

# Driehaus US Small Cap Equity Fund

## Q4 2023 Commentary

### Portfolio Management



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### 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 15.1 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 31<sup>st</sup> July 2019 and had AUM of USD 571m as of 31<sup>st</sup> December 2023. During the fourth quarter of 2023, the Fund underperformed its benchmark, the Russell 2000 Growth Index TR USD (the "Index"), returning 8.9% (I USD share class) compared to 12.7% for the Index.

### Market Overview

The equity market action in the December quarter continued to be driven by the direction of US Treasury yields. After a rough October month for equities, the stock market bottomed at the end of October as Treasury yields peaked. As yields fell (the 10-year Treasury yield went from 5% in late October to under 4% in late December), equities experienced a sharp rally for the last two months of the year.

Lower yields were fueled in part by continued positive signs of disinflation towards the Fed's target inflation level of two percent. Slowing inflation prompted Federal Reserve Chair Jay Powell at the December Federal Open Market Committee (FOMC) meeting to pivot away from raising interest rates and toward possibly cutting rates in 2024. This is an important change in the Fed's monetary policy positioning.

The Russell small cap indices saw strong double digit returns for the December quarter, with gains of over 20% for the months of November and December as rates declined. Large caps also performed well, with the S&P 500 gaining over 11% for the quarter, but small equities outperformed after the market bottomed as yields fell, aided by the Fed's dovish pivot.

The substantial rally in the December quarter enabled 2023 to end up being a strong year for the U.S. equity market. This was a welcome bounce back after the sharp bear market decline of 2022. For the full year 2023, large caps outperformed small caps

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as the mega cap tech stocks (the Magnificent Seven) drove meaningful outperformance in the large cap indices and the Nasdaq. Interestingly, on an equal weighted basis, excluding the Magnificent Seven, the S&P 500 performed in a similar manner to small caps.

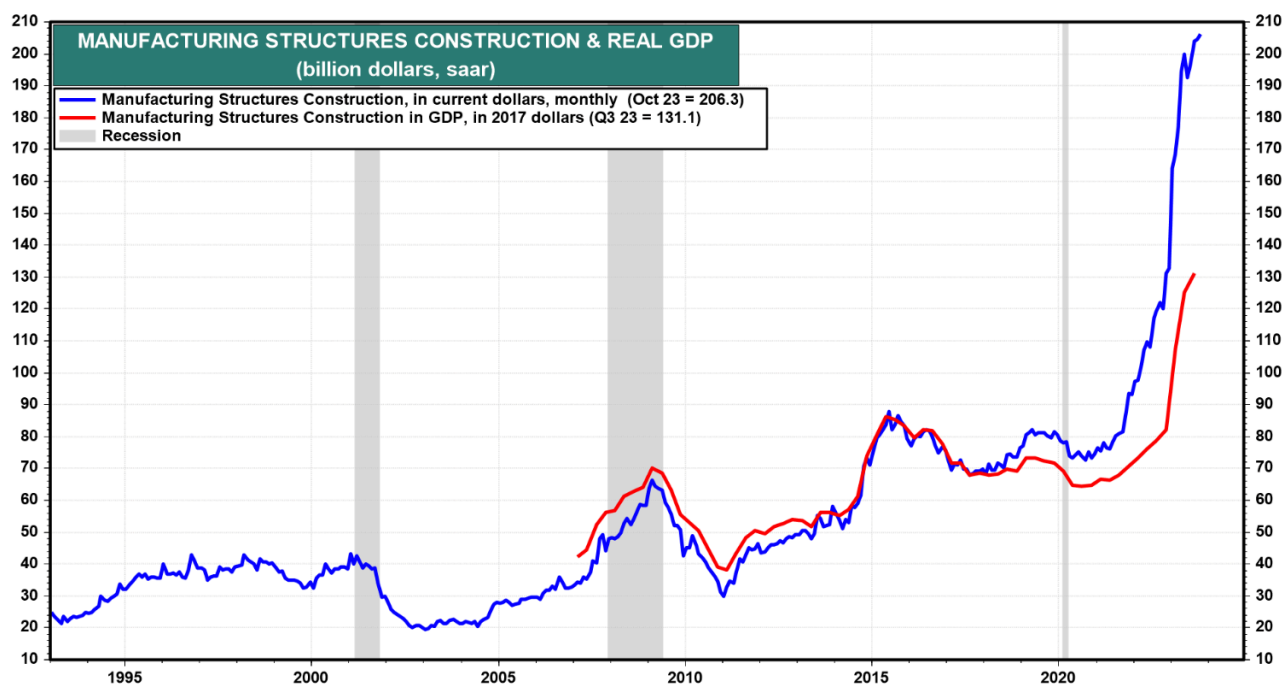
From a macro perspective, the U.S. economy continues to grow and there are no immediate signs of a recession. The labor market remains very resilient with strong job growth and low unemployment claims. While the inverted yield curve still needs to be respected due to its track record of consistently preceding recessions, there are multiple reasons why a recession could be avoided all together. These include tremendous fiscal stimulus, healthy consumer balance sheets, the strong labor market, the unique nature of the post-pandemic recovery, improving productivity, reshoring of manufacturing back to the U.S. and the idea that a number of key areas of the U.S. economy already experienced rolling recessions at different intervals and are now seeing a series of rolling expansions.

