HEPTAGON Capital

Future Trends Equity Fund

Q4 2024 Commentary

Fund Manager

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Investment Objective

The Fund aims to deliver consistent and sustainable long-term returns by investing in a concentrated portfolio of global equities.

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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 Heptagon Future Trends Fund saw a drawdown of over 7% in Q4 but ended 2024 in positive territory. While this was clearly a disappointing performance for the Fund, we believe that the opportunity ahead has rarely looked more compelling when considering growth and valuation metrics. Importantly, we believe that 2024 also comprised some useful learnings, particularly in terms of how we can improve our sell discipline going forward. With these lessons taken on board, we enter 2025 with optimism on prospects and believe that a focused multi-thematic approach to investing in the future has the potential to generate meaningful returns.

A remarkable year

When we sat down to pen this same commentary a year prior, we and almost all others failed to predict that 2024 would be the second consecutive year in which the MSCI World Index would rise considerably (by almost 19%, preceded by a ~24% gain in 2023). The S&P 500 Index did even better than the MSCI World in both years, and the NASDAQ Index outpaced these other two benchmarks. Readers know the reason why: the **AI bubble has continued to expand, driven by a very small number of US-listed mega-cap technology stocks**.

This creates **a clear challenge for managers that believe in pursuing actively managed equity strategies**. Put crudely, there was a much higher chance of outperforming your benchmark (be it the MSCI World, the S&P 500, the NASDAQ, or any other index) if you owned these businesses. Equally, not owning these businesses helps explain why many funds – including Future Trends – underperformed during 2024.

To provide context, NVIDIA alone accounted for ~20% of the MSCI World Index's 2024 gain (or 3.7 percentage points of contribution towards the Index's 18.7% 2024 performance). We have not seen data for the MSCI World Index but given that the US accounts for a greater than 80% weight in this benchmark, data for the S&P 500 Index (available on Bloomberg) serves as a good proxy. Owing to the market concentration in this benchmark (56% of market performance from 7 stocks), only 31% of stocks were able to outperform the index. The S&P 500 Index was up 23.3%, but the median stock was up only 9.7%. No surprise, then, that just 27% of actively managed US equity funds were able to outperform their benchmark in 2024.

What we have learned in 2024

There have been two key learnings for us –

1: Active management is a hard but conscious choice
The Future Trends Fund has always sought to differentiate itself by having a clear investment process that combines top-down thematic perspectives with bottom-up fundamental analysis. We have a strict set of stock selection criteria and are big believers in active management. **The active share of the Fund has averaged more than 95% over the past year**.

We have regularly put the question to both ourselves and our investors, **"what kind of future would you rather own?"** Compare and contrast the Future Trends Fund with the MSCI World Index. There is zero overlap between our top ten holdings and those of the Index. Our future is explicitly pan-thematic and diversified, compared to the significant mega-cap tech concentration of the MSCI World. Further, while our ten leading holdings comprise 54.7% of the Fund, the comparable figure for the MSCI World is less than half this number. Whereas our tenth largest holding (Keysight Technologies) accounts for a 4.4% weight in Future Trends, position number ten in the MSCI World is just a 0.9% weight.

MSCI World Index Top – 10 constituents and weights

Apple	5.5%
NVIDIA	4.7%
Microsoft	4.3%
amazon	3.0%
Alphabet	3.0%
Meta	1.8%
TESLA	1.7%
BROADCOM	1.5%
J.P.Morgan	1.0%
Berkshire Hathaway Inc.	0.9%
	Top – 10: 27.2%

