HEPTAGON Capital

Driehaus US Small Cap Equity Fund

Q3 2021 Commentary

Fund Manager

Jeff James

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.

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The **Driehaus US Small Cap 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 Driehaus Capital Management LLC ("Driehaus") is the Sub-Investment Manager meaning Driehaus exercises discretionary investment authority over the Fund. The Fund was launched on 31st July 2019 and had AUM of USD 549m as of 30th September 2021. During the third quarter of 2021, the Fund outperformed its benchmark, the Russell 2000 Growth Index TR (the "Index"), returning 0.4% (I USD share class) compared to -5.7% for the Index.

Market Overview

The September quarter was a down period for the U.S. equity market as the number of headwinds and concerns expanded, causing economic growth to slow and equity multiples to contract slightly. While the largest capitalization stocks outperformed, helping the S&P 500 to eke out a tiny gain of 0.6%, the rest of the market struggled as size was an important driver of returns. Larger cap stocks outperformed mid caps, which outperformed small caps, which outperformed micro caps. Value also managed to outperform growth during the period.

The small cap indices have now consolidated in a sideways fashion since the spring of this year and are off approximately ten percent from their highs earlier this year. The S&P 500, which reached new price highs throughout the quarter, has now declined about five percent from its recent early September high.

The equity market is typically weak during the August to October period, but multiple fundamental concerns have also pressured equities with the Delta variant the most prominent having caused another major wave of new COVID cases. As a result, many parts of the U.S. brought back mask policies and other social distancing restrictions. While most of new cases are among the unvaccinated population, especially in terms of severe disease, this wave certainly impacted the economic momentum that had been accelerating during the first half of 2021. Economic (GDP) growth slowed as consumer travel and leisure spending decelerated, supply chains continued to be severely impacted, labor markets remained extremely stressed and the return to office policies for many companies were delayed.

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

Inflation, interest rates and monetary policy were also a major focus for equity investors. Despite Fed Chair Jerome Powell's "transitory" description of inflation, the elevated price levels are proving to be stubborn as supply chains and labor markets continue to be impacted by COVID. The extreme, widespread shortages and extended lead times across most industries and the lack of visibility regarding a return to normal for most supply chains is something that has not been witnessed before. The same can be said of the labor markets. The number of open or unfilled jobs (over 11 million) is a record and far exceeds the number of job applicants seeking work (roughly 8 million). Nearly every industry is having a difficult time finding workers. Many believed that as the extended and generous unemployment benefits ended in early September and as schools reopened, workers would return but this process is also proving to be slower than most expected. This is putting additional upward pressure on wages and overall inflation. The supply chain and labor issues are holding back the potential for economic growth and have reduced consensus economic growth assumptions for the second half of this year. Supply chains and labor markets should normalize over time, especially if this Delta wave is the last significant one. As these supply side issues slowly normalize, their recovery will be a tailwind for economic growth. Interest rates, which appear to have bottomed in early August, are rising again and may continue to do so. Increasing rates, within reason, and upward sloping yield curves can be positive signs of economic growth but the pace of the increase in rates (and inflation) and the potential pressure on monetary policy are risks that will need to be monitored carefully.

There are numerous other risks. These include: the U.S. debt ceiling, Fed tapering and eventual tightening, the re-appointment of Fed Chair Jerome Powell, the passage and the size of the infrastructure bill, rising crude oil prices, tension between China and Taiwan, Evergrande and the over-levered China real estate sector and future potential COVID variants.

Positively, the demand side of the economic equation remains robust. Pent up demand, low inventories, rising incomes, record net worth and the new economic cycle are all driving very strong demand. At the same time, the lack of product, rising prices and extended lead times could impact demand and overall economic potential. Still, we expect demand to remain strong enough as the supply chains and labor market slowly recover over the next several quarters.

Stock and sector leadership continues to be rotational. Cyclicals led in the first half of 2021 fueled by the reopening of the economy. Then as yields fell and Delta cases rose in the September quarter, many WFH (work from home) stocks performed better and many cyclical stocks in the consumer discretionary and industrials sectors lagged. As Delta variant cases peaked in early September and are now steadily declining, many "reopening" cyclicals are beginning to benefit.

Our overall sanguine view is supported by our conviction that the economy is still early in its recovery. Given the COVID-induced recession ended last year, we are just entering the second year of this expansion and historically the last five U.S. economic cycles have lasted five to ten years. No two cycles are the same, but this expansion is off to a stronger start despite many of the unprecedented aspects of this one.

Corporate earnings remain robust and have made new highs, as equities have pulled back from their highs earlier this year. Together, higher earnings and lower stock prices have created more attractive valuations and have set up an attractive dynamic as the market looks ahead towards the year end and into 2022. As the market digests the current macro uncertainties, we are finding many appealing opportunities both among cyclicals as well as secular growth companies.

Performance Review

For the September quarter, the Driehaus US Small Cap Equity Fund outperformed its benchmark. The Fund gained 0.4%, while the Russell 2000 Growth Index declined -5.7%. The Fund also outperformed the Russell 2000 which fell by -4.4% and the S&P 500 which gained 0.6%.

The relative outperformance versus the Russell 2000 Growth Index was driven by the portfolio's strong performance in several sectors including healthcare, technology, consumer staples and industrials.

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The market's stock and sector leadership continue to be very rotational. While cyclical and reopening stocks performed best in the first half of the year, within the portfolio secular growth parts of technology and healthcare performed well as Delta cases rose and economic growth slowed in the September quarter.

The portfolio from a bottom-up basis continues to experience strong earnings reports with robust positive surprises, estimate revisions and bullish fundamental outlooks. It also benefitted from good balance and diversification across the various growth categories (secular, cyclical, consistent, recovery) which boosted outperformance.

By sector, the following sectors saw positive absolute returns for the quarter (in order of magnitude): technology, consumer staples, financials and healthcare. As the market declined, several sectors experienced negative absolute returns, including consumer discretionary, communication services, and materials. The positive relative returns for the quarter were primarily from (in order of magnitude): healthcare, technology, and consumer staples. Consumer discretionary, materials and communication services detracted on a relative basis.

Healthcare

Healthcare outperformed as the sector contributed 334 basis points on a relative basis. The portfolio's holdings were down just 0.3% versus a decline of 11.8% for the index's healthcare holdings. Several biotech holdings performed well as there was increased optimism on their clinical pipelines and some holdings reported strong clinical trial data.

IPO activity within the group remains strong with many companies coming public during the quarter. The level of innovation we see in healthcare is exciting. Biotech/therapeutics, molecular diagnostics and med-tech all stand to benefit strongly looking forward as these companies improve the standard of care and provide better outcomes for patients.

Technology

Technology outperformed while contributing 297 basis points on a relative basis. It continues to see strong fundamental trends in most of its sub-industries. IT service stocks remain strong. Software recovered after a choppy first half. The performance of our semiconductor holdings was also strong while semi capital equipment holdings were mixed. Telco equipment holdings continue to perform well as the outlook for rural broadband spending is robust.

Consumer Discretionary and Staples

The consumer discretionary sector holdings, which saw strength in the first half of the year, had broad weakness in the September quarter as the Delta-related cases soared. Supply chain, reduced stimulus benefits and labor issues were also sources of the sector's weakness. As a result, and as attractive opportunities developed in other sectors, we reduced our weighting in consumer discretionary from 20.0% to 12.4% during the quarter. As the Delta cases are now falling and most are vaccinated, we do expect the sector to recover. Supply chain issues will linger but they may be discounted in some situations. As the economy continues to grow and labor markets normalize, we expect the very high savings rates and massive pent-up demand to continue to drive solid consumer spending. We remain impressed with robust financial strength of the U.S. consumer as wages, net worth and overall household balance sheets are the strongest we have ever seen. As the consumer is such a core segment of the aggregate U.S. economy, we highlight the strength of the consumer's financial position in Exhibits 1-3.

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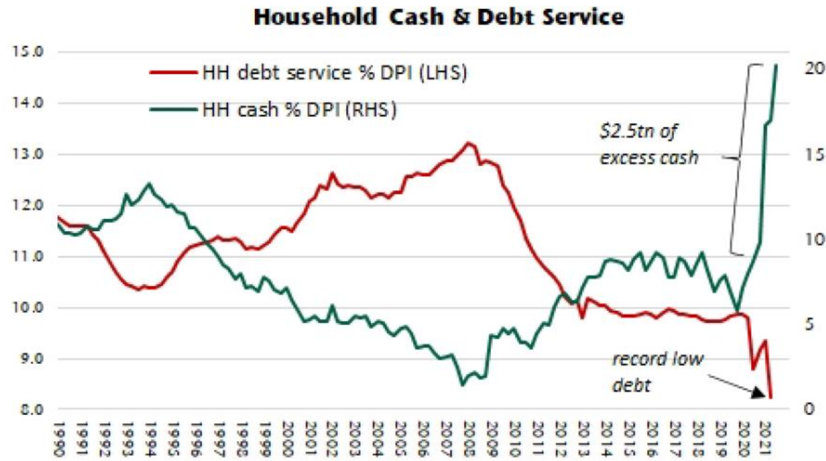
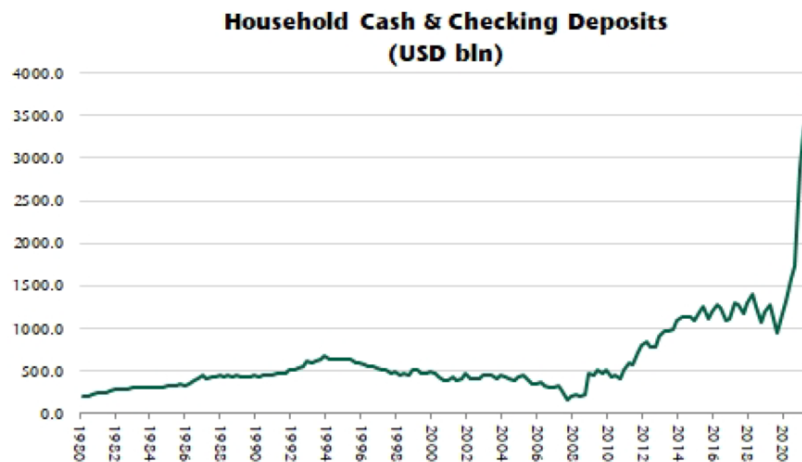
Exhibit 1: Household Cash & Debt Service



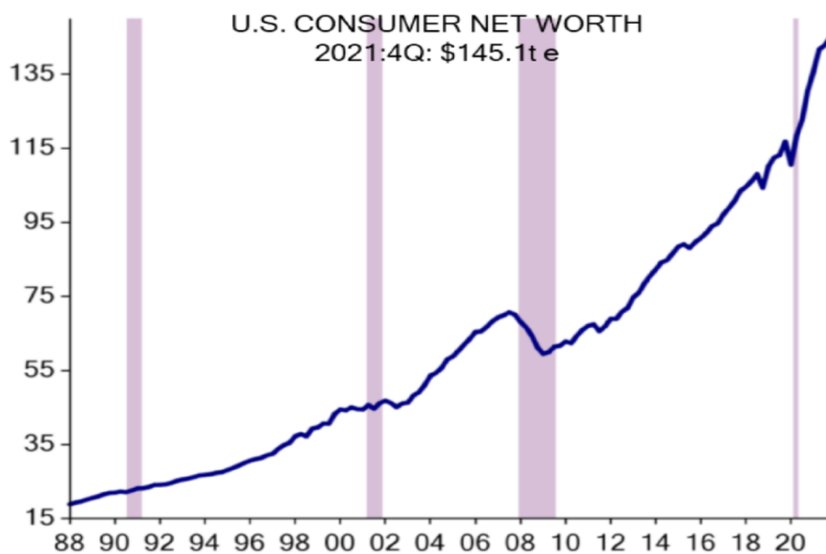
Source: Haver, JEF Economics

Exhibit 2: Household Cash & Checking Deposits (USD bn)



Source: Haver, JEF Economics

Exhibit 3: US Consumer Net Worth



Source: Evercore ISI

Consumer staples also added nicely to outperformance as an energy drink producer and a skin products company performed strongly.

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Outlook & Positioning

The outlook for the economy and earnings remains positive as there are multiple drivers supporting this economic expansion. We believe the level of earnings will continue to make new highs. The overall direction of equities will follow the path of earnings as the economic expansion continues. That said, multiple factors are causing stocks to churn sideways. The Delta variant has slowed economic growth over the past few months. The severe stress in supply chains and the labor market don't have recent precedent. Inflation remains elevated and is the highest in years and various political and geopolitical concerns are depressing investor sentiment. Overall, though as the supply side issues slowly improve and we potentially move to a post-pandemic period, the U.S. expansion could prove to be self-sustaining.

The mRNA based COVID-19 vaccines are working very well and appear to provide good protection especially against severe disease. The percentage of adult Americans who are vaccinated is over seventy percent. Delta cases are now in decline after peaking in September and the risk of an additional major COVID wave is low, but naturally unpredictable.

Smaller cap valuations are attractive on a relative basis versus large caps looking at the past four decades. Earnings growth rates for smaller companies are much stronger than large caps. Micro and small caps generally perform well for years from the beginning of a new economic expansion. For instance, post the Nasdaq Bubble and post the Great Financial Crisis, smaller caps outperformed large caps for five to six years.

In terms of portfolio positioning, we have an attractive mix of secular and cyclical growth holdings that should continue to benefit the Strategy as the market continues to be so rotational. By sector healthcare remains our largest absolute weight, followed by technology, consumer discretionary, industrials and financials. Relative to the benchmark, the Strategy is overweight technology, financials, consumer staples, consumer discretionary and energy. The Strategy is underweight health care, industrials, and real estate.

Overall, we see many dynamic investment opportunities in attractive and strong industries, which fit our investment philosophy of companies exhibiting growth inflections, differentiation, market share gains, strong revenues and expanding profitability.

Quarterly Contributors

- Monday.com Ltd. (Ticker: MNDY) is a low code/no code enterprise workflow management software platform vendor. In August, MNDY reported 2Q21 results with revenues 13% better than expected and issued guidance for 3Q21 15% above consensus estimates. Additionally, the earnings report showed strong leverage with MNDY's timeline to profitability brought forward by a year from 2H2023 to 2H2022. We took modest profits on strength post earnings results.
- Ambarella, Inc. (Ticker: AMBA) engages in the development and sale of video compression, image processing, and computer vision solutions. In early September AMBA reported 2Q21 earnings that showed broad upside with revenues 6% above consensus with guidance for 3Q21 revenues 15% better than consensus, driven by production volumes ramp of Artificial Intelligence (AI) powered Computer Vision (CV) processor chips for the auto and security end markets. The strategy added to the position post this update as ABMA is in the early stages of growth acceleration driven by proliferation of CV processor chips.

Quarterly Detractors

- GrowGeneration Corp. (ticker: GRWG) owns and operates 62 specialty retail hydroponic and organic gardening stores. The Team initiated a position in May 2020, as stay at home orders due to COVID and a rapid pace of new store additions yielded accelerating revenue and earnings growth. In June and July 2021, growth has slowed, as difficult growth comparisons from 2020 are lapped and wildfires in California disrupted outdoor growing activity. This was reflected in more muted guidance for 2021 that GRWG provided on its 2Q21 earnings call. Due to the decelerating growth profile the Team exited the position.

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- SpringWorks Therapeutics, Inc. (Ticker: SWTX) is a development-stage drug company focused on cancer. During the month, a large shareholder sold a block of stock, and the executing broker placed it poorly. As supply and demand of the equity equilibrated the stock stabilized.

Outright Buy

- Grid Dynamics Holdings, Inc. (Ticker: GDYN) provides digital engineering and information technology services. The strategy initiated the position in July 2021 as industry datapoints showed a sharp acceleration in IT services growth driven by increased need for digital transformation in enterprises. Additionally, while GDYN was negatively impacted from its exposure to retail clients in 1H20 and it was showing a strong revenue recovery from the low point in 2Q20. With that backdrop, GDYN's forward consensus estimates appeared low and valuation was a 35-40% discount to IT services peers, presenting an attractive setup.

Outright Sell

- Upwork Inc. (Ticker: UPWK) operates an online platform that connects businesses and freelancers. In July, the company reported better than expected 2Q21 quarterly results with revenue growing 42%. Despite the strong results and outlook, UPWK's forward guidance hinted at some increased uncertainty in the near-term. Following the quarter, the technical action in the stock was weak and deteriorated further after a competitor expressed similar concerns for its near-term outlook. Due to this reduced visibility and weakening price action in the stock, the Team exited the position.

Sincerely,
Heptagon Capital and Driehaus Capital Management

The views expressed represent the opinions of Driehaus Capital Management, as 30th September 2021, are not intended as a forecast or guarantee of future results, and are subject to change without notice.
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Sector performance attribution- Q3 2021

	Driehaus Small Cap Growth Composite (Port) (%)		Russell 2000 Growth Index (Bench) (%)		Attribution Analysis (%)		
GICS Sector	**Port Avg. Weight**	**Port Contrib. To Return**	**Bench Avg. weight**	**Bench Contrib To Return**	**Allocation Effect**	**Selection + Interaction**	**Total Effect**
Comm. Services	1.78	-0.53	2.81	-0.35	0.03	-0.31	-0.28
Consumer Discretionary	16.78	-1.29	15.02	-0.97	0.05	-0.19	-0.13
Consumer Staples	3.78	0.52	3.62	-0.21	-0.01	0.74	0.73
Energy	2.05	-0.09	1.87	-0.05	-0.06	0.07	0.01
Financials	3.52	0.14	5.11	-0.07	-0.10	0.21	0.11
Health Care	25.08	0.09	29.52	-3.53	0.27	3.06	3.34
Industrials	19.90	-0.01	13.84	-0.05	0.31	0.09	0.39
Information Technology	20.67	2.77	21.96	-0.22	-0.11	3.07	2.97
Materials	4.75	-0.65	3.00	-0.24	-0.03	-0.28	-0.32
Real Estate	0.35	-0.15	2.93	0.00	-0.18	-0.14	-0.32
Utilities	0.40	-0.08	0.31	0.02	-0.05	-0.09	-0.14
Cash	0.96	0.00	0.00	0.00	0.05	0.00	0.05
Other*	0.00	-0.15	0.00	0.00	-0.16	0.00	-0.16
Total	**100.00**	**0.56**	**100.00**	**-5.68**	**0.01**	**6.23**	**6.24**

Sources: Driehaus Capital Management LLC, Factset Research Systems, Inc., eVestment Alliance
**Other refers to securities not recognised by Factset.*
Data as of 30 September 2021

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Annualized Total Returns as of 30th September 2021, gross of fees

	Q3 21	YTD	1-Year	3-Year	5-Year	10-Year
Driehaus Small Cap Growth Composite	0.7%	16.1%	51.9%	27.4%	29.7%	24.1%
Russell 2000 Growth Index TR	-5.7%	2.8%	33.3%	11.7%	15.3%	15.7%

Source: Driehaus Capital Management, Morningstar

Driehaus manages the Irish regulated Driehaus US Small Cap Equity UCITS Fund according to the same investment principals, philosophy and execution of approach as it manages the Driehaus Small Cap Growth Composite, 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. The Driehaus Small Cap Growth Composite is provided in the table above to show a longer track record for the underlying strategy.

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Important Information

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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

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 identified 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)

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