HEPTAGON Capital

Driehaus US SMID Cap Equity Fund

Q4 2024 Commentary

Portfolio Management

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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 19.7 billion of assets under management.

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Opinions expressed whether in general or in both on the performance of individual investments and in a wider economic context represent the views of the contributor at the time of preparation.

The **Driehaus US SMID 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. Since the Fund has a relatively short time period, the following commentary makes extensive reference to the Driehaus Small/ Mid Cap Growth Strategy to provide a better understanding of how the team has managed this strategy over a longer time period. The Fund was launched on 9th December 2024 and has an AUM of USD 160m as of 31st January 2025. From this inception date, the Fund underperformed its benchmark, the Russell 2500 Growth Index TR USD (the "Index"), by -0.8%.

Market Overview

The U.S. equity market experienced broad dispersion of leadership during the December quarter. Growth outperformed value by a wide margin. Large caps and micro caps both outperformed small caps handily. The broader U.S. indices saw slight declines throughout October, following the U.S. election in November the market saw robust gains. The market was optimistic following Donald Trump's victory and the Republicans winning both the Senate and the House in Congress fueled by the belief that pro-growth and pro-US policies will drive economic strength.

However, the strength in November was not sustained as equities saw a sharp decline in December. That weakness was caused by several factors. One being that the market was overbought after the move higher in November and investor sentiment reached bullish extremes entering December. An overbought market with too many bulls doesn't typically trigger a broad sell-off alone without a catalyst. That major catalyst was the sharp rise in long-term treasury yields which had risen nearly 90 basis points from the September lows to mid-December. Another factor was a key shift in the Federal Reserve's forward guidance when it cut the federal funds rate for the third time this year in mid-December. The Fed's "Dot plots" in its Summary of Economic Projections (SEP) was updated to suggest only two rate cuts in 2025 which

was less than the four cuts expected by the market. Another factor was the reality of some of the emerging aspects of President-Elect Trump's new administration (let's call it Trump 2.0) which were beginning to weigh on the market's initial optimism. These concerns include the impact of new proposed tariffs and some of the rather unorthodox nominees of Trump's new cabinet. More on this below.

The market's rise in November was arguably well deserved as many market variables were flashing green, such as:

- Corporate earnings continued to display strength during the September quarter earnings season in late October and early November.
- Many sectors and industries are benefiting from robust themes and secular trends.
- The U.S. economy continues to hum along. Consumer spending remains solid. The service economy (ISM Services remains nicely above 50) continues to expand more than offsetting the sluggish manufacturing side of the economy (ISM Manufacturing still below 50, though it appears to be recovering).
- The labor market remains strong as payrolls and new job formation continue to increase. Jobless claims remain low, and the unemployment rate remains steady at just over 4%.
- Though wage growth is moderating, overall inflation is not falling as fast as hoped. It does continue to show progress towards the Fed's 2% target, but this is partly why the Fed reduced its rate cut forecast for 2025.
- The Fed does remain in a dovish cutting cycle despite the less than dovish new rate reduction forecast for 2025 (potentially two cuts versus the estimate of four).
- The Trump and Republican's victory in early November are pro-growth and have awakened the market's animal spirits.
- So, the market now has two bullish "Puts" out of Washington D.C. – a "Fed Put" and a "Trump Put". This Trump Put was powerful during Trump's first term (2016-2020) and historically the evidence suggests the market performs well when the Fed is in a cutting mode.
- Further supporting the equity market are relative valuations that are favorable for small caps relative to large caps. Valuations have been supportive of small caps in past market cycles with the early 2000's being the most similar period to now when small caps traded at similar deep relative discounts to large caps. See Exhibit 1 and 2 below which show how small caps often trade at a premium forward P/E multiple to large caps but have traded at a deep discount for a few years now.

