Heartland Mid Cap Value Fund 3Q20 Portfolio Manager Commentary

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Executive Summary

- Stock selection was positive on an absolute basis with Materials and Consumer Staples leading on the upside.
- The gap between top and bottom performers reached levels not seen since the “Dotcom” era.
- Buying activity highlighted differing views on timing of the recovery among sectors and industries.

Third Quarter Market Discussion

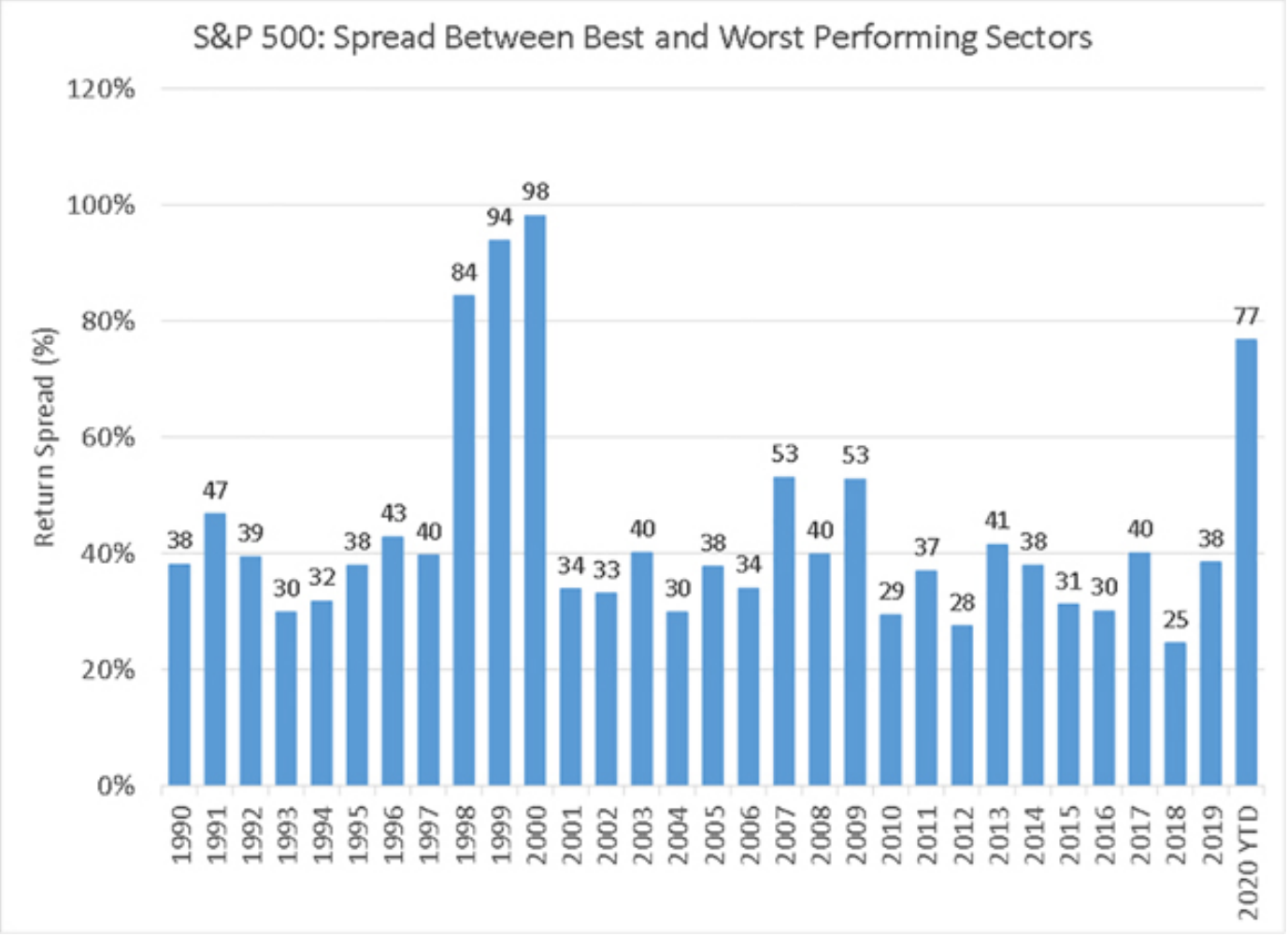
Equities spent much of the period building on strength that began in late Spring as investors seemed to conclude the worst of the COVID-19 recession was over. The optimism reflected the view that a combination of an accommodating Federal Reserve and government stimulus would propel earnings to pre-pandemic levels.

While the tone was generally upbeat, buying activity highlighted differing views on timing of the recovery among

sectors and industries.

Large growth companies were among the top beneficiaries, as investors seemed to continue to chase yesterday's winners. While performance among Financials and Real Estate was more subdued, the dynamic led to the gap between top and bottom performers reaching levels not seen since the "Dotcom" era, as shown below.

