HEPTAGON
Capital

2H21

HEPTAGON EUROPEAN FOCUS EQUITY FUND

SUSTAINABILITY REPORT

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European Focus: Sustainability Report 2H21

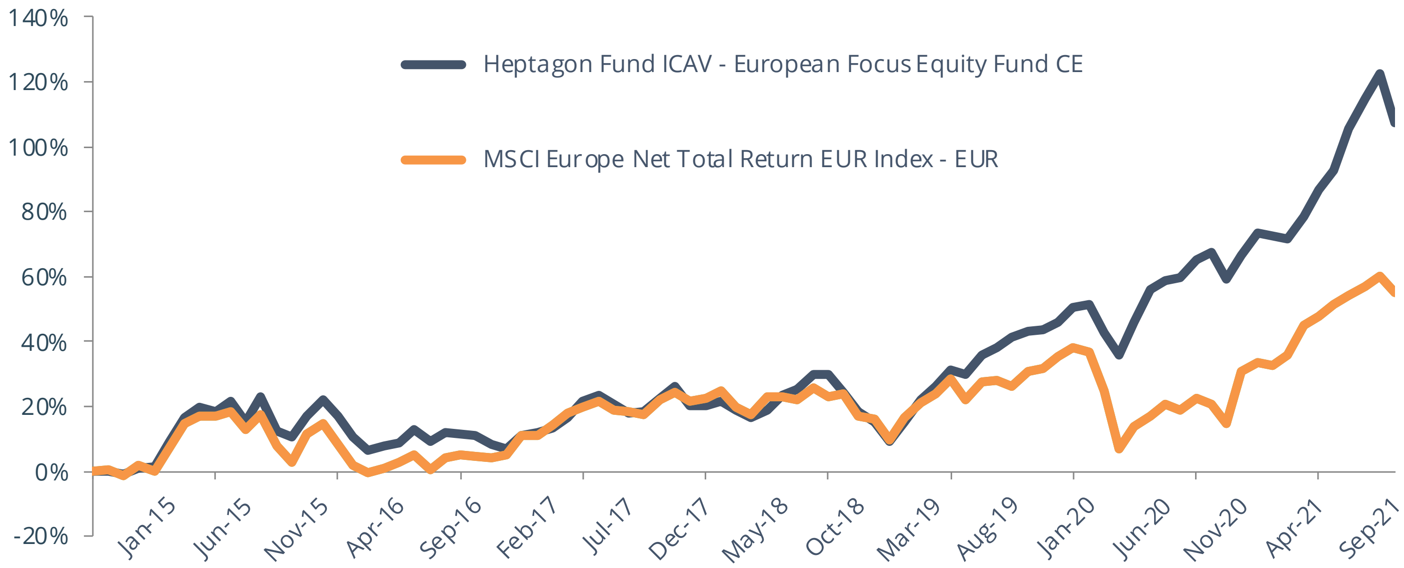
The Heptagon European Focus Equity Fund ("European Focus"), which was launched on 26-Aug-14, has returned 19.65% in absolute terms (as of 30-Sep-21), outpacing the 16.20% gain of its benchmark (the MSCI Europe NR EUR Index) with an implied annualised return of 10.86% vs. that of the benchmark at 6.41%. Christian Diebitsch, the Portfolio Manager, has been managing European Equities adhering to this style since 2007 and has beaten the benchmark by more than 6.15%[1] annualised as of 30-Sep-21.

Monthly Returns: Class CE - Net of fees

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total	MSCI Europe	Excess Return
2014								0.0%*	0.0%	-1.0%	1.8%	0.5%	1.2%*	0.0%*	1.2%
2015	7.8%	6.9%	2.5%	-1.2%	2.8%	-5.2%	6.8%	-8.7%	-1.5%	5.8%	4.4%	-4.3%	15.5%	8.2%	7.3%
2016	-5.5%	-3.8%	1.5%	0.5%	3.9%	-3.2%	2.6%	-0.6%	-0.1%	-2.9%	-1.2%	3.9%	-5.2%	2.6%	-7.8%
2017	1.0%	1.0%	3.1%	4.2%	1.4%	-2.3%	-2.3%	0.4%	3.5%	3.0%	-4.6%	-0.2%	8.2%	10.2%	-2.0%
2018	1.5%	-2.6%	-1.7%	2.0%	3.7%	1.4%	3.6%	0.2%	-4.3%	-4.7%	-2.9%	-5.0%	-8.9%	-10.6%	1.7%
2019	5.5%	5.9%	3.1%	4.3%	-1.3%	4.7%	1.6%	2.5%	1.3%	0.3%	1.8%	2.9%	37.5%	26.0%	11.5%
2020	0.6%	-5.8%	-4.8%	7.3%	7.0%	1.9%	0.5%	3.5%	1.4%	-4.9%	4.4%	4.2%	15.4%	-3.3%	18.7%
2021	-0.5%	-0.5%	4.1%	4.6%	3.1%	6.5%	4.7%	3.5%	-6.7%				19.6%	16.2%	3.4%

