# Driehaus Emerging Markets Sustainable Equity Fund

## Q2 2021 Commentary

## Fund Manager

**Richard Thies** **Chad Cleaver** **Howard Schwab**

## 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 13 billion of assets under management.

## Contact


**Heptagon Capital**
63 Brook Street, Mayfair,
London W1K 4HS

Tel: +44 20 7070 1800
Fax: +44 20 7070 1881
email london@heptagon-capital.com


The **Driehaus Emerging Markets Sustainable Equity Fund** (the "Fund"), 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. Driehaus exercises discretionary investment authority over the Fund. The Fund was launched on June 25, 2012 and had AUM of USD 97m as of June 30th, 2021. Driehaus Capital Management LLC was appointed Sub-Investment Manager of the Fund on December 6, 2016. Prior to this OFI Global Institutional, Inc. was the Sub-Investment Manager from June 25, 2012 to December 5, 2016.

The Fund (I USD share class) has a 5-star Morningstar rating over the past 3 and 5 years since Driehaus took over portfolio management.

## Market Overview

Secular growth and work-from-home assets outperformed in 2020 as the world struggled with the initial onset of COVID-19. In the first quarter of 2021 cyclical and value assets rebounded as vaccines were rolled out and the world emerged from lockdown. That quickly led to myriad reports of inflation, with concerns amplified by the Fed's stated willingness to let the economy run hot.

In the second quarter, the backdrop shifted as apprehension grew over peaking economic growth (the World Bank forecasts 5.6% world GDP growth in 2021 followed by 4.3% in 2022). And some of the concerns over inflation began to recede, at least temporarily. Several factors contributed to this.

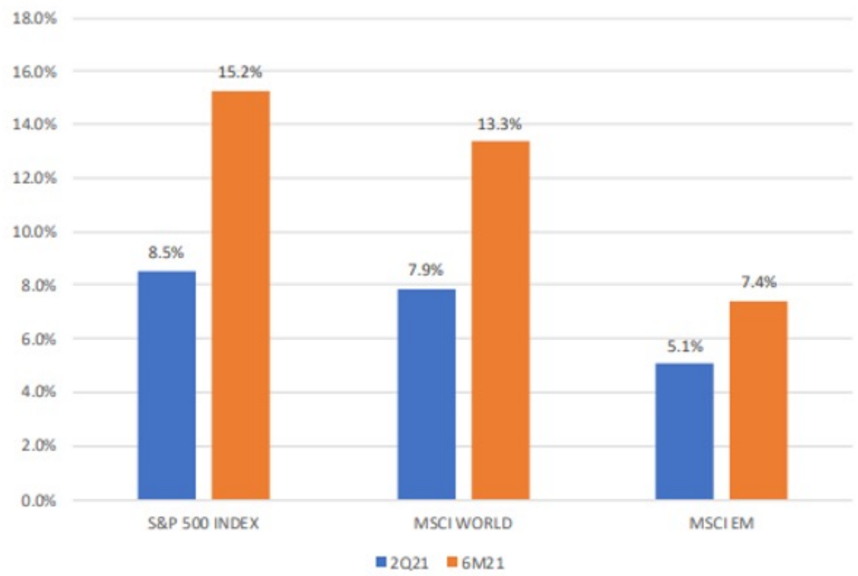
First, the Fed indicated it may not be as dovish as previously thought. Despite the Fed's average inflation targeting framework, the June FOMC meeting showed that most members expect at least two rate hikes in 2023 with some members expecting hikes as early as 2022. This meeting was taken to indicate that the Fed may not let the economy run as hot as previously expected, which in turn lowered long-term growth expectations and flattened the yield curve. After peaking on the last day of the first quarter at 1.74%, the US 10-year yield drifted downwards throughout the spring and finished the quarter below 1.50%.

