

Driehaus US Micro Cap Equity Fund

Q2 2024 Commentary

Portfolio 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 849m as of 30th June 2024. During the second quarter of 2024, the Fund outperformed the Russell Micro Cap Growth Index TR USD (the “Index”), returning -0.2% (I USD share class) compared to -5.6% for the Index.

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 18.0 billion of assets under management.

Market Overview

The U.S. equity market experienced a mixed second quarter. Large caps experienced positive gains driven (again) by strength in the mega cap tech stocks. Large cap stocks outperformed micro caps, small caps, and mid caps overall, which were down in the low single digit percentage range for the quarter. Absent those select mega cap stocks, large caps would have performed similarly to small caps and the average U.S. stock.

The U.S. economy is moderating based on a slew of weaker data recently. Inflation data is also moderating and there are positive signs it is trending favorably towards the Federal Reserve’s two percent target. Inflation is not at two percent yet, but most components of inflation suggest its trajectory is positive enough for the Fed to consider interest rate cuts in the second half of the year. For now, we view the slower economic growth as benign and not recessionary though the pace of economy data will be important to monitor near-term. Importantly, the slowing economic conditions appear to be having a favorable impact on inflation.

The broader market and the small cap indices, while down a few percent, consolidated in a constructive manner for the quarter. While many individual stocks and several industries outperformed as their earnings stood out, this broader market consolidation is likely a function of market participants focusing on how economic and inflation data will frame the macro-outlook for the second half of the year and how it will influence the Fed’s monetary policy.

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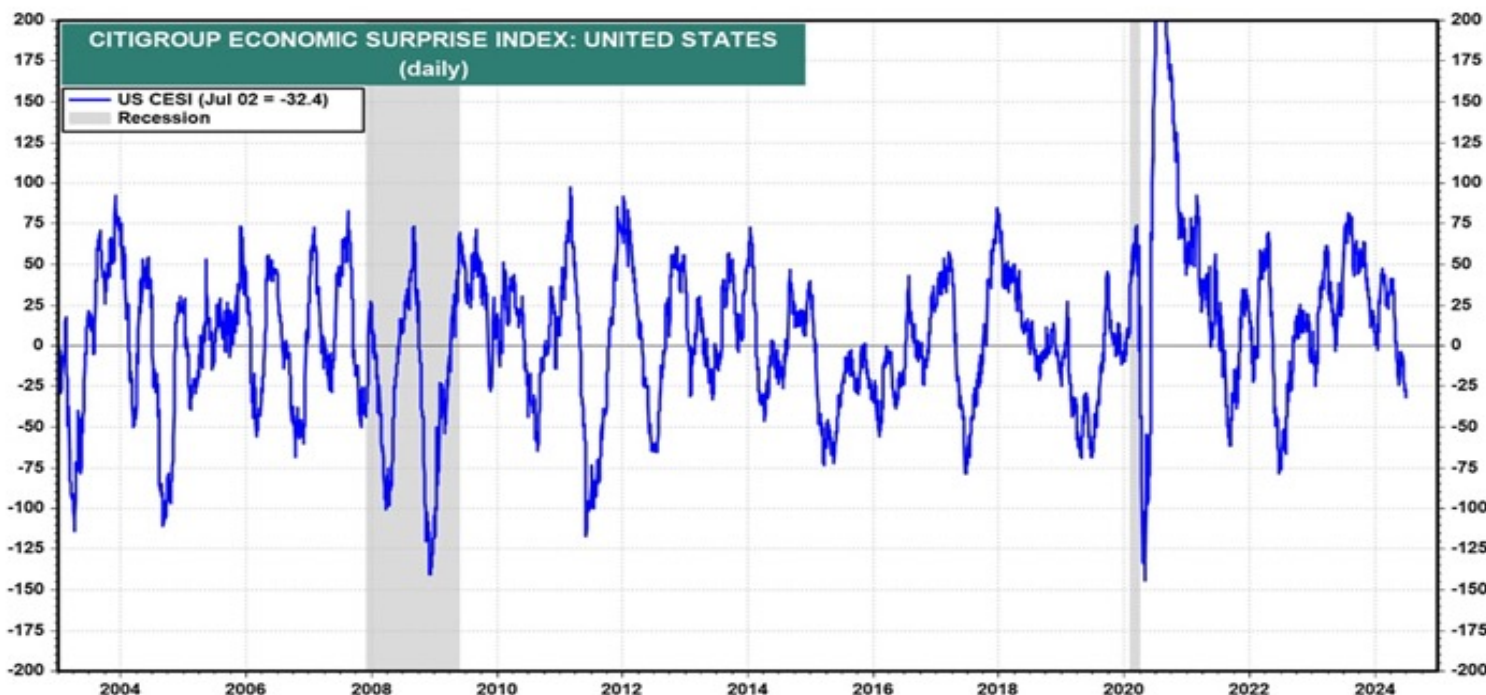
The most recent inflation data was encouraging as May and June's consumer price index (CPI) and producer price index (PPI) inflation readings were lower than expected. This along with rising unemployment claims raised market expectations that the Fed will ease monetary policy sooner rather than later. The first half of the year did see rate cut expectations pushed out to the right several times, but the market continues to expect two interest rate cuts this year with close to ninety percent odds of the first rate cut occurring in September. The reasons behind the rate cuts will be particularly important. Lower rates due to inflation approaching the Fed's target with positive economic conditions will be well received by the equity market. On the other hand, rate cuts due to the economy becoming too weak will likely not be well received.

