HEPTAGON
Capital

Future Trends Equity Fund

Q2 2024 Commentary

Fund Manager

Alex Gunz

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 3.0% gain in the second quarter of 2024, putting the Fund ahead of its benchmark. Several factors including portfolio changes were responsible for this performance, and we believe that the Fund is well-positioned for outperformance in the remainder of the year. We are confident that the approach we continue to pursue – offering investors *a different kind of future* that does not rely on US mega-cap tech businesses – will play out in our favour, particularly as corporate earnings growth broadens out. Since inception in 2016 there has been no change in our multi-thematic and concentrated investment philosophy.

Outperformance in a concentrated market

If you're not familiar with AI and the impact it has had on driving stock market returns, then you have probably been living on a different planet. **As believers in the future, we have no doubt that artificial intelligence will revolutionise our lives** in ways that we cannot even currently conceive of. Consider the precedent of mobile telephony. Had the proud owner of a Nokia 3310 in 1999 been shown the iPhone 15 of 2024, they would not have believed it possible: a handset with no buttons, operated with face-ID. Users today can make a call to anywhere in the world in full-colour, perfect quality video with zero latency. More than that, the 'phone' is now a de facto computer in your pocket with similar broadband speeds to its desktop equivalent. All this has been achieved in the space of a generation, and with compute power only increasing exponentially, the potential for AI should be evident.

Our issue, however, is over **how best to play this theme, and what price to pay for it**. The experience of Cisco is hugely instructive. Its routers continue to power the Internet, just as the company foresaw in the late 1990s yet its share price has never returned to peak levels. Cisco delivered just under 100% annualised returns in the decade through to its all-time high in late 1999. In the subsequent decade, its annualised returns were, according to Bloomberg, -8.5%. History may not repeat itself, but it can still rhyme.

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

NVIDIA needs no introduction, but a few statistics do bear mentioning. The business briefly became the world's largest company during June. This is quite remarkable, given the company was capitalised at less than $400bn just five years ago. It took NVIDIA just 32 trading days to gain its latest $1tr of market value (all data courtesy of Bloomberg).

We are not suggesting that NVIDIA is this era's Cisco but consider the sheer impact its mighty ascent has had on the overall stock market's performance. Year-to-date, the MSCI World Index is up 11.8% and the S&P 500 Index is up 14.5%. NVIDIA alone has driven one-third of the latter's performance so far this year. Over 60% of the Index's 2024 performance has come from just five stocks (NVIDIA, Microsoft, Amazon, Meta and Apple). In Q2, the concentration was even more pronounced: 90% of the market's return came from just three stocks (NVIDIA, Apple and Microsoft). We have not seen equivalent data for the MSCI World Index but assume it to be comparable.

Have no doubt, **this is a very concentrated market**. Look beneath the bonnet and the data are very revealing. **Both an equally weighted S&P Index and MSCI World Index underperformed in Q2, losing 3.1% and 2.2% respectively**. Against this background, we were pleased to see the Future Trends Fund gain 3.0% *despite* having owned none of the above mega-cap tech businesses over this period. We believe that four main factors were responsible for outperformance of the Fund in Q2.

Stock selection played a clear role. We will discuss leaders and laggards in more detail later in this report, but **two of our businesses added over 30% during the quarter**. First Solar gained 33.6% and ARM Holdings closed the period 30.9% higher. Both are indirect beneficiaries of the boom in all things AI but have robust business models and superb visibility. The former has sold all its available capacity through to the end of 2026 and has orders going out as far as 2030. At ARM, ~90% of its revenues are recurring, given its licensing model for semiconductor architecture IP.

Position sizing mattered. The Future Trends strategy emphasises high-conviction and low turnover. **Our two largest businesses as of the end of the quarter were Novo Nordisk and ASML**, at 7.0% and 6.8% weights respectively. We have owned the former since inception and the latter since August 2017. ASML has delivered ~40% annualised returns to the Fund and Novo ~24% annualised returns. In Q2, Novo added another 14.0% in absolute share price terms and ASML 8.1%.

The Fund benefited positively from M&A activity. On 26 April 2024, **Darktrace announced that it had agreed to a takeover bid** from private equity group, Thoma Bravo. Thoma and Darktrace had previously explored a deal in summer 2022, but this fell through. We were investors at this time and sold on the initial bid approach. We used the subsequent sell-off in Darktrace shares to reinitiate a position in January 2024 and almost exactly the same price as our initial February 2022 investment. In the short period we owned Darktrace on the second occasion, we generated a ~75% return for the Fund from this investment. Darktrace is the fifth business (after ARM – when Softbank acquired it prior to its recent relisting – Sophos, Avast and Covetrus) the Fund has owned that has been on the receiving end of positive M&A.