## **I A look ahead towards 2024**

Could the long bear market for small caps be over? The bear market started in 2021 and was one of the longest and deepest small cap bear markets in history. The recent price action in equities suggests the bear market may be over and a new market cycle may be underway. Again, we must respect the inverted yield curve and the potential for a recession, but there are compelling reasons to be bullish as 2024 gets underway. Consider the following:

- Inflation is trending positively towards the Fed's two percent target. High inflation and the Fed's hawkish policy strategy which raised the federal funds rate by over 500 basis points to tame inflation was the ultimate cause of the 2021-2023 bear market for small caps and the average U.S. stock. The primary drivers of this recent inflation were all pandemic related and they have all normalized. Rent inflation, which is the largest component in the Personal Consumption Expenditures (PCE) and the Consumer Price Index (CPI) calculations, works on a lag, and should continue to fall meaningfully, putting downward pressure on official inflation readings.
- The Fed has made a dovish pivot and has guided for rate cuts in 2024. This is a huge and important shift. The number of Fed rate cuts is of course uncertain. Some are calling for three rate cuts while others are calling for up to six cuts. Driehaus expects something closer to three cuts as six cuts would require an intense recession. Rate cuts (along with lower inflation) should be positive for equity multiple expansion.
- The U.S. consumer is in good shape as their balance sheets are generally strong and the labor market remains healthy. Consumer confidence is mixed but consumer spending remains resilient. Some argue the low-end consumer has largely depleted its Covid-related savings but as long as the labor market remains solid, this risk to economic growth remains low. Also, some labor market metrics have softened incrementally, but thus far jobless claims, layoffs and job openings all remain strong historically.
- Technology spending and AI (Artificial Intelligence) may drive meaningful productivity gains. Tech spending should remain strong (absent a recession) as corporate profits remain positive. There are multiple positive trends and themes within technology and AI that are driving IT spending, and many expect it to increase productivity as AI applications become more prevalent.
- Reshoring remains a powerful theme. It is creating a boom in construction and manufacturing. Companies have recognized the challenges of supply chain disruptions and geopolitical issues. Driehaus believes the trend towards reshoring (or onshoring) should be meaningful for multiple years looking ahead. This is a huge driver for economic growth for the U.S. and a big tailwind for many industrial and technology companies. To illustrate, consider the acceleration in growth of new manufacturing construction in Exhibit 1.

