



# Heartland Value Fund 1 Q23 Portfolio Manager Commentary

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## Executive Summary

- With growing concerns over a banking crisis, fear returned to the marketplace.
- Active, long-term investors should have a decided advantage in this environment, as fundamentals — including valuations, balance sheet strength, and sound business strategies — matter again.
- As economic, credit, and liquidity risks are on the rise, it's more important than ever to know what you own.

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**“Risk comes from not knowing what you're doing.”**

**—Warren Buffett**

Fear returned to the market in a big way in the first quarter. And for selective, long-term value investors, this was welcome news.

Whether or not bank failures in March wind up sparking a full-fledged financial crisis, one thing seems clear: A year into the Federal Reserve's tightening cycle, rising rates are putting balance sheets under pressure, leading to tighter lending standards, widening credit spreads, and a growing perception of risk.

An important change is that fundamentals matter again, as investors are now demanding evidence of financial strength in the aftermath of the recent collapse of Silicon Valley Bank, Signature Bank, and Silvergate Capital. For value investors looking to own well-run businesses at reasonable prices, this is a heartening turn.

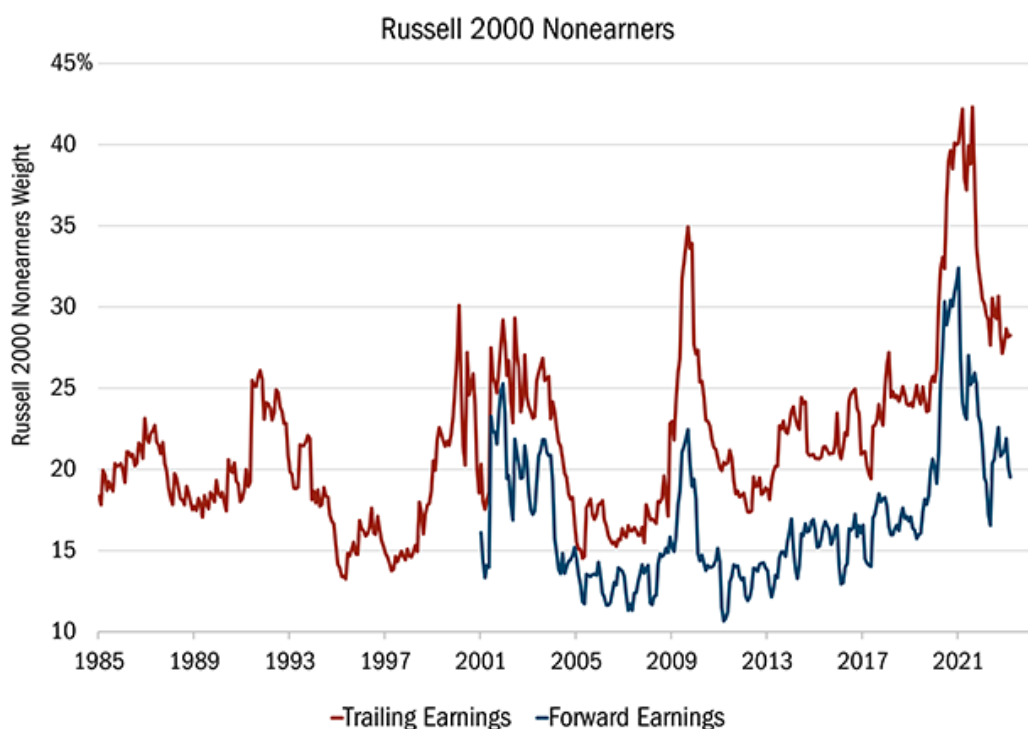
Of course, this change in mindset comes at a cost, reflected by rising volatility and risk in the market. After an early-year risk-on rally that pushed the Russell 2000® Index of small-cap stocks up nearly 10% through the start of March, concerns over a banking crisis sent the benchmark down more than 7% for the month. For the quarter, the Heartland Value Fund outperformed, returning nearly 2.74%, while the Russell 2000® Value Index closed down -0.66%.