Next, the price of key industrial commodities like copper and lumber rolled over during the quarter as demand softened (to some degree in response to the rapid increase in prices over the last year but also as supply bottlenecks eased). China also acted to contain commodity prices by announcing plans to release strategic reserves of metals onto the market (one notable exception within commodities was oil where prices have continued to climb as recovery demand has outpaced supply and OPEC+ has not yet been able to agree on production increases).

Third, COVID-19 has continued to weigh on sentiment, particularly after the emergence of the highly contagious "delta" variant. While early findings indicate that the main vaccines are effective against new variants including delta, much of the world is still struggling to ramp up vaccinations, particularly within Emerging Markets (EM).

Finally, China continued to focus on limiting new credit growth and has been more focused on reorganizing the economy than growing it, at least relative to recent history (Exhibit 1).

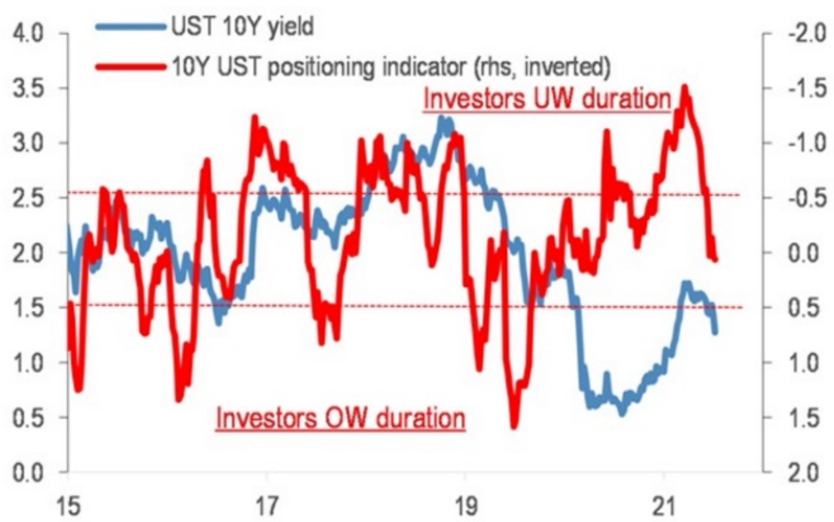
**Exhibit 1: Global Indices Total Return 2021**




*Source: Bloomberg*

Meanwhile, positioning had become increasingly concentrated in value and cyclical stocks as well as treasury shorts (betting that rates would continue to rise) (Exhibit 2).