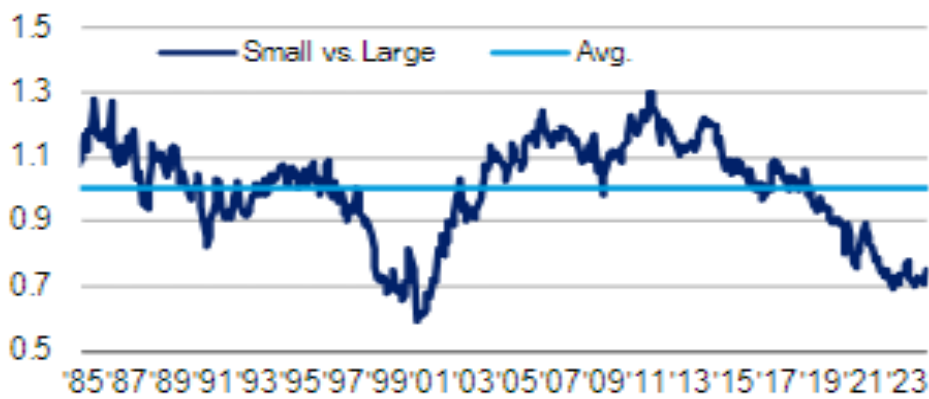
Exhibit 1: Manufacturing Structures Construction and Real GDP



Source: LSEG Datastream and Yardeni Research

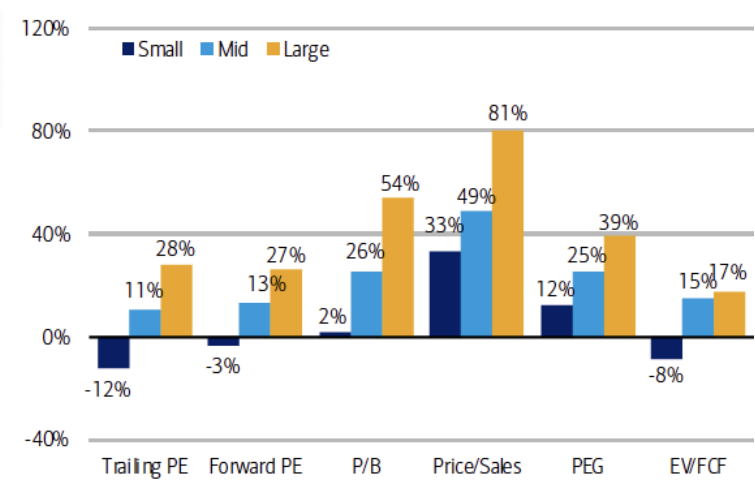
- Housing is experiencing a strong recovery. The recent fall in mortgage interest rates since late October is supporting new home construction. There is a large shortage of homes in the U.S. as the country has underbuilt new homes compared to population growth since the housing bubble preceding the Great Financial Crisis (the GFC). Home construction is an important economic multiplier. This should give a boost to many housing-related companies and industries.
- The geopolitical environment remains volatile but most of the global challenges should remain contained. The wars in Ukraine and Gaza are sad, awful tragedies and the concern is they spread into broader regional conflicts. While possible, the risk to markets should be modest if the conflicts remain contained to their current geographic areas and crude oil doesn't spike materially higher. The China-Taiwan conflict is another uncertain wild card, but the current economic woes in China likely reduce the chances of a Chinese invasion near-term. Economic conditions around the world are mixed but are unlikely to cause major economic weakness in the U.S.
- The valuation difference between small caps and large caps continues to be very favorable for small caps. Please see the valuation charts in Exhibit 2. Two of the charts show how small caps typically trade at a premium to large caps but currently they trade at a deep discount. While Driehaus have highlighted these charts previously, they believe they remain relevant.

Exhibit 2: Valuation Charts  
Relative Forward P/E: Russell 2000 vs 1000, 1985-12/31/2023



