



# Heartland Opportunistic Value Equity Strategy 4Q22 Portfolio Manager Commentary

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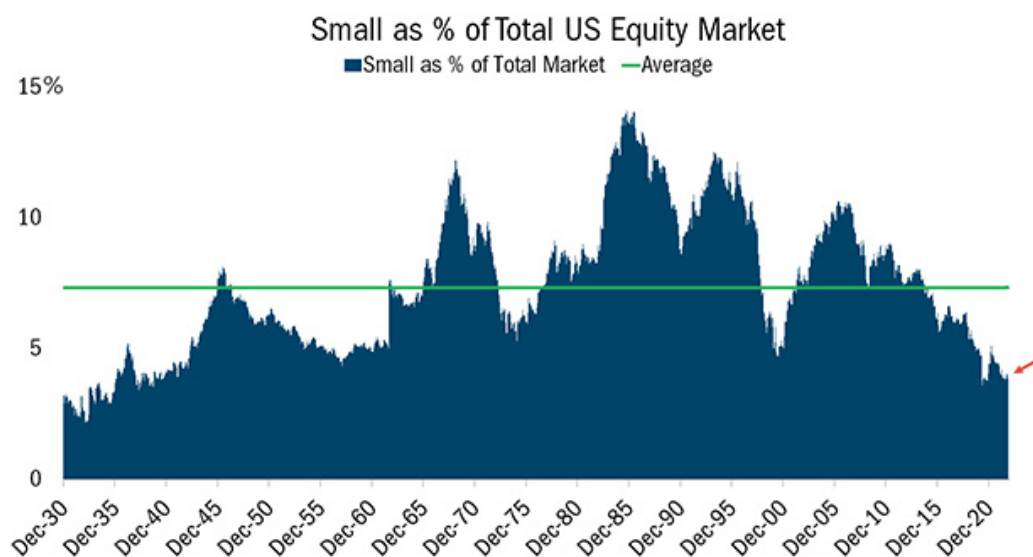
## Executive Summary

- The shifting mood of investors proved to be constructive for active and selective value investors.
- The markets inched closer to the point where economic risks are starting to get priced into securities, a positive for long-term investors.
- The fourth quarter offered renewed opportunities to buy attractively priced small-cap companies that are trading at a significant discount to their intrinsic value.

## Fourth Quarter Market Discussion

During the quarter, the mood of the market continued to bounce back and forth from hope of a quick Federal Reserve pivot to fear that a recession was a *fait accompli* thanks to aggressive interest rate hikes throughout the year. While these erratic shifts in sentiment proved to be unsettling, this was a constructive environment for active and selective value investors.

As Warren Buffett famously noted, “a wildly fluctuating market means that irrationally low prices will periodically be attached to solid businesses.” We took advantage of this volatility in the fourth quarter—as we have historically—adding several small-cap businesses to our Strategy. As depicted in the chart, we believe small caps are poised to outperform large caps in coming years as a result of their orphaned status and discounted valuation. Normally small caps underperform in bear markets like 2022, but they tend to outperform in bull markets following a period of large-cap dominance.



Source: Center for Research in Security Prices (CRSP®), The University of Chicago Booth School of Business; Jefferies, Monthly data 12/1/1930 to 12/31/2022. The data in this chart represents small cap’s percentage of the US equity market. Note: Small is represented by deciles 6–10 based on market

cap. All indices are unmanaged. It is not possible to invest in an index. **Past performance does not guarantee future results.**

The economy continues to show signs of weakening, and we're seeing deteriorating fundamentals across more industries. While the market is getting excited about the possibility of "peak inflation," there is still the potential for fallout from the Federal Reserve actions taken to ensure inflation does not remain persistently high. Nevertheless, several names we added to the portfolio in the fourth quarter are cyclical in nature.