**Exhibit 2: Treasury Yield and Positioning**

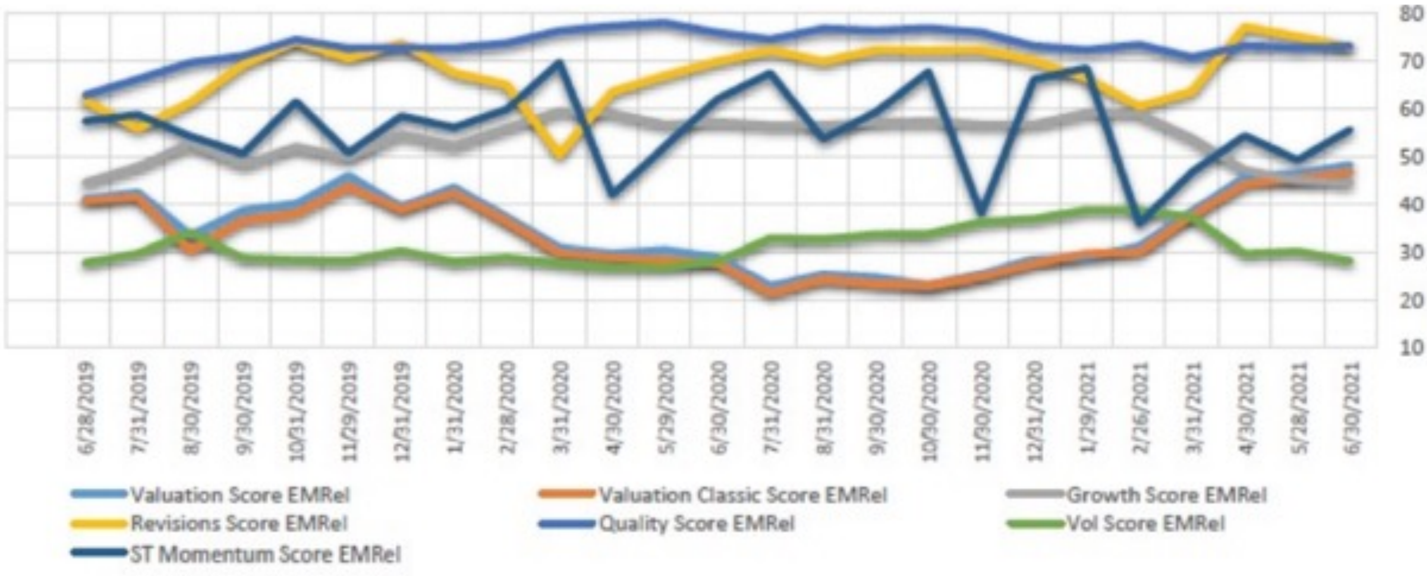



*Source: JPMorgan*

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

Aside from industry positioning data, our team tracks the factor composition of the quintile of stocks with the highest medium-term momentum to approximate these risks (Exhibit 3). Since the initial vaccine efficacy data was announced, the stocks with the highest momentum were increasingly coming from lower valuation cyclical areas like banks, miners, and construction equipment. Conversely, the momentum of growth stocks had started to fall. These factors contributed to a reversal of factor performance towards the end of the second quarter (i.e. growth rebounding against value).

**Exhibit 3: Q1 Medium-Term Momentum (With 1M) Decomposition – Factors**




*Source: FactSet Research Systems LLC*

Besides factor and risk rotations, one of the biggest issues for EM at large is what is happening in China. There has been an avalanche of regulatory announcements that have meaningfully weighed on sentiment and performance, especially in the internet industry. Long-time EM investors are well used to parsing policy pronouncements and regulations, but the magnitude of what has been announced recently has made the landscape even more challenging. We address this in more detail in the 'Outlook and Positioning' section below.

## Performance Review

The Heptagon Driehaus Emerging Markets Sustainable Equity Fund (Class I USD) returned +7.6% in the second quarter, besting the 5.0 return of the MSCI EM Index.

Health care, information technology and financials were the top performing sectors during the quarter. Within health care, the Fund's position in a China-domiciled manufacturer of biologics services performed particularly well. Within information technology, the Fund held stocks benefiting from rising demand for artificial intelligence (AI) computing: a chip design company, a leading semiconductor capital equipment maker, and a chip substrate manufacturer. The deployment of AI computing has been broadening out from just the hyperscale cloud services providers to the broader enterprise market as tools like recommendation engines and natural language processing become more common. The materials and energy sectors detracted from performance primarily due to active underweights in steel, iron ore and energy related stocks.