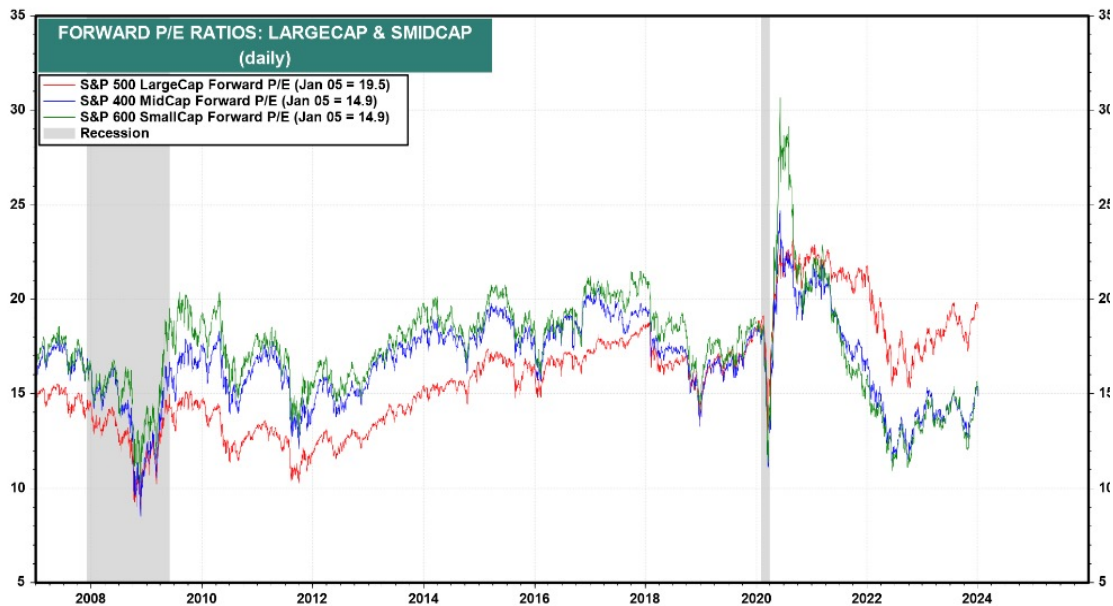
Source: BofA US Equity & Quant Strategy, FactSet

Small Cap Least Expensive vs History on Half of Metrics Except Price/Sales, PEG and P/B  
Russell 2000, Russell Midcap and Russell 1000: Valuation Premium (discount)  
vs history across metrics (1/31/1985-12/31/2023)



Source: BofA US Equity & Quant Strategy, FactSet

Forward P/E Ratios: Large Cap & SMID Cap



Source: LSEG Datastream and Yardeni Research

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## I Performance Review

For the December quarter, the Driehaus US Small Cap Equity Fund underperformed its benchmark. The Fund gained 8.9% (I USD share class) net of fees, while the Russell 2000 Growth Index was up 12.7%, the Russell 2000 rose 14.0%, and the S&P 500 grew 11.7%.

For the full year 2023, the Driehaus US Small Cap Equity Fund underperformed its benchmark. For the year, the Fund appreciated 18.2% (I USD share class) net of fees, while the Russell 2000 Growth Index gained 18.7%, the Russell 2000 rose 16.9%, and the S&P 500 gained 26.3%. Market cap (i.e., size) was clearly a key risk factor driving returns for the market in 2023.

It was a difficult quarter for the Fund on a relative basis. The rally in November and December was led by laggards over the past year with many low-priced stocks driving the index higher. Short covering was also a leading risk factor which resulted in many stocks with the highest short interest outperforming. This type of leadership is not uncommon in the initial phases of a new market rally and can be considered a good sign that the rally has legs. However, in Driehaus's decades of experience this sort of laggard, short covering driven rally has never proven to be a sustainable market dynamic. Still in the last two months of the year, in Driehaus's view, this rally was consistent with lower quality fundamental companies outperforming.

By sector, the December quarter performance is summarized as follows:

### Industrials

Industrials added 356 basis points in absolute terms but detracted 53 basis points on a relative basis as the Fund's holdings were up slightly less than those in the index and the Fund was overweight the sector. The Fund continues to be positive on the sector as reshoring remains a strong theme and importantly, the Fund sees many individual holdings with robust fundamental trends. The Fund also holds positions with positive trends in strong areas such as commercial aerospace, infrastructure and building materials. The outperformance of the benchmark was largely due to a sharp bounce-back, particularly in building materials, where the Fund is underweight the Index. Rather than any performance issues with the Fund's holdings, which were generally positive, laggard stocks within the index appreciated with the general market.

### Technology

Technology underperformed by 158 basis points versus the index, as the Fund's holdings returned 7.3% versus a gain of 13.9% for the index. By sub-industry, the Fund's holdings outperformed in communication equipment and electronic equipment, but those gains were more than offset by underperformance in semiconductors and software. Semiconductors detracted as two semis that had been successful positions over the past year declined during the quarter as their key end market, EVs (electric vehicles), experienced demand weakness. The Fund exited both of those positions. A couple of semi cap equipment positions performed well as they are benefitting from infrastructure buildout for AI. Software contributed over 100 basis points in absolute terms but detracted in relative terms.

