HEPTAGON
Capital

Driehaus US Micro Cap Equity Fund

Q3 2022 Commentary

Fund Manager

Jeff James

Investment Objective

The investment objective of the Fund is to achieve long-term capital growth. The Fund's Sub-Investment Manager, Driehaus Capital Management LLC, is a privately-held boutique asset management firm located in Chicago, USA. The firm was founded in 1982 and has USD 11.3 billion of assets under management.

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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 **Driehaus US Micro Cap 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 Driehaus Capital Management LLC ("Driehaus") is the Sub-Investment Manager meaning Driehaus exercises discretionary investment authority over the Fund. The Fund was launched on 7th December 2016 and had AUM of USD 599m as of 30th September 2022. During the third quarter of 2022, the Fund outperformed the Russell Micro Cap Growth Index TR USD (the "Index"), returning 8.6% (I USD share class) compared to 2.1% for the Index.

Market Overview

The September quarter was a rollercoaster for U.S. equities. Stocks rallied strongly to the mid-point of the quarter, then peaked, and then sold off sharply for the second half retesting the June lows. The first half rally was fueled by optimism that inflation was showing signs of easing, low valuations and better than expected earnings. The sharp retest was driven by inflation data easing more slowly than expected, the Fed's continued hawkish policy and the market's fear that the Fed will drive the economy into a hard landing or a pending crisis.

Growth outperformed value and small cap equities outperformed larger ones for the quarter. Still, market conditions remained challenging with heavy selling pressure and extremely poor investor sentiment. The bear market continues as investors weigh the pace of inflation and Fed rhetoric against the backdrop of slowing economic growth.

One key negative has been that U.S. economic growth, while slowing, has held up relatively well. This is a case of "good news is bad news". The good news - a still strong labor market and still (slightly) positive economic conditions - signals to the market that the Fed's monetary policy will have to remain aggressive, which is the bad news. The danger is the Fed will "overdo it". Interest rates have surged since the start of the year. The Fed Funds rate has gone from near zero to over 3% and is set to increase again in November. Mortgage rates have more than doubled from under 3% to over 6%. The US dollar is at its highest level since the 1980s. Quantitative tightening (QT) is progressing after a period of quantitative easing (QE). The goal, of course, is slower growth to drive inflation lower but the fear is the Fed's actions will create some sort of financial crisis, causing severe economic pain and an earnings recession.

Additionally, the risk from economic stress and turmoil in other key important parts of the world and the threat of a black swan event is growing. War, geopolitical risk, a looming energy crisis, currency stress, global recession, and an interest-driven debt crisis (there typically is one when rates rise sharply) are all concerns. These risks are depressing sentiment and driving equity valuation multiples to their lowest levels in years.

Still, a couple of major positives, we believe, could offset these concerns and need to be emphasized. One is valuation.

Consider these points:

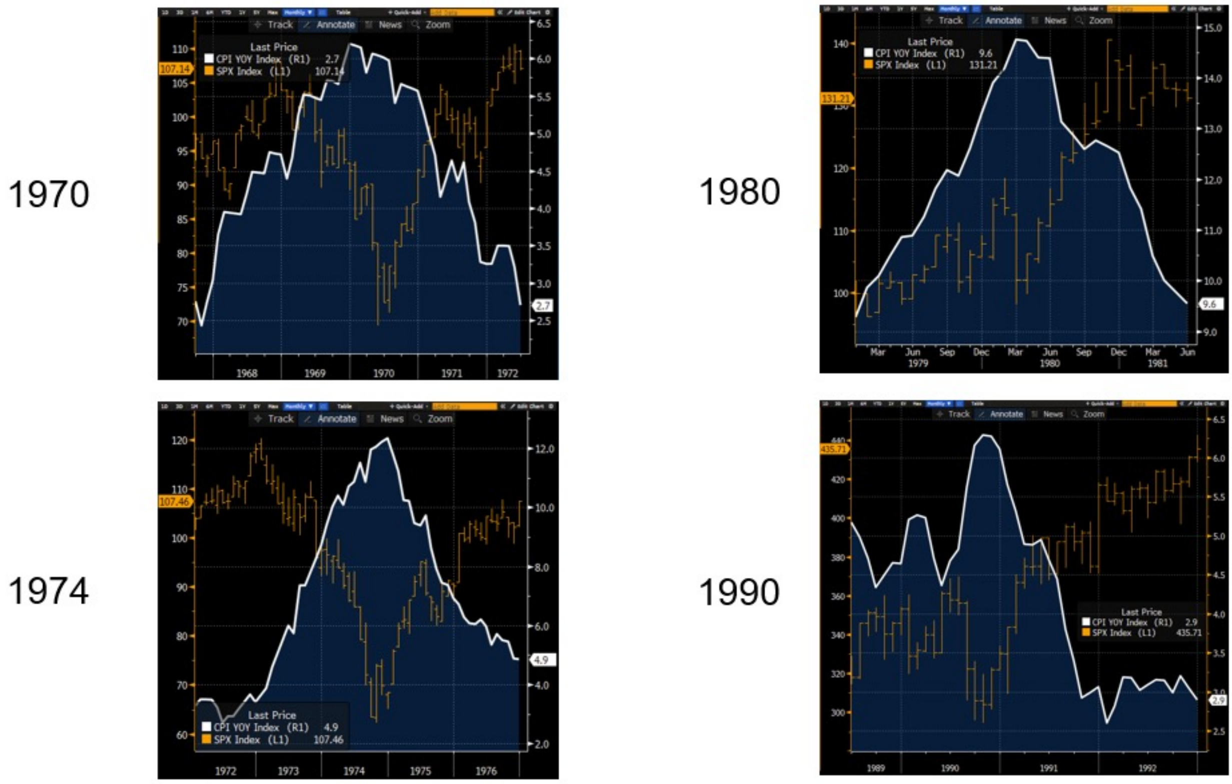
- Overall equity multiples have pulled back sharply, possibly discounting many of these concerns.
- Small caps trade at their second largest discount (25 to 30%) relative to large caps since the inception of the Russell 2000 Small Cap Index in 1980. Yet historically, small caps typically trade at a premium to large caps.
- Equities already trade at valuations below or near levels that are typically observed during past recessions.
- We currently hold many stocks within our portfolio that trade at a discount to where they have traded historically.

Second is inflation, which is the main driver of this bear market. It is persistently high and the Consumer Price Index (CPI), the key inflation measure that peaked in June, has only come down slightly and has remained higher than the consensus has estimated. Still many soft or leading inflation indicators point to significant slowing in inflationary pressures, even as CPI (and Personal Consumption Expenditures (PCE)) have not yet reflected this.

Consider the following:

- M2, the most watched measure of the money supply and a key leading indicator of future inflation, has fallen sharply. M2 growth has plunged from its high of 27% to now just 2.8% year-over-year.
- Most commodities have fallen sharply, including food and energy prices (and gasoline prices) in the U.S.
- Average hourly earnings (AHE), have peaked and are falling. Labor demand is falling (Job Openings and Labor Turnover (JOLTs) data), and labor participation is improving.
- Institute for Supply Management (ISM) prices paid for manufacturing and services, have peaked and are falling steadily. This is a clear sign that economic demand is falling as the Fed tightens and supply improves with supply chains recovering.
- Shipping rates have plunged as have other transportation costs as supply chains heal.
- Consumer inflation expectations (such as the University of Michigan Inflation Expectations Index) are well off their highs.
- Market-based expectations like the various durations of the TIPS/Treasury Breakeven Rates have also come well off their highs suggesting inflation will as well.
- Historically, CPI topping out has coincided with equities bottoming out. This occurred in prior higher inflationary times, specifically in 1970, 1974, 1980 and 1990 (Exhibit 1).

