Driehaus US Micro Cap Equity Fund

Q2 2021 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.

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The **Driehaus US Micro Cap Equity Fund** (the "Fund") is a sub-fund of Heptagon Fund Plc which is an open-ended umbrella type investment company 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 December 7, 2016 and had AUM of USD 911m as of June 30th, 2021. During the second quarter of 2021, the Fund outperformed its benchmark, the Russell Micro Cap Growth Index TR (the "Index"), returning 7.0% (I USD share class) compared to 3.2% for the Index.

Market Overview

The June quarter was another positive period of appreciation for the U.S. equity market. The single digit percentage gains for the indices were broad-based but most of the market was stuck in a side-ways consolidation. The churning, rotating action was below the surface of the S&P 500 and Nasdaq, both of which reached new all-time highs driven by the strength of the largest technology stocks.

The consistent retreat in bond yields during the quarter was a major factor driving the direction of stocks. The decline in yields occurred despite elevated inflationary pressures and robust economic growth. Growth stocks were supported by the falling yields and driven by strong performance in the technology and healthcare sectors. Cyclical stocks (outside of the energy sector) and "reopening" stocks generally underperformed in the second half of the quarter as yields continued to fall and concerns about "peak" growth and the emerging Delta variant increased.

From a macro standpoint, the combination of very strong monetary and fiscal stimulus is providing tremendous support for the post-COVID economic recovery. The successful uptake of the COVID vaccines by nearly 70% of U.S. adults is enabling the economic reopening. These factors together with powerful pent-up consumer demand and very low inventories across most industries are producing economic strength and a rapid recovery in the labor market but are also fueling the threat of inflation.

The pace and sustainability of inflation has been an all-consuming topic for the market. The Federal Reserve believes it is transitory, but how long is transitory? Many indicators suggest the rate of inflation may have already peaked versus easy year-over-year comparisons. Peak stimulus and peak economic growth rates may have already occurred, a view corroborated by the decline in most commodity prices and bonds yields. Importantly, "peak" rates of growth don't mean the end of the economic cycle. Inflation and economic growth can remain elevated for some time. The U.S. economy is in year one of a new cyclical expansion and for context the last five U.S. expansions lasted 5 to 10 years. Still, component and inventory shortages together with labor shortages will continue and are being reported (or complained about) by nearly every industry. Some fear this is holding back economic growth and is pressuring corporate margins and the potential for even higher earnings. That is likely true, but the interesting part is that supply chain and labor constraints will likely elongate the cycle and prevent overheating.

It has become widely understood by market participants that economic growth and earnings will be strong as the economy reopens. The ongoing consolidation or rotation over the past couple months, outside of some of the largest S&P 500 stocks, is likely the result of the market transiting through a period of uncertainty. There is uncertainty surrounding monetary policy as the Fed will soon begin to transition away from crisis level monetary accommodation via tapering of asset purchases. There is also uncertainty around the magnitude of deceleration in economic growth from peak growth rates to a more sustained (but still strong) level of economic growth. A series of economic indicators have missed expectations recently but that is potentially due to component and labor shortages. As the market digests these uncertainties, it is likely setting up some appealing opportunities in the second half of the year as many cyclicals and small caps consolidate and earnings and the economy establish a new sustainable level of growth. Of course, these scenarios could be disrupted if the variants cause COVID cases to spike and economic shutdowns are mandated. Positively, the evidence to date suggests the mRNA vaccines continue to perform relatively well versus the variants, especially in limiting severe disease and new booster shots will likely become available versus the variants later this year.

Performance Review

For the June quarter, the Driehaus US Micro Cap Equity Fund solidly outperformed its benchmark. The Fund had a 7.04% return, while the Russell Microcap Growth Index experienced a gain of 3.18%. The Fund also outperformed the small cap indices, such as the Russell 2000 which gained 4.29% and the Russell 2000 Growth which rose 3.92%, but it did trail the S&P 500 which gained 8.55%.

The relative outperformance versus the Russell Micro Cap Growth index was driven by the portfolio's strong performance in several sectors including consumer discretionary, industrials, energy, and technology.

Despite the outperformance and positive absolute returns, it was a challenging quarter. The market's stock and sector leadership were very rotational. Cyclical and reopening stocks which had performed well over the prior couple quarters pulled back as bond yields declined, peak growth fears increased and as the Delta variant spread late in the quarter. Conversely, secular growth stocks, which had a poor first quarter, resumed their leadership and performed well late in the quarter. Macro factors, such as the daily direction of bond yields, risk factors and correlations appeared to be more impactful than bottom up characteristics during the quarter. Many "reopening" stocks should handily exceed consensus expectations as their fundamental trends remain strong but most experienced multiple compression regardless. Despite this, the portfolio benefited from strong earnings reports and being well diversified across the various growth categories (secular, cyclical, consistent, recovery) which helped it outperform.