The Fund has an overweight in the tech sector of roughly 230 basis points. The Fund's exposure to the tech sector increased slightly during the quarter.

### Healthcare

Healthcare added 300 basis points in absolute returns and outperformed by 32 basis points versus the benchmark as the Fund's holdings had greater returns than the holdings in the index. Biotech/pharma was the big mover driving sector returns. It added 232 basis points to absolute performance but detracted 36 basis points on a relative basis. A handful of biotech holdings performed well with several announcing successful clinical trial data, but two biotech positions announced disappointing clinical results. One of these disappointments was more mixed in Driehaus's view and they remain very positive about the company's outlook. The other was a more severe outcome and the Fund has exited that position. One holding was acquired by a big pharma company for nearly a 50% premium versus the prior day's close

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and it gained nearly 80% for the quarter. The Fund is positioned with an absolute weighting in biotech/pharma at over 14.5%, which is overweight the index's 13% weighting.

Within biotech/pharma, Driehaus are quite encouraged as they believe their holdings have 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. Driehaus anticipates promising results from upcoming clinical trials as they prove successful outcomes.

The other sub-industries within healthcare contributed nearly 70 basis points on a relative basis. Driehaus are bullish on the outlook for the Fund's medical equipment (med devices) holdings. It outperformed by 32 basis points, and the Fund was slightly overweight the med device sub-industry.

## Financials

Financials underperformed by 124 basis points versus the index. About half of the underperformance in financials occurred in the payments area as two holdings had adverse reactions to quarterly reports. The Fund sold one of the positions and maintained the other as Driehaus believe the outlook for this holding remains bright. The other half came from specialty insurance as one position that has been very successful for the Fund over the past several years pulled back in price as it experienced a deceleration in its growth rate. Driehaus believes the deceleration was due to one-time factors and the outlook for this holding remains very bright.

## Consumer Staples

Consumer staples outperformed the index by 14 basis points and contributed 91 basis points in absolute terms. The outperformance was driven by a cosmetic manufacturer that continues to outperform as well as a specialty food company that continues to grow rapidly, gain market share, and expand its earnings well above expectations. The Fund continues to see positive trends for several holdings in the specialty beverage, food, and health/beauty industries. The Fund reduced the Fund's weighting to the sector by 100 basis points but maintain an overweight position at 6.9% versus 5.4% for the index.

## Energy

The energy sector contributed eight basis points in relative returns but detracted 28 basis points in absolute returns. A couple uranium producers continued to perform well but that strength was more than offset by modest underperformance in oil services as that group pulled back with the weakness in crude oil. The Fund reduced its sector exposure from over 8% to 4.8% (versus 4.5% for the index) as the oil/gas stocks weakened and the Fund identified better opportunities elsewhere.

## Consumer Discretionary

Consumer discretionary contributed 119 basis points in absolute terms but detracted 10 basis points in relative terms. The Fund saw strength in several areas including specialty retail, home building, building materials, and e-commerce. This strength was offset by underperformance in declines in a couple auto supplier positions that the Fund have since exited. The Fund maintains an underweight exposure to the sector at 8.8%, versus 11.1% for the index.

## Outlook & Positioning

The December quarter marked an important juncture for the equity market with inflation continuing its trend lower, the very significant policy pivot by Jay Powell and the Federal Open Market Committee (FOMC), and the robust equity rally in November and December. Near-term the market is a bit overbought after the sharp year-end rally, but the market's breadth and overall technical picture are the best Driehaus have seen since before the bear market. Near-term market conditions will continue to be influenced by the direction of treasury yields, inflation, and of course, the Fed. Valuations remain appealing for small caps, especially compared to large caps. As detailed above, small cap stocks in general continue to trade at their second largest discount to large caps over the past 40 years. The case for small cap stocks is also very compelling as history shows that small caps typically materially outperform during the first five years or more of a new market cycle and post dovish policy shifts by the Fed.