This is not because we believe volatility and selling are behind us, but rather based on our view that the markets have inched closer to the point where economic risks are starting to get priced into securities. Throughout this downturn, we have been looking for signs that investors are finally coming to grips with the economic realities ahead. This would allow us, as contrarians, to lean into economically sensitive businesses that offer a more compelling risk versus reward and that could lead the market in the early stages of the next cycle.

We have seen some of our four key indicators flash green recently. For starters, a recession is now consensus as a [majority of economists](#) surveyed by The Wall Street Journal predict that the U.S. economy will contract in the next 12 months. This marks the first time that the Journal survey put the probability of a recession above 50% since the COVID-19 economic shutdowns.

At the same time, sell-side analysts have begun to ratchet down their earnings estimates, particularly in certain industries. For example, estimates are down from their peak by double-digit percentages in the Semiconductor, Retail, and Building Product industries, and analysts are already expecting lower earnings in 2023 relative to 2022. While we believe broad index estimates remain too high — as evidenced by the consensus sell-side forecast calling for 2023 S&P 500 earnings to grow 5% over 2022 — pockets of extreme weakness reinforce our belief that the market is now firmly in the midst of a negative earnings revision cycle, which is helping to reset expectations.

Another sign of a potential reset is when management teams become transparent about falling demand. Three months ago, we noted that companies were finally beginning to cut their profit outlooks. That trend accelerated in the fourth quarter amid growing concerns about slowing demand. We wouldn't describe this as broad-based "capitulation" just yet, but we're moving in the right direction.

Finally, we aim for stocks on our watch list to hit our "buy" targets before starting a position. In addition to favorable catalysts and valuation considerations, we assign price targets to companies under both good and bad scenarios. This helps ensure that we are staying true to our [10 Principles of Value Investing](#)<sup>™</sup>, which demands paying low prices relative to earnings, cash flow, and intrinsic value to create a margin of safety.

This approach has paid off in a year in which our Strategy was down 2.42%, net of bundled fees, while the Russell 3000<sup>®</sup> Value Index is down 7.98%. And because adhering to buy targets allows us to play offense slowly and selectively, we believe it sets us up well for the coming year and beyond.

## Attribution Analysis & Portfolio Activity

The Strategy's outperformance during the fourth quarter was driven by robust stock selection in the Information Technology and Healthcare sectors. The Strategy's Communications Sector underweight also aided performance while Energy holdings lagged the benchmark driven by a decline in refiner crack spreads, a reversal as compared to trends experienced earlier in 2022.

While we selectively added cyclical companies in the fourth quarter, it's important to note that our traditional focus on higher-quality businesses with defensive characteristics spread out among sectors allowed us to take this approach.

**Industrials.** These are companies like **Simpson Manufacturing (SSD)**, which designs and manufactures connectors and fasteners used in new construction. Simpson dominates the domestic wood connector market, controlling roughly 75% share thanks to the company's high value add. If a structural connector fails, the building is uninhabitable, yet Simpson products typically account for <0.5% of a building's construction cost. As a result, the

company enjoys pricing power and a long-term median operating margin (earnings before interest and taxes, or EBIT, divided by sales) of 17%, versus 12% for its Building Product industry peers.

But the stock was down around 45% through late October, as investors grew concerned about a housing recession. Simpson's earnings will be down significantly in 2023; however, we believe the stock is undervalued relative to normalized earnings. Longer term, the rise in building code requirements should result in more demand for SSD connectors per unit of construction.

When we purchased SSD, the stock was trading at a price/earnings ratio of around 12 based on forecasted earnings over the next 12 months. That was well below Simpson's long-term median valuation of 21 times earnings. Today, the shares are trading at 16 times earnings for the next 12 months, after analysts cut their fiscal 2023 forecast by around 20% since the end of the third quarter.

