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Capital

Driehaus US Small 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 Small 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 31st July 2019 and had AUM of USD 444m as of 30th September 2022. During the third quarter of 2022, the Fund outperformed its benchmark, the Russell 2000 Growth Index TR USD (the "Index"), returning 2.7% (I USD share class) compared to 0.2% 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

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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).

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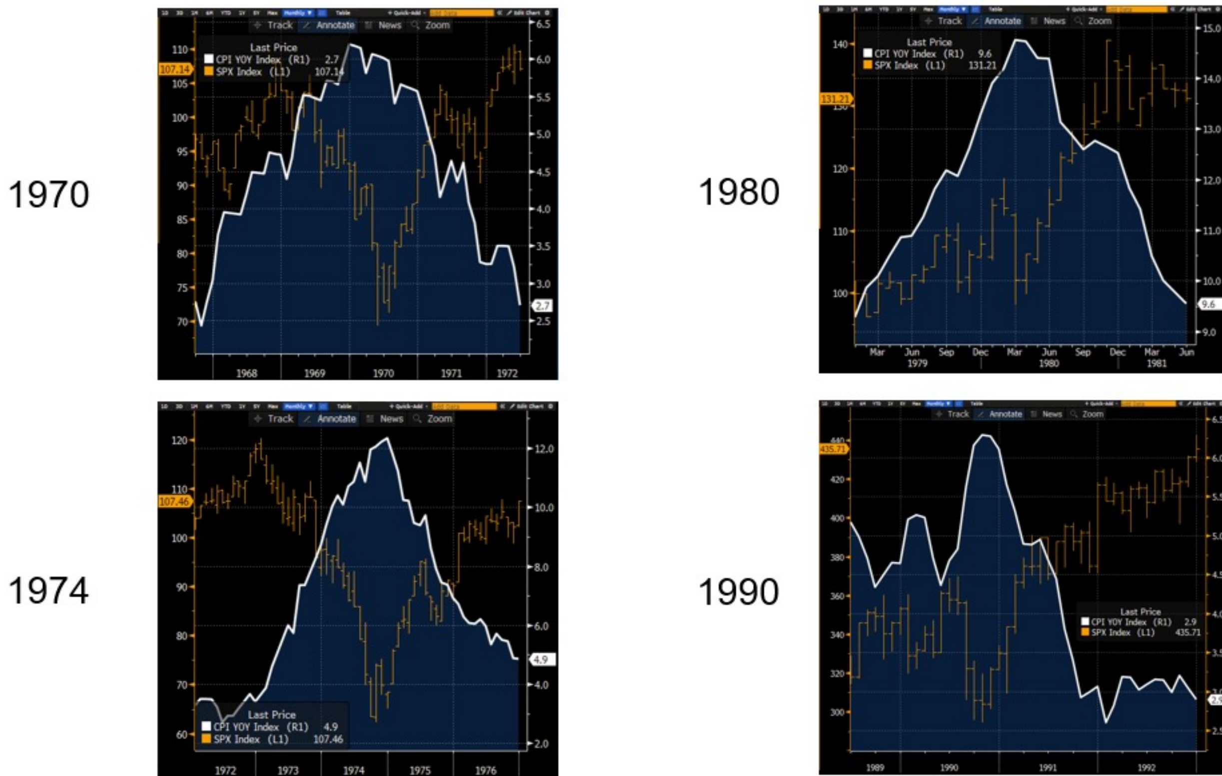
Exhibit 1: During periods of high inflation, market bottoms often coincide with CPI Topping out



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 Small Cap Equity Fund outperformed its benchmark.The Fund appreciated 2.9%, net of fees, while the Russell 2000 Growth Index gained 0.2%. By comparison, the Russell 2000 was down 2.2% and the S&P 500 was down 4.9%.

The outperformance of the Driehaus US Small Cap Equity Fund was led by strong earnings resulting in positive absolute return performance. By month, the Fund had relative outperformance versus the benchmark in August and September and underperformance in July. The Fund 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:

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Technology

Technology outperformed by 173 basis points as our holdings strongly outperformed the benchmark's tech holdings. Our tech holdings gained 5.3% while the benchmark's tech holdings were down 4.2%. 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 67%, more than doubling that of the index. Strong earnings were led by multiple product cycles and robust rural broadband equipment spending.

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

Consumer Discretionary

Consumer discretionary outperformed by 48 basis points on a relative basis. Our consumer holdings gained nearly 5% while the benchmark's consumer holdings gained 1.4%. A restaurant company and a fitness-oriented franchise operator had strong earnings and were outperformers, as was an e-commerce marketplace business. 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 32 basis points vs the benchmark. This strength was led by medical devices which returned more than 10% versus 8% for the benchmark. The group was led by several 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 inline with the benchmark but returned 170 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 23% but is a small underweight in relative terms. The biotech and medical device groups appear to be at the early stages of emerging from long bear markets as fundamentals improve and valuations remain compelling.