Exhibit 1: During periods of high inflation, market bottoms often coincide with CPI Topping out



Source: Bloomberg

So as the market enters the fourth quarter of 2022, equities have retested their June lows. Valuations have pulled back. The market is entering a more favorable seasonal time of the year. Investor expectations for the upcoming September quarter earnings season have been reduced. We do expect the aggregate earnings trend to generally weaken as the economy is slowing. Is that now largely priced in? Like it was three months ago for the June quarter earnings?

More broadly looking ahead to year-end and next year, the direction of equities and multiples will continue to depend on the trajectory of inflation and how the Fed reacts to the inflation data as well as economic conditions. As economic data weakens and the labor market softens, that "bad news" could become "good news" to the Fed as they see that tighter financial conditions are impacting demand and helping to ease inflation.

Performance Review

For the September quarter, the Driehaus US Micro Cap Equity Fund outperformed its benchmark. The Fund appreciated 8.6% (I USD share class) net of fees, while the Russell Microcap Growth Index gained 2.1%. By comparison, the Small Cap Russell 2000 was down 2.2%, the Russell 2000 Growth was up 0.2% and the S&P 500 was down 4.9%.

The outperformance of the Driehaus US Micro Cap Equity Fund was led by strong earnings resulting in positive absolute return performance. The Fund had relative outperformance versus the benchmark for each of the quarter's three months and had strong absolute returns for July and August as the market rallied and negative absolute returns for the final month as the market retested its second quarter lows.

By sector, performance is summarized as follows:

Technology

Technology outperformed by 352 basis points as our holdings strongly outperformed the benchmark's tech holdings. Our tech holdings gained 19.3% while the benchmark's tech holdings were down .39%. Strong earnings, individual product cycles and other idiosyncratic factors were positive drivers. We maintained a slight sector underweight as multiple macro and industry headwinds remained in play.

By sub-industry, telco equipment was the standout. Six holdings had double digit returns as our telco industry holdings gained 50%, doubling that of the index. Strong earnings were led by multiple product cycles and robust rural broadband equipment spending. Also, one wireless equipment holding was acquired by a larger company at a nice premium during the quarter.

The other key sub-industries in technology, IT services, semiconductors and software each experienced positive absolute and relative returns. Holdings in each of these industries achieved greater returns than compared to the benchmark's components. Strong earnings, low valuations and one takeout drove the outperformance in these groups.

Consumer Discretionary

Consumer discretionary outperformed by 163 basis points on a relative basis. Our consumer holdings gained nearly 9% while the benchmark's consumer holdings were down just over 5%.

A restaurant company and a fitness-oriented franchise operator had strong earnings and were outperformers, as were two e-commerce marketplace businesses. Overall, the consumer discretionary sector remains challenging as the economy slows and consumer confidence remains extremely low. Leisure reopening spending remains healthy as the demand for travel and experiences post-Covid remains strong, however, equity investors remain skeptical of the sustainability of this strength. Overall, we see many attractive businesses at appealing valuations that we believe will be positioned to perform well as inflation eases and when the equity market begins to recover.

Healthcare

Healthcare outperformed by 91 basis points vs the benchmark. This strength was led by medical devices which returned more than 20% versus 7.8% for the benchmark. The group was led by a half dozen different medical device holdings that outperformed with strong quarterly reports supported by robust demand as medical procedures recover post-Covid. Many elective procedures were postponed as hospitals focused on treating Covid patients. We believe this theme is sustainable given the number of postponements. Also, our holdings are innovative companies with new solutions providing superior patient outcomes which enable them to take market share from larger players.

Biotech and pharma holdings performed in line with the benchmark but returned nearly 400 basis points in absolute performance. Multiple holdings performed well due to positive clinical trial updates and increased optimism on positive data readouts over the coming months. One therapeutic holding focused on sickle cell anemia was acquired by a big pharma company during the quarter.

Healthcare remains the portfolio's largest sector in absolute terms at 33% but is a small underweight in relative terms. We did increase exposure to the sector during the quarter by 450 basis points, mostly in biotech and medical devices as these groups are beginning to emerge from long bear markets as fundamentals improve and valuations remain compelling.