** Since CE share class inception 26/08/2014*

Cumulative Performance Since Inception



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

Source: Morningstar and BBH, sourced on 30/09/2021

[1]This figure refers to Christian Diebitsch's historical track record performance which was achieved at prior firms unaffiliated with Heptagon Capital. The portfolio managed by Christian Diebitsch at these prior firms followed the same investment objective and philosophy as the Fund. The performance of the previously managed portfolios is presented to provide a better understanding of how the Portfolio Manager of the Fund has managed this strategy over a longer time period. This figure presents returns from the following portfolios which were managed by the Portfolio Manager: Returns for the period 31/03/2007 – 30/09/2008 are from the WP Stewart European Equity Fund which was solely managed by the Portfolio Manager, Christian Diebitsch. Returns for the period 30/09/2008 – 16/10/2009 are based on a Paper Portfolio that Christian Diebitsch maintained whilst not managing a live portfolio. Returns for the period 16/10/2009 – 15/07/2014 are from the Seilern Investment Management European Equity Fund which was solely managed by Christian Diebitsch. Returns for the period 15/07/2014 – 26/08/2014 are based on a Paper Portfolio that Christian Diebitsch maintained in preparation for the launch of the Heptagon Fund Christian Diebitsch, is now the sole Portfolio Manager at Heptagon Capital for the Heptagon European Focus Equity Fund since 26/08/2014. Heptagon Capital has not verified the performance of the Paper Portfolios. Paper Portfolios assume a 90bps management fee and 20bps trading cost. Performance is shown for the C EUR share class.

ESG Focus: Changes to the C-Suite and Board Directors in European Focus
Executive summary

The biggest takeaway from this exercise is not how the holdings had evolved on a company-by-company basis, but by looking at the different paradigms and trends over the five years under observation. The key findings are that:

- COVID-19 has accelerated sustainability trends including diversity and ESG-linked compensation.
- Companies have been receptive to investor engagement but face significant headwinds from regulators.
- More has changed inside the companies' Executive Management Teams than in their Board Rooms.
- The average Portfolio company increased its number of key decision-makers.
- Female participation in the C-suite of our holdings has doubled over 2015-2020.
- The average number of Board members remained steady during the past five years.
- Female presence in the Board Rooms is approximately twice as high as in the C-suite in our Portfolio companies.
- Remuneration of top-executives and Board of Directors has been broadly unchanged as a percentage of sales in our Portfolio companies.

Introduction

The COVID-19 pandemic has been a shot in the arm for sustainability as ESG-integrated funds saw less volatility and generally fared better than their non-ESG counterparts[2]. The pandemic also accelerated existing trends around improving board diversity in both the C-suite and executive management teams, in addition to more pressure from investors and regulators for matching sustainability targets with ESG-linked compensation[3].

Enhancing corporate governance practices in European companies is nothing new but investors and policy makers are now more focused than ever on tackling short-termism and further embedding sustainability into long-term corporate strategies. European Focus is built around high-quality companies including good corporate governance as companies with strong governance deliver superior return to shareholders and have more cash to reinvest in the business[4]. As a result corporate governance leaders can operationally outperform those with weak governance. In this report, we drill down into the external drivers that are raising the bar for good corporate governance practices and how the Executive Management Teams (EMTs) and the Boards of Directors (BODs) of our Portfolio companies have reacted to these changes over the past five years.