Economic conditions

Economic conditions in the U.S. have slowed. Some of the economic data is becoming concerning but in aggregate terms economic growth remains positive. There could be several reasons for the slowdown. It is possible that the still inverted curve could be having its traditional detrimental impact, just on an exceptionally long lag. It is also possible that the sustained higher level of interest rates and the cumulative amount of inflation are negatively impacting economic demand, especially for the bottom half of consumers. On the other hand, it is also possible that the current slowdown is a mid-cycle slowdown that the economy has experienced many times in past cycles. Let's consider the strengths and weaknesses of the following important economic indicators:

- The Citi Economic Surprise Index dropped to its lowest level since August of 2022. However, as the chart below illustrates, it has reached this level many times during prior mid-cycle soft patches, and it is still well above the level reached during past recessions.

Exhibit 1: Citi Economic Surprise Index

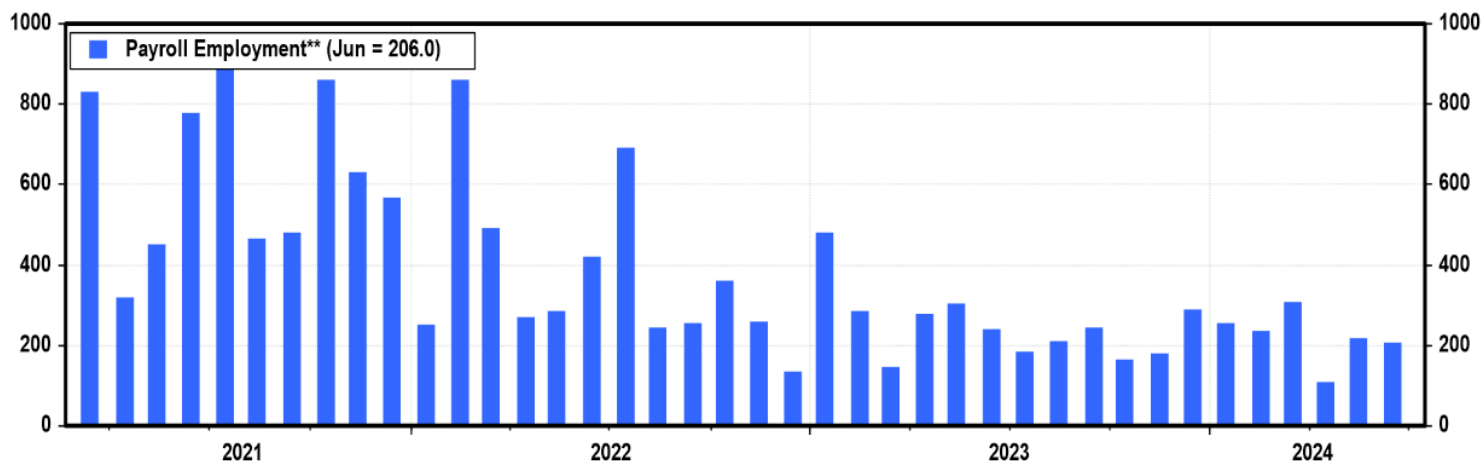


Source: Yardeni Research

- The labor market has slowed, and it is likely the key area of the economy that the market and the Fed are evaluating to gauge the status of both the economy and inflation. Here are some key labor market indicators:
 - Job gains did grow 206,000 in the month of June but have slowed to an average of 177,300 during the second quarter, down from 267,300 in the first quarter. Constructively, the second quarter average was within the range of average monthly job gains seen in 2018 (190,300) and 2019 (165,700). Overall, the trend of monthly jobs added is still solid; here is the monthly trend since early 2021:

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

Exhibit 2: Monthly Jobs



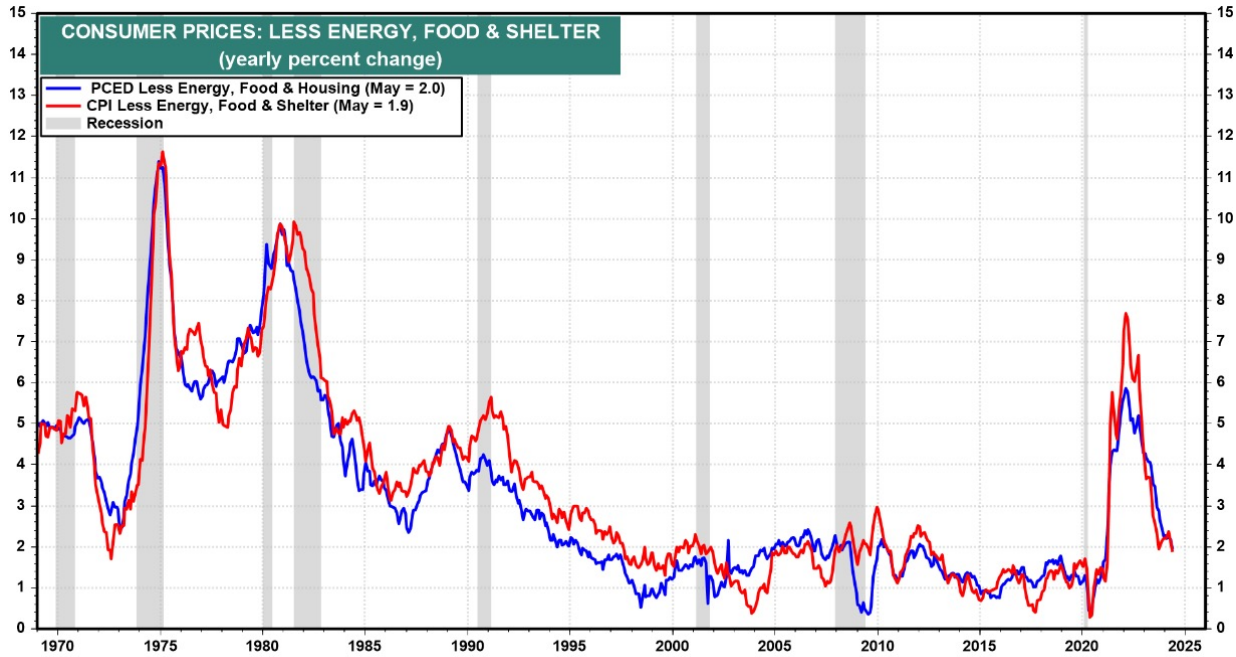
Source: Yardeni Research

- Job openings have also slowed from their pandemic highs but rose 221,000 in May to 8.14 million which is still a healthy level. Job openings per worker were flat at 1.2, well below the 2022 high but still well above historical levels since the year 2000.
- More concerning are jobless claims and continuing claims, both of which have risen in recent months. Also concerning is the unemployment rate which has risen to 4.1%, from its low of 3.4% in April of 2023 (a level not seen since the 1960s), and a rise of 0.5% within the past year which has triggered the Sahm Rule, which says historically a recession follows such an increase. There are some who argue that claims and unemployment were simply unusually low following the pandemic. Others suggest the adult unemployment rate is still low, considering that for age groups 25 years of age and above, the unemployment rate remains around 3%.
- Overall, this weakness in the data could be just a normalization, after an extended period of very tight labor conditions and since job gains and job openings remain favorable. Positively, modestly weaker current labor market conditions may encourage the Fed to ease. Either way the labor market needs to stabilize to give the market confidence that the trajectory of the general economy can remain positive.
- The Institute for Supply Management (ISM) data for both manufacturing and services has weakened below 50, indicating contraction, but remain above levels usually consistent with recessions.
- The Atlanta Fed's GDPNow, a running estimate of GDP growth based available economic data, also indicates a slowdown is underway. It is now projecting 1.5% GDP growth, down from 4.2% in the middle of the second quarter. This is a sizeable negative change, but it still suggests positive growth for the second quarter.

