European Focus Fund: Monthly Commentary
September 2021

Fund Manager

Christian Diebitsch

Investment Objective

The Fund aims to deliver long-term capital appreciation by investing in European equities. The Fund employs a high conviction, bottom-up, low turnover, research driven strategy with a focus on companies that exhibit sustainable long- term growth.

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

What a difference a day makes – taper tantrum part two

September marked a distinct reversal in the price action of European equities which were on a roaring ascent for seven consecutive months. In fact, most Western stock markets saw profit-taking in September as leading central banks adopted a more hawkish stance to the timing of starting to taper their respective bond-buying programs. As always, the Fed has been very clear that monetary stimulus will be gradually scaled back depending on the pace of economic recovery, employment and inflation. The first hint that the sugar bowl would be removed followed from the FOMC meeting on the 28th of July when Chairman Jerome Powell remarked that 'transitory' inflationary pressures were at large in the US. At the annual central bank symposium in Wyoming on the 27th of August, Powell clarified that the Bank would differentiate between: (*i*) when the actual tapering process will start and; (*ii*) when the Bank will begin to raise interest rates. As the economic recovery, supply-chain issues, higher energy prices etc. have gradually pushed inflation and inflation-expectations higher, the FOMC meeting on the 22nd of September made it clear that the tapering process may commence soon after the Bank's next meeting on the 3rd of November.

Against this backdrop, the price action of asset classes dramatically changed following the Fed's comments in September. Long bond yields shot up (similar to what happened in February following the FOMC meeting on the 27th of January) and the US dollar started to appreciate. While a stronger US dollar normally benefits European equities (and indeed European Focus) given the region's significant export-dependency, higher bond yields generally have a negative impact on equity markets – and – initially on growth stocks in particular. Although the vast majority of the Portfolio holdings in European Focus are '*European Champions*' with leading-global footprints and pricing power, these attributes tend to command a premium valuation against the broader market. Consequently, European Focus had a weak month in September. The Fund fell by -6.67% in absolute terms vs. -3.01% of the benchmark index (-366bps underperformance), but the Fund still showed a healthy gain of +19.65% for the year to the end of September vs. +16.20% of the benchmark (+345bps outperformance). Closer analysis shows that the bulk of the underperformance of the Portfolio in September was triggered by the Fed's communiqué on the 22nd, i.e. over the last six trading days of the month.

The table below shows some market metrics from the end of August until the FOMC meeting starting on the 21st of September, over the last six trading sessions of September and during the full month. The left-part of the table (31-Aug to 21-Sep) shows that over the first three weeks, most factors behaved similarly to how they had behaved during most of 2021 and the Portfolio duly outperformed its benchmark. The middle-part of the table (21-Sep to 30-Sep) illustrates the development of the six last trading sessions and the right-part of the table (31-Aug to 30-Sep) the performance over the month of September.

Date	31/08/2021	21/09/2021	% Chg 31/8 to 21/9	21/09/2021	30/09/2021	% Chg 21/9 to 30/9	31/08/2021	30/09/2021	% Chg 31/8 to 30/9
Oil ($)	68.5	70.56	3.01%	70.56	75.03	6.34%	68.5	75.03	9.53%
EUR/USD	1.181	1.173	0.67%	1.173	1.157	1.34%	1.181	1.157	2.00%
US10yr	1.31	1.32	1.05%	1.32	1.4873	12.45%	1.31	1.49	13.64%
US5yr	0.77	0.83	7.35%	0.83	0.9649	16.37%	0.77	0.96	24.92%
US2yr	0.21	0.21	2.20%	0.21	0.2755	28.80%	0.21	0.28	31.63%
S&P500	4522.68	4354.19	-3.73%	4354.19	4307.54	-1.07%	4522.68	4307.54	-4.76%
MSCI	282.62	275.68	-2.46%	275.68	274.11	-0.57%	282.62	274.11	-3.01%
Energy	102.14	105.39	3.18%	105.39	115.13	9.24%	102.14	115.13	12.72%
Finance	63.03	60.31	-4.32%	60.31	63.11	4.64%	63.03	63.11	0.13%
Materials	353.94	326.58	-7.73%	326.58	327.32	0.23%	353.94	327.32	-7.52%
Tech/IT	195.02	195.59	0.29%	195.59	182.05	-6.92%	195.02	182.05	-6.65%

Source: Bloomberg

Analysing the different factors, the table shows that oil performed particularly well last month (the oil price started to move higher in a more distinct fashion from around mid-August) and it closed nearly +10% higher in September. The US dollar considerably strengthened against the euro following the FOMC meeting. Since there is normally a negative correlation between the oil price and the US dollar (i.e. a weaker dollar tends to lead to a higher oil price), we construe that the higher prices for oil as well as the US dollar on this occasion pertained to 'other factors', such as higher energy demand in China, shortage of natural gas reserves in Europe, the UK petrol crisis and the risk of energy/electricity disruptions during the forthcoming winter.