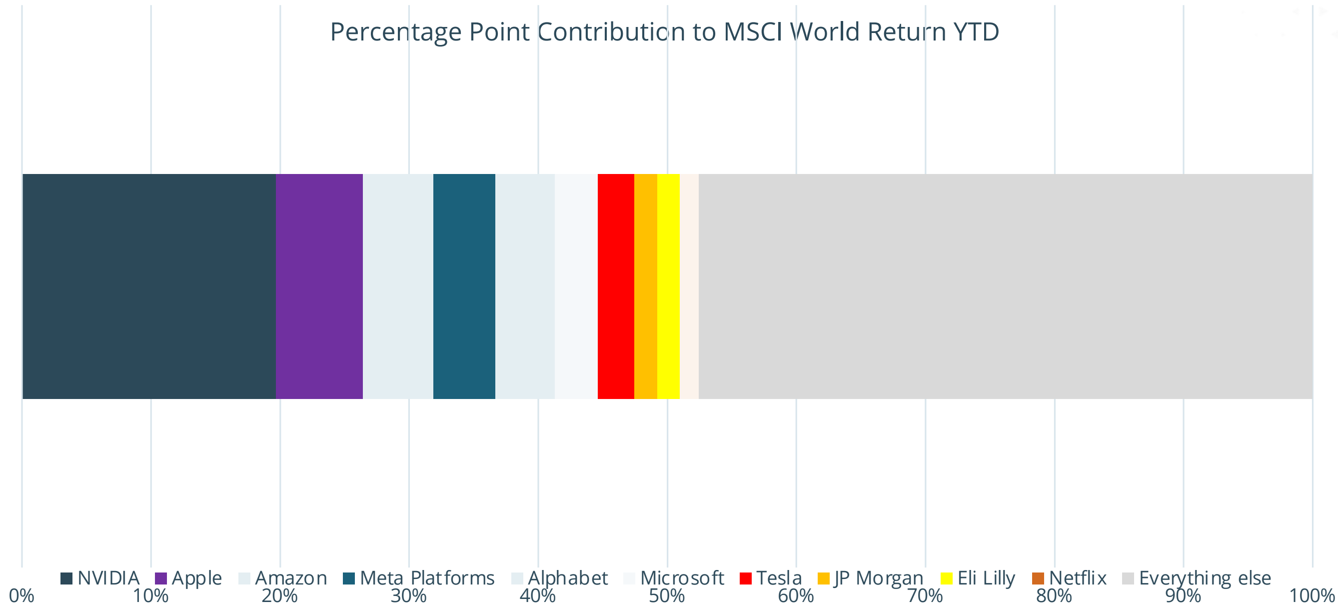
Heptagon Future Trends Fund Top – 10 constituents and weights

CHENIERE	6.7%
QUANTA SERVICES	6.7%
paloalto NETWORKS	6.6%
INTUITIVE SURGICAL	5.9%
EQUINIX	5.6%
ASML	4.9%
mastercard	4.7%
ThermoFisher SCIENTIFIC	4.6%
EMCOR Build. Power. Service. Protect.	4.5%
KEYSIGHT TECHNOLOGIES	4.4%
	Top – 10: 54.7%

Source: MSCI, Heptagon Capital as of 31/12/2024 or Future Trends; 31/12/2024 for MSCI World.

As all readers will be aware, **given the marked outperformance of the largest stocks in the MSCI World Index, there has been a clear cost – in performance terms – attached to not owning these businesses in the Future Trends Fund**. As noted above, even beyond NVIDIA and its technology peers, we calculate that the ten largest companies in the MSCI World accounted for 9.8 percentage points (or over 50%) of the Index's return in 2024. This accounts for the *largest single reason* why the Future Trends Fund underperformed in 2024.

The Magnificent Seven Effect



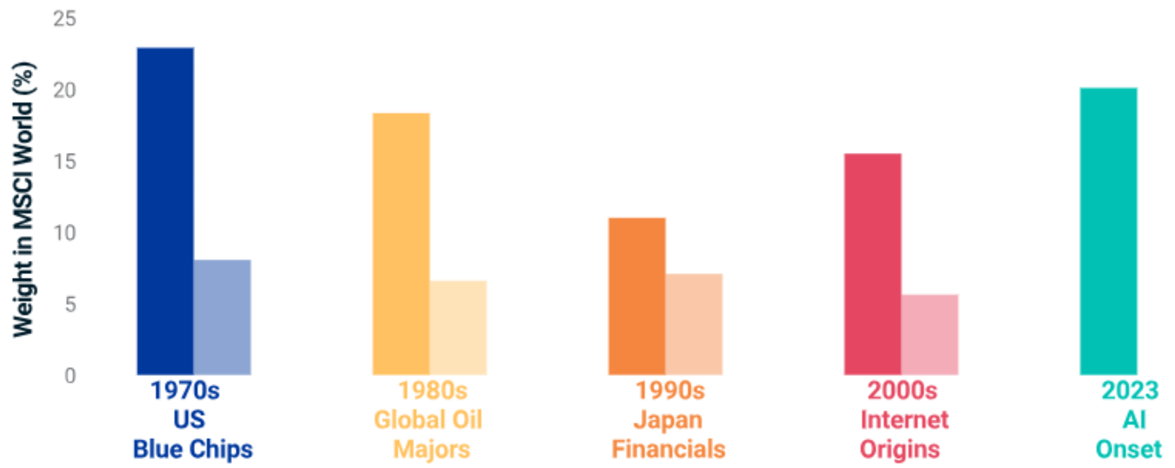
Source: FactSet, Heptagon Capital

For illustrative purposes only

We do not dispute the quality of the franchises of these major businesses. Further, we believe that AI will likely change the world in ways that all readers of this piece cannot easily conceive, just as the Internet did a generation prior. However, **our concern relates to the *expectations* embedded in these businesses. After marked outperformance, the bar to deliver further share price gains is now higher** and should earnings growth disappoint, especially relative to elevated consensus forecasts, then this could be a major source of share price disappointment.