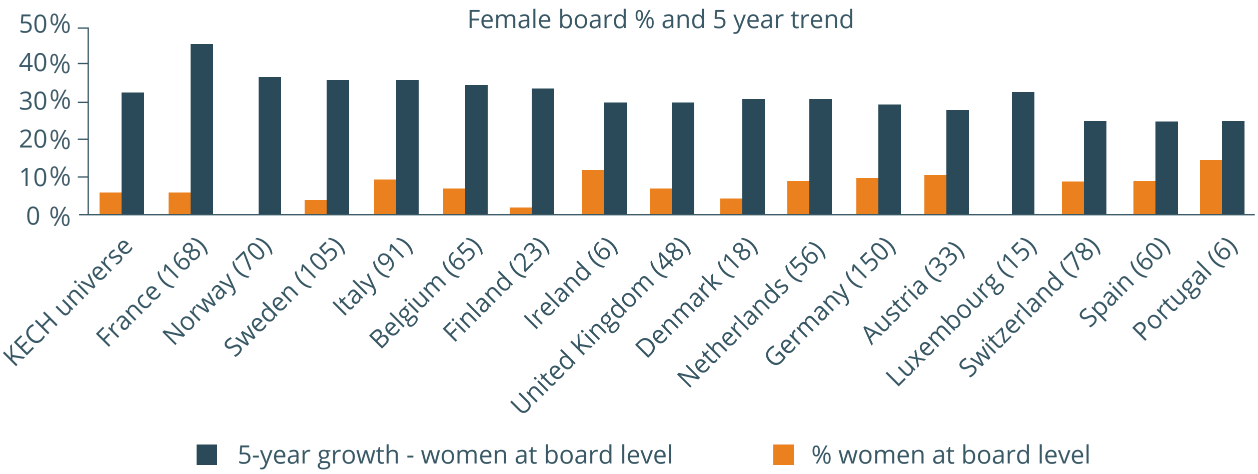
Policy response has helped

Europe has seen a wave of sustainability-related disclosure requirements and corporate governance standards at both a national and regional level as policy makers seek to tackle short-termism and create a more diverse and sustainable corporate governance framework, including the EU Corporate Governance Directive which has been developed as part of the Green Deal. Investors will benefit from improved and harmonised disclosure standards but it also highlights that not all European companies are there yet.

National requirements have been a significant driver for increasing female representation on boards over the last 5 years. Norway was a pioneer in this space by setting the first mandatory quota for 40% female directors on boards in 2003, since then France, Spain and Italy have enacted similar laws for larger publicly listed companies[5].

[2]Morgan Stanley Institute for Sustainable Investing, Sustainable Reality: 2020 Update
[3]Harvard Law School Forum on Corporate Governance, 2020 Global and Regional Corporate Governance Trends, January 2020
[4]Grant Thornton, Corporate governance and company performance, 2019
[5]Kepler Cheuvreux, ESG Research: French proposal for gender quota in senior management, March 2021

France's quota on gender has led to the highest representation of women on boards amongst European peers (KECH coverage)



Source: Kepler Cheuvreux, Bloomberg

The EU is currently contemplating compulsory ESG metrics in compensation plans but is yet to publish the final report (expected by the end of 2021). Currently these are either being voluntarily adopted by companies following investor engagements or are being set out on a 'comply or explain' basis in various national corporate governance codes.

No one size fits all

The percentage of European companies linking executive compensation plans to ESG targets has increased more than eightfold in the last decade, from 4% in 2008 to 34% in 2020[6]. As with traditional compensation disclosure there is a lack of consistency on what metrics are being used and how these are then reported. The challenge is that ESG-linked executive compensation must be in line with the long-term strategy and be bespoke to the business.

Current trends show that on average ESG metrics make up around 15% of executive pay[7] with short term targets linked to social KPIs, including diversity, and LTIPs predominantly focusing on environmental issues such as climate. Investors must work with boards to ensure these targets are significant, measurable and transparent in order to avoid the risk of excessive pay from ESG metrics and to effectively protect shareholder value.

Management and Board Composition of European Focus

European Focus has always placed considerable emphasis on the quality of its Portfolio companies in a holistic sense including good corporate governance. The Fund does not invest in harmful industries and there is an ingrained ethos in the investment philosophy that Portfolio companies should do good for society and operate in a highly ethical manner. We have used the Portfolio composition as of the end of September 2021, which consisted of 20 companies and compared how these companies' top-management teams and boards have changed in terms of size, age, female participation and compensation from the data in their 2015 annual reports in comparison with their 2020 annuals.