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As outlined earlier in this commentary, there are multiple reasons to be constructive on the market as 2024 gets underway. Key reasons are lower inflation, potential rate cuts or at least more dovish Fed policy, the current economic strength, and the ample evidence that the widely expected recession is not here yet. There are multiple reasons the U.S. should continue to avoid a recession. That said, we do need to respect the impeccable record of the sharply inverted yield curve in predicting recessions. There is of course the long and variable lag of monetary policy, and it would be historically unique for a recession to be avoided, nonetheless the reasons for economic growth to continue are very persuasive.

In terms of portfolio positioning, the Fund had an attractive mix of secular and cyclical growth holdings. By sector, healthcare is the Fund's largest absolute weight, followed by industrials, technology, consumer discretionary, and financials. On a relative basis, the Fund is overweight industrials, consumer discretionary, consumer staples and financials. The Fund is underweight healthcare, technology, and energy.

## I Quarterly Contributors

**Nuvalent, Inc Class A (NUVL)** is a clinical stage biopharmaceutical company, which focuses on creating precisely targeted therapies for patients with cancer. In October, NUVL released for the first time in human dose escalation data for their ALK inhibitor, which showed not only proof of concept in later lines of therapy but also provided a signal that made it seem more likely that NUVL's product would provide benefit in earlier lines of patient. As a result, the market's implicit probability of success increased, driving valuation higher.

**BellRing Brands, Inc. (BRBR-US)** is a rapidly growing leader in the global convenient nutrition category offering ready-to-drink shake and powder protein products. The company was a top contributor due to a strong September quarter earnings report and favorable guidance for fiscal year 2024. The company's primary product, Premier Protein, had accelerated consumption and meaningful distribution gains, with improved capacity allowing for incremental promotional activity and expansion of the company's shake flavors.

## I Quarterly Detractors

**Aehr Test Systems (AEHR)** engages in the design, manufacture and marketing of test and burn-in products to the semiconductor manufacturing industry. The company was a top detractor from the Fund as its top customer for wafer level burn-in test equipment forecasted weaker revenue trends from the electric vehicle end market with plans to moderate spend on capital equipment in 2024. The Fund reduced its weighting in the position.

**Chart Industries, Inc. (GTLS)** engages in the manufacturing of engineered equipment for the industrial gas, energy, and biomedical industries. GTLS reported earnings in late October 2023 and missed consensus revenue and earnings per share estimates by ~13% and 14% respectively. Despite this miss, GTLS reduced its FY23 guidance by less than this amount when factoring in divestitures and reiterated FY24 revenue and EBITDA guidance that was 8% and 15% above estimate. Investors believe GTLS's outlook for 2024 is too optimistic which has negatively impacted sentiment. Last year GTLS made a large acquisition that was very unpopular with investors. However, GTLS is tracking ahead on revenue and cost synergies and leverage targets for this acquisition. After the recent sell-off GTLS trades at a very reasonable valuation compared to its historical valuation range and is a less cyclical company. The weak sentiment carried from the earnings report carried over into December and as a result GTLS was a top detractor. The Fund continues to hold a position in GTLS.

## I Outright Buy

**Western Alliance Bancorp (WAL)** is a bank holding company, which engages in the provision of deposit, lending, treasury management, international banking, and online banking products and services. WAL was a top new position after the Fed pivoted away from its hawkish policy, yielding visibility into a more favorable interest environment. With an improved outlook for deposit costs and credit losses remaining low, the Fund expects WAL to see multiple expansion and get more credit for a superior growth outlook.

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**Boise Cascade Co. (BCC)** engages in the manufacture and distribution of engineered wood products (EWP) and plywood. BCC is benefitting from an improving residential construction market. They are driving share gains in Wood Products and producing stronger margins in their distribution business. BCC's Wood Product business has been able to secure veneer supply through strategic acquisitions that have put them in an advantageous position to serve the market relative to their competitors. The result has been improving earnings estimate revisions beginning in mid-2023.