Risk, it should be noted, isn't just a reflection of external forces like rising rates and inflation. It is also a function of what investors know — or more to the point, don't know — about the companies they own, as Warren Buffett famously noted. At a time when financial, market, and economic risks are all on the rise, minimizing investor risk by knowing what you own is more critical than ever.

At Heartland, this notion of having strict standards and maintaining discipline is ingrained in our 10 Principles of Value Investing™, which demands that we focus on compelling valuations, balance sheet strength, and sound

business strategies. The fact that many investors only recognized the strategic vulnerabilities of Silicon Valley Bank after it collapsed speaks volumes about how real the risk of blissful ignorance can be.

Heartland's principles are reflected in the fundamental characteristics of our holdings relative to the small-cap benchmark. Our portfolio, for instance, is underweight leverage and approximately 5% of our holdings are unprofitable based on forward earnings, versus more than 25% for the Russell 2000® Index. We prefer companies with positive earnings dynamics, including upwardly trending estimates. Given that the percentage of non-earners in the small-cap benchmark remains at uncomfortable levels, as seen in the chart below, this is a time for active value investors to be extremely selective in their investment allocations.



Source: FactSet; FTSE Russell; Jefferies, monthly data from 1/31/1985 to 3/31/2023. This chart represents the small cap's percentage of the US equity market by trailing earnings and forward earnings. All indices are unmanaged. It is not possible to invest directly in an index. **Past performance does not guarantee future results.**

## Attribution Analysis & Portfolio Activity

In what was another challenging quarter marked by shifting investor sentiment, stock selection played a critical role in our performance, as is typically the case. This was particularly true in financials. Our selectivity in this sector, coupled with our underweight allocation, allowed us to outperform the benchmark in a challenging part of the market.

**Financials.** As the banking sector has sold off across the board, the market is now pricing in the odds of many banks needing to raise capital. This chaos creates fear, but an opportunity to discover potential opportunities through in-depth fundamental research. For instance, we were able to take advantage of markdowns in the quarter to add to companies with strategic and competitive advantages.

**First Interstate BancSystem (FIBK)**, a community bank headquartered in Billings, MT, is a good example. The banks that failed in early March lent money to specific customer bases that were high risk. Silicon Valley Bank lent money to venture-backed startups that often generated no cash flow. In the case of Silvergate, it lent money to crypto currency market participants.

That's not the case with First Interstate. The company operates outside the spotlight in the Northwest. It maintains the second largest share of deposits in Montana and Wyoming and has executed strategic acquisitions to gain access to contiguous states including Idaho, Oregon, Washington, and South Dakota. These are markets

that tend to be more consolidated and less competitive, resulting in higher margins and returns relative to industry peers.

FIBK enjoys a high-quality deposit base with clients who are largely using their accounts for transactional purposes — not to chase yield. The bank only lends to traditional borrowers including local business owners and consumers, and it takes a conservative approach to loan underwriting. We believe First Interstate will be a share gainer throughout this downturn.

First Interstate underperformed other regional banks emerging from the COVID-19 recession, when investors gravitated to lower-quality lenders beaten up during the pandemic. The stock, which has historically traded at a median P/E ratio of 13.6 based on forward earnings, is currently trading at just 9.7 times our FY23 estimates.

**Materials.** In a world of depreciating currencies, we are fans of hard assets, in particular gold miners. In our view, miners will be beneficiaries of the Federal Reserve eventually pausing, reverting to an easy money policy to stem a banking liquidity crisis. Money printing, increased deficits, and a weaker dollar are likely to increase demand for the historical storehouse of value, gold, and for those that produce it.

We own two miners, one of which is **Centerra Gold (CGAU)**. Centerra headquartered in Toronto, operates the Mount Milligan mine producing gold and copper and is awaiting the restart of its Oksut, Turkish mine. Due to a startup delay, the stock has been a laggard, currently priced below book value and net asset value. However, Centerra is debt free with substantial cash and ore reserves. Plus, the stock offers a 3.25% dividend yield. Under new leadership and with the restart of Oksut, we believe the earning power, at current metal prices, could approach \$0.80 per share.

