



Heartland Opportunistic Value Equity Strategy 4Q25 Portfolio Manager Commentary

12/31/2025

Executive Summary

- Despite brief stretches of broadening performance across market caps, large- and mega-cap stocks logged another quarter of outperformance.
- The tech sell-off in November highlighted how fleeting the market's views are on the potential winners and losers of the AI expansion cycle.
- In a market marked by such extreme shifts, we believe it's more important than ever to consider a range of potential outcomes.

Fourth Quarter Market Discussion

While AI dominated the 2025 equity market narrative, many perceived beneficiaries experienced a late fourth-quarter pullback. Despite this late volatility, overall market breadth narrowed as mega-cap stocks significantly outperformed during the first six weeks of the quarter. The Russell 2000® Index of small stocks returned 2.19% in the final three months of the year, trailing the 2.66% gain for the S&P 500.

Reflecting on 2025, we are pleased with the Strategy's absolute performance. While we never want to underperform, we're not surprised that keeping up with broad indices has proven challenging. Speculative investors have confidently rewarded perceived AI winners with unsustainably high valuations. Only time will tell whether fundamentals will remain strong enough for long enough to justify the excessive valuation assigned to pockets of the equity market.

Despite what appeared to be a one-way-train equity market in 2025, it's worth noting that volatility in shares of seeming winners serves as a reminder that nobody knows which companies will be long-term winners from the proliferation of AI.

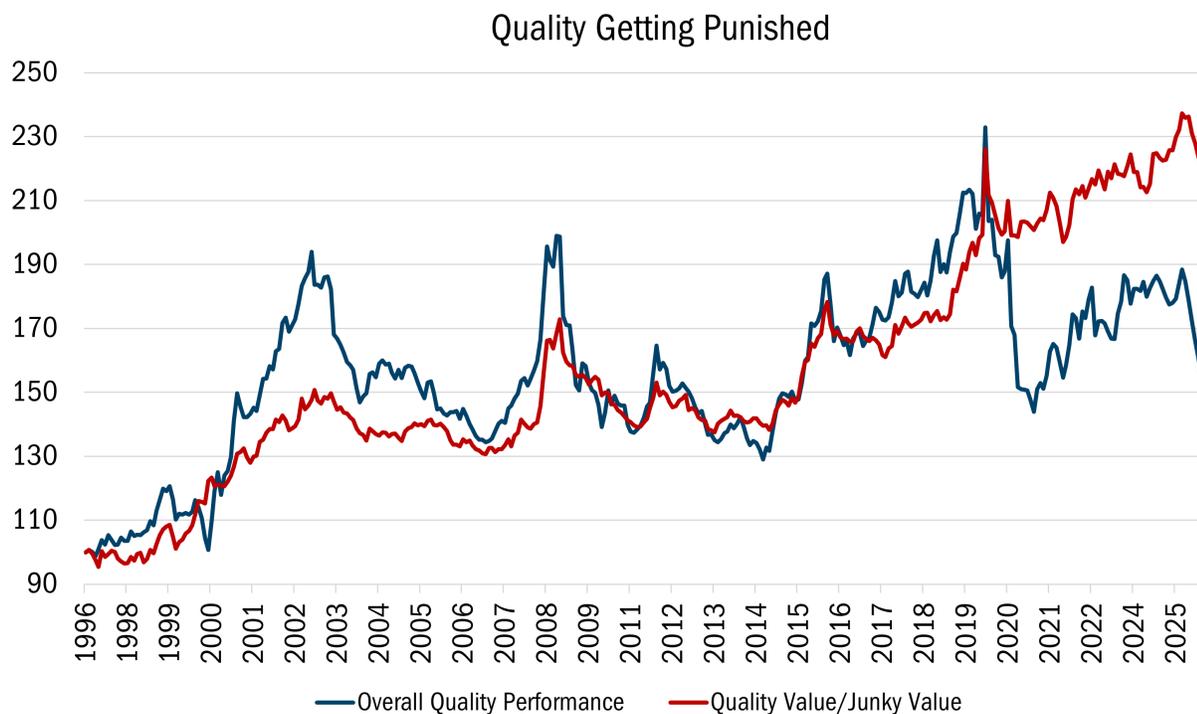
For instance, we previously owned a holding that was widely viewed as an AI leader owing to the company's strategy to be an arms dealer of datacenter capacity. We appeared foolish for eliminating the position in August when shares rose over 40% from our exit price following the company's second quarter earnings report in September. We sold the company because capital spending skyrocketed to a point where it was no longer generating free cash flow, a first in over thirty years. The market added more than \$300 billion to its market capitalization because of a large order from OpenAI. By early December, more than \$500 billion was erased from the company's capitalization as the market began questioning how OpenAI would fund the order. By OpenAI's own admission, it will not be profitable until 2028 at the earliest and analysts suggest 2030 may even be optimistic. To be clear, our thesis when first purchasing this company in 2016 had nothing to do with datacenters or AI. Rather, we saw an opportunity to buy an entrenched database business transitioning to a software-as-a-service business model at an attractive valuation of free cash flow and earnings.