Inflation continues to trend favorably. Inflation readings in May were lower than expected. Most components of CPI and Personal Consumption Expenditures (PCE), the Fed's preferred measure of inflation, are trending lower. Shelter (primarily rents) remains the main component of inflation that is keeping the overall level of CPI and PCE elevated. It is reported on a lag and more real time measures of rent inflation suggest the rate of increase in rents has already returned to low levels. Core PCE and Core CPI, ex housing, reached 2.0% and 1.9%, respectively, in May, as displayed in the chart below. It also illustrates that this cycle of inflation was Covid related and has already returned to the Fed's target when adjusting for the lagging component of shelter.

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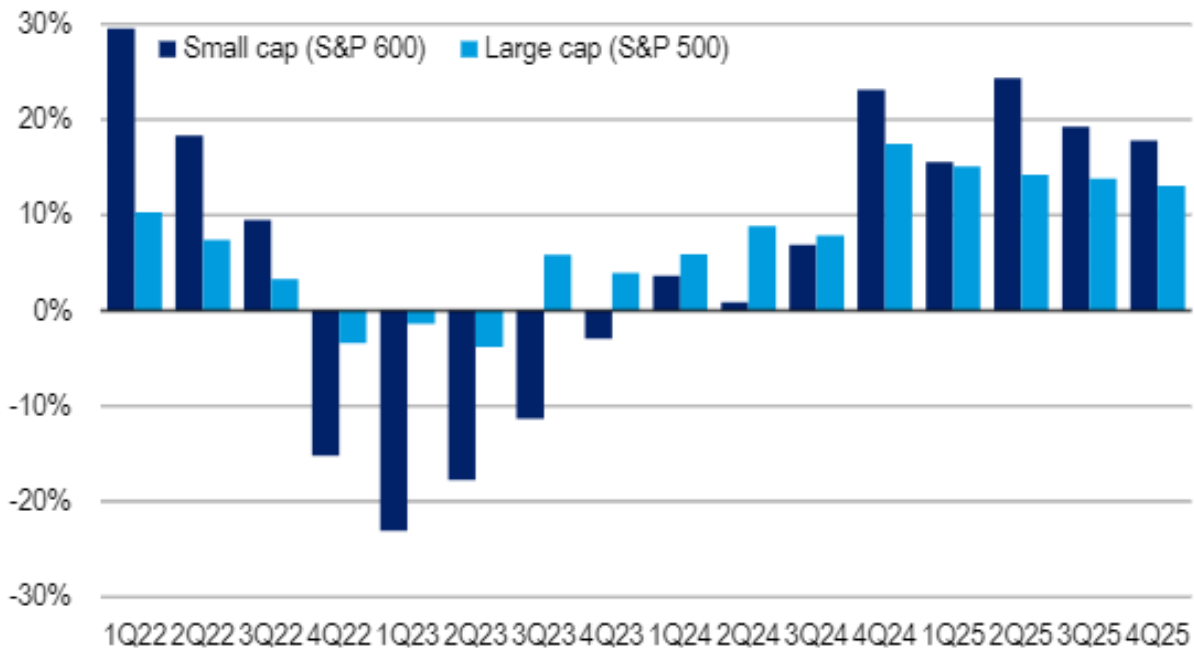
Exhibit 3: Core Consumer Prices ex Shelter Already at the Fed's 2% Target



Source: BEA, BLS and Yardeni Research

So, we have reached the halfway point of the year. Earnings overall are continuing to improve, for both small caps and large caps. As the bar chart below shows, after an earnings recession in 2023, aggregate earnings have turned positive on a year-over-year basis. While delayed a bit versus recent expectations, overall small cap earnings are still expected to outpace large cap earnings in the fourth quarter and in 2025. Many individual small cap companies are seeing earnings growing much faster than these averages.