No technology ever develops in a linear fashion and if the past is a good guide to the future, then it is worth bearing in mind that the 'leaders' of each previous generation (think of Cisco, Dell, Intel et al during the dotcom boom) have always consistently seen their market capitalisations markedly lower a decade after peak hype, per the chart below. As easily as passive money can flow into perceived winners, it too can depart quickly.

Leaders from each era had a much smaller market weight a decade later



Darker shades indicate weight of 10 largest stocks at peak concentration (dates noted above). Lighter shades indicate weight of the same 10 securities one decade later.

Source: MSCI

For illustrative purposes only

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Our approach has been to **stick to our process and seek to find high-quality businesses trading at reasonable valuation levels relative to the opportunity ahead**, even if this has meant missing out on some performance in the near-term. This is the cost attached to active management.

2: Not all themes endure forever
When we exit from a business in the Future Trends Fund, it is usually for a combination of reasons. Typically, this will be a function of the theme losing viability coupled with concerns about the positioning of the business we own mounting. There is an inevitable correlation between these two elements. Equally, we will often have higher relative conviction in a new theme/ business and wish to include this at the expense of an existing one.

Over 2024, **the majority of our exits have been as a function of our loss of conviction in a given theme**. In almost all instances, we believe our sell decision was the correct one, based on subsequent share price (under)performance, even if with hindsight, we could conceivably have identified the problems at an earlier stage. Looking forward, this is an area in which we intend to exercise ***more discipline and scrutiny going forward***.

Take **Chegg**. We first made the case for edtech, or the digitalisation of educational services, in 2013. We did not invest in the business until 2020 when the onset of the pandemic created an attractive entry point. This timing proved judicious, as the business gained more than 150% from our initial purchase price through until the end of that year. The share price peaked in February 2021 at just over $113. It now trades at less than $2.

While we did take profit consistently during the upward ascent of the share price, what we perhaps failed to appreciate fully were two things. First, that when the world normalised post-pandemic, it would be harder for Chegg to meet (elevated) expectations. Second, the onset of AI clearly proved highly disruptive to the business. A March 2024 meeting with senior management at Chegg's Santa Clara HQ did not leave us convinced of the company's ability to execute effectively, and we hence sold our shares. From that moment through to the end of 2024, they fell a further 80%.

Another useful case study would be **Aptiv**. We first invested in the business in January 2021 in the hope that Aptiv would benefit from the electrification and automation of vehicles. While the shares did reach a peak of ~$178 relative to our initial purchase price of ~$130, they had declined to ~$84 at the time we exited from our position in January 2024. What became increasingly apparent to us is that however compelling the secular theme might be (and however cheap Aptiv shares may appear – both on multiples and long-term discounted free cashflow basis), cyclical factors matter more in the auto industry.

The evidence continues to mount, in our view, that the auto industry is in a highly challenged position whether as a function of structural over-capacity, supply-side concerns over input costs and availability, consumer issues over affordability and EV range-anxiety, or lack of political buy-in to develop infrastructure. Since our sell-decision, Aptiv's share price has fallen a further 30%. We think it *highly unlikely* that the Future Trends Fund will invest in the car of the future theme again. Nonetheless, the Fund remains exposed to the broader theme of electrification via businesses such as Quanta Services and EMCOR.

One final instance to call out briefly would be **Vestas**. Whereas Vestas delivered a ~250% gain to the Fund from our first purchase in March 2018 through to its peak in January 2021, the shares have subsequently fallen ~70%. We remain believers in the logic of energy diversification but are of the opinion that the prospects for the wind industry look relatively more challenging versus other alternative energy sources such as solar. Wind is also unlikely to find much support under the Trump administration. Vestas has had several well-documented execution challenges over the recent past, and our interactions with management do not leave us fully convinced that these can be resolved any time soon. Further, Vestas' CFO announced his departure towards the end of last year. We sold out of Vestas in December 2024.

Optimistic on prospects for 2025

We enter 2025 with a more focused and higher conviction portfolio than in the past. The Future Trends Fund has exposure to 12 themes via a 22-stock portfolio. Gone is our exposure to the car of the future, edtech, pet economy and wind themes with which we started 2024. In their place, **over the past year we have meaningfully *increased* our exposure to cyber, data, electrification, and platform businesses**, all areas which we believe have strong secular tailwinds.

