HEPTAGON Capital

Driehaus Emerging Markets Sustainable Equity Fund

Q3 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 14.2 billion of assets under management.

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The **Driehaus Emerging Markets Sustainable Equity Fund** (the "Fund"), 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 Driehaus Capital Management LLC ("Driehaus") is the Sub-Investment Manager. Driehaus exercises discretionary investment authority over the Fund. The Fund was launched on 25th June 2012 and had AUM of USD 93m as of 30th September 2021. Driehaus Capital Management LLC was appointed Sub-Investment Manager of the Fund on 6th December 2016. Prior to this OFI Global Institutional, Inc. was the Sub-Investment Manager from 25th June 2012 to 5th December 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

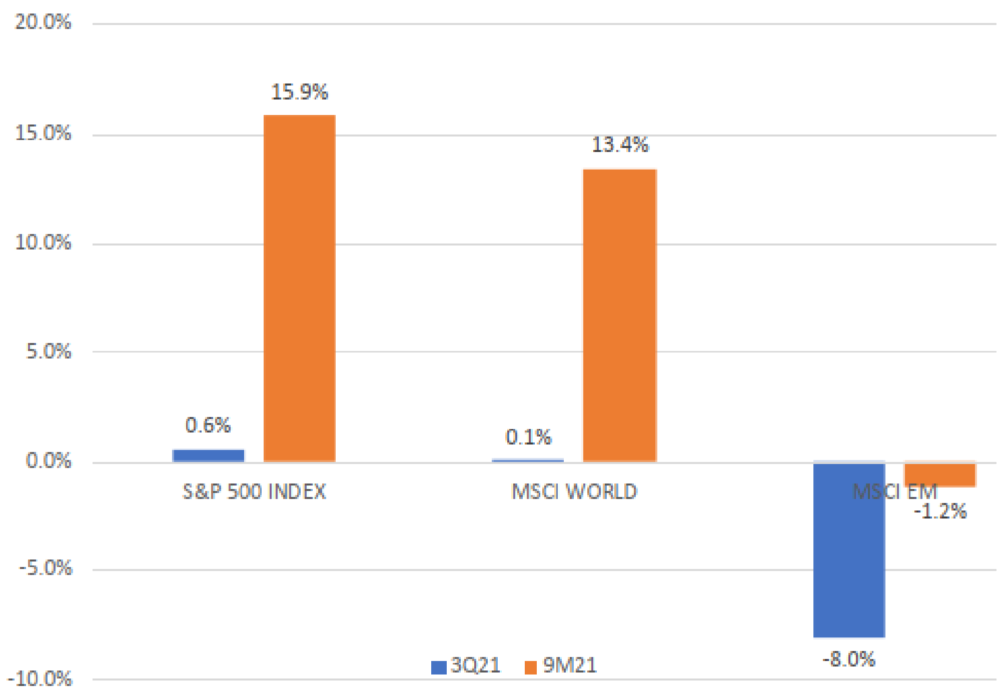
Emerging market (EM) equities declined in the third quarter, underperforming the S&P 500 and MSCI World Index. EM assets were troubled by problems in China and persistent disruptions in the global supply chain. Additionally, hawkish signals from the US Fed contributed to US Dollar appreciation against EM currencies. Markets also struggled with falling growth expectations and ongoing concerns over inflation.

China was the biggest drag on the MSCI EM Index, with MSCI China falling 19% during the quarter and accounting for roughly 80% of the broad index decline. Numerous issues weighed on Chinese assets. (See Exhibit 1).

First, the regulatory crackdown on the major internet companies continued as the government continued its push to reorient the economy to achieve its "common prosperity" goals.

Second, the clampdown on the property sector and the government's unwillingness to step-in with bailouts led a large property developer into default. While the government wants to reduce leverage and clean up risky practices, they cannot afford to let housing prices fall too much. Property is the largest contributor to consumer balance sheets and a key driver of the broader economy (also land sales to property developers are a key funding source for local governments and will be until comprehensive tax reform is passed).