The Haves and The Have Nots



Source: Furey Research Partners, FactSet and Standard & Poor's. 1/1/1990 to 9/30/2020. This chart shows the difference in returns, as a percentage, for the best and worst performing sectors in the S&P 500.
Past performance does not guarantee future results.

Attribution Analysis

The portfolio's holdings in Materials and Consumer Staples outperformed on a relative basis but could not overcome weakness in Consumer Discretionary and Utilities and the strategy lagged its Russell Midcap® Value benchmark for the quarter.

A room with a view. As stocks sold off earlier this year in response to the global pandemic, the Team acted opportunistically by adding industry-leading businesses that were trading at significant discounts relative to their intrinsic value. Hilton Worldwide Holdings Inc. (HLT) is an example of this approach.

Hilton, a global hospitality franchise and property manager with roughly one million hotel rooms under the company's operational umbrella, owns popular hotel brands including the namesake Hilton franchise, DoubleTree, Hampton Inn, and Embassy Suites. Hotel owners enter into multi-year franchise agreements with Hilton in return for access to Hilton's property management expertise, booking software, and Hilton Honors loyalty members.

Shares of the company sold off earlier this year as travel restrictions in response to COVID-19 led to a dramatic downturn in room bookings. Hilton was particularly impacted because of the company's focus on the mid and upper- price point and business travel customers. We viewed the slump in share price as an overreaction to a temporary setback for demand and initiated a position in early summer. Since then, revenue per available room night, an industry metric that measures room rate and occupancy, has improved meaningfully and shares rose double-digits for the period.

We believe Hilton should be a direct beneficiary of rising travel demand going forward, and that the company is in the early innings of a global expansion that could serve as a catalyst for growth in the coming years.

Narrowing the spectrum. While investors spent much of the period bidding up businesses based on sales growth expectations, the portfolio reaped the benefits of some holdings that were driving an improved outlook through self-help measures. Spectrum Brands Holdings (SPB), a household products company, is one such example.

Spectrum sells a variety of home goods through its market-leading brands including Kwikset, Black and Decker, Pfister and Remington. Of the company's $3.8 billion in annual sales, roughly 80% are driven by its top 15 brands.

During the past 18 months, management has undertaken an initiative to exit non-core business lines such as auto care and batteries, reduce debt and improve efficiency. These efforts have begun to produce results and sales figures have exceeded expectations during the COVID downturn.

We believe Spectrum is in the early innings of its transformation and should also see continued organic sales growth as it invests proceeds form divestitures into its business. Despite recent improvements in its share price, the company still trades at meaningful discount to its peers on an enterprise value/earnings before interest, taxes, depreciation and amortization basis.

Returning to power? The portfolio's Utility names lagged on a relative basis with the shortfall stemming from a stock-specific issue in the group. FirstEnergy (FE) is a business we've owned in the past and sold out of after shares had appreciated following its successful transition to a pure regulated utility through the divestiture of its merchant power unit.

We initiated a new stake in FirstEnergy in March after shares sold off due to concerns that the recession would have an outsized impact on the company's industrial-oriented client base. Similar to our successful experience in the past, we felt that the company was attractive given its meaningful discount to its peers.

Subsequent to our investment, FirstEnergy was named in an investigation related to $60 million of payments made by the merchant power entity to Ohio politicians. Our initial reaction when news broke was to reduce our exposure to the company, however, we continued our due diligence on the matter and believe that market reaction overestimated the likely fallout from the investigation.

As shares fell in price, we added to our position in the belief that as the matter proceeds, some of the clouds casting a shadow on the business will subside.

A bad haircut. The portfolio's holding in Consumer Discretionary were up modestly on an absolute basis but lagged the sector average for the benchmark. Most of the weakness came from a single name, Mohawk Industries, Inc. (MHK), a building products company and the dominant U.S. player in flooring. Shares sold off after details from a

class action lawsuit filed against the company were disclosed. The lawsuit alleges that management manipulated sales figures for one of its products through questionable accounting practices.

After digging deeper into the allegations, we chose to significantly reduce our exposure to the name and continue to monitor the situation.

Portfolio Activity

While we continue to monitor macro events that will impact the global economy, our focus remains on finding businesses where we believe valuations reflect a misunderstanding of risk and those businesses that are poised to succeed against a variety of backdrops. Rich valuations across broad swaths of the equities market has left little room for error for businesses striving to meet what we view as overly optimistic earnings estimates. As a result, we have sought to own overlooked businesses where even incremental improvement should result in meaningful upside in share price. The lack of consensus on how long the business cycle will continue its robust growth has led to attractive valuations in both economically sensitive and defensive areas.

Outlook and Positioning

With the expectation that rates will remain near historically low levels for the foreseeable future, many investors have embraced businesses based on rosy forecasts for earnings expansion despite elevated valuations. The dynamic has been a headwind for Value investors like ourselves.

The current challenging environment, should, in our view, give way to a market where businesses fail or succeed based on idiosyncratic factors and where fundamental analysis shines.

As we sort through the companies that hit our radar, we will not change our philosophy or process. The team continues to focus on valuations, balance sheet strength and catalysts that can result in a change in perception by investors. This approach should result in a favorable risk-reward profile in the quarters and years ahead.