A quick recap on what we did in 2024

- **Made seven new investments in the Fund**. Listed chronologically, these were: Darktrace, Match Group, Palo Alto Networks, ARM Holdings, EMCOR, Republic Services and one investment in late December – another platform business – that we have not disclosed publicly yet. A deep dive into Republic, our most recently disclosed investment, follows later in the report.
- **Benefited from one instance of positive M&A**. Darktrace's board approved a takeover proposal (for the second time, from Thoma Bravo – we were also investors the first time around, in 2022) in April 2024. **We made a return of more than 70% on our investment**.
- **Made six other exits from the Fund**. With the exception of Zebra Technologies, our decisions to exit from Aptiv, Chegg, IDEXX Laboratories, TeamViewer and Vestas (listed alphabetically, for convenience) proved to be the correct decision, with the shares falling further post exit. Many of these case studies were discussed earlier.
- Published five new thematic white papers. In addition to our annual outlook piece, we released dedicated notes on cyber in the AI age, why warehouses are the unsung heroes of the modern world, new treatments for Alzheimer's Disease and what the future of housing may look like.
- Took part in over 80 company meetings. Beyond London, we travelled to Denmark, Germany, the Netherlands, Norway and the US.
- Hosted three webinars with senior executives from ARM Holdings, GXO Logistics and Keysight Technologies, which allowed investors to gain insights into our long-standing investments. We plan more of these in 2025.
- Added 49 posts to the Future Trends Blog, which has been running since the start of 2019.
- Conducted 40 meetings with investors across 9 different countries.

Bottom-up prospects look compelling

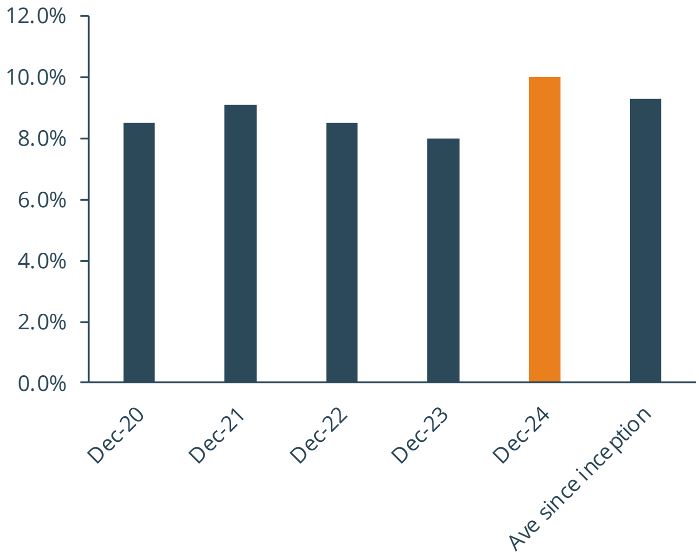
Beyond our top-down work detailed above, we believe that the outputs derived from the models we build in-house for each of the businesses we invest in also demonstrate the strength of the Fund's current positioning.

Begin with growth. Given our focus on investing in the future, it should come as no surprise that our businesses look set to experience superior growth relative to both global GDP and the MSCI World Index. The weighted average output from our models suggests that **our businesses should enjoy compound annual revenue growth of 10.0% over the next three years**. This figure is *higher* than it has been at the start of each of the last five years and compares to an average comparable figure of 9.3% since the inception of the Fund. Further, the growth gap between the Future Trends Fund and the MSCI World currently stands at 6.6 percentage points – in other words, the MSCI World Index is forecast (per Bloomberg) to see a three-year CAGR of just 3.4%. This figure of 6.6pp compares to a long-term average of 5.7pp, and so is clearly also currently superior.

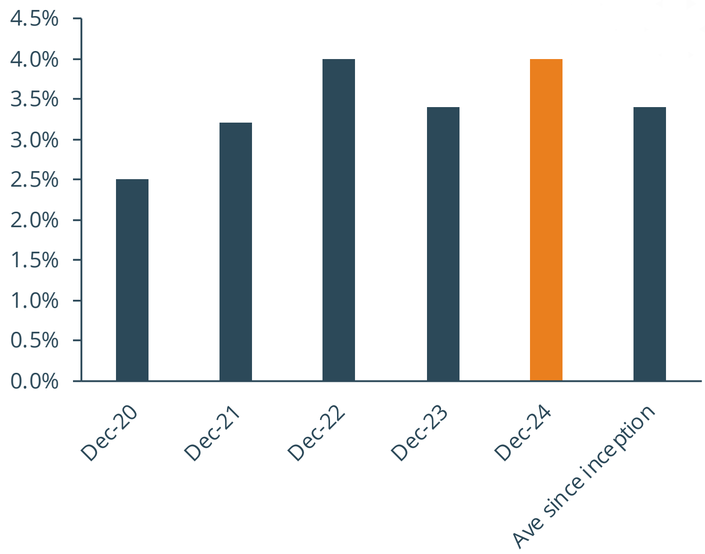
The assumptions we make for EBITDA, earnings and free cashflow growth yield similar conclusions, with the estimates for the Future Trends Fund standing meaningfully ahead of those for the MSCI World on each metric considered. We note that the gap between our assumptions and those detailed on Bloomberg for the MSCI World have also never been wider for earnings.