Exhibit 1: Global Indices Total Return 2021



Source: Bloomberg

Finally, the quarter ended with forced power outages as China navigated a mismatch in energy supply and power demand. We discuss this in more detail below.

The view that global supply chains would normalize in 2021 has also proven to be wrong. Businesses have continued to struggle with goods shortages, extended lead times, and higher logistics costs. Continued COVID-19 outbreaks have reduced manufacturing output in a variety of industries. But even more so it has been extremely difficult to untangle the logistics bottlenecks that are hampering global trade.

After a relatively hawkish Federal Open Market Committee (FOMC) meeting in June, the Fed continued to move towards policy normalization by announcing that they may begin tapering bond purchases as soon as November. They also signaled that the tapering process could be completed by the middle of 2022, faster than many had expected, which implies interest rate hikes may also be closer than previously anticipated.

The Fed's move to normalize policy has not really been driven by an acceleration in growth. Several organizations lowered their 2021 growth forecasts for the world and the United States during the quarter and warned of an uneven recovery. Additionally, job creation in the US has been disappointing. Given this, the Fed's actions appear to be more driven by concerns that inflation may not be as transitory as expected earlier.

Relatedly, commodity prices continued to rise during the quarter. The prices of natural gas and coal in particular rose steeply during the quarter given:

- Wind and solar supply in Europe has been low given poor weather for power generation (plus Europe's nuclear power was mostly decommissioned after the Fukushima disaster)
- Droughts in Brazil and China have reduced the supply of hydropower
- Some supply of coal and gas has been decommissioned because of decarbonization initiatives. Meanwhile, new exploration and production (E&P) projects have slowed given higher capital costs and lack of shareholder desire to invest in new capacity
- Storms across the southern part of the US disrupted refining
- Industrial demand has risen as the global economy recovered

Exhibit 2: Bloomberg Commodity Index*

Source: Bloomberg

**Bloomberg Commodity Index (BCOM) is calculated on an excess return basis and reflects commodity futures price movements. The index rebalances annually weighted 2/3 by trading volume and 1/3 by world production and weight-caps are applied at the commodity, sector and group level for diversification. Roll period typically occurs from 6th-10th business day based on the roll schedule.*

In line with these developments, US treasury rates bottomed out during the quarter and began to rise again. The US Dollar appreciated against most EM currencies. These trends could continue as the Fed begins to peel back its asset purchases.

Within EM, commodity sensitive markets like Russia, Indonesia, Colombia, and Saudi Arabia had strong returns. However, the EM landscape is not universally positively correlated with higher commodities, as many countries are net importers of materials and energy products.

Performance Review

The Heptagon Driehaus Emerging Markets Sustainable Equity Fund (Class I USD) returned -7.0% in the third quarter, beating the -8.1% return of the MSCI EM Index.

Consumer discretionary was the biggest positive sector contributor to attribution. The Fund maintained its underweight to the sector especially amongst China internet stocks. While the regulatory crackdown on the internet industry does not seem to be getting materially worse at this point, the impact of the regulations on both the future earnings power and appropriate valuation of these stocks makes it hard to be outright positive.

Energy stocks were the best performing area within EM and the Fund's underweight position to the energy sector was the single largest detractor to the Fund's relative results. Stock selection within industrials, particularly in China, was the second largest source of underperformance as the renewables space also suffered in the quarter.

China was the biggest positive country contributor, stemming from the Fund's underweight in the market. Much of this relative performance occurred due to the Fund's underweight to several large consumer discretionary/internet stocks that operate in China (as mentioned above).