Consumer Discretionary and Staples

The consumer discretionary sector holdings experienced strong returns (nearly 14%), adding over 300 basis points in absolute returns and 160 basis points on a relative basis and was the portfolio's largest sector overweight vs the benchmark. As the economy begins to reopen and the labor market recovers, the benefits of stimulus, very high savings rates and massive pent-up demand is driving consumer spending above expectations. Notable outperformers during the quarter included several specialty retailers, online gaming/casino vendors and leisure product companies.

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Consumer staples also added nicely to outperformance as an energy drink producer, a wine producer and a skin products company all performed strongly.

Industrials

The industrials sector also performed well. Outperformance of just over 140 basis points came from a handful of holdings in the aerospace, shipping, machinery, and auto leasing industries. After a strong first quarter, leisure focused airlines detracted from performance as cyclical and reopening stocks generally declined despite a robust recovery in demand.

Energy

While it is a small weighting, the portfolio was overweight the energy sector and it returned almost 26% in the quarter contributing over 130 basis points on an absolute basis and over 100 basis points relative. The sector is the best performing sector in the U.S. market so far this year as crude oil surged to well over $70 by the end of the quarter. The sector has largely been abandoned by public investors in recent years due to poor returns and excess capital spending over the past decade. Now the industry is more rational in how it spends capital and the rig count is rising again as demand and the commodity price recovers. From an ESG standpoint, we carefully assess each new holding. We hold one oil service company that improves worker and well site safety and an exploration and product company which has a target of being carbon neutral in the future.

Technology

Technology outperformed contributing 61 basis points on both an absolute and relative basis. It continues to see strong fundamental trends in most of its sub-industries and the group was able to perform well as bond yields fell, enabling some multiple expansion. Software and IT service stocks recovered after they trailed in the first quarter. The performance of our semiconductor and semi capital equipment holdings were mixed. Big picture, the outlook for semiconductors and related capital equipment remains bright as it is one of many industries seeing shortages as inventories are at very low levels. Telco equipment holdings performed well as rural broadband spending is robust due to government stimulus to upgrade connectivity in rural sections of the country.

Healthcare

Healthcare also began to recover as bond yields fell. The portfolio's healthcare holdings outperformed slightly as the sector contributed over 100 basis points on an absolute basis but was neutral on a relative basis as we were underweight the benchmark. It does remain our largest sector weighting on an absolute basis. IPO activity within the group remains strong with many companies coming public during the quarter. The level of innovation we see in healthcare is exciting. Biotech/therapeutics, molecular diagnostics and med-tech all stand to benefit strongly looking forward as these companies improve the standard of care and provide better outcomes for patients.

Outlook & Positioning

The outlook for the economy, earnings and equities remains positive as there are multiple drivers supporting the economic reopening. The mRNA based COVID-19 vaccines are working very well and appear to provide good protection from new variants. The percentage of adult Americans who are vaccinated is near seventy percent. The rise of the Delta variant is a concern, but the risk of it materially impacting the U.S. economy is relatively low given the effectiveness of existing vaccines and additional boosters. For the most part, the U.S. has now come close to fully reopening across the country.

We believe the US economy will likely sustain strong growth well into next year due to many positives, including: the vaccines, pent-up demand, high savings rates, multi-decade low inventories, extremely easy monetary policy and large fiscal policy stimulus. Even as some of these inputs see "peak" growth or peak impact, they all should provide a series of strong tailwinds.

Additionally, smaller cap valuations are favorable compared to large caps with earnings growth rates that are much stronger than large caps. Micro and small caps generally perform well for years from the beginning of a new expansion. Post the Nasdaq Bubble and post the Great Financial Crisis, smaller caps outperformed large caps for five to six years.

These positives need to be framed by the risks that exist. The numerous risks include: the Delta and other virus variants, the sizable segment of the population (about 25% in the U.S.) that is hesitant or refuses to take one of the vaccines, inflation pressures, changes in monetary policy, major changes in interest rates, new regulations on business and higher taxes, a stronger dollar, labor shortages and rising wages. All these risks are nuanced and may end up helping the market climb the wall of worry, but we are monitoring each one carefully.