In order to bring more clarity and consistency for our analysis, we found that the most pragmatic way was to look at each holding on a company-by-company basis for 2015 and 2020 so that each company was analysed on an 'apple-by-apple' basis and subsequently look at the average change for the Portfolio in its entirety.

[6]Diligence Institute, Aligning Pay, People and Planet, August 2021
[7]FT, Half of FTSE 100 companies like executive pay to ESG targets, March 2021

Table 1 below is a quantitative summary of our findings:

Summary of evolution of average EMTs and BODs in European Focus 2020 vs. 2015

	Number	Average Age	# Female Directors	% Female Directors	Compensation % of Sales
Avg Executive Management Teams (2015)	9	52	1	11%	0.22%
Avg Executive Management Teams (2020)	10	55	2	20%	0.20%
Avg Board of Directors (2015)	11	60	3	27%	0.04%
Avg Board of Directors (2020)	11	59	4	36%	0.04%

Source: Company accounts and Heptagon Capital

Mind the disclosure gap

At face value our holdings are generally perceived to be of the highest quality in corporate governance and transparency. We soon realised that the different disclosures were extremely varied and quite inconsistent once you started to drill down into them in more detail with the aim of analysing all the companies in a consistent manner. It was also noted that more recent changes in company disclosure or even over disclosing made comparisons more difficult on a company-by-company basis. We expect this gap to close as policy makers continue to harmonise disclosure requirements in Europe[8] and investors push for additional material and quantifiable metrics to make better-informed investment decisions.

Size doesn't matter

Areas such as sustainability, procurement, supply-chain management, internet/e-commerce etc. have attained much higher prominence, which have required additional expertise in C-suite leadership and coordination over the past five years. The average number of members in the EMTs has risen from 9 in 2015 to 10 in 2020, which is logical since companies have grown and new top-management functions have had to be added including Chief Sustainability Officers, Chief Security Officers and other executive leadership roles that will be crucial for EMTs to navigate the new normal in a post COVID-19 world.

The biggest EMT in terms of number of members during 2015 and 2020 were in: **Intertek, L'Oréal, Nestlé** and **SGS**. It is surprising that **Intertek** (and to some extent **SGS**) are represented in this group given the much smaller sizes of these companies in terms of market capitalisation as well as sales and profits. However, both **Intertek** and **SGS**, which are involved with testing, inspection and certification (TIC, operate matrix structures with both country managers as well as sector-heads.

Breaking through the glass ceiling

We were pleased to note that female representation for EMTs doubled between 2015 and 2020, although female participation is still low in relative terms. We noted that every company, with the exception of **ASML** (which is considered an ESG Leader) and **Zalando**, had promoted at least one female director into its EMT by 2020. Some companies had significantly increased female participation in the C-suite over the five years, such as **Diageo, Dassault Systèmes**, **Tomra** and **Novo Nordisk**. Meanwhile, **L'Oréal, Hermès** and **Atlas Copco** already had a high female representation at more than 20% back in 2015.

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[8] EY, Study on directors' duties and sustainable corporate governance, July 2020

Female participation within the BODs painted a much more positive picture with, on average, double that of EMTs. The average female participation in our Portfolio companies' BODs rose from 3 to 4 (or from 27% to 36%) between 2015 and 2020. The gap between leaders and laggards is widening. For example, **Diageo** had 60% female participation the BOD in 2020, up from 33% in 2015. In the case of **L'Oréal**, the corresponding ratio was 57% in 2020 compared with 27% five years earlier. Other companies which had made significant strides in this respect were **Zalando** (56% in 2020, up from 22% in 2015) and **Lonza** (40% in 2020, up from 20% in 2015).

A steady hand on the tiller

The average age of EMT members in our Portfolio companies increased from 52 in 2015 to 55 in 2020. We found it interesting (and logical) to note that in those cases where companies' management teams have been traditionally stable, the average age has risen the most. In addition, Swiss companies stuck out to have consistently the oldest EMTs in the Portfolio, with businesses like **Lindt & Sprüngli, Nestlé** and **Givaudan** displaying averages that exceed the rest of the Portfolio. The average number of BODs remained unchanged at 11 members from 2015 to 2020 while the average age of their BOD members fell from 60 to 59. We note that for every company, their BODs are older in comparison with EMTs. Again, we find this logical since successful managers tend to get 'pushed upstairs' with age and experience.