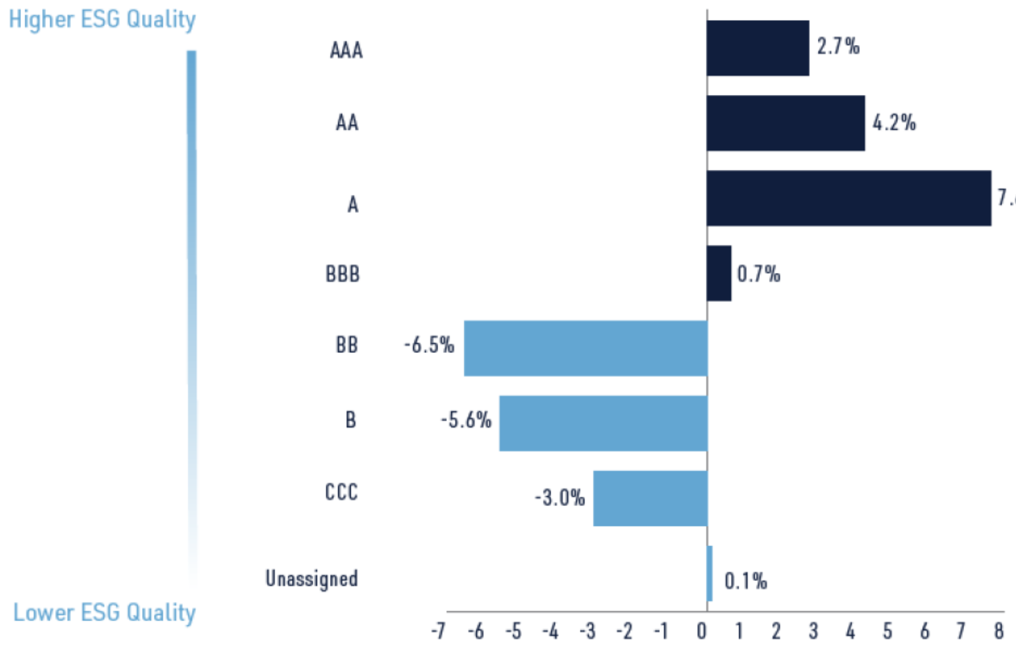
Past performance is no guide to future performance, and the value of investments and income from them can fall as well as rise

Saudi Arabia was the largest detractor from attribution. The Fund carried zero exposure to this commodity-sensitive market as it benefited from underlying strength driven by the energy sector.

Sustainability

The Fund finished the quarter with markedly better ESG characteristics, on an aggregate basis, than its benchmark index (Exhibit 3).

Exhibit 3: ESG Ratings: Fund vs. MSCI EM Index as of 30/9/21
Relative Weights (%pts) versus MSCI Emerging Markets Index



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. We currently see China engaged in two separate energy policies. With coal in short supply and power needs high, the government is currently trying hard to increase coal supply and coal-driven output. Despite that, they have been extremely clear that this is a short-term solution and continue to roll out supportive policies for renewable energy generation. As such, we remain confident in our exposure there and have added in recent months on weakness.

We've continued our engagements with companies to build a broader understanding around their ESG metrics and our expectations as investors. We conduct our engagements to address key opportunity areas of the companies and their overall ESG strategy going forward.

Outlook and Positioning

First, to offer some context on what is happening with China's blackouts. The country still relies on thermal power for roughly 70% of their electricity needs. Shortages of coal and gas meant that power producers either couldn't operate at a high enough capacity or chose not to do so given higher input prices cause operating losses under the existing pricing system.

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As a result, the government began rationing power. The restrictions were applied to both manufacturing and residential users and implemented across 20 provinces. In practicality, that meant factories cutting shifts, elevators being turned off, street lights not working, etc.

The nature of the restrictions varies by location and industry, but analysts estimate that there could be 10-20% cuts to output. The most energy-intensive industries like steel, cement, and aluminum production may see the biggest impact. But production in industries beyond heavy materials are also being disrupted, for example in food, paper products, autos, and tech.

In the meantime, the government is aggressively pursuing all avenues to purchase more fuel and to ramp up existing production as much as possible. They have also quickly overhauled utility pricing to allow power generation companies to raise prices. But there are no quick fixes, and we are likely to see continued outages at least through the winter.

The first order impacts are predictable: less production and slower economic growth. China's manufacturing Purchasing Managers Index (PMI) has already dipped into contractionary territory. But the second and third-order impacts are very difficult to predict with certainty given how dynamic the situation is. The outages have been occurring at multiple industries in a country that accounts for nearly one-third of global manufacturing. Some companies may not even know their supply has been disrupted until it is too late to do anything about it.