We are confident that the US has entered a new economic expansion with many powerful drivers. This should result in a sustained new economic cycle and we anticipate broad participation from most sectors and industries, including both secular growth and cyclical companies. In terms of portfolio positioning, healthcare remains our largest absolute weight, followed by technology, consumer discretionary, industrials and financials. Versus the index, the strategy is overweight consumer discretionary, industrials, energy, and technology and is underweight health care, financials, real estate, and consumer staples.

Overall, we see many dynamic investment opportunities in improving or sustainable industries, which fit our investment philosophy of companies exhibiting positive growth inflections, differentiation, market share gains, strong revenues and expanding profitability.

Quarterly Contributors

- Celsius Holdings, Inc. (ticker: CELH-US) is a lifestyle fitness and energy drink manufacturer. The company's unique positioning as a healthier and fitness-oriented energy drink has proven to be a key driver of its growth. CELH contributed 102 bps in the quarter as the stock has multiple expansion due to a strong 1Q21 earnings surprise, rapid market share gains at new and existing retailers and continued momentum seen in retail scanner data.

- Everi Holdings Inc. (ticker: EVRI-US) is a leading provider of game content and gaming machines, systems and financial technology solutions for land-based and iGaming operators. EVRI has seen consistent market share games in gaming content/machines and has assembled an attractive set of financial technology capabilities that are enabling customers to begin early deployments of cashless gaming. EVRI contributed 74 bps in the quarter as 1Q21 results beat expectations handily followed by a positive preannouncement of 2Q21 results.

Quarterly Detractors

- Magnite (Ticker: MGNI) provides technology solution to automate the purchase and sale of digital advertising inventory. The stock declined & detracted 45 bps as the company's earnings result in early May disappointed with key fast growing CTV segment missing consensus estimates. We eliminated the position to allocate in to higher conviction ideas.

- Pubmatic (Ticker: PUBM) is a cloud infrastructure platform vendor facilitating digital advertising transactions. The stock declined & detracted 37 bps ahead of Google's chrome cookie elimination proposal, IPO lock-up expiration in early June. We continue to see potential upside to forward estimates and maintained our position exiting the quarter.

Outright Buy

- Intellia Therapeutics (Ticker: NTLA) is a development-stage biotech company. The company's gene editing technology is the first of its kind to undergo robust characterization in humans, and their first-in-human results were released in June of 2021. The data released indicated clear evidence of therapeutic effect with a wide margin for safety. Durability and long-term safety will be important to watch going forward.

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Outright Sell

- Magnite (Ticker: MGNI) provides technology solution to automate the purchase and sale of digital advertising inventory. The stock declined as the company's earnings result in early May disappointed with key fast growing CTV segment missing consensus estimates. We eliminated the position to allocate in to higher conviction ideas.

Sincerely,
Heptagon Capital and Driehaus Capital Management

Sector performance attribution- Q2 2021

	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	2.37	0.16	2.09	0.32	0.06	-0.21	-0.16
Consumer Discretionary	22.11	3.05	13.13	1.01	0.41	1.19	1.60
Consumer Staples	5.32	0.87	1.90	0.30	0.43	-0.07	0.36
Energy	5.40	1.36	0.63	0.08	0.14	0.87	1.00
Financials	7.72	-0.04	2.33	0.14	0.18	-0.48	-0.31
Health Care	23.81	1.06	46.32	1.81	-0.18	0.15	-0.03
Industrials	12.77	0.81	8.77	-0.64	-0.41	1.83	1.43
Information Technology	18.67	0.61	20.47	0.17	0.11	0.53	0.64
Materials	0.92	-0.10	1.29	-0.03	-0.07	-0.07	-0.15
Real Estate	0.00	0.00	2.30	-0.03	0.11	0.00	0.11
Utilities	0.19	-0.13	0.77	0.02	0.05	-0.15	-0.1
Cash	0.71	0.00	0.00	0.00	0.09	0.00	0.09
Other*	0.00	-0.34	0.00	0.00	-0.34	0.00	-0.34
Total	**100.00**	**7.31**	**100.00**	**3.16**	**0.57**	**3.58**	**4.15**

Sources: Driehaus Capital Management LLC, Factset Research Systems, Inc., eVestment Alliance
**Other refers to the securities not recognised by Factset.*

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Annualized Total Returns as of June 30th, 2021, gross of fees

	Q2 21	YTD	1-Year	3-Year	5-Year	10-Year
Driehaus Micro Cap Growth Composite	7.6	21.6	94.0	38.8	38.5	24.7
Russell Micro Cap Growth Index TR	3.2	20.6	65.8	17.3	18.8	13.0

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.

Important Information

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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.

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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