On the other side of sentiment, Alphabet’s Google search engine was seen as at risk of disruption by OpenAI and other AI startups. In May of 2025, shares of Alphabet were trading at a 30% discount to the S&P 500, a bargain in our opinion. Not because we ‘knew’ that Alphabet was the AI winner. Rather, we viewed Alphabet as having key assets required to be a meaningful player in the AI race (consistent free cash flow, multiple 5+ billion user apps, real-time data, cloud computing infrastructure, custom application-specific semiconductors, and its own large-language model). Most importantly, the discounted valuation provided us with a margin of safety that gave us comfort in knowing that we didn’t need to be perfectly right in our assessment of the business to make money. Since May, shares of Alphabet have more than doubled.

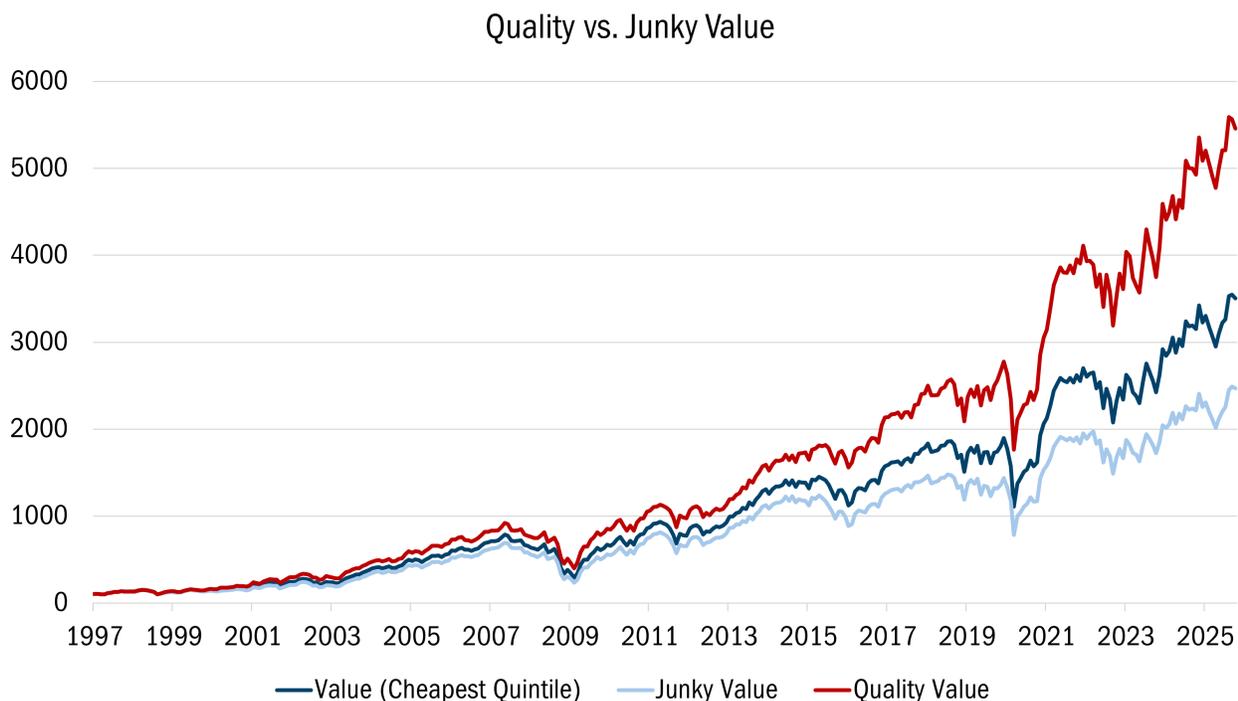
Why is it that companies with market capitalizations measured in the hundreds of billions or multi trillions are moving with such extreme volatility? Is the market not efficient? By our count, both companies have more than thirty smart Wall Street analysts covering the companies. For this reason, it’s hard to believe the market isn’t efficient. We believe the answer lies in how little market participants ‘know’ about the future, which is inherently uncertain. When it comes to revolutionary technology, the future is more uncertain than normal. As a result, participants will act like they ‘know’ by bidding up shares of whatever company looks like the winner right now. We have not and will not play this game. Rather, we will be realistic about what is knowable, what we don’t know, and, critically, what the market is pricing in when allocating capital.