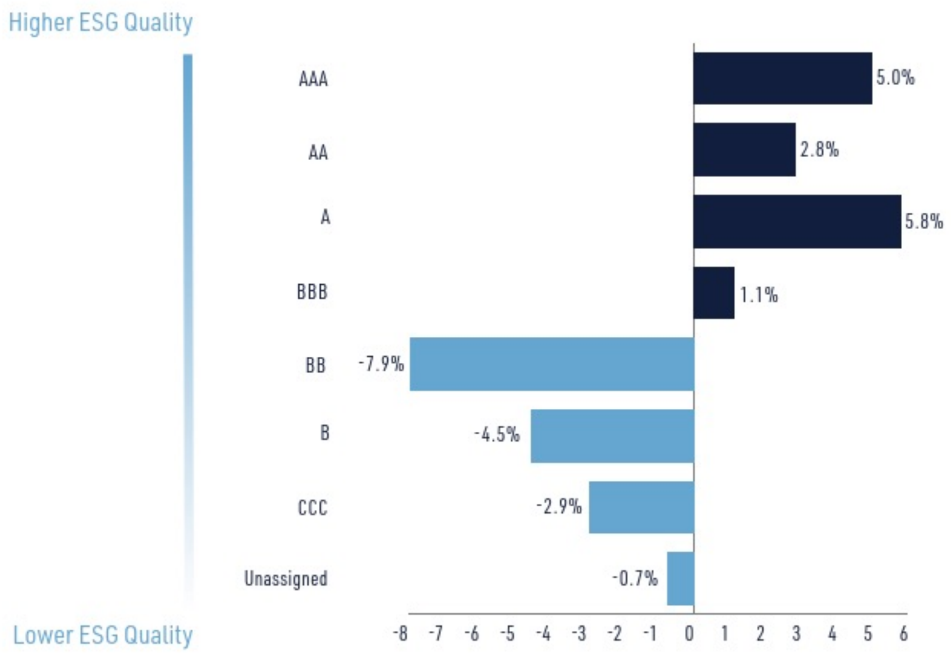
China was the highest contributor to positive attribution on a country basis. The Fund is underweight relative to the benchmark primarily owing to a more cautious view on the earnings outlook given adverse regulatory activity and muted economic growth. India was the largest country detractor. The Fund has a positive active weight which hurt performance as India continued to suffer with COVID-19 during the quarter.

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

## Sustainability

The Fund finished the quarter with markedly better ESG characteristics, on an aggregate basis, than its benchmark index (Exhibit 4).

**Exhibit 4: ESG Ratings: Fund vs. MSCI EM Index as of 30/6/21**




*Source: FactSet Research Systems LLC & MSCI Inc.*

The Fund remains focused on renewable energy-related investments in various capacities. We mentioned in our previous commentary that we had reduced some exposure in some areas where we felt valuations were unattractive. Early quarter weakness in many parts of the battery supply chain and the Chinese EV-OEM space allowed us opportunities to add to favored names. Within this space, we remain positive on the automakers with the highest brand equity in the EV space in China, the battery manufacturing and component space as well as the automotive semiconductor industry.

Additionally, we are starting to see more opportunities in Brazil in companies in areas as diverse as agriculture and sanitation who are among the first emerging market corporates to be benefiting from higher carbon pricing on exchanges globally.

## Outlook and Positioning

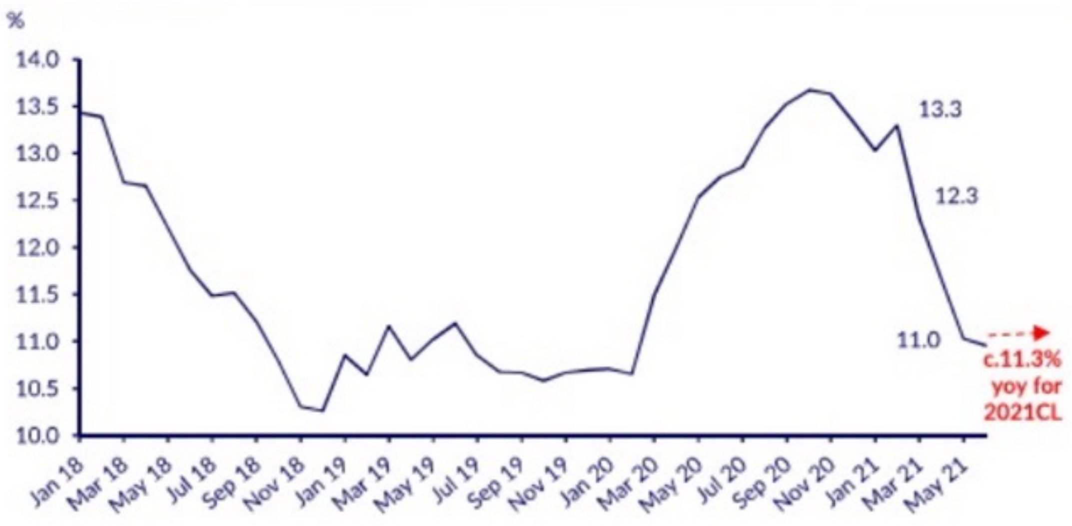
While growth rates will peak this year, the global economic outlook remains on solid ground. US household balance sheets remain healthy due to the high degree of savings and stimulus payments with pent up demand for services. Many industries are still seeing demand run ahead of supply, most notably autos. While some commodities have corrected, the ongoing strength in the price of oil is indicative of robust demand for travel and trade. Both fiscal and monetary policy will remain broadly stimulative even as the Fed moves to marginally scale back monetary accommodation.