Consumer Staples

Staples outperformed by 17 basis points as the sector was mixed. Our holdings were down 1% for the quarter outperforming the benchmark's staples components which were down nearly 7%. Several of our specialty food and beverage holdings performed well but that was offset by a couple that pulled back in price.

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Financials

The financial sector holdings outperformed by 8 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.

Industrials

Industrials underperformed by 18 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. We did slightly increase our exposure to the sector overall during the quarter.

Energy

Energy overall underperformed by 41 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 34 basis points as our holdings were down 2% vs up 4% 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.

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 industrials, technology, consumer discretionary, consumer staples, energy and then financials. Relative to the benchmark, the strategy is overweight industrials, consumer staples and consumer discretionary. The strategy is underweight technology, health care, 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

Calix, Inc (ticker CALX) offers broadband communications access systems that enable communications service providers to transform their networks. CALX was a top contributor in response to reporting 2Q22 revenues and earnings 7% above consensus expectations. The company attributed this strength to broad based demand from service providers upgrading their network infrastructure and its software centric platform seeing increased product module adoption. We added to our position off these positive datapoints.

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Celsius Holdings, Inc (ticker: CELH) is the maker of the leading global fitness drink CELSIUS. CELH was a top contributor as CELH finalized a long-term strategic distribution agreement with PepsiCo, Inc. (ticker: PEP) that included a $550m investment in CELH convertible preferred stock. Additionally, retail scanner data indicated continued robust sales trends. Gross margins are expected to trough in 2Q22, after which cost pressures should recede and earnings growth should accelerate.

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.

MP Materials Corp Class A (ticker: MP) owns and operates a rare earth mining and processing site in the Western Hemisphere. In September, MP was a top detractor as the stock saw weakness due to falling neodymium-praseodymium (NdPr) prices and fears of weakness in European demand and global recession. While the stock has been weak recently, the long-term demand outlook for rare earth materials is positive and we continue to hold a position.

Outright Buy

Wingstop Inc (ticker: WING) operates and franchises more than 1,850 restaurants worldwide that offer classic and boneless chicken wings and tenders with a range of bold, distinctive flavors. We initiated a position with the expectation that the September launch of a chicken sandwich, second-half weighted advertising spend and rollout of a new delivery partner would lead to accelerating sales and earnings in the second half of the year and early 2023. Falling wing costs should provide additional margin benefits.

Outright Sell

RLI Corp (ticker: RLI) is a specialty insurer serving niche property, casualty and surety markets. Specialty insurers came under increased pressure in July and August as 2Q22 earnings from some large participants showed decelerating pricing growth and accelerating losses as courts reopened. With elevated concerns about the trajectory for margins we eliminated the position.

Sincerely,
Heptagon Capital and Driehaus Capital Management

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Sector performance attribution- Q3 2022

	Driehaus Small Cap Growth Composite (Port) (%)		Russell 2000 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	2.73	0.13	2.34	-0.12	-0.04	0.15	0.12
Consumer Discretionary	12.65	0.57	10.99	0.12	0.03	0.46	0.49
Consumer Staples	8.46	0.00	4.34	-0.28	-0.30	0.48	0.18
Energy	5.92	-0.34	6.26	0.04	-0.15	-0.24	-0.39
Financials	3.24	0.15	6.03	-0.07	0.01	0.10	0.11
Health Care	23.86	2.52	23.89	1.75	-0.13	0.45	0.32
Industrials	18.15	-0.65	17.42	-0.07	-0.09	-0.09	-0.17
Information Technology	16.35	0.88	20.28	-0.53	0.11	1.62	1.73
Materials	5.43	0.08	4.26	-0.15	-0.07	0.34	0.27
Real Estate	0.72	-0.01	2.40	-0.41	0.33	0.12	0.45
Utilities	0.43	-0.18	1.80	-0.09	0.06	-0.03	0.03
Cash	2.07	0.00	0.00	0.00	-0.14	0.00	-0.14
Other*	0.00	-0.13	0.00	0.00	-0.14	0.00	-0.14
Total	**100.00**	**3.02**	**100.00**	**0.18**	**-0.52**	**3.37**	**2.84**

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

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

	Q3 22	YTD	1-Year	3-Year	5-Year	10-Year
Driehaus Small Cap Growth Composite	3.1%	-34.8%	-31.2%	14.0%	15.9%	17.1%
Russell 2000 Growth Index TR	0.2%	-29.3%	-29.3%	2.9%	3.6%	8.8%

Source: Driehaus Capital Management, Morningstar

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

The views expressed represent the opinions of Driehaus Capital Management, as 30th September 2022, are not intended as a forecast or guarantee of future results, and are subject to change without notice.

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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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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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