Financials

The financial sector holdings outperformed by 46 basis points. The strength was led by a couple of specialty insurance holdings that performed well. We remain underweight the financial sector overall as banks and other sub-industries remain challenged as the economy slows and capital markets remain difficult.

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

Consumer Staples

Staples outperformed by 29 basis points as the sector was mixed. Our holdings were flat for the quarter outperforming the benchmark's staples components which were down nearly 11%. Several of our specialty food and beverage holdings performed well but that was offset by a couple that pulled back in price.

Energy

Energy overall underperformed by 33 basis points on a relative basis as crude oil pulled back given global demand concerns which put pressure on exploration & production (E&Ps) and oil service stocks. On an absolute basis our holdings detracted 27 basis points as our holdings were down 6% vs down 2% for the benchmark. Given the demand pressure and weaker commodity prices we did reduce our exposure during the quarter and currently maintain a slight underweight.

Industrials

Industrials underperformed by 7 basis points. On an absolute basis our industrial holdings were essentially in line with the benchmark's industrial holdings. A number of services companies and other consistent-growth industrials saw continued strong fundamental performance but sold off as economic growth concerns weighed on the sector. One infrastructure related holding with a focus on renewables was acquired during the quarter at a healthy premium. We did reduce our exposure to the sector overall during the quarter.

Outlook & Positioning

Market conditions remain challenging. Macro factors continue to dominate over bottom-up and industry trends. But as the broader indices have pulled back, retesting their second quarter lows, we believe valuations may now reflect or discount a considerable part of the macro overhang. August and September were once again difficult on a seasonal basis, but the market is now entering a positive seasonal period. Of course, seasonality can be fickle and is simply a tendency. More important are the positive signs we see on inflation as detailed above. The market fears the Fed will remain firm in its current hawkish policy stance until a hard landing occurs or some crisis emerges. Also possible, and optimistically, the Fed will respond and adjust as economic conditions, such as the labor market, show real weakness and/or as inflation shows sustained easing in the form of consecutive favorable monthly inflation results.

Positively, valuations have declined for our portfolio as we see many holdings trading at discounts versus their own history. Micro/small cap stocks in general continue to trade at a deep discount versus large caps, the second largest discount in 40 years. Importantly, current small cap valuations are at levels similar to past recessions. While the odds of a recession have increased materially, current economic conditions remain mixed suggesting flattish economic growth in the near-term.

In terms of portfolio positioning, we have an attractive mix of secular and cyclical growth holdings. By sector healthcare remains our largest absolute weight, followed by technology, industrials, consumer discretionary, consumer staples, financials and then energy. Relative to the benchmark, the strategy is overweight consumer staples, consumer discretionary and industrials. The strategy is underweight health care, technology, financials and energy.

Overall, we still see many dynamic investment opportunities which have attractive valuations. These holdings nicely fit our investment philosophy of companies exhibiting growth inflections, differentiation, market share gains, strong revenues and expanding profitability.

Contributors

Clearfield, Inc. (ticker: CLFD) designs, manufactures, and distributes fiber optic management, protection and delivery products for communications networks. CLFD was a top contributor driven by strong 2Q22 earnings, reporting revenues and earnings 25% above consensus expectations. This strength was driven broad based demand for fiber optic components from service providers upgrading their network infrastructure to enable higher bandwidth at faster speeds.

Ventyx Biosciences, Inc (ticker: VTYX) is a clinical stage biopharma company developing agents to treat psoriasis and other immunologic conditions. In September, two developments occurred that drove VTYX to be a top contributor for the quarter: first, VTYX presented initial in human data that demonstrated potentially best-in-target PK/PD; second, there was a positive regulatory development that reduced uncertainty regarding VTYX's total addressable market. We added to our position on the back of these positive developments.

Detractors

Duckhorn Portfolio (ticker: NAPA) is the premier producer of luxury wines in North America. NAPA was a top detractor due to two secondaries by existing holders in July. This was followed by an adjustment to FY23(Jul) expectations ahead of initial guidance based on comments at an investor conference in September where management pointed to additional costs and category weakness. We maintained our position.