The backdrop in China is also starting to shift. After getting the initial outbreak of COVID-19 under control, China's policy makers clamped down on credit growth in pursuit of their longer-term goal to reduce leverage in the system. This dynamic, combined with appreciation in the Chinese Yuan (CNY) and higher commodity prices, acted to tighten financial conditions and weighed on growth in the first half.

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

However, the country announced a cut in its Reserve Requirement Ratio (RRR) for essentially all banks in early July. The real economic impact of this should be relatively modest. It releases more liquidity into the system but does not directly stimulate consumption (and some of the liquidity will be used to repay maturing medium-term lending facilities rather than supporting new lending).

**Exhibit 5: China's total social financing balance growth (YoY)**




*Source: CLSA, PBOC, Wind*

Nevertheless, the RRR cut is still impactful as a signalling device. The market generally interprets these actions to mean that the People's Bank of China (PBOC) was uncomfortable with the degree that growth is slowing and will take steps as needed to support the economy. We do not take this to indicate a full-blown easing cycle but do think it modestly improves the outlook for Chinese equities, particularly with respect to local investors being willing to take more risk. (Exhibit 4).

However, the slightly dovish shift in monetary policy has been more than offset by some of the most extreme regulation on the internet and adjacent industries that we can recall. Last year, a China observer may have concluded that blocking the Ant Group IPO was done to get the company (and its founder) under control and to make sure incentives were aligned as to avoid risky lending practices. But the events of 2021 make clear that the regulators have far more comprehensive ambitions.

It is beyond the scope of this commentary to detail everything that has been announced. Nevertheless, an overview of the key developments offers some perspective as to the scope of the crackdown:

- Penalties for abusive market actions such as: 1) forcing a merchant or restaurant to list exclusively on one ecommerce platform, 2) selling items below cost, 3) failing to get proper approval of past investments.
- Blocking of industry mergers that lead to too much market concentration.
- Mandatory data management and cybersecurity reviews to make sure sensitive data is not brought outside of the country. Also, a crackdown on unnecessary data collection. And banning of apps that do not comply, at least temporarily.
- Expected changes that would clamp down on the variable interest entity (VIE) structure that has enabled foreigners to own companies in certain restricted industries such as internet and education. (We don't think this rule will result in forced delisting or annulment of existing VIEs.)
- Reduction in online payment and lending fees.
- Expected restrictions on third-party after school tutoring and requirements that schools offer better extracurricular programs. Also, more controls over time spent playing online games by minors.

In isolation, these actions do not really seem overly extreme. While many of them are about increasing state control over the tech giants, some of these things are also being done to help the average citizen or small business. It is not so much any one action that is a problem but more the lingering uncertainty as to how strictly these will be implemented and what else may be in the pipeline.

Clearly, figuring out the outlook amidst all these ongoing actions has become challenging, especially because much of this is not yet finalized. But we can sketch out some of the broad ramifications:

- Investors needing to increase the discount rate assigned to China internet stocks, both because of the increased earnings uncertainty but also because these actions collectively indicate an industry that is operating at the behest of the state rather than shareholders (this has always been true in China but was easier to ignore when the government was not harming the profit outlook).
- Fewer new equity listings in the US, more in Hong Kong and Mainland China. Those that do list will require explicit government clearance (meanwhile, the US is still moving forward with plans to delist foreign companies that do not comply with SEC audit requirements). This will serve to further fracture the technology and financial ecosystems of the West and China.
- Given China internet has long been a favorite industry for investors, we could see outflows to other internet and large cap EM names.

