

Heptagon Kettle Hill US L/S Equity Fund

Q3 2021 Commentary

Fund Manager



Andrew Kurita

Investment Objective

The Fund aims to achieve long-term capital growth through investing primarily in US small-capitalization stocks. The Fund's Sub-Investment Manager, Kettle Hill Capital Management, is a long/short equity fund manager, established by Andrew Kurita in 2003 and is in New York, USA.

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The **Heptagon Kettle Hill US L/S 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 Kettle Hill Capital Management, LLC ("Kettle Hill") is the Sub-Investment Manager meaning Kettle Hill exercises discretionary investment authority over the Fund.

The Fund was launched on October 5, 2017 and had AUM of USD 122m as of September 30, 2021. Since launch to the end of Q3 2021, the Fund has returned 6.5% (Z USD share class) compared to 4.0% for its benchmark, the HFRX Equity Hedge Index, on an annualised basis. During the third quarter of 2021, the Fund returned -3.2% compared to 1.3% for the HFRX Equity Hedge Index.

For the quarter ended September 30, 2021, Kettle Hill Partners, LP had a loss of 3.00%, net of all fees. Longs subtracted 4.01%, and shorts contributed 1.01%. Ending exposure was 82% gross and 58% net, 70% gross long and -12% gross short, resulting in a long/short ratio of 5.64:1.

I Q3 2021 Winners and Losers

Best Long—Zions Bancorporation, National Association (ZION)

ZION is an interest-rate-sensitive bank, and their loan yields and earnings are tied to short-term interest rates. Net-interest margins on their loan book decline as rates decline and increase as rates increase. In July, the emergence of the Delta variant created concern about the global recovery, and the benchmark ten-year-treasury yield declined from 1.6% to 1.1%. LIBOR determines their loan yields, not the ten-year treasury. ZION's stock dropped as investors became less certain about future interest-rate increases from the Fed. It traded near book value and was only 10x earnings, assuming no increase in rates. Every 100-basis-point increase in rates would increase earnings by more than \$1 per share on a \$4.50 EPS base. We viewed Delta and the growth scare as temporary and believed that the Fed would begin to raise rates on schedule. We made a timely purchase in July and sold the last of our stock in October. The price now reflects the benefits from a 100-basis-point increase in rates and is fairly valued.

Worst Long—Wynn Resorts, Limited (WYNN)

WYNN is an operator of casinos and resorts. Our research led us to believe the company would benefit significantly from a resurgence in both the global economy and gaming industry as well as from an increase in consumer and business travel. The company owns premier assets in several markets globally, initiated new operations in the online sports-betting space and achieved a significant amount of cost cuts throughout the pandemic. The company's stock was significantly impacted by the macro-economic effects from the surging Delta variant, the uncertainty around US-China relations and the renewal of their gaming license in Macau.

Best Short—MS-IWM/ iShares Russell 2000 (MSKHIWM)

The Firm will occasionally use index ETFs as a tactical hedge. We believe we traded MSKHIWM well around the volatility in the market during the quarter, shorting rallies and covering on dips.

Worst Short—Lowe's Companies, Inc. (LOW)

LOW is a home improvement retailer. Over the past year, the company benefitted as work-from-home city dwellers moved to the suburbs and consumers invested in home improvement projects. Our research viewed the company as trading at a high valuation on peak earnings, with negatives from declining housing affordability and the possibility of a rising interest-rate environment going forward. We observed a decline in the growth rate of spending in credit card data. The company released better-than-expected results and guidance, contrary to the slowdown that was apparent in the credit card data.

Q3 2021 Review

Concerns regarding the emergence of the Delta variant caused an extreme rotation from small-cap stocks to large-cap stocks; the Russell 2000 declined -4.36% while the S&P 500 was up 0.58%. Most of the damage to the portfolio occurred in July. We were aware of the Delta variant growth in June and took measures that we deemed were appropriate to protect the portfolio, i.e., by shorting cruise lines and reducing exposure to potential recovery stocks. This concern was reflected in the market as stocks dropped sharply in the first week of July. However, many immunologists and public health experts involved with COVID-19 research and vaccine efficacy were of the opinion that, barring any additional significant mutation of the virus, this could be the final wave of COVID-19. We made a forecast of vaccine adoption and natural infections to estimate when herd immunity in the US might be reached. Based on this analysis, we covered recovery shorts and added to recovery longs in expectation of a truncated COVID-19 wave.