Exhibit 4: Small cap profit growth expected to outpace large cap profits growth in Q4 and in 2025



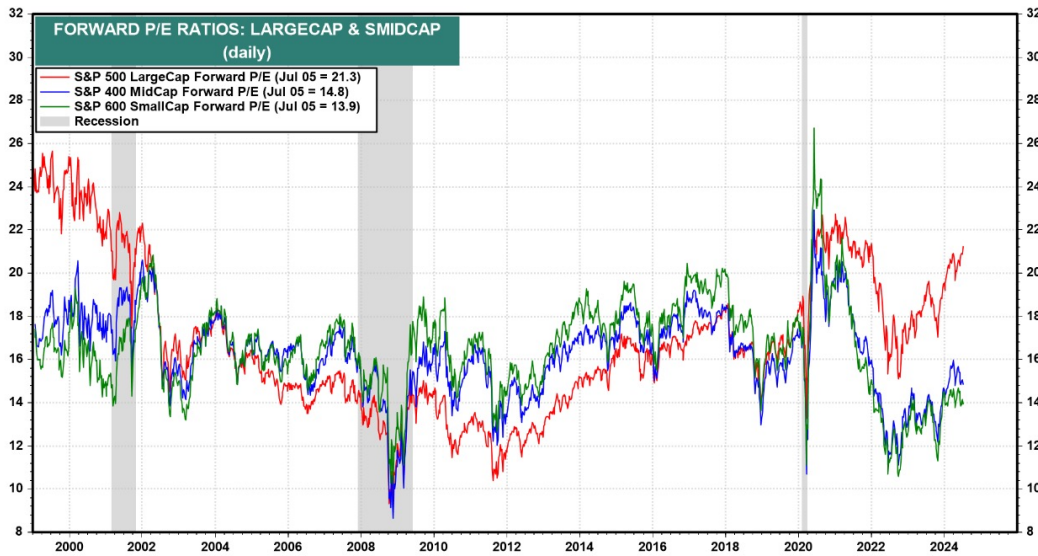
Source: BEA, BLS and Yardeni Research

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I How are valuations?

Given the strength in large cap performance since the market highs in 2021, large cap valuations have traded at a premium to micro and small cap valuations. Note the two valuation charts below. Whether looking at the Russell or the S&P indices, small caps currently trade at a deep relative discount. Historically, this is unusual as small caps have traded at a premium to large caps over the past several decades. This premium has likely been due to the inherently bigger growth potential and greater prospects for M&A (mergers and acquisitions). The first valuation chart below also shows how the absolute and relative valuations for small caps are both at a major discount compared to the past two and a half decades.

Exhibit 5: Small Caps remain historically cheap on an absolute and relative basis



Source: Yardeni Research

Exhibit 6: Small Caps remain historically cheap vs large caps

Relative Forward P/E: Russell 2000 vs Russell 1000, 1985-6/30/2024



Source: BofA Global Research

Overall, the macro environment has become more uncertain on the economic front but clearer in terms of inflation. Assuming our base case scenario holds, where the current economic moderation stabilizes, earnings recover as consensus estimates assumes, disinflation continues and the Fed leans dovish, the outlook for equities for the second half of the year could be quite attractive.

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Historically, a positive first half of the year usually leads to a positive second half of the year, especially during Presidential election years. Of course, if the recent economic weakness deteriorates further or if the improvement in inflation were to stall, the outlook for equities would become more bearish. As always, we will be monitoring these macro developments carefully as they will play a heavy role in the market's outlook, and they will influence our selection of particular industries and individual stocks.

I Performance Review

For the June quarter, the Driehaus US Micro Cap Equity Fund outperformed its benchmark by 540 basis points. The Fund gained -0.2% (I USD share class) net of fees, while the Russell Micro Cap Growth Index was down -5.6%, the Russell Micro Cap index declined 5.3%, the Russell 2000 fell 3.3%, the Russell 2000 Growth dropped 2.9% and the S&P 500 grew 4.3%.

Individual company earnings and fundamental outlooks were strong for our holdings during the second quarter. These bottom-up results are supported by multiple themes and industry trends that we view as sustainable. In terms of attribution, the portfolio's outperformance was primarily driven by a strong stock selection effect of 5.6%, although this was slightly offset by a sector allocation effect of 4 basis points. The healthcare sector led the way, contributing outperformance of 3.2%, the technology sector contributed outperformance of 2.0%, and the industrial sector contributed outperformance of 2.0%.