**Materials. Packaging Corp. Of America (PKG)** is the third-largest producer of containerboard and corrugated packaging in North America. Packaging production and pricing is highly correlated to economic activity, so it's no surprise that PKG is off more than 20% from its April 2022 all-time high. The stock actually held up longer than expected, in part because there was a substantial amount of double ordering by PKG customers in the aftermath of the COVID-19 disruptions. Now that supplies are elevated, it will require lower production and demand stabilization to work off the extra inventory.

Though the company's earnings are expected to fall by around 20% next year, we think PKG could generate close to \$500 million in free cash flow. Meanwhile, investor sentiment is likely to improve as the market comes to grips with the economic slowdown, and our best guess is that PKG can work off its excess inventory in the first half of 2023.

**Communications.** Fourth-quarter volatility didn't just allow us to identify potential early-cycle leaders. In some cases, it allowed us to upgrade to best-in-class holdings. For example, in Q4, we recognized losses in a large-cap cable operator to start a position in small-cap **Cable One (CABO)**.

Cable One is a broadband and cable provider with a focus on rural markets in the Midwest, Northwest, and Southeast. **Graham Holdings Company (GHC)** spun CABO out in 2015, and investors became attracted to management's strategy to exit pay TV, which has been in secular decline amid the streaming boom, in favor of more-profitable broadband. As a result of this early strategic pivot, CABO operates with one of the highest margins in the cable market.

The stock was considered a "work from home" winner during the pandemic and became overvalued in 2021 as a result. So far this year, though, the stock has fallen 60%, and it now trades at just 8.3 times enterprise value to next 12 months EBITDA. By comparison, CABO's median valuation post spin-off is 11.5 times EV/EBITDA.

In another example of "upgrading" our Communication sector holdings, we recognized a loss in a company and used the proceeds to increase our existing position in **Alphabet (GOOGL)**, parent of Google.

In February, we initiated a position in a stock that got hit hard on revenue headwinds. At the same time, management was aggressively investing in portions of the business, which we believed detracted significant value from the enterprise. As for Alphabet, we originally purchased shares in 2020 during the pandemic. We subsequently trimmed our position in 2021 as the stock approached our view of intrinsic value, though we didn't exit the position entirely. Fast forward to September, and GOOGL was back to our "buy" target.

We reassessed the decision to own both stocks and decided to upgrade the portfolio to Alphabet at the start of the fourth quarter.

## Outlook

In a year when the Nasdaq Composite Index lost more than 30%, the S&P 500 fell more than 18%, and aggregate bond indices are down more than 10%, we're pleased that our investment process provided investors with downside protection. While we don't believe our performance should be judged over a quarter or a year, we do

believe 2022 represented a market environment that rewarded long-term fundamental investors, unlike 2020 and 2021 when the market rewarded speculation.

Warren Buffett’s famous two rules of investing—1: Never Lose Money and 2: Don’t Forget Rule No. 1—was forgotten by many market participants after years of easy money. A plethora of companies that were the best performing stocks of 2020 and 2021 may never see prior peak valuations again because they burn cash and depend upon the kindness of strangers to sustain their lofty expectations. Our focus is on compounding wealth over time, which requires minimizing losses in bear markets while also identifying opportunities that only arise when fear is pervasive. Simpson Manufacturing and Cable One are two examples of small-cap opportunities that arose in the fourth quarter, and we look forward to highlighting others in coming quarters.

We want to thank you for your continued trust and confidence.

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## Portfolio Management Team



### Troy McGlone

Vice President and Portfolio Manager



### Colin McWey

Vice President and Portfolio Manager

## Composite Returns\*

12/31/2022

[<> Scroll over to view complete data](#)

	Since Inception (%)	10-Year (%)	5-Year (%)	3-Year (%)	1-Year (%)	YTD (%)	QTD (%)
Opportunistic Value Equity Composite (Net of Advisory Fees)**	9.69	9.73	6.89	6.93	-1.01	-1.01	13.42
Opportunistic Value Equity Composite (Net of Bundled Fees)	7.64	7.70	5.02	5.21	-2.42	-2.42	13.04
Russell 3000® Value	7.18	10.16	6.50	5.88	-7.98	-7.98	12.18

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

\*Yearly and quarterly returns are not annualized. The Strategy's inception date is 9/30/1999.