Increased focus in the portfolio has also helped. We discussed in our prior quarterly that we had conducted a thorough review of our portfolio's holdings and took the decision to make **exits from Aptiv, Chegg and TeamViewer** during Q1 (the last of the trio is only being disclosed now, since the trade occurred right at the end of the quarter). We came to the conclusion that cyclical concerns trump the secular opportunity in respect of the auto sector (Aptiv) and that Chegg's consumer edtech model lacked clear strategic direction. The TeamViewer sale was used partly to fund the acquisition of ARM. All three businesses we now no longer own have continued their share price declines subsequent to our exits, and so *not* owning them has contributed to better performance.

One important takeaway that should hopefully be evident to readers from these different narratives ought to be **the extent to which the Future Trends Fund is thematically diversified and concentrated** is. We currently own 21 businesses exposed to 13 different themes. Despite recent portfolio changes, **the average business owned by the Future Trends Fund has been part of the portfolio for 52 months** (on a weighted basis).

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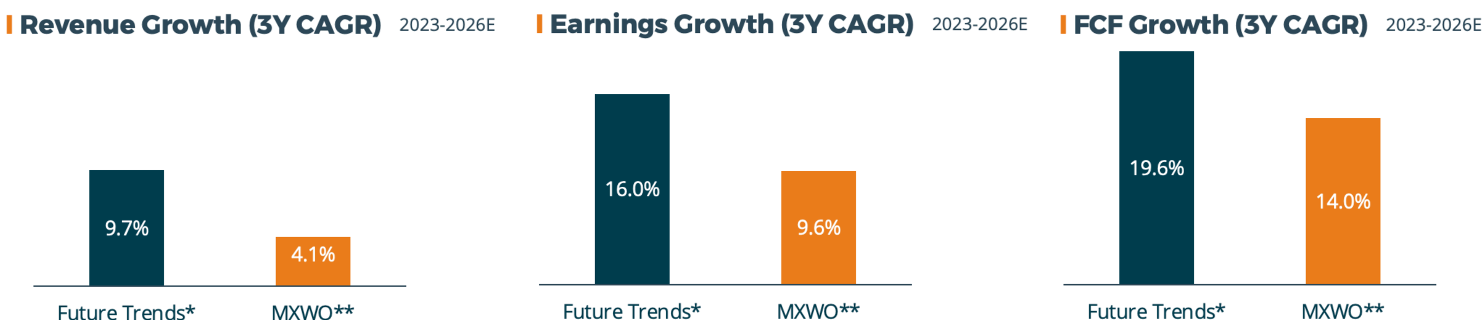
Much of the work we do is therefore premised on **deepening the conviction we have in our existing holdings**, reviewing the investment case constantly. Over the past quarter, we published two thematic deep-dives and 11 Blog posts. Thematically, we focused on the opportunity for how GLP-1 drugs used to treat obesity could also potentially help manage Alzheimer's Disease, one of the final healthcare frontiers. **Novo Nordisk** would be a clear beneficiary were ongoing trials to result in successes. Additionally, we discussed how warehouses are the unsung heroes of the modern world, critical to the efficient functioning of supply chains. Future Trends has exposure to this theme through **Prologis** and **GXO**.

Part of our work for the latter thematic piece took us to the north of England to conduct a warehouse tour, a site visit referenced in our subsequent Blog post. Beyond this activity, we travelled to Germany to meet with one of ASML's critical suppliers. We also visited a vertical farm, attended London Tech Week and dropped in on the largest energy conference in Europe, among other activities. Q2 was also a busy period for interacting with corporate management teams. We conducted 16 meetings and **year-to-date have met management from 19 of our 21 current portfolio holdings**.

All our top-down thematic work and ongoing management interaction is reinforced by our thorough bottom-up analytic research. Importantly, **earnings estimates for the Fund continue to improve**. Every month we aggregate and then weight the (typically below consensus) forecasts in our company models. What is evident to us is that our estimates are now *higher* than they were at the end of 2023, helped both by portfolio changes and underlying upgrades. This is the case when reviewing revenues, earnings and free cashflow. On a three-year compound annual growth basis, our Fund should see growth of 9.7%, 16.0% and 19.6%, for revenues, earnings and free cashflow respectively. When compared to Bloomberg consensus, our forecasts are ahead.