**Wingstop, Inc. (WING)** is a franchisor and operator of restaurants, which engages in the provision of cooked-to-order, hand-sauced, and tossed chicken wings. The Fund initiated a position after multiple data sources indicated sales trends were outperforming despite lapping difficult compares associated with the launch of a chicken sandwich in 2022. Subsequently, 3Q23 earnings significantly exceeded consensus estimates and the Fund further increased the Fund's position.

## **| Outright Sell**

**Axcelis Technologies, Inc. (ACLS)** engages in the manufacture of capital equipment for semiconductor chip manufacturing including ion implant tools for Silicon Carbide (SiC) modules used in electric vehicles. The Fund eliminated the position from the Fund as multiple Silicon Carbide (SiC) module manufacturers reported weaker than expected growth in 4Q23 driven by weak trends in the electric vehicle end market with plans to moderate spend on capital equipment in 2024.

**Procore Technologies Inc. (PCOR)** engages in the development of cloud-based construction management software. During the quarter, PCOR reported weaker than expected results as higher interest rates resulted in longer lead times and delays in planned construction projects with 2024 revenue growth expected to be below 20% vs market expectations of 25%. The Fund eliminated the position given the large downside revision to company's growth.

**Tidewater Inc. (TDW)** engages in the provision of offshore marine support and transportation services to the offshore energy industry. The firm offers the towing of, and anchor handling for, mobile offshore drilling units, transporting supplies and personnel necessary to sustain drilling, work over and production activities, offshore construction and seismic and subsea support, geotechnical survey for wind farm construction, and a variety of specialized services such as pipe and cable laying. The Fund eliminated the position during the quarter as oil prices declined on macroeconomic fears and increased supply.

Sincerely,

**Heptagon Capital and Driehaus Capital Management**



## Sector performance attribution- Q4 2023

	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	2.11	0.57	2.58	0.46	-0.01	0.16	0.15
Consumer Discretionary	8.21	1.19	11.07	1.56	-0.02	-0.07	-0.09
Consumer Staples	7.31	0.91	4.56	0.63	0.12	0.02	0.14
Energy	7.24	-0.28	5.16	-0.6	-0.56	0.65	0.09
Financials	5.75	-0.57	6.44	0.81	0.00	-1.24	-1.24
Health Care	16.24	3.00	21.17	3.17	-0.05	0.44	0.38
Industrials	26.38	2.94	19.96	2.50	-0.07	-0.68	-0.74
Information Technology	22.18	1.37	21.66	3.04	-0.11	-1.46	-1.57
Materials	2.98	0.28	4.17	0.55	0.00	-0.16	-0.16
Real Estate	0.00	0.00	1.62	0.35	-0.13	0.00	-0.13
Utilities	0.00	0.00	1.61	0.15	0.06	0.00	0.06
Cash	1.59	0.00	0.00	0.00	-0.10	0.00	-0.10
Other*	0.00	-0.12	0.00	0.00	-0.12	0.00	-0.12
<b>Total</b>	<b>100.00</b>	<b>9.28</b>	<b>100.00</b>	<b>12.61</b>	<b>-1.00</b>	<b>-2.33</b>	<b>-3.33</b>

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

\*Other refers to securities not recognised by Factset.

Data as of 31<sup>st</sup> December 2023

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**Annualized Total Returns** as of 31<sup>st</sup> December 2023, gross of fees

	Q4 23	YTD	1-Year	3-Year	5-Year	10-Year
<b>Driehaus Small Cap Growth Composite</b>	9.4%	20.0%	20.0%	-1.0%	17.7%	14.2%
<b>Russell 2000 Growth Index TR</b>	12.8%	18.7%	18.7%	-3.5%	9.2%	7.2%

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 31<sup>st</sup> December 2023, 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

This Fund has been classified as an Article 8 for the purposes of the EU's Sustainable Finance Disclosure Regulation ('SFDR'). The Fund promotes environmental and/or social characteristics but does not have sustainable investment as its primary objective. It might invest partially in assets that have a sustainable objective, for instance assets that are qualified as sustainable according to EU classifications but does not place significantly higher importance on the environmental objective of each underlying investment. Please see [Prospectus](#) for further information on the Funds environmental and/or social characteristics and relevant sustainability risks and principal adverse impacts which may impact the Fund's performance.

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

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