HEPTAGON Capital

Driehaus US Micro Cap Equity Fund

Q2 2022 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. The firm was founded in 1982 and has USD 11.2 billion of assets under management.

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The **Driehaus US Micro 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 7th December 2016 and had AUM of USD 552m as of 30th June 2022. During the second quarter of 2022, the Fund stayed inline with the Russell Micro Cap Growth Index TR USD (the "Index"), returning -22.4% (I USD share class) compared to -22.4% for the Index.

Market Overview

The June quarter was another difficult period for U.S. equities. It was among the worst in terms of total percentage decline for a quarter for the Russell Micro Cap and Russell 2000 indices. The first half of 2022 was also among the most extreme. It was the worst percentage decline ever for a first half of a year for the Russell 2000 and the Russell 2000 Growth. It was also the worst first half of a year for the S&P 500 since 1970. While the market declines were severe across all market cap ranges and nearly every industry, the smallest market caps and growth declined more than larger caps and value.

Amid growing bearish sentiment and fear of a Fed-induced economic slowdown, equity multiples were under severe pressure. Fighting the Fed when the Fed is fighting inflation is typically not favorable for equities in the short-term. Inflation thus far has proven more persistent and stubborn than hoped. The May Consumer Price Index (CPI) report released on June 10th showed that inflation in the U.S. accelerated, reaching a new cycle high. This further pressured equities through the end of the quarter as market participants concluded the Fed would have to further raise interest rates and tighten financial conditions more aggressively. This monetary stance by the Fed increases the risk of U.S. recession.

While inflation is the number one focus for the Fed, positively, there are multiple signs the underlying drivers of inflation are easing:

- M2 (the widely used measure of the money supply) has slowed from a peak of 27% y/y growth to a more normal 6% increase y/y. It will likely continue to ease.

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

- Average hourly wages also appear to have peaked as labor participation rates are improving.
- Supply chains are improving (though issues remain) helping logistics, shipping and container costs to come down.
- Inventories in many industries are returning to normal or in some cases are at elevated levels – thus reducing goods inflation and prompting discounting.
- Most commodity prices have fallen and some sharply. Though crude oil does remain over $100.
- The core CPI (ex-food and energy) and Personal Consumption Expenditures (PCE) have eased from recent highs.
- Market-based measures of inflation expectations have eased meaningfully, for instance the 5-year break-even inflation expectations have eased.

While these are very encouraging secondary signs, market participants and the Fed want to see total CPI peak and improve materially to conclude inflation is convincingly on track for a decline to lower levels. The June CPI is expected to be reported very soon in July and will be the next critical update on inflation.

Two key factors in coming months will be the rate at which inflationary pressures ease and to what degree economic growth slows. It will be critical for the market to see evidence of easing inflation. Economic conditions are slowing, but how much it slows going forward is the topic of much debate. Weakness is evident in the durable goods sectors of the economy as strong demand for durable goods during Covid continues to wane. Recent ISM Manufacturing data has been below expectations. Consumer spending continues to shift to services, leisure, travel and hospitality as those parts of the economy are seeing robust spending. The recent ISM Services report was nicely above expectations. How sustainable spending on services will be is also an open question as the economy slows and the price of crude oil remains elevated.

Will the U.S. economy deteriorate into a recession? It is getting close, and the market is concluding that a recession is a high probability as equity multiples have fallen sharply, consistent with past recessions. Also, a Fed tightening cycle this aggressive makes a recession seem reasonable and justified. Sentiment readings across consumers, small businesses, and professional investors have dropped to all-time low levels only seen during actual recessions. U.S. GDP may be negative for the first half as the current expectations continue to decline. The Atlanta Fed's GDP Now tracking model was recently revised suggesting a negative GDP reading for the second quarter. While two quarters of negative GDP reading is the common definition of a recession, the official definition (by the NBER – the National Bureau of Economic Research) looks at a variety of factors.

Whether or not a recession happens, it is shaping up to be a non-traditional one as the labor markets are far more robust than what we have seen during past recessions. Other traditional recession indicators are not consistent with a recession yet. These include the yield curve (using the 10 year-3 month and 30 year-the Fed Funds Rate spreads), household incomes, ISM data and high yield credit spreads. Further, corporate earnings remain at all-time highs. At this stage, more relevant is how severe will the current economic slowdown be and how much will earnings be impacted. The strong labor markets and the high level of excess household savings could cushion the current slowdown.

The market's key focus is on inflation. Our base case view is that inflation will come down in the second half as financial conditions have tightened sharply. The pace of the easing is a key question. Will it remain persistently high or will it quickly rollover as many secondary indicators have already? The trajectory of inflation going forward will be key for equity multiples as investors interpret how the Fed will handle inflation going forward.