We also note that the average age of Swiss BODs continued to run at a higher average than for the Portfolio average, such as in the cases of **Lindt & Sprüngli** (average age 74) and **Nestlé** (average age 64) at the top. However, faster-moving European technology companies, such as **ASML** (average age 64) and **Dassault Systèmes** (average age 61), also seem to have harnessed more seniority in their BODs in comparison with the Portfolio average.

Compensation plans still lack consistency

Compensation disclosures remain inconsistent for EMTs as pay packages are unique for each business depending on business model, corporate culture and whether to include stock-options or not. Once we started analysing this topic, almost immediately we realised that we had opened Pandora's Box. While every company disclosed the CEO's compensation and some companies disclosed that of the CFO, not every company revealed the total remuneration of the entire EMT and/or how low in the organisation stock-options were allocated or linked to material and measurable environmental or social metrics. EMT's overall compensation as a percentage of group sales had slightly fallen from 0.22% in 2015 to 0.20% in 2020 (despite +33% appreciation of Europe's equity markets between 2015 to 2020). Adding to this conundrum is the fact that, because of COVID-19, the combined sales of the Portfolio grew by only +2% in 2020. That is still a stark difference compared with the MSCI Europe index where the combined sales of the constituents fell by some -19%. Moreover, 2020 is likely to have been an abnormal year in that several managers voluntarily decided to forego any bonuses because of the pandemic.

Compensation of BODs is more consistent in terms of how companies report their total remuneration and the inclusion on ESG-linked compensation, predominantly in the LTIP over the last 2 years (for example, **Diageo** 20% & **Nestlé** 15% of executive compensation tied to ESG). However, because of differences in how remuneration is calculated and allocated depending on business, culture etc, we again looked at BOD-compensation on a company-by-company basis so that we were able compare 'apples-with-apples'. Some companies allocate equities to their BODs, while stock option allocation was more an exception. Some companies ran remuneration policies for their BODs where they awarded a set cash compensation and/or add-on in respect of attendance per BOD meeting. Despite the appreciation of the European equity markets between 2015 and 2020, BOD-compensation was unchanged at 0.04% as a percentage of sales. We construe that there is generally a smaller equity content in BODs' total remuneration than for members of EMTs. However, that does not change our core hypothesis that the paradigm is generally for a higher performance-based component across EMTs as well as BODs now compared with the past.

Looking Ahead

As sustainability becomes more fundamental to the long-term strategic and operational success of companies, management will need to continue to adapt to the accelerated corporate governance trends in a rapidly changing post COVID-19 era.

This report has shown that over the last 5 years companies in the portfolio have moved in the right direction in line with what we have noted in the external environment. Strong headwinds will come from increasing regulatory requirements and investor demands to further improve practices. The gap between leaders and laggards will need to be addressed. Those caught in the middle can gain the most from improving their own external ESG ratings and attracting investors who look to avoid over-paying for ESG. Racial and ethnic diversity in EMTs & BODs is an area that is less advanced than gender[9] but is rapidly moving up the agenda. We expect that as company disclosure requirements are formalised around climate, diversity and other sustainability KPIs both the quality and consistency of ESG-linked compensation disclosure will expand across both cash components and LTIPs.

Using recommendations from the PRI on board diversity or ESG-linked compensation[10], guidance from investor initiatives such as the 30% club and the Fund Manager's own extensive knowledge of the securities in the Portfolio, we will continue to engage and work with company management to incorporate sustainability into long-term strategic decisions. Companies have positively responded to investor pressure with dedicated ESG investor days to present on such issues, in which we frequently participate, and this is captured for future discussions.

Investment Objective of European Focus

European Focus contains what we regard as 'great' companies in 'good' industries. This investment philosophy should be well-suited to helping society rebuild in a post-COVID-19 world, since businesses tend to sustain society in a durable way and, typically, in a manner that has genuine ethical values. The Fund has a 'best-ideas' quality, consisting of only 20+ stocks which are selected from a pre-defined Investment Universe of around 40 companies. Since its inception, the outperformance ratio of this entire Investment Universe for European Focus vs. the benchmark index has ranged between 55% to 65%. However, if this timeline is extended to 2009, i.e. around the time of the 'Great Recession', the outperformance ratio is essentially similar.