For more detail by sector, the June quarter performance is summarised as follows (in order of relative outperformance):

Healthcare

Healthcare added 13 basis points in absolute returns and outperformed by 315 basis points as our holdings were down 0.49%, outperforming the decline of 9.5% for the index. A significant portion of the outperformance came from the medical device sub-industry as it contributed 159 basis points in relative outperformance. Among the med device holdings that performed well, two were focused on ophthalmology and another on diabetes. But the key performer in the quarter was an innovative company servicing the organ transplant market. This holding gained 103% as it reported another large quarterly earnings surprise. Its revenues grew 133% year-over-year, which was well above expectations, as it generated substantial operating leverage that produced earnings per share of 35 cents vs the consensus estimate of two cents. It also raised its forward guidance significantly.

Biotech/Pharma outperformed, contributing 103 basis points relative to the index. Our absolute weighting in the biotech sub-industry did not change during the quarter and we currently have an inline weighting versus the index. The Fund remains underweight in the pharma sub-industry. Within biotech/pharma we remain encouraged fundamentally as we believe our holdings have very promising and innovative clinical stage therapies demonstrating superior efficacy and safety in important disease indications, such as obesity, epilepsy, endocrinology, diabetes, neurology, autoimmune diseases, vaccines, and oncology. We anticipate promising results from upcoming clinical trials.

Most of our exposure continues to be in medical devices and biotech/pharma on a sub-industry basis. Our healthcare absolute exposure increased 210 basis points during the quarter but our relative underweight finished the quarter at 630 basis points versus the benchmark.

Technology

Technology added 49 basis points in absolute performance and outperformed by 195 basis points versus the index, as our holdings returned 5.4% versus a loss of 9.2% for the index's holdings. All the outperformance, 210 basis points, came from the semiconductor group, as our semi holdings significantly outperformed, appreciating 25.7% versus a decline of 19.7% for the index. We held a handful of holdings that reported strong earnings reports and are benefitting from the hardware infrastructure buildout to support AI (Artificial Intelligence) applications. These holdings range from semi cap equipment companies to semiconductor/component suppliers to data centers. During the quarter we did increase our exposure to semiconductors, raising our overweight from 3.4% to 5.6% as the fundamental outlook for our holdings and the industry as a whole have improved dramatically.

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Software also outperformed during the quarter, but we maintain an underweight as IT budgets are shifting away from enterprise software towards AI and its supporting infrastructure. Cybersecurity remains a robust area within software as cyber-attacks continue to grow in number and sophistication. Several industries have been hard hit this year by cyber-attacks that have severely disrupted their operations in high profile attacks.

We increased our tech sector exposure by 90 basis points, maintaining an underweight due to our underweight in software. The increase in exposure to the sector occurred in a variety of hardware companies tied to AI.

Industrials

Industrials added 150 basis points in absolute terms and contributed 195 basis points of relative outperformance as our holdings gained 8.2%, outperforming the 0.20% decline for the industrial sector in the index. We remain overweight the sector at 20.9% vs 15.1% for the index. We continue to be positive on the sector as reshoring remains a strong theme. We also hold positions benefiting from attractive trends within commercial aerospace, infrastructure, and data centers where AI is driving demand for various technologies and equipment.

Consumer Discretionary

Consumer discretionary detracted 52 basis points in absolute terms but added 16 basis points in relative terms. We saw strength in restaurants, specialty retail, and for-profit education. Homebuilding is a sub-industry that we reduced as the group began to lag and fundamentals are slowing due to unfavorable home affordability. Overall, we decreased our sector exposure by 300 basis points, ending the quarter with an overweight exposure at 10.8%, versus 6.9% for the index.

Consumer Staples

Consumer staples contributed 64 basis points in absolute terms and added 11 basis points in relative terms as our holdings gained 31.9%, outperforming the 15.4% return for the index. We reduced our exposure slightly and maintain a small underweight for the sector. Among our holdings there is a specialty food company and a cosmetics company which performed well during the quarter as they both continue to gain share and post strong earnings surprises. This strength was offset by weakness in an energy drink company. This holding has been a significant outperformer for the past several years for the portfolio, but the company experienced sharp revenue deceleration during the quarter as it faces tough comparisons of three consecutive years of one hundred percent plus revenue growth. We believe the stock is going through a valuation adjustment as it seeks to stabilize its growth trend at a more modest level. As a result, we exited the position.