It is also noticeable how bond yields moved higher since the FOMC meeting – particularly over two-and-five-year durations. The S&P 500 and our benchmark index, the MSCI Europe index, both fell during September with the bulk of the drawdowns occurring from the 21st. When looking at the sector breakdown for Europe, energy stocks performed well throughout September while financial stocks (primarily banks and insurance companies) did very well over the last six trading sessions of the month. While European technology and IT stocks performed well until the 21st of September (the sector appreciated by +0.29% and the MSCI Europe index fell by -3.73%), there was a considerable drawdown from that date until the end of the month (-6.92% vs. -0.57% respectively).

A closer look at the performance of European Focus in the last column of the table shows that, primarily due to higher bond yields the Portfolio suffered greatly from the 21st September until the end of the month. Hence, in the month to the end of 21st September, the Portfolio fell by only -0.77% vs. -2.46% of the benchmark (i.e. an outperformance of +246bps) while for the year to the end of 21st September, the Fund had risen by +27.21% vs. +16.87% of the benchmark (i.e. an outperformance of +1034bps).

Given the tilt of European Focus towards growth stocks, it is clear that the latter part of September did not offer great trading conditions for the Fund as some of the larger positions performed the worst. Zalando fell by -15.4%; Tomra -14.4%, Atlas Copco -10.2% and L'Oréal -10.0%. The best performing stock in September was Diageo (+3.2%) following an upbeat AGM/trading statement that the company had made '*a strong start to FY21/22*'. The other outperformers in the Portfolio last month all had more-or-less defensive biases, such as EssilorLuxottica (-0.5%); Novo Nordisk (-1.0%) and Nestlé (-2.6%).

Given the multi-year bull market for equities (and indeed for bonds) – it has been a worthwhile strategy to '*buy on the dips*'. Against this backdrop some market observers may find it contentious to recommend investing in a stock (or a fund) after a brief period of underperformance – especially now when bond yields have been rising. Such a view coincides with remarks from various market commentators and even the Fed that supply-side constraints have caused more investors to query whether inflation will be transitory or longer lasting. In fact, this has caused some to argue that the world may even enter a period of stagflation.

The knee-jerk reaction when bond yields move higher is to take profits in growth stocks (similar to what happened in 1Q21). However, we note such companies generally have better pricing power (as indeed those in European Focus) compared with those in the broader market and this attribute should become ever more important if the world moves into a slower pace of growth with stagflation-like characteristics. If bond yields were to continue to move higher when inflationary pressures are building, companies with pricing power should be better positioned to raise their prices. Furthermore, on several occasions in the past we have commented that investors' focus will shift with more attention placed on the balance sheet strength of companies and in this context, European Focus stands out. Our analysis shows that the Portfolio currently has a net debt to EBITDA ratio of around 1x which compares with around 3x of the MSCI Europe index. In short, it should be considerably less painful for the companies in European Focus to service much lower interest expenses than it will be for the broader European market, which is on average more heavily indebted, and this should ensure a solid relative performance for the Fund going forward.

In our opinion, the key impetus to the strong performance of equities in 2021 was anticipation of higher corporate growth rates (for sales as well as for profits). In this respect, we make two observations. *First*, base numbers for comparison in 1Q21 and 2Q21 were highly attractive due to the severe magnitude of the lockdowns in the 1Q20 and 2Q20.

2021 has so far seen a gradual build-up of economic activity in most of Europe, but since many European countries have partly re-opened in 3Q20, it may suggest that base numbers for comparison may become slightly more difficult in the short term. However, this should prove to be only a temporary issue since most of Europe reimposed strict lockdown restrictions in 4Q20. Furthermore, since the lockdowns in 4Q20 continued into 1Q21 as well as 2Q21, we would argue that the forthcoming 1Q22 and 2Q22 reporting periods should face relatively easy base numbers for comparisons.

Secondly, on several occasions in the past we have argued that it is a fool's game trying to predict exchange rates. Nonetheless, we believe the current '*direction of travel*' speaks for a stronger US dollar vs. the Euro as the Fed is ahead of the ECB in terms of its tightening cycle. According to our calculations, the current US dollar rate stands more than 3% stronger against the Euro for 1Q22 as well as 2Q22. This should help to further bolster analysts' sales and earnings estimates when revisions are made over the next few reporting periods.

Christian Diebitsch, Fund Manager

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