The market’s extreme reactions, and the speed with which they are taking place, illustrate how fleeting investor confidence can be. At Heartland, considering a range of possible outcomes is core to our process. Before initiating a position in any stock, we play out a variety of scenarios, reflecting how the market might value each business under different conditions. This includes a base case, a ‘blue sky’ scenario, a ‘downside’ scenario should circumstances worsen, and a ‘max downside’ case in the event of a potential shock.

Under any circumstance, we believe this approach is important for determining the realistic risk/reward proposition for securities under consideration. But it will be especially useful as the market broadens, a process that paused in the fourth quarter. For instance, while investors have been willing to look beyond mega-cap tech lately, non-earners among small-caps continue to outperform, a sign that speculation hasn’t gone away. Even within the value universe, junkier parts of the market continue to lead, even though high quality value has outperformed over the long run (see the charts below).



Source: The Leuthold Group. Monthly data from 12/31/1996 to 10/31/2025. The data in this chart shows the comparison of Quality Performance to Quality/Junky Value over time. All performance and return numbers are based on monthly rebalancing and members are equal-weighted. Value is a composite that consists of P/E, P/Sales, P/book and this factor is ranked across the largest 1500 stock universe and the cheapest quintile is considered Value. Quality is defined by 3 factors: ROE, Leverage (debt/assets) and operational (sales and earnings) stability. Then, ranked the largest 1500 US stocks by this composite 3-factor quality rank. The top quintile is high quality and bottom quintile low quality. Quality Value is defined as the cheapest stocks that are also in the top 2 quintiles of the quality rank. Junky Value is defined as the cheapest quintile stocks that are also in the bottom 3 quintiles of the quality rank. All indices are unmanaged. It is not possible to invest directly in an index. **Past performance does not guarantee future results.**



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As the market breadth improves, considering a variety of outcomes should help investors weigh the full range of risks. At Heartland, another way we try to control for risk is by focusing on our 10 Principles of Value Investing™, which directs us to attractively priced, financially sound, and well-managed businesses that can grow intrinsic value.

Attribution Analysis

During the quarter, our Strategy returned 0.79%, trailing the Russell 3000® Value Index, which was up 3.78%. Stock selection was mixed with 8 of the 11 underperforming, most notably Information Technology and Healthcare.

In absolute terms, the smallest stocks in our portfolio, representing companies with market caps below roughly \$750 million, were our Strategy's best performers. However, when it comes to the impact of security selection, we had the most success with mega-cap and mid-cap names, while the selection effect among small-cap was fairly neutral. Part of this goes back to the fact that many top returners in the small-cap benchmark were profitless companies, a group we generally avoid due to our adherence to the 10 Principles of Value Investing™.

Portfolio Activity

One profitable company whose shares we've held for years, and that demonstrates why a focus on shareholder value creation matters in the long run, is **Old Republic International (ORI)**, a specialty property & casualty commercial insurance underwriter.

Old Republic is a classic self-help story. We initiated the position in 2019 and added to it in 2020, as the shares took a hit due to the start of the pandemic. Shortly after, ORI was transformed from an insular insurance underwriter with disparate assets to a well-run company with a management team that uses capital allocation as a lever for value creation. That was after current CEO Craig Smiddy took over the company. Prior management made a bad decision in the early 2000s by entering the mortgage insurance market.

Smiddy unwound the mortgage insurance portfolio, extracted excess capital, and returned that capital to shareholders. He and his team have proven to be admirable capital allocators. When the stock was highly discounted relative to intrinsic value, from 2022 to 2024, 20% of the company was repurchased. When the shares were more fairly valued, management authorized five special dividends over our ownership period. Cumulatively, all the dividends that ORI has issued through this time, including ordinary quarterly payouts, have totaled more than \$15 a share, which is remarkable for a stock that was trading in the low-to-mid \$20 range in 2019.