While the near-term market outlook is uncertain and will be volatile, the intermediate term outlook is looking more compelling. Historically when equities have fallen this sharply and equity multiples have declined to these levels, the 12-month outlook for forward returns is positive looking at past precedents. How equities perform in the near-term will largely depend on the next few months of inflation reports and how corporate earnings hold up. Inflation will drive the Fed monetary response. Equity multiples have priced in a great deal of earnings deterioration and how the market responds to the upcoming earnings season will be a key test.

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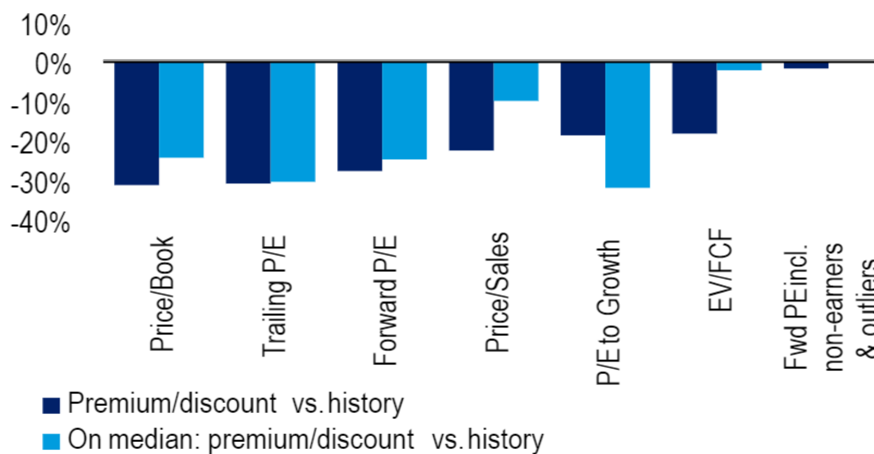
Since the Fed's last official meeting in the first half of June, a lot has changed. Commodity prices and other inflation indicators have eased, and economic conditions have slowed. The monetary policy outlook is very fluid. The Fed Funds future market is actually forecasting rate cuts next year as the economic conditions slow and inflation is expected to slow. As the outlook for inflation improves a recovery in equities could begin in the second half as the market gains clarity on the outlook for the economy. Looking ahead, many intermediate and long-term growth drivers for the U.S. economy and for many industries remain fully intact.

Valuations have declined to historically attractive levels as earnings have stayed at new highs while multiples have compressed meaningfully since last year. While earnings likely will fall over the second half of this year, much of the slowdown may already be priced in. Consider the following:

- Small caps trade at near a 30% discount relative to large caps based on multiple valuation metrics (Russell 2000 vs Russell 1000) going back to the inception of the Russell 2000 index in 1980. (See Exhibit 1 below)
- Small caps typically trade at a premium to large caps and this current relative discount has occurred only once (around the year 2000) since 1980.
- At 10-12x, the forward P/E is at prior recession lows. (See Exhibit 2)
- Small caps historically fall 36% during recessions, based on data from Bank of America, and the current Russell 2000 decline is already similar.

Exhibit 1: Small caps remain historically cheap vs. Large caps

Russell 2000 vs. Russell 1000 valuations vs. history (1985-6/30/22)



Sources: BofA US Equity & Quant Strategy, FactSet

Exhibit 2: Small Cap forward P/Es near the global crisis and Covid recession bottoms

Sources: Yardeni Research

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Performance Review

For the quarter ending in June, the Driehaus US Micro Cap Equity Fund slightly underperformed its benchmark. The Fund declined -22.4%, (I USD share class) net of fees, while the Russell Microcap Growth Index declined -22.4%. By month, the strategy outperformed in April offset by modest underperformance in May and June.

Overall, the market's price weakness was widespread with very few groups acting well and most declining sharply. Macro concerns drove the multiple compression across the equity market. Stocks with higher growth rates underperformed and stocks and industries that had performed well in 2021 continued to underperform. Stocks that were commodity or inflation beneficiaries performed well until early June then declined sharply as the market questioned the sustainability of demand while factoring in recession concerns.

Performance was also challenged as the market has been highly rotational with stock and industry leadership shifting rapidly as macro factors dominated over idiosyncratic (bottom up, company specific) ones during the quarter. Overall earnings reports for our portfolio holdings remained strong with solid forward outlooks. However, stocks typically fell (in most industries) due to sharp multiple compression as market participants are instead anticipating deceleration ahead and have questioned the sustainability of the current positive trends.

By sector, performance is summarized as follows:

Consumer staples posted positive absolute and relative performance.

Consumer Staples

Consumer Staples outperformed by 152 basis points as the sector performed well in what was a very defensive market environment. A number of specialty food and specialty beverage holdings posted strong revenue and earnings expansion that exceeded consensus expectations. We increased our relative overweight exposure to consumer staples during the quarter as the holdings performed well and a couple new specialty food positions were initiated.