In hindsight, this proved to be premature as Delta-related cases grew and the market panicked and overshot to the downside, even though a significant number of the new cases were in relatively unvaccinated areas. The resulting sell-off was sudden and sharp, and the Russell 2000 suffered a drawdown of nearly -7% from July 12th to July 19th. We hit a portfolio-level stop loss in July and, as per our guidelines, reduced our overall gross and net exposures. We were able to stabilize the performance of the portfolio in August, resulting in a gain for the month. September was another volatile month for the equity markets, with heavy sell-offs because of inflation concerns and anticipation of future Federal Reserve rate hikes.

In our opinion, our proactive and tactical top-down, portfolio-level exposure management during August and September was offset by a few company-specific misses. Overall, in the quarter, in our long book, we made money on interest-rate-sensitive banks and selected technology stocks. We lost money on supply-chain-related earnings misses and a policy change in China that impacted one of our longer-term holdings, Wynn Resorts (WYNN). We made money on our short book, driven by what we feel was fortuitous timing on tactical ETF hedges and consumer discretionary and recovery shorts. Overall, it was a challenging quarter for small caps, coupled with a few timing/execution errors in the long book. However, that has not deterred us from continuing with our research process, and we have been able to add some interesting new positions to the book. We believe we are well-positioned for the challenges that the market may present in the future.

I Market and Strategy Overview

Since March of 2020, we have maintained net exposure at the higher end of our historical range, given the remarkable buying opportunity. Going forward, we have positioned the current portfolio more conservatively for the following reasons: The Federal Reserve announced that they are ending quantitative easing with a faster-than-expected tapering schedule. Stocks are currently at high valuations and corporate tax rates are likely to rise. Retailers have unsustainable merchandise margins, with difficult same-store comparisons and the ending of stimulus spending that supports the consumer. We see labor shortages within key industries impacting supply chains and causing inflation as companies pass along higher prices. We have observed that asset markets will continue to lift as long as the Fed is printing money. There is the potential for a hard landing as stimulus is removed and economic growth and net income growth decelerates.

Currently, there are several themes reflected in our long portfolio. We are long what we believe are highly liquid, defensive stocks with strong, recurring revenues. We are long digital economy stocks, security and enterprise software and video game companies. We are long COVID recovery plays within the hotel and restaurant sectors that are tied to later-cycle business and international travel with prospects for recovery in 2022. We are also long interest-rate-sensitive financials. Over the coming months, we expect to invest in strong companies that experience earnings misses due to temporary delays in raising prices to offset cost pressures. We would expect that their margins can be restored in a relatively short period of time.

We are short consumer discretionary companies that we believe are facing difficult comparisons versus COVID-related spikes in consumer demand and government stimulus. We are short what we believe are high-valuation financial stocks tied to high levels of banking activity that should be affected by the end of quantitative easing measures. Similarly, we are short housing and home remodeling stocks that will probably be negatively impacted by a rising-interest-rate environment. Finally, we are short stocks that seem to have long-tail-discounted cash flows and could face increasing valuation compression in investors' valuation models if interest rates increase going forward.

I Operational Update

There have been no changes to our team. We are still operating efficiently under our pandemic contingency plan and expect a return to the office in 2022. We are happy to report that we have just signed the lease for our new office space in New York. We await some minor buildouts by the landlord and expect them to be completed soon. We look forward to seeing you in our new space and will send out our new address information as we get closer to the move-in date.

We will continue to adhere to our valuation, research and risk philosophy going forward as we have done in the past. We believe that we have core positions which reflect superior risk/reward opportunities for our investors. Again, we appreciate your partnership and trust, and we will continue to work hard as stewards of your capital.

Sincerely,

Heptagon Capital and Kettle Hill Capital Management

The views expressed represent the opinions of Kettle Hill Capital Management, as of 30th September 2021, are not intended as a forecast or guarantee of future results, and are subject to change without notice.

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 September 30th, 2021, net of fees

	Q3 21	YTD	1-Year	3-Year	5-Year	10-Year
Kettle Hill Partners, LP	-3.0%	3.3%	16.4%	7.2%	6.0%	7.7%
HFRX Equity Hedge Index	1.3%	9.2%	17.7%	5.0%	4.9%	3.7%

Source: Kettle Hill, Morningstar

Kettle Hill manages the Irish regulated Heptagon Kettle Hill US L/S Equity UCITS Fund according to the same investment principals, philosophy and execution of approach as it manages Kettle Hill Partners, LP, a Delaware Limited Partnership available for U.S. accredited investors that launched in June 2003. 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. Kettle Hill Partners, LP performance is provided in the table above to show a longer track record for the underlying strategy.

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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>.

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

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 identify 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)

I Disclaimers

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