Financial prospects



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

Against this background, we believe that **the Fund is well-positioned for the remainder of 2024**. Two interlinked factors help to reinforce this conviction. As discussed previously, this is clearly a highly concentrated market. However, **momentum as a style factor is mean reverting**. We do not believe it to be durable over the long term. Overshoots typically end abruptly. Data from Alpine Macro, one of our research providers, show that both average and median peak-to-trough drawdowns from momentum businesses have been larger than start-to-peak gains.

Related, and supported by our own work referenced above, **earnings growth is broadening out**. We made the case in our latest View From The Top macro commentary, that the rally in equities could be sustained by a combination of decent economic growth, high but falling inflation and an ongoing recovery in corporate earnings. The chart below shows that whereas mega-cap tech was responsible for almost 100% of the S&P 500 Index's year-on-year earnings growth in Q1 2024 (and NVIDIA alone for ~30%), by Q4 this year, the rest of the Index should be contributing to over 60% of the market's earnings growth, per FactSet data. Assume similar for the MSCI World.

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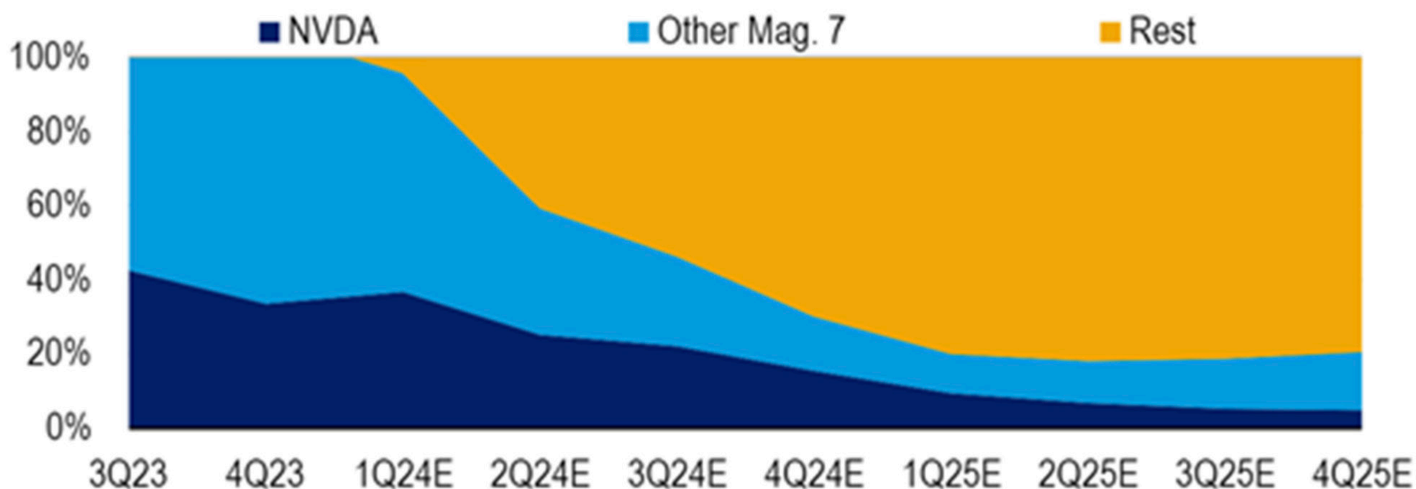
Earnings growth is broadening



Source: BofA Global Research, FactSet

In summary, we are pleased with second quarter outperformance and understand the reasons behind year-to-date underperformance (no mega-cap tech exposure). Our strategy is to stay focused on the longer-term opportunity. All the businesses in which we invest are supported by robust financials and the themes to which they are exposed have significant runways ahead. We believe our **pan-thematic and concentrated portfolio is well positioned for the future**.

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

Alex Gunz, Fund Manager
June 2024

Appendix 1: Q2 leaders and laggards –

The Future Trends Fund gained 3.0% during the second quarter of 2024, which compares to a 2.6% return for the MSCI World. Interestingly, only 8 of our businesses (or 9, if Darktrace were included for the period we owned it during the quarter) outperformed over this period, but the *magnitude* of these gains combined with *positioning sizing* help drive overall Fund returns. On a year-to-date basis, the same dynamic has also played out.