Considering these developments, the strategy maintained its underweight to China during the quarter and modestly brought down its consumer discretionary weight (where many internet stocks are classified). Additionally, rather than trying to call out policy winners and losers, our team has been increasingly focused on anchoring our investment decisions based on our confidence level in the fundamental earnings drivers.

As the second largest economy and manufacturing engine of the world, it is impossible for EM to really disconnect from what's happening in China. Fortunately, there are some positive offsets beginning to emerge. Part of what makes EM challenging is how heterogeneous it is; the "asset class" is nothing more than a loosely linked group of countries across the world. But this also means it offers a highly dynamic opportunity set. Given how fast the world changes, there is usually something positive happening.

We are becoming increasingly positive on two emerging developments. First, India is increasingly building out its domestic manufacturing capabilities. Last year the government instituted a production-linked incentive (PLI) scheme that aims to make domestic manufacturing more competitive and encourage investment. The PLI scheme is targeted at multiple sectors and should help India compete more effectively with other regional manufacturing hubs.

So far PLI has seen good initial traction and anecdotally multiple companies that we follow have talked about increasing production in India. Given the size of the domestic market we think firms are well incentivized to participate. Additionally, India's timing is good as the trade war and pandemic have revealed how fragile supply chains are when too concentrated geographically. If the PLI scheme and similar efforts are successful in building up India's manufacturing base, it could set off a virtuous cycle with rising employment and infrastructure development which in turn would drive up income levels and consumption (GDP per capita in China is still >5x higher than in India).

The second dynamic we're positive about is increased equity capital markets activity in South East Asia and India. These markets have historically had few listed technology and internet stocks. But thanks to rising private market funding, high smartphone penetration, and a relaxation of some listing rules we expect to see several new companies list publicly in the coming years. These companies operate in markets with some of the most attractive demographics where basic services like banking are still highly underpenetrated. Perhaps most importantly, they will likely face a much less adversarial regulatory environment compared to Chinese and Western internet firms.

In conclusion, while the markets are always filled with uncertainty, the current market backdrop is especially challenging. Investors need to manage through a normalization in economic growth and policy even as new COVID-19 variants present risks.

It's still not clear whether we're heading back into the 'secular stagnation' world of the last five years or if the second quarter was just a blip on the way to inflation and faster growth. Meanwhile, the regulatory environment globally is increasingly antagonistic which could limit justified valuations and future growth opportunities.

Investors need to be laser focused on observing the world around them and how it has changed because of the pandemic. But disruption and turmoil will lay the foundation for growth and new possibilities. We will continue to work hard on your behalf to find these opportunities and are grateful for your trust and confidence.

