Heartland Value Plus Fund 1Q21 Portfolio Manager Commentary

3/31/2021 | Fund Commentary Archive | HRVIX, HNVIX

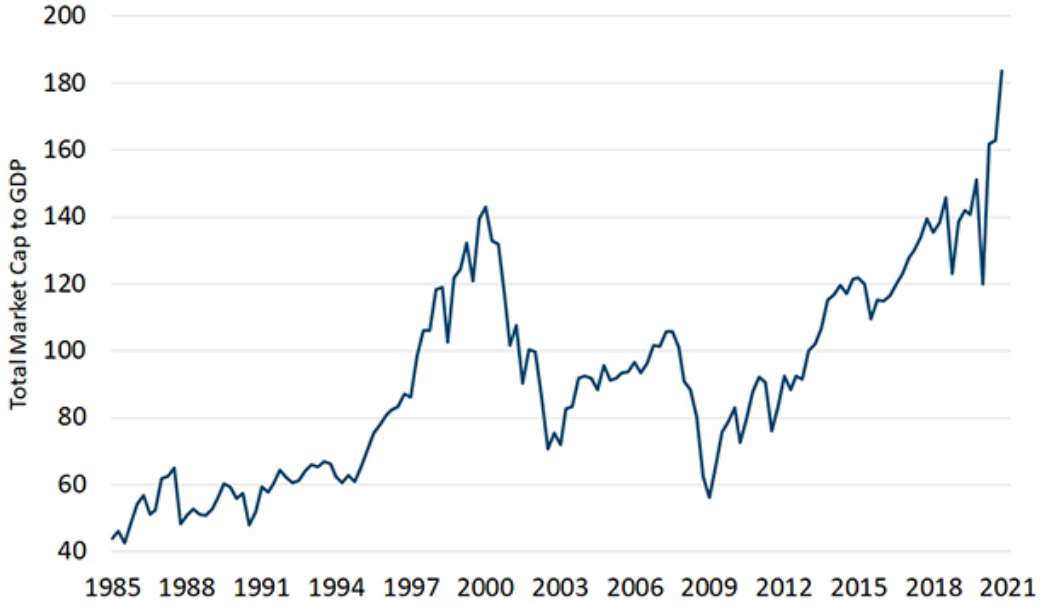
Executive Summary

- The portfolio was up sharply and kept pace with its benchmark, the Russell 2000® Value Index.
- Investors have finally shown a willingness to look beyond a small pool of large-cap names.
- We welcome investors' increased attention to smaller companies, but also think the current "extreme optimism" is overdone.
- We are taking a longer view by seeking businesses we believe could be well positioned to weather long-term uncertainty.

First Quarter Market Discussion

Extreme optimism took hold of the market as investors responded to approval of a $1.9 trillion deluge of new stimulus spending by the federal government and the rapid rollout of COVID-19 vaccinations. The euphoria led to a widespread runup for equities and drove the so-called Buffett indicator to its highest level in of the past 35 years. The ratio, shown below, compares the market cap of virtually all publicly traded U.S. companies to the GDP of the U.S. As illustrated, investors are paying nearly $1.85 for every dollar of GDP produced—or about 40% more than the historical average. When updated GDP numbers are released in the coming weeks, we expect that ratio to move even higher.

Total Market Cap to GDP



Source: FactSet Research Systems Inc., Quarterly data 3/29/1985 to 12/31/2020. Total Market Cap is represented by the Wilshire 5000 Total Market Index. All indices are unmanaged. It is not possible to invest directly in an index.

Past performance does not guarantee future results.

The buoyant mood reflected by the Buffett indicator led investors to flock to more volatile names and leveraged companies. The willingness to embrace debt-laden businesses continues a trend evident during the past few quarters—but now, investors have finally shown a willingness to look beyond a small pool of large-cap names. The result was outperformance by shares of smaller companies.

Attribution Analysis

The portfolio was up sharply and kept pace with its benchmark, the Russell 2000® Value Index, for the period. Stock selection in Information Technology was strong as were holdings in the Utilities sector. The portfolio's holdings in Consumer Discretionary were up sharply but lagged the benchmark average for the group.

Healthy growth. The portfolio's Health Care names were up on a relative and absolute basis and built on strength they enjoyed in late 2020. Phibro Animal Health Corp. (**PAHC**), was up double-digits for the second consecutive period.

Phibro, an animal health and mineral nutrition company that produces vaccines, microbial products, and medicated feed additives, saw its shares rise after reporting better than expected earnings in February. We anticipate the company should continue to see healthy gains in free cash flow generation in 2021, as it begins to reap the benefits of investments made in 2020.

Additionally, Phibro has seen growing demand for its products as animal production has rebounded following a slowdown in the meat packing industry due to COVID-19. As food inflation has accelerated, we expect Phibro's products will see increasing demand as the company's customers look to capitalize on rising protein prices. Despite the favorable outlook for the company, shares trade at 10x estimates of 2022 enterprise value/earnings before interest, depreciation and amortization (EV/EBITDA).

In control. The portfolio's IT holdings boosted results and we continue to find opportunities in a variety of industries in the space. Methode Electronics, Inc. (MEI) is a manufacturer of electronic controls and components primarily for the automobile and industrial end markets and is an example of the type of business we favor.

Shares of Methode advanced nearly 10% during the period following management reporting solid quarterly results and a robust sales forecast for 2022 along with improving margins.