Energy

The energy sector detracted 32 basis points in absolute returns but 15 basis points in relative returns. We maintained the same absolute weight during the quarter and ended the quarter with an overweight position at 4.3% vs 3.1% for the index.

Financials

Financials detracted 118 basis points in absolute terms and 91 basis points in relative terms. All of the underperformance came from specialty insurance as a couple positions pulled back in price after positive performance last year and in the first quarter.

We remain positive on the insurance industry as it is undergoing significant positive change in pricing and the supply/demand environment. We are also positive on other holdings in the capital markets, regional banking sub-industries. We did reduce our exposure to the sector from 9.5% to 7.5% and have a slight underweight versus 7.8% for the index.

Outlook & Positioning

Equities performed in a mixed fashion during the June quarter as the mega cap stocks continued to outperform and investors monitor the macro environment as both economic data and inflation continue to moderate.

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The positive outlook consists of economic growth stabilizing (we believe it will stabilize despite the current soft patch), favorable inflation trends, a neutral to dovish Federal Reserve monetary policy position, the prospect of rate cuts later in the year and improving earnings. Small caps also continue to trade at a deep discount to large caps. The market's breadth and overall technical picture also remain attractive.

A more bearish outlook consists of further economic weakness, inflation that becomes sticky and doesn't trend lower, either of which will reduce multiples for equities. Other key bearish variables could be weaker earnings, US political disfunction and geopolitical issues outside of the U.S. We continue to lean positively, as we see the economy, inflation and earnings continuing to trend in a favorable direction.

In terms of portfolio positioning, we have an attractive mix of secular and cyclical growth holdings. By sector, industrials are our largest absolute weight, followed by healthcare, technology, and consumer discretionary. On a relative basis, the Fund is overweight industrials, energy, and technology. The Fund is underweight healthcare, financials, and communication services.

Sincerely,

Heptagon Capital and Driehaus Capital Management

I Sector performance attribution- Q2 2024

GICS Sector	Driehaus Micro Cap Growth Composite (Port) (%)		Russell Microcap® Growth Index (Bench) (%)		Attribution Analysis (%)		
	Port Avg. Weight	Port Contrib To Return	Bench Avg. weight	Bench Contrib To Return	Allocation Effect	Selection + Interaction	Total Effect
Comm. Services	3.43	-0.43	2.80	-0.08	0.03	-0.40	-0.36
Consumer Discretionary	11.93	-0.52	10.08	-0.47	-0.03	0.19	0.16
Consumer Staples	2.28	0.64	3.36	0.48	-0.22	0.33	0.11
Energy	4.64	-0.32	3.32	-0.17	0.04	-0.18	-0.14
Financials	8.38	-1.18	7.50	-0.11	0.05	-0.95	-0.90
Health Care	31.44	0.13	35.39	-3.69	0.25	2.99	3.24
Industrials	21.14	1.50	15.39	-0.02	0.29	1.67	1.96
Information Technology	13.03	0.40	16.37	-1.56	0.10	1.85	1.95
Materials	3.14	0.27	3.45	-0.03	-0.06	0.24	0.19
Real Estate	0.00	0.00	1.10	0.03	-0.09	0.00	-0.09
Utilities	0.00	0.00	1.24	0.00	-0.06	0.00	-0.06
Cash	0.59	0.00	0.00	0.00	0.03	0.00	0.03
Other*	0.00	-0.30	0.00	0.00	-0.29	0.00	-0.29
Total	100.00	0.19	100.00	-5.61	0.05	5.75	5.80

Sources: Driehaus Capital Management LLC, Factset Research Systems, Inc., eVestment Alliance

*Other refers to securities not recognised by Factset.

Data as of 30th June 2024

Annualized Total Returns as of 30th June 2024 gross of fees

	Q2 24	YTD	1-Year	3-Year	5-Year	10-Year
Driehaus Micro Cap Growth Composite	0.3%	15.1%	16.3%	-3.0%	17.0%	17.6%
Russell Micro Cap Growth Index TR	-5.6%	0.7%	2.5%	-13.6%	2.9%	3.6%

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.

The views expressed represent the opinions of Driehaus Capital Management, as 30th June 2024, are not intended as a forecast or guarantee of future results, and are subject to change without notice.

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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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