In terms of valuation, what stands out as most interesting to us is that the free cashflow (FCF) yield for the Future Trends Fund is currently 4.0%. We have discussed on many prior occasions why free cashflow is the most important financial metric on which to focus, since it is the most transparent indicator of underlying financial health. Compare the 16.9% three-year forecast free cashflow CAGR of the Fund with the 12.7% equivalent for the MSCI World. **Our 4.0% forecast FCF yield compares to a long-term average for the Fund of 3.4%**. The only other times the Fund's FCF yield has reached this level (or higher) were in late 2018 and late 2022, both times of noted market stress. The current 4.0% figure compares to just 3.0% for the MSCI World.

Start-Year Revenue outlook for the Future Trends Fund (3Y CAGR)



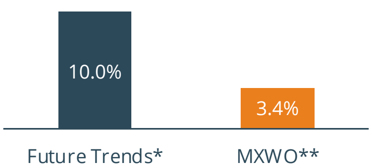
Start-Year forecast FCF yield for Future Trends Fund



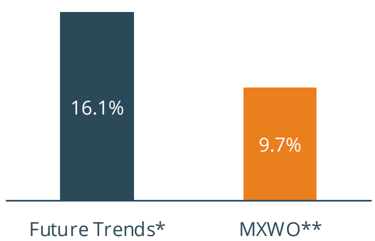
*Sources: MSCI, Bloomberg, Heptagon Capital. *Weighted average for the Fund. **MSCI World NR USD.*

Although many investors tend to focus on P/E metrics, since they are easily understood and commonly used, we place less emphasis on this valuation tool since earnings can clearly be distorted by both tax and share buybacks. Free cashflow cannot. For the record, the Fund's current 12-month forward P/E is 30.2x, well above that for the MSCI World (20.7x). We believe that this can easily be 'justified' by the superior growth and free cashflow metrics we discussed above. It is also worth noting that **on a long-term discounted free cashflow basis, our average business is currently 36.4% undervalued**. Only in December 2022, was there a bigger undervaluation on this metric.

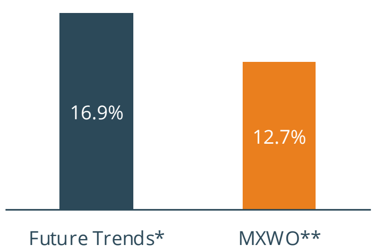
Revenue Growth (3Y CAGR) 2024-2027E



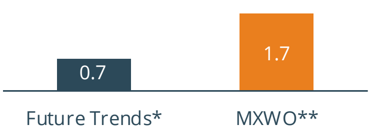
Earnings Growth (3Y CAGR) 2024-2027E



FCF Growth (3Y CAGR) 2024-2027E

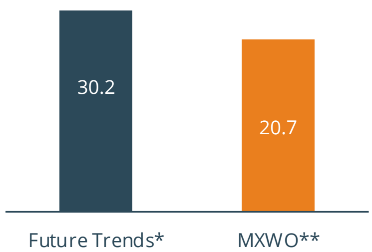


Net debt/EBITDA (x) 2024E



1Y forward FCF yield (%) 2025E

1Y forward P/E (x) 2025E



*Sources: MSCI, Bloomberg, Heptagon Capital. *Weighted average for the Fund. **MSCI World NR USD.*

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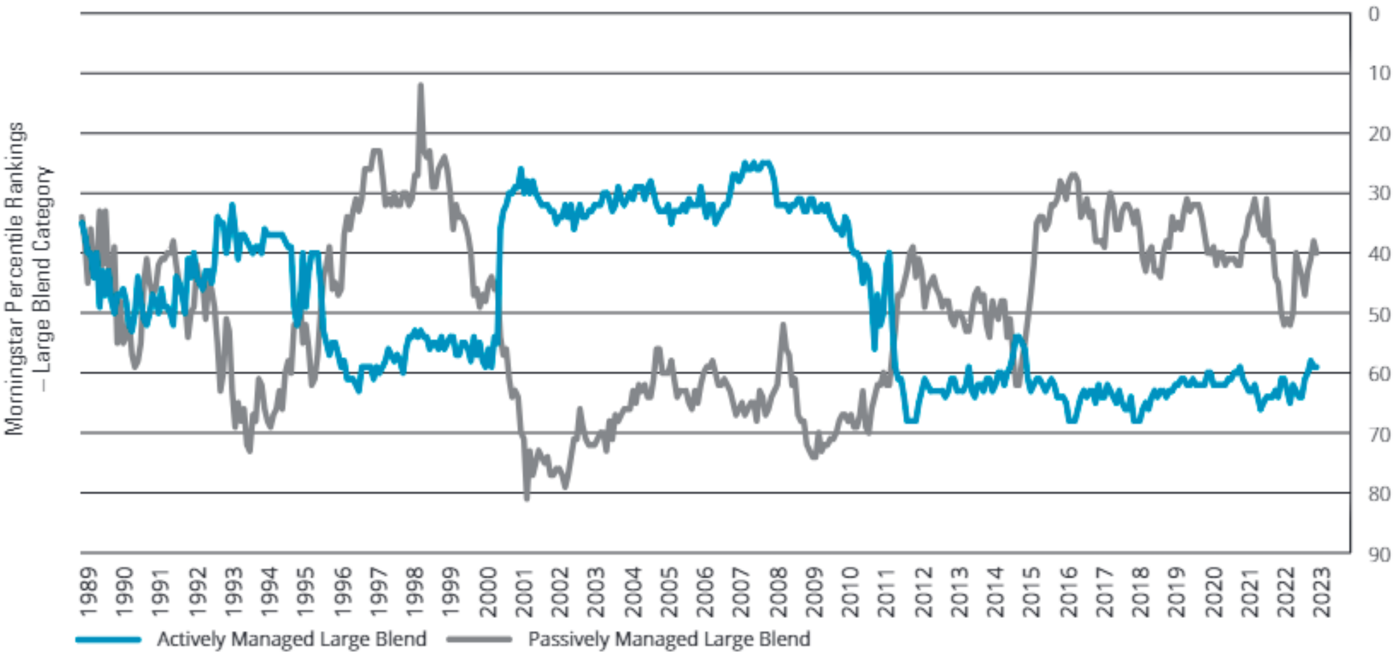
Further potential tailwinds for the Fund