Beyond Darktrace (which generated a 37.2% return over the 19 trading days we owned it in the quarter), **our two largest gainers were First Solar and ARM Holdings**, up 33.6% and 30.9% respectively. While results from both companies were solid and resulted in consensus earnings upgrades, thematic factors probably played a greater role in driving returns.

As the largest domestic manufacturer of utility/ industrial-scale solar panels in the US, First Solar has clearly benefited from growing trade tensions between the US and China. In particular, the decision of the Biden administration to levy higher tariffs on Chinese panels should work to the benefit of First Solar. Furthermore, given the increased demands that AI workloads will place on the grid, the critical role of solar as a source of alternative energy is only likely to be reinforced. AI has also helped drive interest in and share price appreciation for ARM Holdings. The business is discussed in more detail below, but more chips (whether CPUs or GPUs) means greater revenues for ARM.

Dispersion between leaders and laggards is inevitable in a multi-thematic Fund. Over the past quarter, this was equivalent to over 50 percentage points. **SIG Combibloc, Vestas and Match Group** all lost more than 15% in the quarter. Throughout this period, however, SIG and Match were the Fund's two *smallest* positions, limiting the downside impact. The position sizing was a partial function of market capitalisation, whereby we typically award smaller businesses with lower weights. SIG and Match are capitalised at $7.5bn and $8.4bn respectively.

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SIG shares were 17.8% lower in the quarter following an underwhelming Q1 trading statement and subsequent earnings downgrades. We spent time with SIG's CFO and came away reassured that trends for the manufacturer of sustainable packaging solutions are improving, and probably have already passed their nadir. Vestas was 16.5% lower as the turbine manufacturer continues to struggle to convert its strong order backlog into revenues. We also met senior management (CEO and CFO) in the past quarter and have few doubts over Vestas' strategic direction. Match closed the quarter down 16.3% as its strategic turnaround continues to take time to play out. We will continue to monitor developments carefully.

Appendix 2: Deep dive into ARM Holdings –

ARM Holdings became the latest addition to the Future Trends Fund at the very end of Q1. This position was partially funded through the sale of TeamViewer (referenced previously) and through lowered weightings elsewhere in the Fund. During Q2, we made no name changes other than selling out of Darktrace following its agreed takeover approach. Darktrace proceeds were distributed across the Fund.

Future Trends has had a long history with ARM. It was one of the original 20 businesses in the Fund, when we launched in 2016. When Softbank acquired ARM in July 2016, it was the fourth largest holding within the Fund. We exited with a ~60% return. Softbank took ARM private and only relisted it on the stock market (NASDAQ, versus the LSE previously) in September 2023. Throughout, we continued our research and dialogue. Subsequent to relisting, we met ARM in London in December 2023 and travelled to California to spend time with CEO Rene Haas, in March 2024.

For those unfamiliar with ARM, **the business is the world leader in semiconductor compute architectures**. Thought of another way, 70% of the world's population use ARM-based products. ARM's CPUs have enabled advanced computing in over 99% of the world's smartphones and more than 285bn chips, powering everything from sensors to supercomputers.

Companies license ARM's products for a fee, which gives them access to ARM's compute IP portfolio and enables the companies to create ARM-based chips (microcontrollers/ microprocessors). Once customers have licensed the IP, designed and shipped a chip, ARM receives a per-unit royalty on the ASP of the chip shipped. Over time ARM has sought to move to a strategy of licensing a portfolio of ARM products to an entire organisation through a subscription model, making it easier for customers to access and use ARM products (and thus feeding the royalty model). With a typically 3-year contract, **ARM has high visibility over 90% of its revenues**.

ARM is exposed to multiple structural drivers - faster compute processors are required to enable the future. The increasing complexity of workloads drives higher architecture per chip (design costs are rising with each new technology node). AI workloads will demand more processing power – as LLMs proliferate, more inferencing will occur in the handset, translating into higher demand for ARM's technology. More complexity implies greater value per chip and hence more royalties and a better margin mix. NVIDIA's most advanced GPUs contain ARM architecture within them. ARM is also expanding its IP into adjacencies such as data centres, the Internet of Things and the automotive sector.

ARM's positioning helps inform its financial guidance, which calls for **15% annual long-term revenue growth and further margin expansion**. Our conviction in ARM was reinforced by a visit in May to its research and development facility in Cambridge, England. The business also has strong sustainability credentials, as discussed in our most recent quarterly sustainability report. A full briefing note on the business is available on request.

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SFDR

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