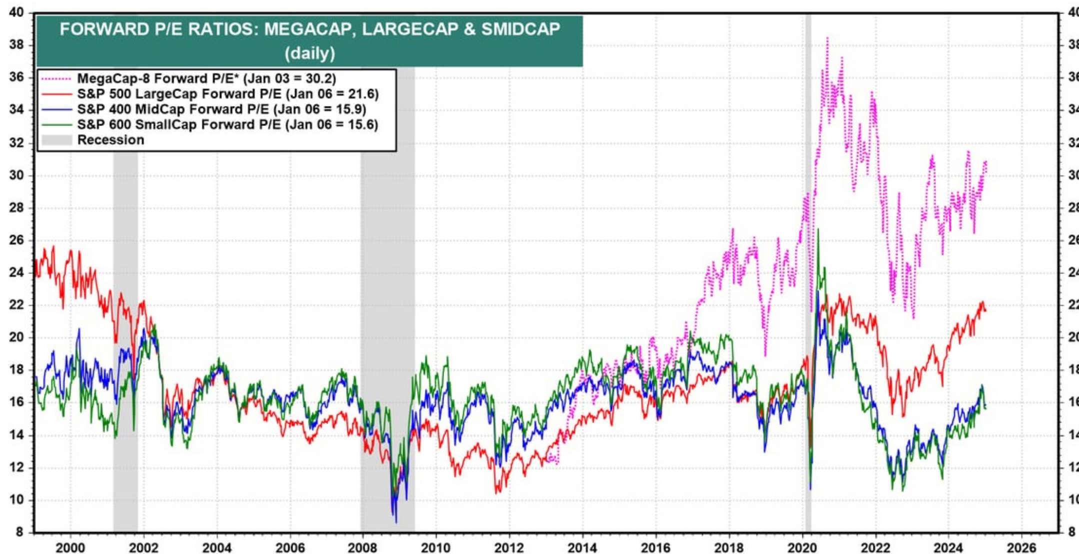
Exhibit 1: Small Caps Remain Historically Cheap vs Large Caps

Relative Forward P/E: Russell 2000 vs Russel 1000, 1985-12/31/2024

Source: BofA US Equity & Quant Strategy, FactSet

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

Exhibit 2: Forward P/E Ratios: Mega Cap, Large Cap, SMID Cap (daily)

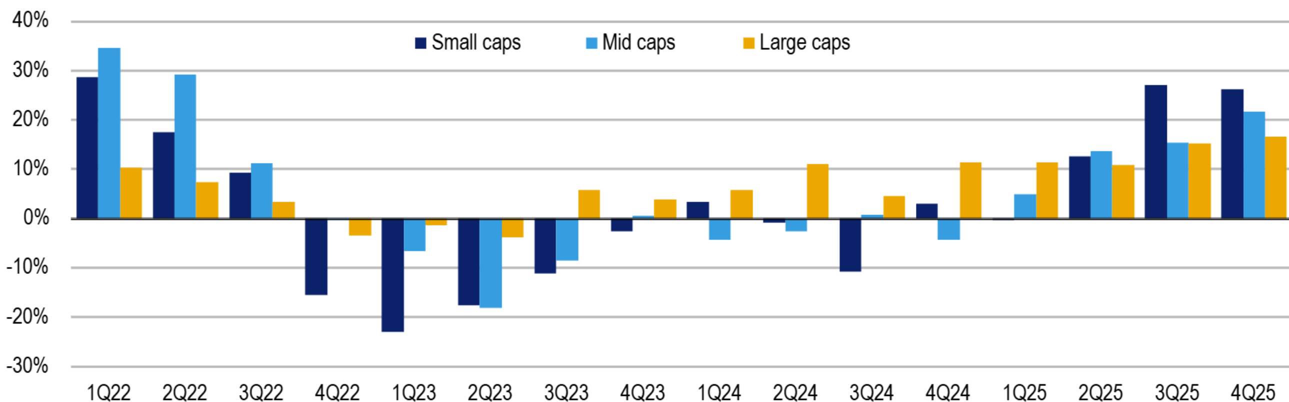


Source: Yardeni Research

**MegaCap-8 stocks include Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, NVIDIA, and Tesla. Both classes of Alphabet are included.*

- Key to this valuation set up is the consensus forecast for small and mid cap earnings to continue to recover and accelerate from 2024 throughout 2025. Exhibit 3 below shows consensus earnings for small and mid caps (the two blue bars) are expected to continue to recover and accelerate on a year-over-year basis:

Exhibit 3: Bottom-up Consensus Quarterly YoY ESP Growth for S&P 600, S&P 400 and S&P 500, 1Q22-4Q25E



Source: BofA US Equity & Quant Strategy, FactSet

After the strong November, going into early December, sentiment had become elevated. Then the rise in rates caused equities to fall sharply. A strong rebound in economic surprises, mixed inflation data (not falling fast enough), the concern that Trump's growth-oriented policies would sustain deficit spending and a more hawkish tone from the Fed together drove long-term treasury yields higher. After bottoming in September at 3.6%, the 10-year treasury yield rose nearly 100 basis points hitting 4.6% in early January. This sharp rise in longer-term yields began to weigh on economic growth expectations and put pressure on P/E's and overall valuation multiples.

Market breadth (the ratio of advancers to decliners) in November was strong but breadth flipped very negatively in December. By some measures market breadth saw some of its weakest readings in decades. It is unusual to see such weak price action and breadth during December, a strong seasonal month. However, from a positive perspective, the sell-off in December may have resolved the elevated sentiment and the overbought technical conditions. Observing the broader market, many stocks pulled back price-wise in a constructive manner (there was relatively little technical damage). Additionally, the core drivers of the market's strength in 2024 remain very much in place: improving earnings,

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sustained economic growth, a positive shift in Washington DC with Trump winning a second term, the Republicans regaining control of Congress and the Fed still in an easing mode. Notably, this positive backdrop will need long-term rates to behave without rising to new highs for this cycle.

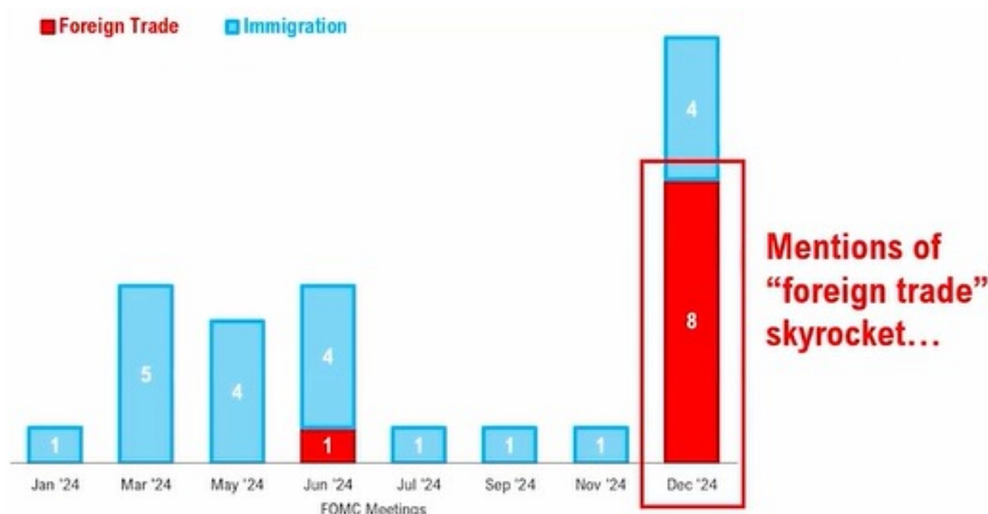
What do Trump and the Republicans winning control of Congress potentially mean for U.S. equities and the economy?

There is general optimism that the incoming administration will positively affect regulatory, tax and energy policies which will spur economic improvement. The President-Elect has sharply increased optimism in public opinion polls as well as animal spirits in market prices and in terms of market investor sentiment and psychology.

However, there is concern and uncertainty surrounding several issues. The first concern is tariffs. The recent December Federal Open Market Committee (FOMC) minutes showed a lot of discussion and concern among FOMC members about the impact of upcoming trade policy and tariffs on inflation (see bar chart below). Theoretically, additional tariffs may raise inflation and hurt economic growth. Surveys show tariffs are causing companies to begin to look for alternative suppliers, to adjust purchasing decisions and to consider implementing price increases. On the other hand, higher prices if they occur would be a one-time rise rather than a sustained rise in the rate of change of prices. Also, Trump is aware that one of the reasons he won the election was due to inflation so he may be careful to not further increase it. It may be a matter of watching what he does rather than what he says. Additionally, many of his tariff threats are his way of negotiating with other countries on certain issues. Further, evidence of incremental inflation caused by tariffs during his first term is minimal. Either way, at a minimum, tariffs certainly do raise the level of risk of inflation, and they increase uncertainty, both of which are drivers of increasing yields, which has been responsible for recent volatility and multiple compression in the U.S. equity market since early December.

Another concern for the market is the likely reduced immigration and potential deportations. While deportations are likely to be very limited (despite the rhetoric, Trump's first term saw far fewer deportations than other presidential terms since at least 1980), they are causing concern around labor availability in the housing, construction, hospitality and other industries with higher levels of migrant labor.

Exhibit 4: Of Mentions of "Trade " and "Immigration" in FOMC Minutes



Source: Fundstrat, FOMC

Despite this elevated uncertainty surrounding tariffs, the December FOMC minutes also show overall inflation is largely trending favorably. Positively, the minutes show core inflation is trending back to long-term trends as "participants observed…core goods and…core services…excluding housing" are trending "close to those seen during earlier periods of price stability". Also, "firms are more reluctant to increase prices" and "the price increases were concentrated largely in categories that…aren't reliable signals…of the future trajectory of inflation".

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An additional concern is Trump's new appointees to his Cabinet and other key leadership positions. While most of these appointees are not impactful to individual stocks, one nomination in particular has had an impact. Trump's nomination of Robert F Kennedy Jr (RFK Jr) to head Health and Human Services (HHS) has caused volatility and multiple compression in the healthcare sector. RFK Jr has unorthodox and controversial views on vaccines, the relationship between drug companies and the Food and Drug Administration (FDA) and the drug approval process in general. While the FDA will have a separate commissioner, it is a critical department that falls under the purview of HHS. So many fear he will change and elongate the drug approval process. While possible, this is unlikely to have a material impact on the approval process of innovative and novel therapeutics in most disease categories.

Another area of the market that has seen multiple compression is for the many companies that have the federal government as a customer. The Department of Government Efficiency (DOGE) is a brand new presidential advisory committee headed by Elon Musk and Vivek Ramaswamy to recommend removing regulations in order to reduce federal government expenditures and to increase government efficiency. It has a stated goal to cut federal government expenditures by $2 trillion dollars. The market's knee jerk response is to sell off any stock that has revenue exposure to the federal government. While some companies will see reduced expenditures, most companies will see little to no impact.

Overall, the impact of Trump's policies should be positive for many parts of the economy, and Driehaus believe many industries will see a benefit from deregulation, lower taxes, reshoring, infrastructure and other policies.

Performance Review

The Driehaus Small/Mid Cap Growth strategy outperformed its benchmark by 90 basis points for the fourth quarter, gaining 3.3% versus a gain of 2.4% for the Russell 2500 Growth. For comparison, the Russell 2500 gained 0.6%, Russell 2000 0.3%, the Russell 2000 Growth 1.7%, and the S&P 500 2.4%.

For the full year of 2024, the strategy outperformed its benchmark by 1,421 basis points gaining 28.1% versus 13.9% for the Russell 2500 Growth as well as 12.0% for the Russell 2500, 15.2% for the Russell 2000 Growth, 11.5% for the Russell 2000, and 25.0% for the S&P 500.

Sectors contributing positively to returns during the quarter (in order of relative impact):

Technology
Technology contributed 98 basis points on a relative basis and 242 basis points in absolute terms, as the holdings gained 15.2% versus a gain of 8.7% for the Index's tech holdings. The team increased their exposure to the sector from 16.5% to 20.3% during the quarter, a slight underweight versus the benchmark at 21.0%. Strength during the quarter came from semiconductors and networking equipment suppliers providing gear to data centers for AI applications. This was offset by relative weakness in software as the group did see strength in cyber security companies but underperformance from a few enterprise software companies that saw multiple compression as interest rates rose and the broader market sold off in December.

AI (Artificial Intelligence) was the dominant theme for 2024. Particularly AI infrastructure spending was robust for the year especially for companies exposed to the strong and growing capex (capital expenditures) trend in data centers. Looking ahead, the team continue to be positive on AI as a powerful and transformational theme. While they do expect the 40% increase in capex to decelerate in 2025 and 2026, they believe AI infrastructure spending will remain strong.

Communication Services
Communications Services contributed 72 basis points on a relative basis for the quarter and contributed 78 basis points in absolute terms. The Strategy's holdings appreciated 65.3% versus 8.2% for the Index. Driehaus increased the exposure to this small sector to 2.1% from 1.4% versus an Index weighting of 1.8% by the end of the quarter. Outperformance came from a media company that has successfully merged with its largest peer and a newly public social media company that had robust earnings, rapid growth and strong market share gains.

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Financials

Financials contributed 51 basis points on a relative basis for the quarter and 112 basis points in absolute terms. The Strategy's holdings rose 12.9% versus 7.2% for the Index. The team maintained the exposure to the sector at 9.5%, versus the Index at 9.8% by the end of the quarter. They saw strength among the holdings in capital markets with outsized gains from an online brokerage firm, and in fintech with a strong advance in a Buy Now Pay Later (BNPL) company which saw rapid growth and strong upward estimate revisions. The team's holdings had tiny declines in banks and specialty insurance.

Consumer Staples

Consumer Staples contributed 39 basis points in relative terms and 55 basis points in absolute terms. The holdings gained 14.1% versus a gain of 4.3% for the Index. The team increased the exposure from 3.7% to 4.2% during the quarter, a slight overweight versus the Index at 3.0%. Strength came from a specialty beverage company, a specialty grocery store, and a pet food supplier as each outperformed with strong earnings surprises and market share gains.

Energy

The Energy sector contributed 4 basis points in relative returns and 13 basis points in absolute terms. The energy stocks rose 5.5% versus a decline of 3.8% for the Index. Driehaus increased their exposure from 2.6% to 4.2% maintaining an overweight versus 3.8% for the Index. The Sund's holdings in oil services, exploration and production and uranium mining all saw gains. The team continue to view the outlook for the supply and demand for uranium to be very favorable and sustainable. In addition, the outlook for natural gas is becoming increasingly attractive as they see demand drivers such as AI and LNG positively impacting U.S. producers.

Sectors detracting from relative returns during the quarter (in order of relative impact):

Healthcare

Healthcare detracted 150 basis points in relative terms and 256 basis points on an absolute basis as the holdings declined 12.1% versus 5.2% for the Index. The team decreased their exposure from 21.6% to 20.4% during the quarter, which compares to 20.6% for the Index. The portfolio is overweight biotech and medical devices while underweight the other smaller healthcare sub-industries within the benchmark.

The Healthcare sector saw widespread multiple compression after the appointment of RFK Jr to run HHS. As mentioned earlier he is controversial, and the market fears he will have a negative impact on the approval process for new drugs and medical devices. His impact remains to be seen, and a lot will depend on the new FDA commissioner. Driehaus believe their portfolio holdings with innovative new therapies will still see their drug candidates get approved. The only holding that potentially has direct exposure to RFK Jr's actions is a developer of pneumococcal vaccines. While Driehaus believe this company does have a best-in-class vaccine in a very large market that will ultimately get approved, they were uncomfortable with its potential multiple compression, so they did reduce this position during the quarter. This particular stock was one of their largest outperforming stocks in the September quarter after it posted positive data, so they essentially took profits on those gains.

Biotech underperformed due to multiple compression related to uncertainty surrounding RFK Jr and higher interest rates during the quarter. The biotech positions declined 7.3% versus 6.5% for the Index for the quarter. For the full year, the biotech positions were still a material outperformer, gaining 14.7% versus 8.2% for the Index.

Driehaus remain encouraged fundamentally as they believe their biotech holdings have very promising and innovative clinical stage therapies demonstrating superior efficacy and safety in important disease indications, such as obesity, epilepsy, endocrinology, diabetes, neurology, autoimmune diseases, vaccines, and oncology. Driehaus anticipate promising results from upcoming clinical trials.

Medical devices detracted for the portfolio, as one holding saw a sharp decline after disappointing earnings and forward guidance. Driehaus did reduce this position sharply while maintaining a small weighting for now.

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Consumer Discretionary

Consumer Discretionary detracted 16 basis points on a relative basis and 8 basis points in absolute terms. The holdings fell 0.1% versus a gain of 1.0% for the Index. The team decreased their sector exposure from 13.9% to 13.5% versus 14.1% for the Index, mostly by reducing exposure to home builders and building suppliers. They saw a pullback in many of their stronger positions in the month of December in restaurants and home builders as the market declined and interest rates rose. The portfolio saw strong gains from an online auto retailer, and two shoe companies as each reported strong earnings and upward estimate revisions. Driehaus have a positive outlook for consumer spending as the labor market remains healthy, and consumer incomes and net worth remain at new highs.

Materials

Materials detracted 14 basis points in relative terms and 29 basis points on an absolute basis as the holdings declined 17.7% versus 7.1% for the Index. Driehaus decreased their exposure from 2.6% to just 1.0% during the quarter, compared to 3.4% for the Index. Their holdings saw declines from a construction material supplier and two metal and mining companies.

Industrials

Industrials detracted 6 basis points in relative terms but contributed 133 basis points in absolute terms, with the holdings rising 3.9% versus 5.2% for the Index. The team remain overweight the sector, though they decreased the exposure from 26.5% to 23.3% versus 20.7% for the Index. Driehaus continue to be positive on the sector with numerous holdings with strong earnings outlooks and also several compelling investment themes. These include positions benefitting from attractive trends within reshoring, infrastructure, commercial aerospace, and data centers where AI is driving demand for various technologies and equipment. One software and hardware supplier to police departments and first responders saw strong gains after it posted robust earnings and increased guidance. The team did see small declines in two service companies with modest exposure to the federal government.

Outlook & Positioning

Equities saw gains in the December quarter. Small and mid caps outperformed after the election with significant gains in November but then sharp declines in December as interest rates rose and the Fed proved less dovish than anticipated. Looking ahead, corporate earnings are improving, economic strength appears sustainable, valuations for smaller cap equities are relatively attractive, the new Trump administration should be largely positive for equities and the Fed is still in a rate cutting cycle, all of which are historically favorable for equity prices.

The team believe these positive variables outweigh several bearish concerns or risks, including potential stickiness of the rate of inflation, the risk of tariffs, geopolitical events and rising interest rates. Of these, Driehaus view rising interest rates to be the biggest risk.

In terms of portfolio positioning, the team have an attractive mix of secular and cyclical growth holdings with strong earnings. By sector, Industrials remain the team's largest absolute weight, followed by Healthcare, Technology, and Consumer Discretionary. On a relative basis, the strategy is overweight Industrials, Consumer Staples, and Communication Services. The Strategy is underweight Technology, Materials, Financials, Healthcare, and Consumer Discretionary.

Quarterly Contributors

Astera Labs, Inc. (ALAB) designs semiconductors used in high-speed connectivity applications in data centers, such as PCIe retimers, switches. ALAB was a top contributor as the company reported strong 3Q24 results with revenues 16% higher and guided 4Q24 revenues 15% higher than expected. Strength was driven by robust retimer product sales to multiple hyperscalers with company expecting new Switch product sales to start in 4Q24 and to accelerate revenues through 2025.

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Axon Enterprise Inc (AXON) develops advanced electronic control devices for law enforcement, military, and corrections/consumer markets. In August, AXON reported 2Q24 revenue and earnings per share that exceeded consensus expectations by 5% and 17%. The company also raised its guidance for 2024 due to the strong 2Q24 results and potential for new products to expand its total addressable market. As a result, AXON's stock performed strongly and was a top contributor during the quarter.

Quarterly Detractors

TransMedics Group, Inc (TMDX) was a top detractor for the fourth quarter of 2024. The company sells equipment and services that enable more, and higher-quality transplants for patients that need them. During the fourth quarter the company released their fiscal third quarter earnings and in that release the company missed consensus expectation on revenue for the first time since the team bought the stock. The market had been accustomed to large revenue (and earnings) beats, and the miss relative to expectations was poorly received by the market. Shares of TMDX traded down 38% the day of the release.

Vaxcyte, Inc. (PCVX) was a top detractor for the fourth quarter of 2024. The company is a clinical stage biopharmaceutical company that is developing highly differentiated vaccines for infectious disease. During the fourth quarter, President-elect Trump announced the nomination of RFK Jr. to lead the US Department of Health and Human Services, and given RFK Jr's negative opinion of vaccines the market perceived increased risk to Vaxcyte's future, potential dominance of the markets for which they had shown best-in-category data. Shares of PCVX traded down 28% during the fourth quarter of 2024.

Outright Buy

Astera Labs, Inc. (ALAB) designs semiconductors used in high-speed connectivity applications in data centers, such as PCIe retimers and switches. As above, in 4Q24, the company reported strong 3Q24 results with revenues 16% higher and guided 4Q24 revenues 15% higher than expectations. Strength was driven by robust retimer product sales to multiple hyperscalers with company expecting new Switch product sales starting in 4Q24 and expected revenues to increase through 2025. Driehaus initiated a position in the Strategy as ALAB is experiencing product cycle driven growth with both retimer and switch product seeing increased sales to drive upside to 2025 consensus revenues and earnings estimates.

JBT Marel Corporation (JBTM) makes food processing machinery. During October, JBTM reported 3Q24 Revenue and Earnings per share that exceeded estimates by 3% and 6%. The company also reported orders +10% and expressed some confidence in end market stabilization. Additionally, JBTM provided increased confidence in closing their announced acquisition of Marel Corporation which would increase market share into a stabilizing market. To gain exposure to the expected uplift, the Strategy initiated a position in JBTM.

Outright Sell

Baldwin Insurance Group, Inc (BWIN) is an independent insurance distribution firm. BWIN was a top sell after concerns arose regarding funding capacity for a homeowners insurance program that had been a meaningful driver of organic growth. Moderating tailwinds from rate and exposure also pressured the outlook for organic revenue growth.

Wingstop, Inc (WING) engages in operating and franchising over 2,450 restaurants worldwide that focus on chicken wings. WING was a top sell due to moderating same store sales growth after lapping more difficult comparisons.

Sincerely,
Heptagon Capital and Driehaus Capital Management

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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

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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

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