs. Higher rates have compressed valuations, dividend yields are attractive in the 4% to 7% range for some stocks in our portfolio, maturities have been extended far into the future, and supply growth has been limited. We think we will be paid a respectable yield while waiting for fundamental and valuation catalysts to play out.

On the short side, our research in the tech, financial and consumer sectors provide potential opportunities, and we have identified companies that we believe are losing share and are likely to miss consensus earnings numbers. We think commercial construction will falter in 2024 as the pipeline of projects in backlog are completed.

I Operational Update

There were no material operational changes or updates for the quarter.

I Conclusion

Thank you once again for your investment in Kettle Hill. We believe that over twenty years, we have delivered on our goal to generate alpha and provide an attractive risk-adjusted rate of return for our investors. We think that over the long run, stock picking will thrive as the market for small cap stocks continues to be highly inefficient.

Sincerely,

Heptagon Capital and Kettle Hill Management

The views expressed represent the opinions of Kettle Hill Capital Management, as of 31st December 2023, are not intended as a forecast or guarantee of future results, and are subject to change without notice.

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Annualized Total Returns as of 31st December 2023, net of fees

	Q4 23	YTD	1-Year	3-Year	5-Year	10-Year
Kettle Hill Partners, LP	7.3%	11.9%	11.9%	4.0%	7.2%	6.1%
HFRX Equity Hedge Index	3.6%	6.9%	6.9%	5.1%	6.1%	2.9%

Source: Kettle Hill, Morningstar

Kettle Hill manages the Irish regulated Heptagon Kettle Hill US L/S Equity UCITS Fund according to the same investment principals, philosophy and execution of approach as it manages Kettle Hill Partners, LP, a Delaware Limited Partnership available for U.S. accredited investors that launched in June 2003. However, it should be noted that due to different regulation, fees, taxes, charges, and other expenses there can be variances between the investment returns demonstrated by each portfolio. Kettle Hill Partners, LP performance is provided in the table above to show a longer track record for the underlying strategy.

I Important Information

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I Risk Warnings

The Fund is subject to special risk considerations including geographic concentration risk, portfolio concentration risk and operational risk. The investment return and principal value of an investment will fluctuate so that the investor's shares, when redeemed, may be worth more or less than their original cost. Any investor should consider the investment objectives, risks and charges and expenses of the fund carefully before investing. Where an investment is denominated in a currency other than the investor's currency, changes in rates of exchange may have an adverse effect on the value, price of, or income derived from the investment.

I SFDR

The Fund takes sustainability risks into account within the investment process, and this is disclosed in accordance with Article 6 requirements of the Sustainable Finance Disclosure Regulation ('SFDR') in the Fund's [Prospectus](#). However, the Fund does not have as its objective sustainable investment and does not promote environmental or social characteristics for the purposes of the SFDR. Sustainability risks may occur in a manner that is not anticipated by the Sub-Investment Manager, there may be a sudden, material negative impact on the value of an investment and hence the returns of the Fund. As a result of the assessment of the impact of sustainability risks on the returns of the Fund, the Sub-Investment Manager aims to identify that the Fund may be exposed to sustainability risks and will aim to mitigate those risks.

Authorised & Regulated by the Financial Conduct Authority (FRN: 403304)

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For all definitions of the financial terms used within this document, please refer to the glossary on our website:
<https://www.heptagon-capital.com/glossary>

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