\*\*Shown as supplemental information.

The US Dollar is the currency used to express performance. Returns are presented net of advisory fees and net of bundled fees and include the reinvestment of all income. The returns net of bundled fees were calculated by

subtracting the highest applicable sponsor portion of the separately managed wrap account fee from the net of advisor fees return.

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## 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.

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

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As of 12/30/2022, Cable One, Inc. (CABO), Alphabet Inc. (Class A) (GOOGL), Packaging Corp of America (PKG), and Simpson Manufacturing Co. (SSD) represented 1.48%, 2.37%, 0.98% and 0.72% of the Opportunistic Value Equity Composite's net assets, respectively. Graham Holdings Co. (GHC) is unowned by Heartland Advisors, Inc.

The future performance of any specific investment or strategy (including the investments discussed above) should not be assumed to be profitable or equal to past results. The performance of the holdings discussed above may have been the result of unique market circumstances that are no longer relevant. The holdings identified above do not represent all of the securities purchased, sold or recommended for the Advisor's clients.

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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.

In certain cases, dividends and earnings are reinvested.

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Heartland's [investing glossary](#) provides definitions for several terms used on this page.

Active Investing is an investment strategy involving ongoing buying and selling actions by the investor. Active investors purchase investments and continuously monitor their activity in order to exploit profitable conditions. Bear Market occurs when the price of a group of securities is falling or is expected to fall. Bull Market occurs when the price of a group of securities is rising or is expected to rise. 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. Defensive Stocks include Health Care, Utilities, and Consumer Staples. These companies usually don't suffer as much in a market downturn as they relate to basic needs. Enterprise Value/Earnings Before Interest, Taxes, Depreciation, and Amortization (EV/EBITDA) Ratio is a financial indicator used to determine the value of a company and is calculated by dividing the entire economic value of the company (enterprise value) by its earnings before interest, taxes, depreciation, and amortization (EBITDA). Intrinsic Value is the actual value of a company or an asset based on an underlying perception of its true value including all aspects of the business, in terms of both tangible and intangible factors. This value may or may not be the same as the current market value. NASDAQ Composite Index is the market capitalization-weighted index of approximately 3,000 common equities listed on the NASDAQ stock exchange and includes all Nasdaq-listed stocks that are not derivatives, preferred shares, funds, exchange-traded funds (ETFs) or debenture securities. Price/Earnings Ratio of a stock is calculated by dividing the current price of the stock by its trailing or its forward 12 months' earnings per share. Risk on/Risk off Theory is an investment setting in which price behavior responds to, and is driven by, changes in investor risk tolerance. Risk-on risk-off refers to changes in investment activity in response to global economic patterns. During periods when risk is perceived as low, risk-on risk-off theory states that investors tend to engage in higher-risk investments. When risk is perceived as high, investors have the tendency to gravitate toward lower-risk investments. Russell 3000® Value Index measures the performance of those Russell 3000® Index 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. S&P 500 Index is an index of 500 U.S. stocks chosen for market size, liquidity and industry group representation and is a widely used U.S. equity benchmark. All indices are unmanaged. It is not possible to invest directly in an index. Sell-Side Analyst is an individual who typically works for a brokerage firm and evaluates companies for future earnings growth and other investment criteria. They sometimes place recommendations on stocks or other securities, typically phrased as "buy", "sell", or "hold." 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. 10 Principles of Value Investing™ consist of the following criteria for selecting securities: (1) catalyst for recognition; (2) low price in relation to earnings; (3) low price in relation to cash flow; (4) low price in relation to book value; (5) financial soundness; (6) positive earnings dynamics; (7) sound business strategy; (8) capable management and insider ownership; (9) value of company; and (10) positive technical analysis.