Sincerely,
***Heptagon Capital and Driehaus Capital Management***

## Sector performance attribution- Q2 2021

| | Driehaus Emerging Markets Sustainable Equity Fund (Port) (%) | | | MSCI Emerging Markets Index (Bench) (%) | | | |
|---|---|---|---|---|---|---|---|
| **GICS Sector** | Port Avg. Weight | Port Total Return | Port Contrib. To Return | Bench Avg. weight | Bench Total Return | Bench Contrib. To Return | Total Effect |
| **Health Care** | 8.07 | 23.90 | 1.84 | 4.75 | 14.10 | 0.65 | 1.03 |
| **Information Technology** | 29.66 | 7.68 | 2.20 | 20.70 | 3.84 | 0.77 | 0.98 |
| **Financials** | 19.35 | 8.31 | 1.76 | 18.17 | 4.16 | 0.79 | 0.92 |
| **Communication Services** | 10.51 | 5.89 | 0.73 | 11.55 | 1.93 | 0.24 | 0.53 |
| **Consumer Discretionary** | 9.11 | 7.30 | 0.53 | 17.18 | 3.56 | 0.60 | 0.38 |
| **Consumer Staples** | 7.03 | 6.94 | 0.51 | 5.65 | 4.50 | 0.26 | 0.18 |
| **Real Estate** | 1.81 | -4.83 | -0.06 | 2.07 | -6.01 | -0.13 | 0.08 |
| **Utilities** | 1.58 | 4.05 | 0.07 | 1.99 | 2.00 | 0.04 | 0.04 |
| **Cash** | 3.07 | -1.19 | -0.02 | 0.00 | 0.00 | 0.00 | -0.17 |
| **Other** | 0.00 | -0.17 | -0.18 | 0.00 | 0.00 | 0.00 | -0.18 |
| **Industrials** | 5.23 | 9.63 | 0.41 | 4.52 | 13.17 | 0.57 | -0.21 |
| **Energy** | 1.26 | 3.36 | 0.01 | 4.89 | 12.44 | 0.58 | -0.39 |
| **Materials** | 3.31 | 2.26 | -0.01 | 8.53 | 8.19 | 0.67 | -0.43 |
| **Total** | **100.00** | **7.81** | **7.81** | **100.00** | **5.05** | **5.05** | **2.76** |

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

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

## Country performance attribution- Q2 2021

| | Driehaus Emerging Markets Sustainable Equity Fund (Port) (%) | | | MSCI Emerging Markets Index (Bench) (%) | | | Attribution Analysis (%) |
|---|---|---|---|---|---|---|---|
| **Country** | Port Avg. Weight | Port Total Return | Port Contrib. To Return | Bench Avg. weight | Bench Total Return | Bench Contrib. To Return | Total Effect |
| **China** | 22.78 | 9.84 | 2.29 | 34.34 | 2.66 | 0.98 | 1.95 |
| **United States** | 6.36 | 23.81 | 1.45 | 0.08 | -3.59 | -0.00 | 1.12 |
| **South Korea** | 12.64 | 9.53 | 1.15 | 13.36 | 4.83 | 0.63 | 0.57 |
| **Kazakhstan** | 0.98 | 48.67 | 0.37 | 0.00 | 0.00 | 0.00 | 0.33 |
| **France** | 1.95 | 17.19 | 0.34 | 0.00 | 0.00 | 0.00 | 0.25 |
| **Netherlands** | 2.13 | 10.41 | 0.22 | 0.28 | 9.62 | 0.03 | 0.11 |
| **Hungary** | 0.67 | 25.95 | 0.16 | 0.22 | 14.81 | 0.03 | 0.11 |
| **Singapore** | 0.69 | 18.26 | 0.13 | 0.02 | -11.76 | -0.00 | 0.11 |
| **Mexico** | 1.78 | 14.43 | 0.28 | 1.78 | 9.14 | 0.16 | 0.11 |
| **South Africa** | 1.79 | -2.17 | -0.04 | 3.72 | -1.58 | -0.04 | 0.10 |
| **Indonesia** | 1.15 | -1.81 | -0.02 | 1.18 | -5.14 | -0.06 | 0.04 |
| **Japan** | 1.39 | 5.49 | 0.07 | 0.00 | 0.00 | 0.00 | 0.00 |
| **Hong Kong** | 5.04 | 0.36 | 0.06 | 2.98 | -1.88 | -0.05 | 0.00 |
| **Sweden** | 0.22 | -3.08 | 0.00 | 0.00 | 0.00 | 0.00 | -0.03 |
| **Egypt** | 0.35 | -13.74 | -0.06 | 0.07 | -9.23 | -0.01 | -0.07 |
| **Argentina** | 1.04 | 0.17 | -0.02 | 0.11 | 6.07 | 0.01 | -0.08 |
| **Cyprus** | 0.67 | 2.97 | -0.01 | 0.14 | 36.54 | 0.05 | -0.08 |
| **Russia** | 1.44 | 13.91 | 0.20 | 2.70 | 13.59 | 0.36 | -0.10 |
| **Germany** | 1.13 | -6.20 | -0.06 | 0.00 | 0.00 | 0.00 | -0.13 |
| **Cash** | 3.07 | -1.19 | -0.02 | 0.00 | 0.00 | 0.00 | -0.17 |
| **Unassigned** | 0.00 | -0.17 | -0.18 | 0.00 | 0.00 | 0.00 | -0.18 |
| **United Kingdom** | 0.45 | -14.87 | -0.17 | 0.08 | 14.69 | 0.01 | -0.19 |
| **Canada** | 0.19 | -34.35 | -0.21 | 0.00 | 0.00 | 0.00 | -0.22 |
| **Brazil** | 3.86 | 17.62 | 0.72 | 4.89 | 22.91 | 1.01 | -0.27 |
| **Taiwan** | 13.45 | 5.41 | 0.56 | 13.95 | 7.09 | 0.94 | -0.34 |
| **India** | 14.81 | 4.14 | 0.59 | 9.70 | 6.91 | 0.66 | -0.35 |
| **Other countries in benchmark** | 0.00 | 0.00 | 0.00 | 10.39 | 41.28 | 0.36 | 0.17 |
| **Total** | **100.00** | **7.81** | **7.81** | **100.00** | **5.05** | **5.05** | **2.76** |