The following sectors saw positive relative returns but negative absolute returns for the quarter:

Energy

Energy overall outperformed by 73 basis points on a relative basis as crude oil and natural gas prices rose driven by dramatic underinvestment in supply since the end of the Shale Revolution (the prior energy upcycle) in 2014. Exploration & Production (E&Ps) companies reported robust earnings and cash flow generation that impressively outperformed expectations. Earnings revisions went up sharply. Oil Service companies also reported strong earnings. In early June, however, as recession fears grew, the energy sector sold off sharply. We reduced our overweight position in oil/gas companies to a relative equal weight as demand fears grew during the month of June.

Technology

Technology outperformed by 49 basis points due to an underweight position and as our holdings outperformed the tech holdings in the benchmark. We maintained an underweight in semiconductors and our semi holdings outperformed those in the benchmark. We remain underweight as the semi industry remains under pressure as earnings estimates are adjusted lower due to weakness in cell phones and laptops and as the economy slows. Expectations for semi capital equipment are also being adjusted lower. Towards the end of the quarter, we did begin to increase exposure to software and IT Services as some of the worst areas of the market are beginning to perform better and the market is beginning to adjust to potential lower inflation and rate expectations. Fundamentals in software and IT Services remain strong and valuations have come down sharply.

The following sectors saw negative relative returns (in order of magnitude): consumer discretionary, materials, financials, industrials and healthcare.

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Consumer Discretionary

Consumer discretionary underperformed by 161 basis points on a relative basis. Relative underperformance came from the leisure and hospitality sub-industry. As the consumer has shifted spending from durable goods, apparel and household goods to more leisure activities, hotels, gaming, restaurants, and other related services businesses have benefitted fundamentally. However, in the month of June, as recession concerns rose these sub-industries sold off as demand was questioned. Notably, to date, company and industry channel checks remain positive but the market is skeptical that current leisure demand trends will be sustained.

Materials

Materials underperformed by 94 basis points. In April and May, the sector performed well as commodity prices rose driven by underinvestment in supply in recent years combined with continued strong demand. Areas of strength included uranium, aerospace, and agricultural related products. However, in the month of June, recession driven demand concerns caused these relatively strong stocks to underperform as sustainability was questioned. We did reduce our exposure given these macro driven demand concerns from an overweight to an underweight position.

Financials

The financial sector also trailed as it detracted 68 basis points on a relative basis. The weakness was driven by banks due to macro concerns. We did lower our modest exposure to an underweight during the quarter.

Industrials

Industrials underperformed by 20 basis points on a relative basis. A number of services companies, and other consistent growth industrials saw continued strong fundamental performance but sold off as economic growth concerns weighed on the sector. We finished the quarter with an equal weight position.

Healthcare

Healthcare underperformed by 16 basis points with 46 basis points of outperformance in biotech being offset by underperformance in other industries. The sector remained challenging during the quarter. However, as inflation and rate fears may be subsiding late in the quarter, biotech and other non-earners have begun to perform better. We have increased our exposure to biotech and healthcare overall of late as fundamental outlooks remain strong, macro fears (inflation) appear to be shifting and technical action has materially improved.

Outlook & Positioning

The market's conditions remain challenging. Macro conditions continue to dominate over bottom-up and industry trends. The market fears inflation will continue to drive the Fed to further tighten financial conditions and to raise interest rates which will put further pressure on the economy and on earnings.

Positively, valuations have declined for our portfolio and micro/small cap stocks in general. Looking at history, the current declines in price and in multiple are similar to past recessions. While the odds of a recession have increased materially, economic conditions remain mixed. Some economic variables are recessionary while several others are not yet. A second key positive is that multiple inflation indicators are easing.

However, it is not clear how quickly the rate of inflation will come down over the rest of the second half. Several scenarios could play out in terms of the trajectory of the decline in inflation. Also, it is not clear how much the economy and earnings will slow.

A bullish scenario that could unfold is inflation steadily eases over the second half of the year, the Fed's rhetoric in time adjusts to the improving inflation outlook and the economy and earnings continue to deteriorate but only modestly so.

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In this scenario, equity multiples stabilize in the coming months with severe economic and earnings declines already discounted.

A bearish scenario would be inflation remains stubbornly high versus expectations, the Fed is forced to remain very hawkish and economic growth and earnings deteriorate. While we recognize this bearish scenario is possible, our base case is that inflation will ease, earnings deteriorate only modestly, and equity multiples stabilize as they have declined to recessionary levels already.