There are also good reasons to believe that **2025 may also be the year that the rally in equities broadens further beyond mega-tech businesses**. In other words, market concentration may diminish as investors look for opportunities beyond the Mag-7 and take profits after two years of marked gains. As we have discussed elsewhere, expectations for these businesses are now markedly more elevated than was the case at the start of 2023. These dynamics could prove beneficial for the Future Trends Fund.

Mean reversion can also be a powerful force. The chart below shows the degree of cyclicality between actively and passively managed strategies. One style can clearly remain out of fashion for a considerable period of time, but when the tide turns, it is likely to do so in a meaningful fashion. Patient investors can, therefore, be handily rewarded.

Active and passive outperformances are cyclical (rolling monthly 3-year periods, 1989-2023)



Source: Morningstar, Hartford Funds

Finally, as we have detailed earlier in this report, **we intend to focus (even) more on our sell discipline going forward.** In other words, we will look to identify potential problems as early as possible and to be more forceful in our decisions to exit, ideally at as early a stage as possible. At the same time, we also intend to develop a deeper bench of potential Fund replacements, which could be considered as suitable future investment candidates.

Conclusion

The last three years have been brutal for many *truly active* fund managers. Whereas annualised returns for the Future Trends Fund were ~17% (and ahead of the MSCI World benchmark) through to the end of 2021, the Fund delivered negative annualised returns during the subsequent three-year period (ending December 2024). The MSCI World, by contrast, annualised around 6%.

We are grateful for all the ongoing support and interest our investors have shown in the Future Trends strategy. Most crucially, we have stuck to fundamentals throughout the life of the Fund. Our approach has always been pan-thematic and concentrated, driven by both top-down and bottom-up considerations. As this report has hopefully demonstrated, we continue to refine and improve our process and believe that the Fund looks strongly positioned for 2025 and beyond.

Thank you for your ongoing interest in and support for the Future Trends Fund.