The company offers an attractive mix of steady revenue from an established core business and rapid growth from its electric/hybrid vehicle, which may see sales double within the next year. Additionally, Methode's management team has been aggressive in paying down debt and has optimized costs following recent acquisitions.

With Methode shares trading at 7.5x estimates of 2022 EV/EBITDA, we believe the company is an attractive opportunity to capture growing cash flows at a price that could mitigate downside risk.

Portfolio Activity

As bottom-up stock pickers, we continue to focus on individual companies and their ability to succeed in a variety of economic scenarios. However, we also recognize that any unforeseen economic headwinds, higher interest rates or inflationary pressures could be particularly damaging to highly levered companies.

In response, our work continues to center on balance sheet strength and prudent use of capital, and we seek to avoid companies that undertake large-scale transformative acquisitions. Instead, we prefer businesses that are involved in selling off noncore, underperforming business lines or those that have the financial wherewithal to opportunistically make small-scale, bolt-on purchases that further enhance core competencies.

Outlook and Positioning

While we welcome investors' increased attention to smaller companies, we also think the current "extreme optimism" is overdone. The flood of liquidity injected into the market along with still low interest rates has set the stage, we believe, for future growth to pale in comparison to the artificially juiced numbers many companies are currently forecasting.

The willingness to extrapolate the effects of government stimulus into the foreseeable future is misguided, in our view. While the economic outlook has improved given the development of COVID-19 vaccines, the sustainability of economic growth when government checks dry up is still unknown. The latest government stimulus is likely to offer a temporary boost to production and demand, but we expect the long-term expansion to be tepid due to excessive corporate and government debt depressing the economy.

As such, we are taking a longer view by seeking businesses we believe could be well positioned to weather long-term uncertainty. We believe this tactic will produce a portfolio of companies that should endure when interest rates rise and government stimulus dries up.

Thank you for your continued trust and confidence.

Portfolio Management Team

Bradford A. Evans

Evans, CFA, is Senior Vice President and Portfolio Manager of the Value Plus Fund and its corresponding separately managed account strategy. He has 25 years of industry experience, 22 at Heartland.

Andrew J. Fleming

Fleming, CFA, is Vice President and Portfolio Manager of the Value Plus Fund and its corresponding separately managed account strategy. He has 11 years of industry experience, 8 at Heartland.

View Fund Performance

Fund Returns

3/31/2021

‹ › Scroll over to view complete data

	Since Inception (%)	20-Year (%)	15-Year (%)	10-Year (%)	5-Year (%)	3-Year (%)	1-Year (%)	YTD* (%)	QTD* (%)
Value Plus Investor Class	10.59	11.06	8.71	8.18	15.73	15.25	77.45	20.56	20.56
Value Plus Institutional Class	10.72	11.24	8.94	8.44	15.97	15.52	77.92	20.62	20.62
Russell 2000® Value	10.17	9.53	7.38	10.06	13.56	11.57	97.05	21.17	21.17

*Not annualized

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

The inception date for the Value Plus Fund is 10/26/1993 for the investor class and 5/1/2008 for the institutional class.

Value Fund Quick Links

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In the prospectus dated 5/1/2021, the Gross Fund Operating Expenses for the investor and institutional class of the Value Plus Fund are 1.23% and 0.97%, respectively. The Advisor has voluntarily agreed to waive fees and/or reimburse expenses with respect to the institutional class, to the extent necessary to maintain the institutional class' "Net Annual Operating Expenses" at a ratio not to exceed 0.99% of average daily net assets. This voluntary waiver/reimbursement may be discontinued at any time. Without such waivers and/or reimbursements, total returns may have been lower.

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. To obtain a print prospectus, call 800-432-7856. Please read the prospectus carefully before investing.

As of 3/31/2021, Methode Electronics, Inc. and Phibro Animal Health Corp. represented 2.83% and 3.04% of the Value Plus 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 Value Plus Fund invests in small companies that are generally less liquid and more volatile than large companies. The Fund also invests in a smaller number of stocks (generally 40 to 70) than the average mutual fund. The performance of these holdings generally will increase the volatility of the Fund's returns. There is no assurance that dividened paying stocks will mitigate volatility.

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

The Value Plus Fund seeks long-term capital appreciation and modest current income.

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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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Bolt-on Acquisition refers to a company that is added by a private equity firm to one of its platform companies. Bottom-up is an investment approach that de-emphasizes the significance of economic and market cycles. This approach focuses on the analysis of individual stocks and the investor focuses his or her attention on a specific company rather than on the industry in which that company operates or on the economy as a whole. Cyclical Stocks cover Basic Materials, Capital Goods, Communications, Consumer Cyclical, Energy, Financial, Technology, and Transportation which tend to react to a variety of market conditions that can send them up or down and often relate to business cycles. Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) measures a company's financial performance. It is used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions. Free Cash Flow is the amount of cash a company has after expenses, debt service, capital expenditures, and dividends. The higher the free cash flow, the stronger the company's balance sheet. Russell 2000® Value Index measures the performance of those Russell 2000® companies with lower price/book ratios and lower forecasted growth characteristics. All indices are unmanaged. It is not possible to invest directly in an index. Volatility is a statistical measure of the dispersion of returns for a given security or market index which can either be measured by using the standard deviation or variance between returns from that same security or market index. Commonly, the higher the volatility, the riskier the security.

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