Ethics and ESG

The Fund performs granular ESG analysis (similar to the aforementioned comments on Portfolio companies' EMTs and BODs) and also operates with an exclusion list for non-grata industries. Moreover, before a company is approved for inclusion even to the Investment Universe, there is an ESG checklist, where each business is judged equally so that a measured 'apples-to-apples' comparison with other companies in the universe can be made with greater confidence.

Characteristics of Businesses

Universe companies tend to exhibit a focused business with a wide geographic footprint and a diversified customer base. Companies that qualify after thorough due diligence, where each company is analysed, will invariably be noted as those which have stood the test of time. Typically, the average age of foundation of a Portfolio company in European Focus dates back to the 1930s, with several of them having roots going back to the 1800s. Such a long timeline, with success, has naturally afforded them superior scale, industry leadership and acknowledged pricing power.

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[9]Kepler ESG Research, 360 diversity: gender & ethnicity, February 2021
[10]PRI, ESG-linked pay: Recommendations for investors, June 2021

European Focus Seeks

- ✓ Great companies in good industries
- ✓ Businesses focused on doing one thing well
- ✓ World leaders who are #1 or #2 in their fields
- ✓ Companies managed by top-quality leaders and with clean accounts
- ✓ Highly ethical companies in the widest possible sense

A Fund that helps to sustain society; European Focus invests in growth companies that help to sustain society. The key objective is to create ever-rising profits underpinned by organic revenue growth of around 6% (or circa 2x global GDP growth). This combination tends to generate annual EPS growth of 12-17%. In a nutshell: by ignoring the benefit of compounding, if the fund were to generate consistently such returns an investor could become some 1% richer per month.

Universe companies vs. Portfolio stocks; Portfolio holdings are chosen from a pre-defined Investment Universe of around 40 companies of which some 20+ stocks are selected for the Portfolio. Please note the difference; we aim to identify great companies in good industries for the Fund, but we select stocks for the Portfolio. Great companies of course have a higher probability to become good equity investments, but if the timing of the investment is wrong, they can lose a lot of money.

Focused industry leaders with global footprints and pricing power; All companies in European Focus hold world-leading positions in their respective industries and are either #1 or #2 in terms of their market positions. Portfolio companies are domiciled in Europe and focused on a core competence that, over time, has led to high barriers-to-entry and thus created pricing power. The Fund seeks businesses with global footprints. Diversification should come from a wide geographic reach and a large number of customers, rather than through operational spread.

Quality of management and clear business strategy; European Focus places a high emphasis on the quality of management. Portfolio companies tend to have strong and capable leaders who have been with the company for many years. They should be highly ethical and have a clear strategy on how to grow the business over the next 5-10 years. At the same time, the companies' accounts should be clean with few re-statements and they should display healthy cashflow streams, which help to generate high ROIs and be supported by strong balance sheets.

Leading ESG scores; Portfolio companies hold high ESG rankings and the Fund has always enjoyed top scores with leading rating institutes such as MSCI and Sustainalytics. Not only does the Fund have a formal exclusion list, but the investment process also covers a systematic ESG checklist where every investment candidate is treated and analysed equally, enabling comparisons across the Universe.

Proven business models that date back many years; Portfolio companies have stood the test of time and several businesses find roots dating back to the 1800s. When considering the weightings of the stocks in the Fund, the average age of a Portfolio company is nearly 90 years old.

Solid downside capture and sustainable growth during good times; Not only has the Portfolio traditionally displayed solid downside capture during periods of broader market drawdowns, but it has also shown higher-than-average growth and a strong performance during good times.

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

European Focus Avoids

Commodity-based industries, where companies are ‘price-takers’, as well as other mature sectors, such as pure financials, industrials operating in the field of general engineering, automotive stocks and those businesses in a similar vein. It also avoids asset-heavy industries, like the names commonly found within the utility and telecoms sectors.

Financial Profile of Portfolio Companies

Businesses should, as a result, be expected to have asset-light qualities and thus perform better during periods of low-to-moderate inflation. They should also display high ROI, strong balance sheets, and be re-deploying their cashflows back into these core, attractive activities, to support the growth, as opposed to favouring high dividend payments and/or share buy-backs.

We thank you for your interest in the fund and if you have any questions please do not hesitate to be in touch with us.

Christian Diebitsch, Fund Manager

Rupert Davies, Head of ESG

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.

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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

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.

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