Thank you for the opportunity to manage your capital.

Portfolio Management Team

Colin McWey

McWey, CFA, is Vice President and Portfolio Manager for the Opportunistic Value Equity Strategy, as well as the Mid Cap Value Fund and it's corresponding Mid Cap Value Strategy. He has 18 years of industry experience, 11 at Heartland.

Will Nasgovitz

Nasgovitz is CEO and Portfolio Manager of the Opportunistic Value Equity Strategy, as well as the Mid Cap Value Fund, the Value Fund, and their corresponding Mid Cap Value and Small Cap Value Strategies. He also is President and Director of Heartland Funds. He has 20 years of industry experience, 16 at Heartland.

View Fund Performance

Fund Returns

9/30/2020

‹ › Scroll over to view complete data

	Since Inception (%)	20-Year (%)	15-Year (%)	10-Year (%)	5-Year (%)	3-Year (%)	1-Year (%)	YTD* (%)	QTD* (%)
Mid Cap Value Investor Class	4.29	-	-	-	7.17	1.38	-8.05	-14.79	3.06
Mid Cap Value Institutional Class	4.55	-	-	-	7.44	1.61	-7.86	-14.67	3.15
Russell Midcap® Value	4.40	-	-	-	6.38	0.82	-7.30	-12.84	6.40

*Not annualized

Source: FactSet Research Systems Inc., Russell®, and Heartland Advisors, Inc.

The inception date for the Mid Cap Value Fund is 10/31/2014 for the investor and institutional class.

Mid Cap Value Fund Quick Links

PDF Factsheet

Commentary

Attribution & Contribution Reports

Holdings

Email Sign Up

- I am a financial professional or institutional investor
- I am an individual investor

In the prospectus (pdf) dated 5/1/2020, the Net Fund Operating Expenses for the investor and institutional classes of the Mid Cap Value Fund are 1.10% and 0.85%, respectively. The Advisor has contractually agreed to waive its management fees and/or reimburse expenses of the Fund to ensure that Net Fund Operating Expenses for the Fund do not exceed 1.10% of the Fund's average net assets for the investor class shares and 0.85% for the institutional class shares, through at least 5/1/2022, and subject thereafter to annual reapproval of the agreement by the Board of Directors. Without such waiver and/or reimbursements, the Gross Fund Operating Expenses would be 1.36% for the investor class shares and 1.07% for the institutional class shares.

Past performance does not guarantee future results. Performance represents past performance; current returns may be lower or higher. Performance information for institutional class shares of Funds that existed prior to their initial public offering is based on the performance of investor class shares. The investment return and principal value will fluctuate so that an investor's shares, when redeemed may be worth more or less than the original cost. All returns reflect reinvested dividends and capital gains distributions, but do not reflect the deduction of taxes that an investor would pay on distributions or redemptions. Subject to certain exceptions, shares of a Fund redeemed or exchanged within 10 days of purchase are subject to a 2% redemption fee. Performance does not reflect this fee, which if deducted would reduce an individual's return.

An investor should consider the Funds' investment objectives, risks, and charges and expenses carefully before investing or sending money. This and other important information may be found in the prospectus (pdf). To obtain a print prospectus, call 800-432-7856. Please read the prospectus carefully before investing.

As of 9/30/2020, FirstEnergy Corp., Hilton Worldwide Holdings, Inc., Mohawk Industries, Inc., and Spectrum Brands Holdings, Inc. represented 3.13%, 2.24%, 0.69%, and 3.77% of the Mid Cap Value Fund's net assets, respectively.

Statements regarding securities are not recommendations to buy or sell.

Portfolio holdings are subject to change without notice. Current and future portfolio holdings are subject to risk.

The Mid Cap Value Fund invests in a smaller number of stocks (generally 30 to 60) than the average mutual fund. The performance of these holdings generally will increase the volatility of the Fund's returns. The Fund also invests in mid-sized companies on a value basis. Mid-sized securities generally are more volatile and less liquid than those of larger companies. There can be no assurance that the Fund will grow to or maintain an economically viable size, in which case the Board of Directors may determine to liquidate the Fund.

Value investments are subject to the risk that their intrinsic value may not be recognized by the broad market.

The Mid Cap Value Fund seeks long-term capital appreciation and modest current income.
The above individuals are registered representatives of ALPS Distributors, Inc.

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Economic predictions are based on estimates and are subject to change.

There is no guarantee that a particular investment strategy will be successful.

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Heartland Advisors defines market cap ranges by the following indices: micro-cap by the Russell Microcap®, small-cap by the Russell 2000®, mid-cap by the Russell Midcap®, large-cap by the Russell Top 200®.

Because of ongoing market volatility, performance may be subject to substantial short-term changes.

Dividends are not guaranteed and a company's future ability to pay dividends may be limited. A company currently paying dividends may cease paying dividends at any time.

There is no assurance that dividend-paying stocks will mitigate volatility.

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Heartland's investing glossary provides definitions for several terms used on this page.