Looking ahead, the company should continue to grow organically by investing in new short-tail lines of business by recruiting best-in-class talent to add niche exposures with sustainable and high return potential. Managers who join ORI buy into the business over a 10-year period with ultimate payout not realized for 15 years.

The stock currently trades at roughly fair value on an absolute basis while still being at a discount relative to its larger peers. We expect the CEO to continue driving intrinsic value growth in the coming years.

A new mid-cap holding in the quarter was **Prestige Consumer Healthcare (PBH)**, whose over-the-counter brands are familiar to many including Dramamine motion sickness relief, Clear Eyes eye drops, and CompoundW wart removal products among others. The stock had been a laggard, losing more than 30% since mid-May, thanks to supply chain issues related to its eye care business. PBH's supplier was simply not able to ship enough products to meet demand for the company's Clear Eyes business, causing Prestige to lose sales and lower 2025 profit guidance.

The company has since fixed this issue by acquiring that supplier for \$100 million. This asset acquisition raised concerns that management was pivoting their capital allocation strategy because they had historically outsourced manufacturing to third parties. We believe the manufacturing asset purchase is a function of tight ophthalmic industry production capacity and the high regulatory hurdles that must be met to add more capacity.

The eye care business should recover as customers re-stock, and we expect the company's 2027 earnings to accelerate now that its supply chain issues are behind it. Yet after the sell-off, PBH shares trade at less than 13 times earnings, based on consensus estimates for profits over the next 12 months. Meanwhile, the stock sports a free cash flow-to-enterprise value yield of nearly 6.5%.

A multi-year holding that has struggled recently is **Watsco (WSO)**, the largest wholesale distributor of HVAC and refrigeration equipment in the United States. The company is run by father-son duo Albert (Al) and AJ Nahmad. In 1973, Al acquired a controlling stake in the company when it was a small components manufacturer. He soon

pivoted the company's strategy to distribution, and he has built a holding company that focuses on capital allocation and on building technology infrastructure that can be leveraged by their independently run business units and by the company's HVAC contractor customers. A demand lull caused by declining new home construction activity, the weakening financial health of consumers, and the fact that demand had been pulled forward the prior year ahead of known price increases drove the stock down more than a third since February.

Why are we still attracted to this business? For starters, around 85% of its revenues are tied to the replacement of HVAC systems and components, where demand is driven by equipment failure, regardless of where we are in the economic cycle. In addition, HVAC original equipment manufacturing is a highly consolidated industry, and government efficiency standards continue to add costs to the hardware that WSO sells. This creates a backdrop where Watsco benefits from inflation in products sold. Meanwhile, its capital-light business model, where capex accounts for only around 0.5% of sales, helps to ensure that inflation won't chip away at cash flow available for shareholder returns or growth investments.

While the market seems to be focused on short-term volume headwinds, WSO is positioned to benefit from technology investments that uniquely favor it. For example, the company has a modern tech stack and a fully digitized platform, unlike most of its peers. In recent years, management has deployed pricing optimization tools that price products based on data unique to each customer.

The company is also using AI to identify pricing outliers that can be addressed by their sales team quickly and has made investments in AI-enhanced customer service, technical support, and software development, which we believe will drive margin expansion and share gains. Meanwhile, the stock sports a free cash flow-to-enterprise value yield of around 5%, which is closer to 7% on a normalized basis. We used recent weakness in shares to increase our position in the company.

Outlook

We continue to view this market opportunistically and we are well positioned for a sustained broadening of the equity market. Yet recent volatility surrounding the AI trade, and the speed with which investors have been reassessing the potential winners and losers of this theme, reinforces the importance of considering a range of potential outcomes. Our willingness to consider these 'what ifs?' and our 10 Principles of Value Investing™ will continue to drive our process as a new wave of opportunities — and risks — present themselves.

Thank you for your continued trust and confidence.

Portfolio Management Team



Troy McGlone

Vice President and Portfolio Manager



Colin McWey

Vice President and Portfolio Manager

Past performance does not guarantee future results.

The Opportunistic Value Equity Strategy seeks to capture long-term capital appreciation by investing in companies with market capitalizations greater than \$500 million. The Strategy's flexible pursuit of value positions it as a core holding for investors.

In addition to stocks of large companies, the Opportunistic Value Equity Strategy invests in stocks of small- and mid-cap companies that are generally less liquid than large companies. The performance of these holdings generally will increase the volatility of the strategy's returns.

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In certain cases, dividends and earnings are reinvested.

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

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