Chef's Warehouse, Inc. (ticker: CHEF) is a premier distributor of specialty food products in the US and Canada. After meaningful appreciation in June, CHEF was a top detractor during the quarter as the stock pulled back on concerns about moderating benefits from food inflation and slower growth in restaurant industry sales.

Outright Buy

Harmonic Inc (ticker: HLIT) engages in the development and sale of video delivery software, products, system solutions, and services. HLIT's software-centric platform, CableOS, was introduced a few years ago and has found traction among service providers displacing incumbent legacy systems box vendors, a transition that is in the early innings of adoption. This has allowed HLIT to grow its backlog throughout 2022, providing earnings growth visibility for the next several years as these deployments are completed. At its most recent analyst day, HLIT outlined its goal to achieve $1 in annual EPS by 2025, more than double vs 2022 consensus earnings expectations.

Outright Sell

Sierra Wireless (ticker: SWIR) engages in the provision of device-to-cloud and networking solutions with its Embedded Broadband and Internet-of-Things Solutions (IoT) segments. In August, Semtech (ticker: SMTC) offered to buy SWIR for $31/share via an all cash offer. We sold it out of the Fund as we did not expect competing and better offers to emerge.

Sincerely,
Heptagon Capital and Driehaus Capital Management

Sector performance attribution- Q3 2022

	Driehaus Micro Cap Growth Composite (Port) (%)		Russell Microcap® Growth Index (Bench) (%)		Attribution Analysis (%)		
GICS Sector	Port Avg. Weight	Port Contrib To Return	Bench Avg. weight	Bench Contrib To Return	Allocation Effect	Selection + Interaction	Total Effect
Comm. Services	0.43	0.02	1.79	-0.28	0.26	0.10	0.37
Consumer Discretionary	13.92	1.13	9.33	-0.40	-0.37	2.01	1.64
Consumer Staples	11.60	0.00	3.76	-0.41	-1.06	1.35	0.29
Energy	6.93	-0.27	5.29	-0.18	-0.06	-0.27	-0.33
Financials	3.37	0.17	6.50	-0.15	0.17	0.30	0.47
Health Care	31.58	5.38	35.75	4.27	-0.60	1.52	0.91
Industrials	11.00	-0.38	11.99	-0.31	0.04	-0.12	-0.08
Information Technology	17.92	3.12	19.25	0.12	0.06	3.45	3.52
Materials	1.59	-0.02	2.89	-0.31	0.18	0.17	0.35
Real Estate	0.00	0.00	2.14	-0.21	0.33	0.00	0.33
Utilities	0.02	-0.09	1.22	-0.03	-0.01	-0.06	-0.08
Cash	1.65	0.00	0.00	0.00	-0.43	0.00	-0.43
Other*	0.00	-0.29	0.10	0.00	-0.05	-0.26	-0.30
Total	**100.00**	**8.76**	**100.00**	**2.11**	**-1.54**	**8.19**	**6.65**

Sources: Driehaus Capital Management LLC, Factset Research Systems, Inc., eVestment Alliance
**Other refers to securities not recognised by Factset.*
Data as of 30 September 2022

Annualized Total Returns as of 30th September 2022, gross of fees

	Q3 22	YTD	1-Year	3-Year	5-Year	10-Year
Driehaus Micro Cap Growth Composite	9.0%	-32.8%	-27.9%	23.0%	19.2%	20.0%
Russell Micro Cap Growth Index TR	2.1%	-31.6%	-37.1%	4.4%	0.7%	6.6%

Source: Driehaus Capital Management, Bloomberg

Driehaus manages the Irish regulated Driehaus US Micro Cap Equity UCITS Fund according to the same investment principals, philosophy and execution of approach as it manages the Driehaus Micro Cap Growth Composite, 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. The Driehaus Micro Cap Growth Composite is provided in the table above to show a longer track record for the underlying strategy.

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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.

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