In terms of portfolio positioning, we have an attractive mix of secular and cyclical growth holdings. By sector, healthcare remains our largest absolute weight, followed by technology, industrials, consumer discretionary, consumer staples and energy. Relative to the benchmark, the strategy is overweight consumer staples, consumer discretionary, energy and, industrials. The strategy is underweight health care, technology, and financials. Overall, we still see many dynamic investment opportunities which have reduced valuations versus the start of the year and a year ago. These holdings nicely fit our investment philosophy of companies exhibiting growth inflections, differentiation, market share gains, strong revenues and expanding profitability.

Contributors

Sierra Wireless (ticker: SWIR) engages in the provision of device-to-cloud and networking solutions with its Embedded Broadband and Internet-of-Things Solutions (IoT) segments. SWIR was a top contributor in the quarter due to strong earnings in mid-May with revenues and guided revenues 20% above consensus. Drivers included broad based demand strength for its modules and enterprise routers across IoT end markets and supply chain improvements.

Day One Biopharmaceuticals Inc (ticker: DAWN) is a development stage biotech company focused on cancer. DAWN was a top contributor due to an update to prior data in which N and duration of follow-up increased. The data were encouragingly strong, suggesting line-of-sight to approval and utilization, as well as differentiation from prospective competitors.

Detractors

Aspen Aerogels, Inc (ticker: ASPN) is a manufacturer of insulating material used across various industries including refineries, LNG facilities, and recently electrical vehicle batteries. In June, ASPN announced, and later retracted, a very large stock offering intended to finance capital expansion plans. The stock was down significantly on the deal announcement, and as a result was a large detractor during the quarter.

SpringWorks Therapeutics (ticker: SWTX) is a development stage biotech company focused on cancer. SWTX was a top detractor due to the release of multiple new datasets, most of which were encouraging, but one of which left room for confusion. The confusion generated by one of the datasets resulted in the stock being particularly weak, leading the strategy to reduce exposure.

Outright Buy

The Chefs' Warehouse, Inc (ticker: CHEF) is a premier distributor of specialty food products in the US and Canada. CHEF was a top outright buy during the quarter as we saw potential for a recovery in restaurant industry sales and rising food inflation to yield accelerating revenue and earnings growth. This thesis was reinforced when CHEF raised guidance in late June.

Outright Sell

NMI Holdings, Inc (ticker: NMIH) is a private mortgage insurance company. NMIH was the largest outright sell during the quarter as a rapid increase in mortgage rates increased our concerns about the trajectory of the housing market. A weaker housing environment would be detrimental to new policy growth and credit costs.

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Sector performance attribution- Q2 2022

	Driehaus Micro Cap Growth Composite (Port) (%)		Russell Microcap® 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	0.78	-0.18	1.80	-0.67	0.13	0.10	0.23
Consumer Discretionary	15.06	-5.08	14.02	-2.82	-0.07	-1.48	-1.55
Consumer Staples	8.03	0.55	2.49	-0.25	0.78	0.74	1.53
Energy	12.24	-2.46	6.51	-1.86	0.19	0.54	0.74
Financials	3.68	-1.25	3.64	-0.54	-0.01	-0.67	-0.68
Health Care	26.59	-6.65	34.57	-8.27	0.16	-0.32	-0.16
Industrials	13.52	-3.15	12.51	-2.74	0.05	-0.24	-0.20
Information Technology	10.48	-1.64	16.57	-3.74	-0.04	0.53	0.49
Materials	5.56	-2.38	4.08	-0.96	0.27	-1.21	-0.93
Real Estate	0.42	-0.25	2.96	-0.59	-0.09	-0.14	-0.24
Utilities	0.00	0.00	0.75	-0.03	-0.12	0.00	-0.12
Cash	3.65	0.00	0.00	0.00	0.84	0.00	0.84
Other*	0.00	-0.27	0.11	0.00	-0.24	-0.02	-0.26
Total	**100.00**	**-22.77**	**100.00**	**-22.46**	**1.86**	**-2.17**	**-0.31**

Sources: Driehaus Capital Management LLC, Factset Research Systems, Inc., eVestment Alliance
**Other refers to the securities not recognised by Factset.*
Data as of 30 June 2022

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Annualized Total Returns as of 30th June 2022, gross of fees

	Q2 22	YTD	1-Year	3-Year	5-Year	10-Year
Driehaus Micro Cap Growth Composite	-22.3%	-38.3%	-36.0%	15.3%	19.3%	20.5%
Russell Micro Cap Growth Index TR	-22.4%	-33.0%	-44.0%	0.1%	1.6%	7.0%

Source: Driehaus Capital Management, Bloomberg

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

Sincerely,
Heptagon Capital and Driehaus Capital Management

The views expressed represent the opinions of Driehaus Capital Management, as 30th June 2022, are not intended as a forecast or guarantee of future results, and are subject to change without notice.

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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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