Regardless, thinking through some potential implications:

- China's trading partners (i.e. everyone) are likely to see weaker demand
- China's urgent purchasing of natural gas and coal could amplify emerging shortages in other energy importers like Europe and India. Aside from Malaysia and Indonesia, all EM Asian countries are net energy importers
- The Chinese government may adopt a more stimulative stance, but their options may be more limited without sufficient electricity to increase production
- Improved economic outlook and increased political influence for commodity exporters like Russia and Gulf Cooperation Council (GCC) countries
- Inflation ends up being stickier than previously anticipated given reduced manufacturing capacity and higher energy input costs

How these issues interact and amplify each other is impossible to predict.

Given this backdrop, it is reasonable to expect global rates to continue to move higher. As mentioned above, the US Fed has already indicated it's on the verge of starting to taper. Several EM central banks have already hiked policy rates, either to normalize the accommodation put into place during the worst of the pandemic or to combat inflation.

Brazil has already seen a sharp rise in inflation, reaching over 10% year over year in September. In turn, the Brazilian Central Bank has hiked rates by 425 basis points. That has started to cool the economy, especially consumption. (However, this has not helped the Brazilian Real, which saw a sharp depreciation during the quarter exacerbated by concerns over fiscal policy and political risks around the 2022 presidential election.)

Russia has also been hiking, but their economy is in much better shape given the positive leverage to oil and gas prices. The Ruble has unsurprisingly been one of the strongest currencies in EM this year and was second only to the Indonesian Rupiah in the third quarter in terms of appreciation against the USD.

On the positive side, the world is likely to finally be moving past the worst of COVID-19. Immunity levels continue to rise, either from vaccination or infection. And with improving treatments there has been rising acceptance that the world can manage with COVID-19 and avoid the most extreme negative consequences (overflowing hospitals and high mortality rates). That means moving past the strict lockdowns intended to completely eradicate the virus.

This is likely to result in both rising demand as well as some normalization of stressed supply chains (e.g. Malaysia, a back-end hub for the semiconductor production that plays a significant role in the auto supply chain, has started to ramp back up to full utilization as vaccination levels have risen).

Given the current backdrop, we think a few attributes are especially important in making investment decisions. First, at the country or sector level, whether an entity is a net energy importer and whether an industry is highly energy intensive. Interest rates also remain highly relevant. The Fund increased its active weight in sectors that including consumer discretionary, information technology and financials while reducing active weights to the health care, utilities and real estate sectors. From a country perspective, while China remains the Fund's largest underweight exposure, we took advantage of market weakness by reducing the Fund's active underweight. The Fund also increased its active weight to Argentina, Mexico and Brazil while reducing active positions tied to North Asian countries and India.

At the stock level, we think that pricing power is one of the most critical attributes so that margins can be protected. We have also been working on unique opportunities that benefit from the current backdrop. For example, stocks that are leveraged to grid investment and modernization should be well positioned given the need to better manage energy distribution. Batteries have gotten a lot of attention given they benefit from rapidly growing electric vehicle adoption. But they are also likely to see accelerating demand at the grid level to help balance the intermittent generation inherent to wind and solar.

The ramifications of COVID-19 are only starting to emerge. We expect the coming decade to be rife with industry disruption and societal changes. This will be challenging for markets and society at large but should also lead to attractive opportunities for active management. We thank you for the opportunity to manage your capital during this time and look forward to the work to come.

Sincerely,
Heptagon Capital and Driehaus Capital Management

Sector performance attribution- Q3 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
Consumer Discretionary	9.70	-22.82	-2.48	15.90	-22.93	-4.12	1.07
Information Technology	32.13	-3.78	-1.20	21.09	-5.91	-1.21	0.84
Financials	20.05	3.57	0.68	18.74	0.97	0.21	0.55
Cash	4.67	0.18	0.01	0.00	0.00	0.00	0.42
Materials	3.16	7.21	0.16	8.85	-4.83	-0.44	0.16
Health Care	6.95	-10.29	-0.76	4.90	-13.02	-0.66	0.12
Unassigned	0.00	-81.13	-0.08	0.00	0.00	0.00	-0.08
Communication Services	9.72	-17.60	-1.82	10.61	-15.11	-1.68	-0.21
Consumer Staples	6.34	-9.01	-0.54	5.74	-4.41	-0.24	-0.25
Real Estate	0.85	-43.35	-0.48	1.86	-14.34	-0.29	-0.27
Utilities	1.00	-12.96	-0.18	2.09	7.44	0.16	-0.41
Industrials	3.93	-16.57	-0.72	4.98	-6.32	-0.31	-0.47
Energy	1.49	19.19	0.26	5.24	9.10	0.49	-0.52
Total	**100.00**	**-7.15**	**-7.15**	**100.00**	**-8.09**	**-8.09**	**0.94**

Sources: Driehaus Capital Management LLC, Factset Research Systems, Inc., eVestment Alliance
Data as of 30 September 2021

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- Q3 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	22.05	-20.07	-4.99	31.98	-19.04	-6.66	0.84
United States	7.77	-0.37	0.01	0.08	-11.30	-0.01	0.60
Netherlands	2.90	9.38	0.32	0.32	9.24	0.03	0.47
Cash	4.67	0.18	0.01	0.00	0.00	0.00	0.42
Singapore	1.25	15.32	0.17	0.02	0.60	0.00	0.26
India	15.02	8.90	1.22	11.14	12.57	1.28	0.25
Argentina	1.37	16.74	0.15	0.15	25.46	0.03	0.19
Japan	1.48	2.72	0.03	0.00	0.00	0.00	0.15
Germany	1.03	1.99	0.02	0.00	0.00	0.00	0.10
Kazakhstan	1.07	1.08	0.02	0.00	0.00	0.00	0.10
Hungary	0.76	8.69	0.07	0.25	7.69	0.02	0.09
Canada	0.19	3.84	0.03	0.00	0.00	0.00	0.06
South Korea	11.27	-14.21	-1.60	13.10	-13.23	-1.79	0.04
Indonesia	1.54	9.17	0.14	1.21	9.42	0.11	0.04
France	1.50	-7.98	-0.08	0.00	0.00	0.00	0.03
Australia	0.46	0.37	-0.01	0.02	-4.03	-0.00	0.02
Brazil	4.58	-22.03	-1.06	5.03	-20.19	-1.05	-0.04
Cyprus	0.65	-13.94	-0.10	0.19	-1.31	-0.00	-0.06
Unassigned	0.00	-0.09	-0.08	0.00	0.00	0.00	-0.08
Mexico	1.64	-1.91	-0.07	1.88	1.41	0.03	-0.11
Uruguay	0.13	-16.13	-0.14	0.00	0.00	0.00	-0.12
Russia	1.54	12.28	0.18	2.96	11.24	0.32	-0.25
Taiwan	12.76	-3.58	-0.45	14.60	-2.06	-0.29	-0.27
South Africa	0.99	-28.02	-0.31	3.32	-5.85	-0.19	-0.28
Hong Kong	3.38	-17.82	-0.63	2.86	-7.85	-0.23	-0.35
Other countries in benchmark	0.00	0.00	0.00	10.90	-6.25	0.32	-1.15
Total	**100.00**	**-7.15**	**-7.15**	**100.00**	**-8.09**	**-8.09**	**0.94**

Sources: Driehaus Capital Management LLC, Factset Research Systems, Inc., eVestment Alliance. Data as of 30 September 2021

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

	Q3 21	YTD	1-Year	3-Year	5-Year
Driehaus Emerging Markets Sustainable Equity Fund	-7.0%	0.6%	20.5%	14.9%	13.0%
MSCI Emerging Markets NR Index	-8.1%	-1.2%	18.2%	8.6%	9.2%

Source: Morningstar

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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.

Authorised & Regulated by the Financial Conduct Authority (FRN: 403304)

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