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

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

## Annualized Total Returns as of June 30th, 2021, (I USD share class)

| | Q2 21 | YTD | 1-Year | 3-Year | 5-Year |
|---|---|---|---|---|---|
| **Driehaus Emerging Markets Sustainable Equity Fund** | 7.6% | 8.2% | 45.6% | 16.0% | 16.7% |
| **MSCI Emerging Markets NR Index** | 5.0% | 7.4% | 40.9% | 11.3% | 13.0% |

*Source: Morningstar*

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

## Important Information

Past performance is not an indication or guarantee of future performance and no representation or warranty is made regarding future performance. This communication is for information purposes only. It is not an invitation or inducement to engage in investment activity.

The document is provided for information purposes only and does not constitute investment advice or any recommendation to buy, or sell or otherwise transact in any investments. The document is not intended to be construed as investment research. The contents of this document are based upon sources of information which Heptagon Capital believes to be reliable. However, except to the extent required by applicable law or regulations, no guarantee, warranty or representation (express or implied) is given as to the accuracy or completeness of this document or its contents and, Heptagon Capital, its affiliate companies and its members, officers, employees, agents and advisors do not accept any liability or responsibility in respect of the information or any views expressed herein. 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. Where this document provides forward-looking statements which are based on relevant reports, current opinions, expectations and projections, actual results could differ materially from those anticipated in such statements. All opinions and estimates included in the document are subject to change without notice and Heptagon Capital is under no obligation to update or revise information contained in the document. Furthermore, Heptagon Capital disclaims any liability for any loss, damage, costs or expenses (including direct, indirect, special and consequential) howsoever arising which any person may suffer or incur as a result of viewing or utilising any information included in this document.



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

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)

## Disclaimers

Source: MSCI. The MSCI information may only be used for your internal use, may not be reproduced or redisseminated in any form and may not be used as a basis for or a component of any financial instruments or products or indices. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each other person involved in or related to compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties (including, without limitation, any warranties of originality, accuracy, completeness, timeliness, non-infringement, merchantability and fitness for a particular purpose) with respect to this information. Without limiting any of the foregoing, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including, without limitation, lost profits) or any other damages. (www.msci.com)

The Global Industry Classification Standard ("GICS") was developed by and is the exclusive property and a service mark of MSCI Inc. ("MSCI") and S&P Global Market Intelligence ("S&P") and is licensed for use by Heptagon Fund plc. Neither MSCI, S&P, nor any other party involved in making or compiling the GICS or any GICS classifications makes any express or implied warranties or representations with respect to such standard or classification (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability and fitness for a particular purpose with respect to any of such standard or classification. Without limiting any of the foregoing, in no event shall MSCI, S&P, any of their affiliates or any third party involved in making or compiling the GICS or any GICS classifications have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages.