HEPTAGON
Capital

European Focus Equity Fund

Market commentary and attribution analysis as of 31st March 2024

Portfolio Management

Christian Diebitsch

Investment Objective

The Fund aims to deliver long-term capital appreciation by investing in European equities. The Fund employs a high conviction, bottom-up, low turnover, research driven strategy with a focus on companies that exhibit sustainable long- term growth.

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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.

Performance and executive summary

The Heptagon European Focus Equity Fund performed well during 1Q24. The Portfolio advanced by +10.73% in absolute terms to a NAV of €220.56 outperforming the benchmark MSCI Europe Net (EUR) index which rose by +7.63% in comparison (+310bps relative performance). In our opinion, there were two main drivers to the outperformance of the Portfolio in 1Q24: *(i)* solid FY23 results from the Portfolio companies and *(ii)* lower bond yields, which suits the quality-growth investment style. Monthly analysis shows that European Focus as well as the European equity markets closed higher in all of the months in 1Q24. The Portfolio outperformed in January and February, but it fell slightly behind the benchmark for the month of March as deep-value sectors, which the Fund does not invest in, were in vogue.

2023 was all about inflation while 1Q24 is all about 'core inflation'

One of the key drivers to equity market gains in 2023 was how successful the leading Central Banks were in their aim to push inflation and inflation expectations lower by holding interest rates at 'restrictive' levels. Entering 1Q24, we believe smart consensus had refined its focus to concentrate on 'core inflation', which strips out food and energy prices, in order to gauge *when* the Central Banks would embark on their rate-cut cycles. As 1Q24 progressed, most inflation data economies continued to decline, but one major stumbling block remained – tight labour markets – and thus underlying wage pressures. While each geography has its own peculiarities for the prevailing tightness in labour market conditions, it now appears as if the overall jobs market is softening in most developed economies.

From our inhouse analysis and by speaking to our Portfolio/Universe companies which are involved with recruitment, we construe that:

- Demand for 'talent' is as high as ever
- Candidate confidence has weakened as wage growth has come off
- Clients (i.e. companies) take longer to make up their minds regarding hiring decisions

Hence, it looks as if the employment environment is weakening (albeit slowly), but wage growth still needs to further soften in order for core inflation to decrease. As we go through 2024, we expect slightly higher unemployment rates while wage pressures for 'talent' should continue to be sticky.

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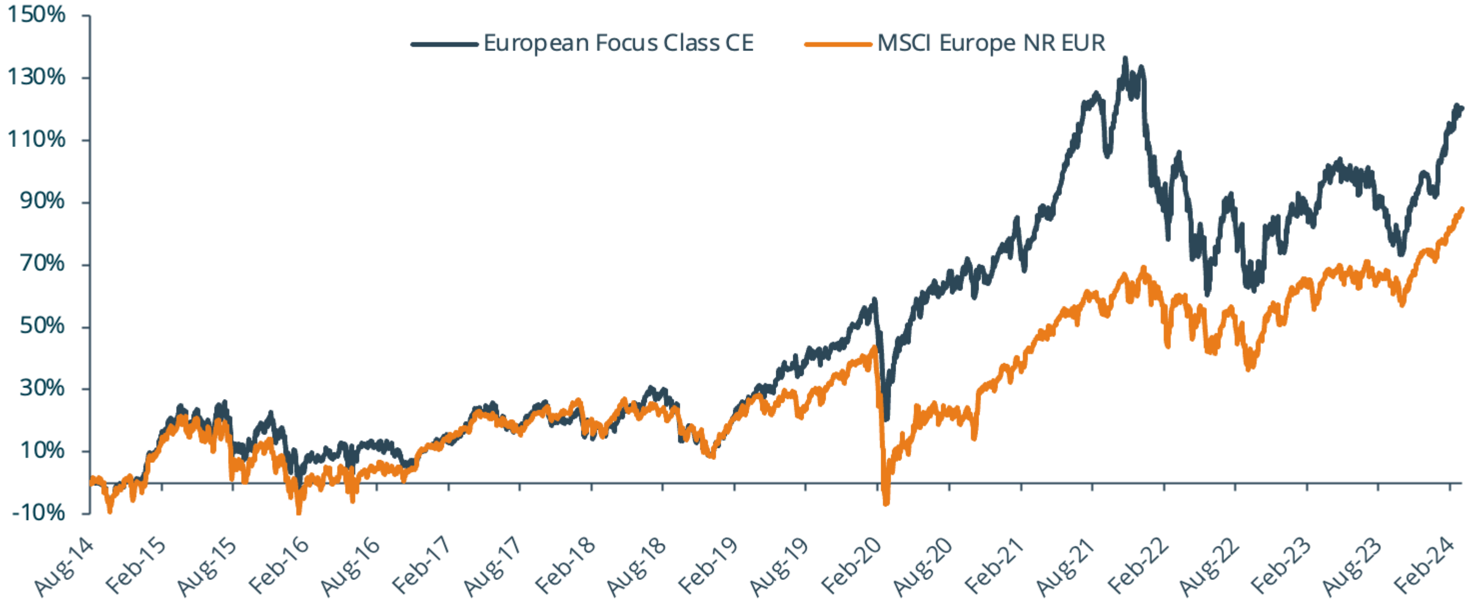
The European Focus CE share class performance since inception on 26 August 2014



**From Fund launch 26/08/2014*
Source: FactSet Research Systems

Attribution analysis for 1Q24

In the below attribution analysis for 1Q24, the performance of each stock has been converted to EUR from its local currency. Each stock's EUR-denominated performance should be compared with the benchmark index, MSCI Europe NR (EUR), which advanced by advanced by +7.6% over the same period.

Contributors

Lonza (LONN SW)

LONN (Switzerland: +52.7% and 3.4% exposure), the world's largest CDMO (Contract Development Manufacturing Organization) was the best-performing stock in the Portfolio in 1Q24. This is a far cry from 2023 when the stock was the third weakest performer in the Portfolio. LONN fell from grace during the summer of 2023 as not much went the company's way in 2H23. Hindsight shows that the problems started upon the release of the 1H23 results (21st Jul-23), which disappointed. Two main reasons were to blame. *First*, there was under-utilization in early-stage biotechnology services (caused by higher funding costs). *Secondly*, there was lower demand for nutraceutical capsules (due to a weaker consumer environment). Management duly cut the FY23 sales guidance from *'high single-digit'* to *'mid-to-high single-digit'* LfL growth as well as the core EBITDA margin guidance from *'30-31%' to '28-29%'*. To add insult to injury, LONN soon afterwards released a communique (18th Sep-23) that Pierre-Alain Ruffieux (the CEO), would leave the company by mutual agreement. Naturally, this raised market concern about the company's medium-term outlook. Around the same time, there was another press release commenting that LONN and Moderna would dissolve its JV as demand for Covid-19 vaccines was waning. LONN swiftly organised an Investor Day (17th Oct-23) to clarify some of these concerns. In our opinion, the main takeaways from the Investor Day were that the medium-term (2024-28) annual LfL sales growth rate should be in the 11-13% range (FY23: 10.9%) and core EBITDA margin in the 32-34% range (FY23: 29.8%). However, LONN's main short-term predicament was that sales growth rate would be subdued in FY24 following a termination fee from Moderna (we believe around CHF200m, or circa 3% of FY23 revenues), which was to be booked as a one-off income.

Fast-forwarding to the release of the FY23 set of results (26th Jan), we consider LONN's Board to have been commendably quick in addressing the market's concerns. Although the company yet again issued a statement which contained considerable restatements and lacked transparency, investors took a liking to the report as the long-standing Chairman and currently acting CEO, Albert Baehny, would (finally) step down. His replacement will be Jean-Marc Huët (Unilever's former CFO and the current Chairman of Heineken), who will assume the role of Chairman of Lonza following the AGM (8th May). Albert Baehny will remain acting CEO until the summer of 2024 when Wolfgang Wienand will take over the helm of LONN. Wienand is currently the CEO of Siegfried Holding AG (another Swiss DCMO).

As a long-standing investor of several Swiss businesses, we consider Switzerland to often foster world-leading businesses where the requirement for *'precision'* is critical (such as in the weaving-machinery industry, watchmaking, medical-technology etc). Against this backdrop, we cannot see why LONN – as a reputable company and world-leading CDMO – would be an exception. LONN will publish 1H24 results on 25th Jul. While we have low expectations for a meaningful improvement of LONN's underlying business, we are hopeful that the new CEO and Chairman along with the rest of the management team will improve – both in terms of transparency as well as disclosure.

Tomra (TOM NO)

TOM (Norway: +31.6% and 5.1% exposure), the world's leading provider of recycling and sorting equipment of beverage bottles and cans, was the second best-performing stock in the Portfolio in 1Q24. Like in the above case of Lonza, this is a far cry from 2023 when the TOM stock was the second weakest performer in the Portfolio. What is different this year is that the EU Council and Parliament have come to an agreement regarding recycling rates. The agreement (5th Mar) states that EU member must ensure separate collection of at least 90% of single-use plastic bottles and metal beverage containers annually by 2029. In order to achieve this target, EU members will need to set up deposit-systems for such packaging formats. In our opinion, TOM's main competitive edge does not relate to its machinery (so called 'RVMs', i.e. Reverse Vending Machines) – but in how to implement different deposit-systems for beverage bottles and cans in different jurisdictions depending on the legislative situation and how they should be optimally funded. This is normally achieved by incentivising consumers to return empty bottles and cans. In a nutshell, TOM acts as a consultant by guiding countries and communities how to best implement deposit systems.

When TOM released the FY23 set of results (15th Feb), the company's order backlog stood at a near an all-time high while the order intake continued to be strong. While we remain cognisant that the company's business volumes often tend to be 'lumpy' due to generally large order values, the Collection division (FY23: 54% of sales and 74% of EBITA), which deals with the core RVMs machinery and deposit systems should continue to perform well. TOM's next set of statement, the 1Q24 result statement, is due on 26th Apr. We expect management to continue to guide for buoyant trading in the Collection and the Recycling divisions, while further highlight progress in restructuring the currently lagging Food division (FY23: 25% of sales and 24% of EBIT).

ASML (ASML NA)

ASML (the Netherlands: +30.9% and 6.7% exposure), the world's leading supplier of semi-conductor manufacturing equipment was the was the third best-performing stock in the Portfolio in 1Q24. The ASML share performed extremely strongly in 1H23 but temporarily underperformed in 3Q23 as technology and other growth-like stocks fell out of favour with investors due to persistent inflation concerns. However, the stock bottomed out and resumed its strong performance as of 4Q23. Two key drivers continue to underpin the company's strong fundamentals. *First*, ASML holds a de-facto monopoly in the EUV technology, which is the most advanced method to manufacture semiconductors enabling chipsets size, speed and thus energy efficiency. *Secondly,* countries recognise that semi-conductors are a necessity in today's society and thus pursue *'tech-sovereignty'*. Over-and-above these strong fundamentals, the US bell-weather company, Nvidia, on-and-off remind investors that AI is here to stay – and to which ASML will supply semi-conductor manufacturing machinery for many years. ASML will publish 1Q24 results on 17th Apr; we believe these numbers will continue to be strong and that analysts will continue to upgrade their sales and profit forecasts.

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Novo Nordisk (NOVOB DC)

NOVOB (Denmark: +26.2% and 9.3% exposure), the world's largest manufacturer of insulin and obesity drugs, was the fourth best-performing stock in the Portfolio in 1Q24 (and the second best-performer in 2023 as well as the best performer in 2022). NOVOB de-throned LVMH to become Europe's largest company by market capitalisation in 3Q23 and this has been the case since then. The fundamentals of the company's top-selling obesity drug, *'Wegovy'*, still appear to be truly amazing. The focal points for healthcare authorities and society in general to consider are: *(i)* obesity should be regarded as a chronic and relapsing disease; *(ii)* the market value of obesity drugs is expected to reach some $200bn within the next decade; *(iii)* according to the WHO more than 1bn people globally are currently suffering from obesity and this number is expected to double by 2035 due to sedentary lifestyles and rising availability of processed food; *(iv)* the World Obesity Federation expects the economic cost of obesity to reach around 3% of global GDP by 2035.

Putting these market drivers into context; NOVOB's FY23 sales reached nearly $34bn, of which less than $5bn related to obesity drugs (circa 18%), which implies that there is a considerable upside potential for obesity drugs assuming that NOVOB will capture a significant part of the market, which has been the case of the insulin market. A few additional attributes also attract us in respect of the FY24 outlook and beyond. *First*, the company will ramp-up production of Wegovy in 2024 to meet demand. *Secondly*, Wegovy will be rolled out in several European countries. *Thirdly*, NOVOB has also set its sight also on the *prevention of obesity* in order to better understand the underlying causes of weight gain. NOVOB is scheduled to release 1Q24 results on 2nd May; we have no reason to believe that this report and the FY24 guidance will be anything but solid.

Zalando (ZAL GY)

ZAL (Germany: +25.3% and 2.4% exposure), Europe's largest online fashion retailer, was the fifth best-performing stock in the Portfolio in 1Q24 (which is also a far cry from 2023 when it was the worst-performing stock in the Portfolio). The poor performance of the ZAL share continued during January and February 2024. However, the 4Q24 set of results (13th Mar) exceeded lowly set expectations, but the ZAL share had an extremely positive reaction by the investment community as management outlined a new (and possibly workable medium-term strategy) during an Investor Day which followed the formal quarterly results webcast. What has changed is that ZAL has recognised that its market shares across Europe in the online segment is *'decent'* – not only in the DACH region but also in other parts of Europe and management convincingly stated that Europe has several *'challenges'* in terms of integration given: some 40+ countries, 30+ languages, multiple currencies along with dozens of payment, delivery and return solutions.

Against this backdrop, ZAL aims to use its current position as a leading online apparel retailer by providing a *'European platform'* which aims to serve customers and their lifestyles on a conform and easy-access-basis. At the heart of the company's offering will be fashion (garments, shoes, make-up etc.) which will be complemented by lifestyle (sports, 'family & kids', entertainment and more). As ZAL already has considerable market shares across Continental Europe in the online segment, it will enhance its marketing and logistics services which already support the circa 6000 brand names that are on the ZAL's platform. We still believe the 'jury is out' as to whether management will be successful in its aim. However, we note that ZAL's quarterly base numbers for comparison are extremely low for FY23 implying that the company's growth rate is poised to accelerate in FY24. ZAL's next reporting point will be the 1Q24 set of results, which is due on 7th May.

Detractors

Hays (HAS LN)

HAS (the UK: -12.3% and 2.6% exposure), Europe's largest specialist recruitment company was the weakest performing stock in the Portfolio in 1Q24. The HAS share is the most addition to in the Fund (we initiated a 2.5% position in HAS on 14th Dec-23), which we added to boost our second most recent position, Page Group (see below). As in the case of Page Group, the HAS share typically display excellent bounce back characteristics once underlying business conditions (i.e. LfL net fee growth) starts to improve. In our view, what makes HAS (and Page Group) interesting is the underlying *'talent shortage'* caused by the tight labour markets. HAS closes its accounts by

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the end of June; although the company's recent 1H23/24 results (22nd Feb) fell short of market expectations, the stock still responded positively by investors. Like its UK peer, Page Group, HAS' management commented that candidate confidence has fallen in line with lower wage growth (currently in the range of flat to +5%) along with longer lead-times for clients (i.e. companies) to reach hiring decisions. We construe this implies that recruitment volumes will remain to some extent suppressed in the short-term. However, as 2024 progresses HAS' net fee base numbers for comparison will become considerably easier which implies that business momentum is poised to accelerate. We do not expect this to become visible in the company's 3Q23/24 trading statement, which is due on 17th Apr, but more likely in the 4Q23/24 trading statement, which is scheduled for 11th Jul.

Dassault Systèmes (DSY FP)

DSY (France: -7.2% and 4.3% exposure), the world's leading provider of software for 3D-solutions was the second-weakest performer in the Portfolio in 1Q24. We are somewhat confounded by the weakness of this stock given the strong performance of the European Information & Technology sector (+17.6%) in 1Q24. We believe a few near-term shortcomings were the main reasons. *First*, DSY's 4Q23 set of results (1st Feb) fell slightly short of consensus as 4Q23 LfL sales growth and profits came in at the lower end of guidance. This is unusual since DSY's management tends to gradually raise the full-year guidance quarter-by-quarter as each fiscal year progresses. At the webcast, management commented that 'broadly speaking' clients had shown more hesitation in 4Q23 than previously expected partly due to the conflict in the Middle East. From a regional perspective, the Americas (41% of sales) showed a sequential LfL sales slowdown from +9% to +3% between 3Q23 and 4Q23 while Europe (38% of sales) displayed a similar picture as LfL sales growth fell from +21% to +15%. Meanwhile, the APAC region (21% of sales) showed unchanged sequential LfL growth at +5%. *Secondly*, given the formal appointment of Pascal Daloz, a 25-year veteran in DSY (with prior roles as COO and CFO) to CEO, as of 1st Jan-24 and the long-standing CEO, Bernard Charlès to Executive Chairman, the market may have taken a view that management came across as too conservative in terms of the FY24 outlook. In our opinion, this was the case as management guided for only 8-10% LfL sales growth in FY24 (FY23: 9%) and FY24 EBITA margin guidance 32.5-32.8% (FY23: 32.4%). DSY will publish its 1Q24 results statement on 24th Apr. We expect management to raise start raising the FY24 guidance at this point, which is normally the case.

Page Group (PAGE LN)

PAGE (the UK: -6.6% and 4.6% exposure), Europe's second largest specialist recruitment company was the third weakest performing stock in the Portfolio in 1Q24. Like its British peer, Hays (see above), the PAGE share is the second most recent position in the Fund (we initiated a 1.5% position in HAS on 31st Aug-23). Due to the aforementioned *'talent shortage'* in the case of Hays (above), PAGE's net fees have up well as the company is more reliant on permanent placement than its other British peer. However, PAGE Group's LfL growth rate has now fallen sequentially for six consecutive quarters. While we anticipate that they are likely to continue to be on a downward trajectory for max another one quarter, LfL net fee growth should start to recover due to much easier base numbers for comparison. Once such a reversal in the trend line kicks in – this stock (along with Hays) – tends to bounce back in the range of 80-120% over the next 12-18 months. It is our aim to continue to further add to this position in 1H24. PAGE's publish its 1Q24 trading statement (15th Apr) was at the lower end of market expectations reflecting LfL net fee growth of -12.7% (4Q23: -8.9%; 3Q23: --7.99%; 2Q23: -6.5%; 1Q23: -2.4%). As the base numbers for comparison are entering an easier phase from 2Q24, we anticipate LfL net fee growth will turn positive, and that PAGE's management will start to guide for a recovery in 2H24. The company's 2Q24 trading statement is due on 10th Jul.

Nestlé (NESN SW)

NESN (Switzerland: -6.3% and 3.4% exposure), the world's largest food manufacturer, was the fourth weakest performing stock in 1Q24 (and the fifth weakest-performing stock in the Fund in 2023). NESN's FY23 set of results (22nd Feb) fell slightly short of market expectations. However, there was a few other issues with the report. *First*, investors did not appreciate that pricing (and not volumes) was the prime driver to top-line growth throughout all four quarters in FY23. *Secondly*, the company reconfirmed that the long-standing CFO, Francois-Xavier Roger, will leave the Group by 1st Jun; the successor is Anna Manz, who is currently the CFO of the London Stock Exchange. *Moreover*, the market took a negative view to the NESN report given a lower-than-expected LfL sales growth guidance for FY24 of only around 4% (which is expected to be driven by volume growth) and a *'moderate'* increase in the underlying EBIT margin (FY23:15.6%) and in the underlying EPS growth, which is expected to be in the range of 6-10% in CC-terms. NESN's next reporting point will be the 1Q24 revenue report which is due on 25th Apr. at this point, we expect management to back-end load the FY24 sales and profit guidance to 2H24.

L'Oréal (OR FP GY)
OR (France: -2.7% and 5.9% exposure), the world's largest provider of cosmetics and make-up products, was the fifth weakest performing stock in the Portfolio in 1Q24. During most of last year OR's business went from strength-to-strength, but those drivers appeared to appear to have (temporarily) gone partly astray in 4Q23. The FY23 set of results, which also included the 4Q23 sales report (8th Feb), fell short of highly set market expectations. There were three shortcomings with the report. *First*, having been the strongest growing division in 3Q23, the Consumer Products (FY23: 38% of group sales) reported sharply lower LfL growth of +7.7% in 4Q23 compared with double-digit growth in the prior three quarters (3Q23: 13.4%; 2Q23: 15.4%; 1Q23: 14.7%). *Secondly,* having been the strongest growing region in 3Q23, Europe (FY23: 32% of group sales), this market also reported lower LfL growth of 11.6% in 4Q23 albeit still in double-digit territory (3Q23: 16.2%; 2Q23: 20.8%; 1Q23: 16.0%). *Thirdly*, L'Oréal Luxe (FY23: 37% of group sales), reported mediocre LfL growth of only 0.4% in 4Q23 (3Q23: 3.2%; 2Q23: 8.6%; 1Q23: 6.5%) primarily because of North Asia (FY23: 26% of group sales including China). In our opinion, the investors took an excessively negative view to report – particularly since consensus has only reduced the group's sales and profit revisions for FY24 and FY25 by a range of -1% and -2% for each year. OR will release the 1Q24 sales report on 18th Apr. Like most other companies in our Portfolio, we expect OR's management to guide for a recovery in FY24, but the recovery profile will be backend loaded until 2H24.

European Focus Portfolio changes

The '5/10/40' UCITS rule states that: *(i)* positions over 5% cannot have an aggregate weighting which exceeds 40% and *(ii)* an individual position cannot have a weighting which exceeds 10%. As trades of less than 1% are too small to have any meaningful impact on the Fund's performance, we generally only comment on trades exceeding this level.

We did not make any trades exceeding +1% during 1Q24 (1Q23: 4 trades).

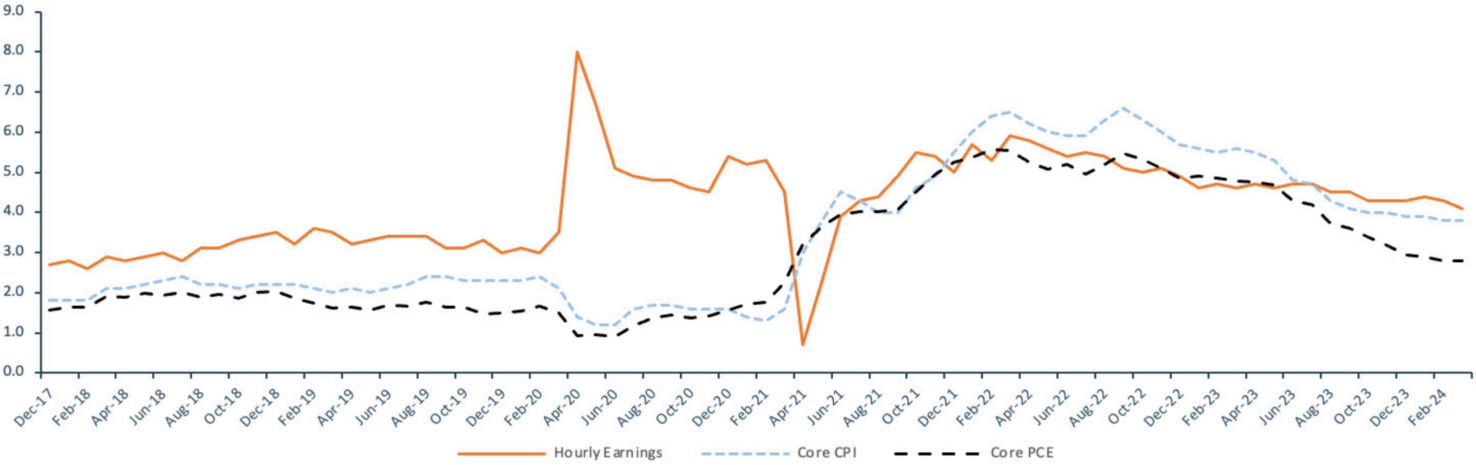
Looking ahead – a likely return to *'traditional normal'*

The current situation
We would argue that there is no preset level of interest rates that is required to bring down inflation, but in our opinion the Fed is ahead of other Central Banks by having assessed underlying economic conditions correctly. Chairman Jerome Powell was the first Head of a Central Bank to abandon the 'transitory' expression and changed the Bank's narrative to what level of interest rates should be raised to be regarded as 'restrictive'. With hindsight we construe that the Fed got it broadly right.

Looking at the trajectory of inflation, US interest rates have been in restrictive territory for some time. This was noticeable as headline inflation dropped from a peak of 9.1% in Jun-22 to 3.0% in Jun-23 (US monthly CPI registered 12 consecutive declines in headline inflation). The second and current part of Central Banks' inflation-fight is to combat underlying price pressures, i.e. core inflation. Unfortunately, core inflation remains stubbornly high in most leading economies primarily because of strong employment markets. However, since 4Q23 core inflation in the US appears to be declining (see chart below) as: *(i)* monthly job-creation data (non-farm payroll numbers) has bottomed out and *(ii)* 'Hourly Earnings' (wage growth) appears to be in decline (partly confirmed by the conversations we have had with our Portfolio companies).

As the Fed time and time again has reiterated its commitment to bring inflation and inflation expectations down to the self-imposed target of around 2%, we believe the Bank will not start to lower the Fed Funds rate until annual Hourly Earnings (i.e. wage growth) is consistently at around or below core inflation (see chart below).

Hourly earnings vs. core inflation (core CPI and core PCE)



Source: Bloomberg

The timing of the reversal of the tightening cycle is anyone's guess, but our research shows that an average Fed rate hike cycle lasts 10 quarters (i.e. 2.5 years) and over that period, the Bank typically eradicates 80% of headline CPI. Since the Fed's first interest rate hike in the current cycle was made in Mar-22 – if history is a guide – the current trajectory would indicate this will last until Sep-24. The Fed has made several *'hawkish pauses'* since 2H23, but we still believe that the first rate cut is some time off.

Possible key drivers for equities in 2024

We believe inflation and inflation-expectations (i.e. bond yields) will continue to be one of the key considerations to how investors will construct their Portfolios in 2024, but we also expect market participants will need to gradually factor in a gradual economic recovery in the US.

At the time of writing, US core CPI was still running at 3.8% Y/Y in Mar-24 (unchanged from February), which is still considerably higher than the Fed's overarching objectives of: *(i)* bringing inflation down to its 2% target; *(ii)* to restore price stability while at the same time *(iii)* achieve maximum employment. Consequently, we expect the Fed to put off any interest rate cuts for the time being.

FOMO

Equities as an asset class tends to perform best when economic growth is accelerating. From top and bottom down perspectives, US macroeconomic activity appears to have bottomed out in 2023 and is now picking up; GDP forecasts were gradually raised for 2023 throughout last year while growth forecasts 2024 have been raised more recently. The important US PMI Manufacturing index for Mar-24 saw a first to above 50 (50.3, i.e. expansion) for the first time since 3Q22 having bottomed out in 2023.

The broader US employment readings for Mar-24 turned out to be stronger-than-expected. The monthly non-farm payroll numbers (job-creation) have been creeping up after having broadly flatlined in 2023. Also, US job-participation has been strengthening after having taken a sharp tumble during the pandemic in 2020.

Over the past few weeks, we have noticed that several market commentators have expressed concern that the US economy may be currently too strong for the Fed to embark on its next rate cut cycle. However, we would argue that in pretty much any way, it is better if an economy (i.e. the US) can grow at a healthy pace even when its Central Bank is applying restrictive rates since it shows underlying strength. In the medium-term, we would argue that this paradigm will lead to a more 'normal' economy with traditional business cycles, which used to be the case, and which the world has not fully experienced since Central Banks embarked on their QE-strategies to combat the Great Recession in 2008-09 and during the pandemic. For active managers this should be good news since it is (arguably) less difficult to pick appropriate stocks for different parts of the economic/stock market cycle than in an artificial economic environment when Central Banks are trying to manipulate particularly the long end of the yield curve through QE.

Quality-growth as an investment philosophy should sits well with the current outlook
Not only should the broader equity markets be bolstered by the aforementioned strengthening fundamentals, but those drivers should be well-suited for the quality-growth investment style since companies in this space tend to be *'price-setters'* as opposed to *'price-takers'*. In fact, we would argue that in contrast to the pre-pandemic era, when inflationary pressures were broadly zero, slightly higher underlying inflation makes this strategy even more attractive since the price component of the top-line can be raised by at least underlying price increases. Add to this that companies' mark-ups following higher input costs should act as an underpinning to higher profit margins.

Where are we in the economic and the stock market cycles?
Last quarter we argued that from a macroeconomic standpoint, the current business cycle appears somewhat inscrutable. A number of market commentators convincingly argued that global economics were at the end of the cycle while another group argued equally well that global economics showed similar signs as those that are visible at the beginning of a recovery.

Analysing different clusters of stocks and their price action in the broader equity markets often gives meaningful insight regarding the appetite or aversion to risk. When looking at growth and recovery-driven vs. defensive sectors in 2023, it is clear that the latter industries (such as Consumer Staples) were out-of-favour as they underperformed the benchmark index in all four quarters and – interestingly – the same trend was evident in 1Q24. The other side of the spectrum is that more cyclically exposed businesses, such as Information/Technology, Consumer Discretionary, (Finance) and Industrials outperformed the benchmark in three-out-of-four quarters last year as well as in 1Q24. Against this backdrop, we are even more confident today that economic momentum and thus equity markets are more likely to be at the beginning of an upturn than the other way around.

The table below sets out the monthly and quarterly investment returns of the key European industry sectors, the benchmark MSCI Europe index as well as the performance-ranking of European Focus in 1Q24. We draw the following conclusions from the below table:

- Technology and growth-like stocks as well as Consumer Discretionary were the best-performing cluster of stocks in 1Q24 – underpinned by strong gains in January and February. However, these sectors lagged more defensive sectors in March as concern over the timing of when Central Banks would start to cut interest rates kicked in on the back of stronger-than-expected US macroeconomic data.
- Interest-rate sensitive – deep-value sectors like: Real-estate, Energy, Finance, Materials and Utilities (none of which the strategy invests in), were by far the best-performing sectors in March.

Sector performance of the MSCI Europe NR (EUR) index and European Focus in 1Q24

Sector	Jan-24	Sector	Feb-24	Sector	Mar-24	Sector	1Q24
Information/Technology	9.7%	Consumer discretionary	7.4%	Real estate	8.2%	Information/Technology	17.6%
Healthcare	3.9%	Information/Technology	6.0%	Energy	6.7%	Consumer discretionary	11.6%
Communication services	3.6%	Industrials	5.8%	Finance	6.6%	**European Focus**	**10.7%**
Consumer discretionary	2.2%	**European Focus**	**4.6%**	Materials	6.3%	Finance	10.1%
European Focus	**2.2%**	Finance	2.2%	Utilities	4.1%	Industrials	9.2%
MSCI Europe Net	**1.6%**	**MSCI Europe Net**	**1.9%**	**MSCI Europe Net**	**3.9%**	**MSCI Europe Net**	**7.6%**
Finance	1.1%	Materials	0.7%	**European Focus**	**3.6%**	Healthcare	7.0%
Consumer staples	96.0%	Healthcare	0.0%	Healthcare	3.0%	Communication services	4.3%
Industrials	82.0%	Communication services	-1.4%	Industrials	2.4%	Materials	3.2%
Real estate	-1.9%	Energy	-1.7%	Communication services	2.2%	Energy	2.5%
Energy	-2.2%	Consumer staples	-3.3%	Consumer discretionary	1.9%	Real estate	-1.4%
Utilities	-3.6%	Utilities	-5.7%	Information/Technology	1.2%	Consumer staples	-1.5%
Materials	-3.7%	Real estate	-7.1%	Consumer staples	0.9%	Utilities	-5.4%

Source: Bloomberg

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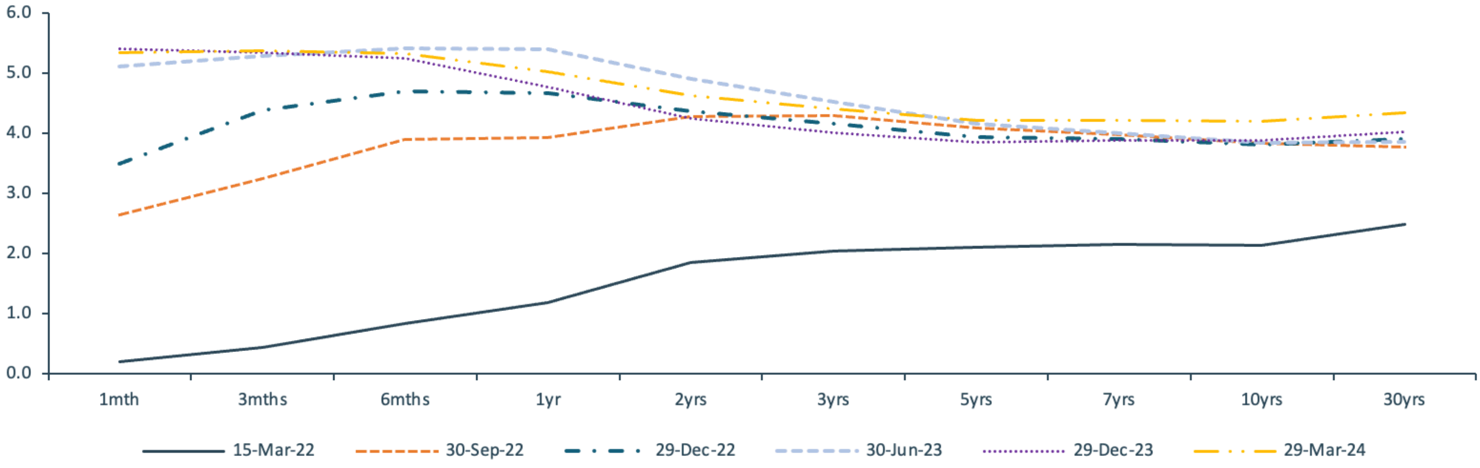
US yield curves at key dates since the Fed's first interest rate hike in Mar-22



Source: Bloomberg and Heptagon

As the US yield curve graph above shows, the curve inverted in 2H23, implying a slowdown in demand. At the time of writing and according to the US futures market, it looks as if bond yields are about to peak, but there is very little anticipated movement – either higher or lower in the next 5-10 years.

Assessment of economic momentum

The first table below sets out annual top-down GDP growth expectations for 2023-25 for some of the world's largest economic areas. The table shows that economic momentum slowed down in 2022 as countries felt the adverse impact following Central Banks' interest rate hikes. In our view, economic momentum regained strength in 2023 (bar the Eurozone) for two main reasons: *(i)* there was a lag between the effect of higher interest rates and the buoyant jobs market due to *'talent shortage*', which meant that wages and salaries continued to rise and; *(ii)* supply-chain constraints eased while consumption recovered and spending was temporarily bolstered by excessive household savings from the pandemic period.

The table below shows that all leading economic areas are expected to experience lower economic activity in 2024 compared with 2023 – possibly because: *(i)* inflation has remained higher-for-longer; *(ii)* pandemic-related household savings have been partly depleted and *(iii)* households have had to rein in their spending due to higher interest rates. However, as the global economy is likely to advance going into 2025, we anticipate that economic activity should gradually regain momentum during 2H24.

Consensus annual GDP growth forecasts for the US and other leading economic regions

% change	2021	2022	2023	2024e	2025e
USA	5.8%	1.9%	2.5%	1.7%	2.0%
Eurozone	5.9%	3.4%	0.4%	0.5%	1.3%
China	8.4%	3.0%	5.2%	4.6%	4.3%
Japan	2.7%	1.0%	1.9%	0.7%	1.1%
Average	**5.7%**	**2.3%**	**2.5%**	**1.9%**	**2.2%**

Source: Bloomberg 1st Apr-24

The table below, which covers 2023 and 2024, is decomposed so that the GDP growth forecasts reflect the average of four rolling quarter at each period when the data was noted starting from Jan-23. In other words, the table illustrates GDP growth expectations for each forward-looking year on a continuous basis.

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Consensus rolling four-quarter GDP forecasts for the US and other leading economic regions

% change	23e (Apr-23)	23e (Jul-23)	23e (Oct-23)	23e (Dec-23)	24e (Apr-23)	24e (Jul-23)	24e (Oct-23)	24e (Dec-23)	24e (Apr-24)
USA	1.1%	1.3%	2.1%	2.4%	0.7%	0.6%	0.9%	1.4%	2.3%
Eurozone	0.6%	0.7%	0.6%	0.5%	1.1%	1.2%	0.8%	0.5%	0.6%
China	5.4%	5.6%	5.0%	5.2%	5.1%	4.7%	4.5%	4.5%	4.7%
Japan	1.0%	1.3%	1.9%	2.0%	1.2%	1.1%	1.0%	0.7%	0.6%
Average	**2.0%**	**2.2%**	**2.4%**	**2.5%**	**2.0%**	**1.9%**	**1.8%**	**1.8%**	**2.0%**

Source: Bloomberg 1st Apr-24

The above table shows that consensus average GDP growth expectations for 2023 were at their lowest level in Apr-23 (left hand column: 2.0%), but as the year progressed, expectations improved to 2.5%. In other words, reality did not turn out to be as bad as economists' initial expectations.

When looking at the US economy in isolation, consensus GDP growth forecasts for 2024 show a different profile as growth projections accelerated during 2H23 (while those for Europe moved in the opposite direction). By the end of 2023 – and more importantly – noting the GDP growth forecasts for 2024 in Apr-24 shows a sharp uptick for the US economy (from 1.4% in Dec-23 to 2.3% in Apr-24).

We also note that the profile of GDP growth expectations in 2H23 converged into a more conventional 'recovery pattern' which typically shows that the US tends to lead global economic activity back on track to prosperity. This is compatible with our opinion that the US is a consumer-driven economy, while Europe (and Asia) are export-dependent. In other words, once the US economy starts to consume, Europe and Asia will export their way back to prosperity. This contrasts with what we considered to be a highly unusual recovery pattern until Jul-23 when economists expected Eurozone GDP growth for 2024 to be higher than that of the US.

The power of compounding

We first introduced the below table in 2021 which depicts 'real' benefits of compounding. The top-part of the table shows how sales, EBITDA and EBIT growth have developed and are expected to progress for European Focus and for Europe (the MSCI index) during 2020-26e, according to Bloomberg's consensus estimates.

The lower part of the table illustrates how these growth rates impact sales and profits based on current consensus prospects. We have anchored the numbers to 2019, i.e. the year before the pandemic. The table shows the benefit of not *'foregoing'* sales and profit growth during periods of economic weakness thereby achieving a much higher base from where businesses can continue to prosper.

Projection of sales and profit growth of European Focus and MSCI Europe index)

European Focus	FY19	FY20	FY21	FY22	FY23	FY24e	FY25e	FY26e	MSCI Europe	FY19	FY20	FY21	FY22	FY23	FY24e	FY25e	FY26e
Sales		2.2%	20.9%	13.2%	10.6%	5.5%	10.2%	9.3%	**Sales**		-14.1%	4.1%	24.4%	0.9%	-1.2%	2.9%	3.2%
EBITDA		5.0%	31.3%	16.9%	10.7%	13.1%	17.0%	12.2%	**EBITDA**		-23.9%	32.6%	23.4%	-2.0%	5.6%	7.8%	4.5%
EBIT		4.8%	61.6%	22.1%	21.1%	20.1%	21.7%	14.9%	**EBIT**		-39.8%	82.9%	26.2%	5.6%	13.6%	6.7%	5.9%

European Focus	FY19	FY20	FY21	FY22	FY23	FY24e	FY25e	FY26e	MSCI Europe	FY19	FY20	FY21	FY22	FY23	FY24e	FY25e	FY26e
Sales	100	102.2	123.6	139.9	154.7	163.2	179.8	196.5	**Sales**	100	85.9	89.4	111.2	112.2	110.9	114.1	117.7
EBITDA	100	105.0	137.8	161.1	178.3	201.6	235.8	264.5	**EBITDA**	100	76.1	100.9	124.5	122.0	128.8	138.8	145.0
EBIT	100	104.8	169.4	206.8	250.4	300.6	365.8	420.3	**EBIT**	100	60.2	110.1	138.9	146.7	166.7	177.8	188.3

Source: Bloomberg dated 28th Mar-24

The above tables are based on the Portfolio weightings of European Focus at the end of 1Q24 for the purpose of forecasting. For the prior years (2019-2023), the year-end weightings of the Portfolio have been used. Based on Bloomberg's consensus forecasts, European Focus and the MSCI Europe index are expected to show the following:

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- **Sales:** European Focus is expected to grow its sales by +5.5% in FY24 compared with a -1.2% sales decline of the MSCI Europe index. For FY25, European Focus is expected to grow its sales by +10.2% compared with only +2.9% of the MSCI Europe index. We are also introducing the FY26 expected growth rates, which for European Focus show sales to growth at a rate of +9.3% vs. only +3.2% of the MSCI Europe index.
- **EBITDA:** European Focus is expected to grow its EBITDA by +13.1% in FY24 compared with only +5.6% of the MSCI Europe index. For FY25, European Focus is expected to show EBITDA growth at +17.0% compared to only +7.8% of the MSCI Europe index and further by +12.2% in FY26 compared to only +4.5% of the MSCI Europe index.
- **EBIT:** European Focus is expected to grow its EBIT by +20.1% in FY24 compared with +13.6% of the MSCI Europe index. For FY25, European Focus is expected to grow its EBIT by +21.7% compared to only +6.7% of the MSCI Europe index and further by +14.9% in FY26 compared to +5.9% of the MSCI Europe index.

Analysing how the revenue profiles of European Focus and the MSCI Europe index have progressed since pre-pandemic levels by using 2019 as the base year clearly illustrates the importance of not *'foregoing'* sales and profits, and thus benefit from compounding.

- **Sales:** European Focus' 'revenue base' is expected to stand at 163.2 at the end of FY24, i.e. some +63% ahead of its pre-pandemic level in 2019, while the MSCI Europe index is only expected to be 110.9, i.e. less than 11% higher than its pre-pandemic level. This is further amplified in FY25 when European Focus is expected to have a revenue base that is nearly 80% higher than its pre-pandemic level, which compares with only +14% of the MSCI Europe index. Further in FY26, European Focus' revenue base is expected to be nearly 2x higher than its pre-pandemic level, which compares with around 20% of the MSCI Europe index.
- **EBITDA:** European Focus' EBITDA base is expected to stand at 201.6 at the end of FY24, i.e. more than twice of its pre-pandemic level in 2019 while the MSCI Europe index is only expected to be less than +30% higher than its pre-pandemic level. This is further amplified in FY25 when European Focus is expected to have an EBITDA base some 135% higher than its pre-pandemic level, which compares with less than +40% of the MSCI Europe index. Further in FY26, European Focus' EBITDA base is expected to be around +165% higher than its pre-pandemic level, which compares with only around +45% of the MSCI Europe index.
- **EBIT:** European Focus' EBIT base is expected to stand at 300.6 at the end of FY24, i.e. more than 3x ahead of its pre-pandemic level in 2019, while the MSCI Europe index is only expected to be around +67% higher than its pre-pandemic level. This is further amplified in FY25 when European Focus is expected to have an EBIT base that is some 265% higher than its pre-pandemic level, which compares with less than +78% of the MSCI Europe index. Further in FY26, European Focus' EBIT base is expected to be substantially more than 4x higher than its pre-pandemic level, which compares with only some +88% of the MSCI Europe index.

If these growth trajectories were to continue into the future – which we construe is a broadly fair assumption given that the average year of foundation for a Portfolio company was 1932 – compounding should be further amplified. Over time, this should be a strong underpinning of the valuation premium of European Focus against the MSCI Europe index.

ESG considerations

European Focus is classified as an **'Article 8 Fund'**, which means that the Fund promotes – among other characteristics – environmental and social factors in businesses in which investments are made follow good governance practices. ESG as a concept has always been integrated part of the investment philosophy of European Focus. This stance is based on the belief that *'doing well and doing good is mutually dependent'* for businesses to be successful in the long-term. In other words, the strategy does not believe that it is good business to cut corners in any of the 'ESG-verticals' given potential repercussions – be it financial risk – such as becoming liable to fines and other damages, reputational issues etc. To facilitate this approach, European Focus has an exclusion list which restricts the strategy from investing in businesses that are generally regarded as harmful to society (fossil-fuel, nuclear, weapons, tobacco, adult entertainment and gambling).

As investors and companies are continuously re-assessing different aspects of ESG, we note that our Portfolio companies in one way or another have aligned part of their managers' remuneration to measurable ESG targets. We estimate that such ESG-related targets affect individual managers' variable compensation by up to 20% depending on industry and company.

Having gone through our Portfolio companies' 2022 (and currently analysing those of 2023) annual and SRI reports, we note that businesses are making substantial progress in improving CO2 emissions, waste, water etc Y/Y. While companies' ESG-disclosures stepped up in 2019, the pandemic caused a severe disruption to how companies could improve going forward.

Given a few years since the pandemic, we have noted the following pattern by most companies: CO2 emissions, waste, water etc. fell sharply in 2020 due to the lockdowns which had a significant effect on business volumes for most of our Portfolio companies. In 2021, however, most businesses focused on recovering lost income from the prior year and consequently, environmental metrics (CO2 emissions, waste, water and proportion of energy-sourcing from renewables) saw a sharp increase. This contrasts with the corresponding readings for 2022 – and further in 2023 – which showed real improvement, both in terms of the reduction of CO2 emissions, waste, water and proportion of energy-sourcing from renewables in absolute terms – but also in terms of disclosure.

Risks and uncertainties

- **Indebtedness:** most countries are increasingly feeling the pain from higher borrowing costs. According to the S&P and the IIF (Institute of International Finance), global indebtedness stands at some $300tn, equivalent to around 350% of global GDP. Traditionally, economists considered countries' debt-to-GDP ratios in the 70-80% range as manageable, but once they reached a level above 100%, the servicing of debt started to compromise countries' flexibility and ability to invest. As global interest rates are likely to stay higher-for-longer, existing debt levels could pose an increasing problem to many economies (and companies).
- **Inflation and bond yields:** headline inflation has substantially declined in most of the world's leading economies and at the time of writing, also core inflation is on a downward trajectory. However, if wage growth remains elevated, Central Banks are unlikely to start cutting their steering rates, which implies that economies could be set for a hard landing.
- **Putin's war with Ukraine and the Israeli/Gaza conflict:** we still see a risk (albeit gradually smaller) that Putin ramps up his war-efforts by deploying nuclear tactical weapons. After more than two years of fighting, we believe that Putin's failed attempt to occupy Ukraine has turned into a *'road to nowhere'*. Against this backdrop, we note similarities between the current Russian/Ukraine War and the 'Soviet/Afghan War' in 1979-89. Once the US stepped up its efforts to supply equipment (in that case 'Stinger' missiles which were used against Soviet attack-helicopters), the Soviet Union's war efforts eventually faded with the result that the country eventually pulled back. Furthermore, the recent conflict between Israel and Palestine in the Gaza Bank could become longer-than-expected and also spread across other parts of the Middle Eastern region (which currently appears to be the case).
- **Geopolitical issues:** China's property-infused credit crisis continues to simmer in the background following the defaults of the real-estate giants, such as Evergrande, Country Garden and Shimao, are having an impact on domestic consumption. Moreover, although China's seemingly close relationship with Russia is worrying from a geopolitical angle, we believe that China's ultimate aspirations are more closely aligned with its economic interests, and this should make the US and the EU Beijing's preferred trading partners for investment and capital allocation. However, China has not yet condemned Vladimir Putin for invading Ukraine. Given the strong worldwide opinion against Russia – and the severe sanctions against this country – it is likely that China is running an even higher reputational risk by not taking a clearer stance against Putin's war efforts.
- **US Presidential Election:** we have added a *'Donald Trump Risk'* should the ex-President get re-elected on 5th Nov-24. Should *'the then 78-year-old'* be sworn in again, we anticipate considerable populistic ideas to be brought to light – many which are unlikely to be well-regarded by the investment community. However, we also note that during Trump's previous term in Office (Jan-17 to Jan-21), the S&P500 index advanced by 78%, which is higher compared to the average term in office advance of 35% since 1929.

Christian Diebitsch, Fund Manager, Heptagon Capital

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