Alex Gunz, Fund Manager
January 2025

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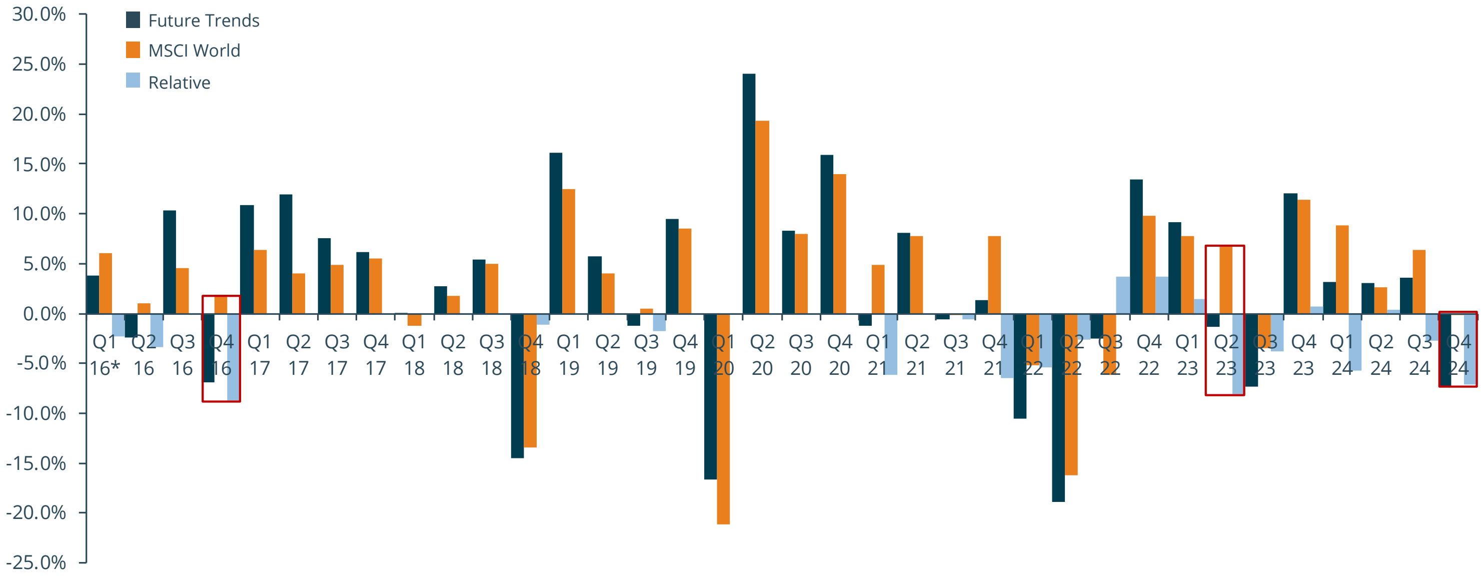
Appendix 1: Q4 leaders and laggards

The Future Trends Fund saw a 7.3% drawdown in Q4, which compares to a -0.2% decline in the MSCI World. This was the *third worst* quarter in performance terms relative to the benchmark. Only Q2 2023 (where the Fund underperformed by 8.1 percentage points) and Q4 2016 (8.7pp) saw more significant drawdowns. The former was characterised by the moment when the AI boom and NVIDIA's parabolic rise truly took off, while the latter coincided with the first time Donald Trump was elected to the Presidency. On each occasion, stock-specific factors did also play a role. It is, however, worth noting that the Fund did outperform for seven subsequent consecutive quarters following Q4 2016.

Quarterly performance: Future Trends vs MSCI World benchmark



Source: FactSet, Heptagon Capital

Although roughly half the businesses we owned throughout the quarter did outperform the MSCI World benchmark, **the magnitude of the drawdowns witnessed by the businesses which *underperformed* the benchmark was markedly *greater* than the extent of the gains enjoyed by our best performing businesses**.

Begin with the good news. **Cheniere Energy was the outstanding gainer in the quarter, delivering a 19.5% return**, equivalent to a 98 basis point contribution over the period. It is one of three businesses (along with Mastercard and Novo Nordisk) that we have owned since the inception of the Fund. As the largest player in the liquefied natural gas space, the business benefited in the quarter from the election of Donald Trump as President. The incoming administration is perceived as likely being supportive for the industry and may increase the permitting for further drilling. Cheniere's execution has been first-class to-date, which has allowed it consistently to raise its financial guidance, including during the most recent quarter, which also aided performance. An announcement to increase shareholder returns was another positive.

We were also encouraged to note that many of our top ten (and long-standing) holdings recorded gains during the quarter. **Equinix, Intuitive Surgical, Mastercard, Palo Alto Networks and Quanta Services** all saw at least 6% share price increases over the period, helped by solid earnings reports. Mastercard's November investor event saw the business provide constructive financial guidance for the period through to end 2027 and beyond.

By contrast, however, **eight businesses in the Fund witnessed drawdowns of more than 10% during the quarter**. Listed alphabetically, the names were: ARM Holdings, First Solar, GXO Logistics, Match Group, Novo Nordisk, Prologis, Thermo Fisher and Xylem. Space does not permit to discuss all the above in detail, but we will focus on some of the most significant moves.

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The largest laggard in absolute terms was First Solar, down 29.4%, even if Novo's negative contribution impact was more significant. Although third quarter results were somewhat underwhelming, the principal reason for the significant share price move was the election. As positive as the Trump administration is perceived as being for the gas (and oil) industry, it is seen as a clear negative for the renewable space. While this provided part of the motivation for our exit from Vestas – discussed above – we remain confident in prospects for First Solar.

The business is a domestic-only manufacturer of solar panels and so can provide the US with an additional means of (cheap) energy independence. Equally, ~90% of all its solar projects lie in Republican districts. Its main manufacturing facility – and a major local employer – lies in Ohio, the state from which Vice President Vance comes. First Solar currently trades on less than 10x consensus earnings for 2025. We see the shares as more than 80% undervalued on a discounted free cashflow basis.

Novo Nordisk was our only other business to fall more than 20% during Q4 (a 20.7% drawdown, equivalent to 225 basis points of negative contribution). Nearly all this move occurred on 20 December, when the shares witnessed a major correction on news that a recent drug trial had not achieved quite the outcome that had been expected. Novo's latest anti-obesity drug demonstrated a 23% reduction in weight for the trial group. While clearly a major achievement, consensus had been for at least a 25% reduction. Part of the move does admittedly show the high expectations embedded in the Novo share price. **We used weakness to add to our position** and believe that the runway ahead for Novo is significant. Novo shares trade at a meaningful (15%+) discount to their average earnings multiple for both the last five and ten years and also offer a superior free cashflow yield relative to history.

One final comment, on **GXO Logistics, our third worst performing business in the quarter**, down 16.5%. Similar to Novo, most of the drop occurred on one trading day (13.8% lower, on 4 December), when the business announced that its CEO would be standing down, once a replacement was found. This news was not a major surprise, particularly given the age of the incumbent (66 years-old). However, an unconfirmed story appeared on Bloomberg at the same time as the official GXO press release suggesting that part of the CEO's decision had been influenced by discussions with the board about the merits or otherwise of a takeover approach. This initial news that a bid may be pending had sent the share price meaningfully higher in Q3 but a potential offer was never officially confirmed or denied. We believe GXO remains an attractive asset on a standalone basis and offers more than 80% valuation upside potential, on our assessment.

For the year, GXO was the Fund's worst performer, down 28.9%, while Novo also featured in the bottom three (10.6% lower). In between these two names was Prologis (down 20.6%). We met with the business on multiple occasions over the year and fundamentals in industrial real estate remain solid, even as the whole REITs sector has continued to lag the market while interest rates have remained high.

At the other end of the spectrum, **Intuitive Surgical gained 54.2%, making it the best-performing business that the Fund owned throughout the year**. ARM, Darktrace and EMCOR all delivered higher absolute returns than Intuitive in 2024, but we did not own any of these for all the period. Darktrace, Quanta Services and Intuitive Surgical had the biggest positive contribution impacts throughout 2024.

Appendix 2: Deep dive into Republic Services Group

During the quarter **we initiated a 3%+ position in Republic Services**. Founded in 1996 and headquartered in Phoenix, Arizona, Republic is a ~$60bn leading player in the environmental solutions industry. Republic ranks as the second largest player in the North American waste market as measured by revenues. It has a customer base of 13m and conducts 5m average daily pick-ups.

Republic sits at the intersection of two key future trends: decarbonisation and circularity. We have focused on these themes since 2018 and most recently in 2023. Over 30% of municipal waste in the US is recycled and/or composted, per the Environmental Protection Agency. Republic sizes its total addressable market as over $110bn and sees mid-single-digit revenue growth through to the end of the decade, driven not only by population and GDP growth, but also owing to reshoring (more domestic waste), increased environmental regulations (e.g. PFAS) and the expansion of the circular economy.

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We were attracted to the waste industry owing to its **resilient business model**. Waste is generated and needs to be disposed of safely no matter the economic environment. Collection and disposal services are governed by long-term contracts (typically 3 years for commercial and industrial collection services, and up to 15 years for residential collection services granted by municipalities). ~80% of Republic's revenues have annuity-like characteristics, and ~45% of contracts benefit from automatic annual pricing indexation to CPI (or higher), providing above-average revenue visibility. Highly diverse customer base. For most customers, expenditure on waste accounts for less than 1% of their total costs. **Consider waste expenditure as a small but essential part of operating costs for any business**. Customer retention rate runs at 94%.

Furthermore, **industry structure benefits incumbents, such as Republic**. The waste disposal business in North America is characterised by high regulatory barriers (permits, extensive regulation) and high capital intensity (all solid waste management companies must have access to a disposal facility, such as a solid waste landfill – and thus the significant capital requirements of developing and operating a landfill serve as a barrier to landfill ownership). With many costs fixed, scale matters. Republic correspondingly reports an above-average return on invested capital versus its industry peers.

Republic has a strong track record, having generated annualised returns of over ~20% in the last ten years and ~19% during the past five. The business has benefited from strong pricing power – owing to the factors outlined above – and resilient margins. The group's strategy is premised on generating further profitable growth through ongoing partnerships with its customers, focusing in particular on deepening its reach through a broader service offering. Exposure to recycling and renewable revenue streams complements the core solid waste business. Republic's financial health provides it with significant scope for investment, both organically and through M&A. In addition, Republic has consistently returned cash to shareholders.

We have had active engagement with Republic across its Investor Relations team and C-suite both prior to and since our investment. **Republic shares currently comprise a 3.6% weight in the Fund**, which we may look to grow over time, particularly since we see the shares as ~25% undervalued on a long-term discounted free cashflow basis. Our Republic position was funded through cash and reducing weightings elsewhere in the portfolio, although the later sale of Vestas allowed us to increase slightly our investment.

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