**Real Estate.** In a market filled with uncertainty, stocks that offer investors an added margin of safety stand out. For **National Storage Affiliates Trust (NSA)**, which was a new addition in the quarter, that comes in the form of strong insider buying.

National Storage is a real estate investment trust that owns self-storage properties, with two thirds of its facilities located in the Sun Belt. The stock has pulled back significantly, which is not surprising given the deteriorating fundamentals in real estate amid rising interest rates and cap rates. We viewed this as an opportunity to purchase a high-quality REIT at a discounted valuation.

Giving us added confidence: Storage REITs are among the best performers in the real estate sector, with net operating income margins north of 70% and the lowest recurring capital requirements. We also like the fact that NSA's insiders share in our optimism. Late last year, National Storage's executive chairman/founder and three directors were significant buyers of the stock.

## Outlook

Dramatically rising interest rates were challenging enough. But now the markets are having to weigh the consequences of a banking crisis brought about by those higher rates and perhaps aggressive lending. In the long run, current anxieties are creating promising opportunities for long-term investors to identify businesses trading at discounted prices that are financially strong enough to withstand and thrive in this environment.

In the near term, though, this is a time to have a balanced approach and take what the market is giving, both on the buy and sell side. Knowing exactly what you own and setting strict standards on fundamental characteristics are, as Buffett noted, integral to reducing risk. They also happen to be rooted in Heartland's 10 Principles of Value Investing™. We believe patient investors will be ultimately rewarded.

Fundamentally Yours, the Heartland Team.

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## Portfolio Management Team



### Will Nasgovitz

CEO and Portfolio Manager



### Bill Nasgovitz

Chairman and Portfolio Manager

[View Fund Performance](#)

## Fund Returns

3/31/2023

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

	Since Inception (%)	20-Year (%)	15-Year (%)	10-Year (%)	5-Year (%)	3-Year (%)	1-Year (%)	YTD* (%)	QTD* (%)
Value Investor Class	10.95	8.86	6.26	6.38	5.83	25.44	-4.91	2.74	2.74
Value Institutional Class	11.02	9.00	6.45	6.54	5.98	25.60	-4.79	2.79	2.79
Russell 2000® Value	10.31	9.24	7.24	7.22	4.55	21.01	-12.96	-0.66	-0.66

\*Not annualized

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

The inception date for the Value Fund is 12/28/1984 for the investor class and 5/1/2008 for the institutional class.

## Value Fund Quick Links



Factsheet



Commentary



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Holdings

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I am a financial professional or institutional investor



I am an individual investor

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*In the prospectus dated 5/1/2022, the Gross Fund Operating Expenses for the investor and institutional classes of the Value Fund are 1.04% and 0.92%, 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 for institutional class shares prior to their initial 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. To obtain performance through the most recent month end, call 800-432-7856 or visit [heartlandadvisors.com](http://heartlandadvisors.com).**

***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 Funds' prospectus. To obtain a prospectus, please call 800-432-7856 or visit [heartlandadvisors.com](http://heartlandadvisors.com). Please read the prospectus carefully before investing.***

As of 3/31/2023, Centerra Gold, Inc. (CGAU), First Interstate Bancsystem, Inc. (Class A) (FIBK), and National Storage Affiliates Trust (NSA), represented 1.79%, 1.15%, and 0.80% of the Value Fund's net assets, respectively.

Statements regarding securities are not recommendations to buy or sell.

Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.

The Value Fund primarily invests in small companies selected on a value basis. Such securities generally are more volatile and less liquid than those of larger companies.

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

The Value Fund seeks long-term capital appreciation through investing in small companies.

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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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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. Book Value is the sum of all of a company's assets, minus its liabilities. Dividend Yield is a ratio that shows how much a company pays out in dividends each year relative to its share price. 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. Inflation Risk is the possibility that the value of assets or income will decrease as inflation shrinks the purchasing power of a currency. Insider Buying is the purchase of a company's stock by individual directors, executives or other employees. Liquidity is the degree to which an asset or security can be bought or sold in the market without affecting the asset's price. It is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid assets. Margin of Safety is a principle of investing in which an investor only purchases securities when the market price is significantly below its intrinsic value. Net Asset Value (NAV) is a mutual fund's price per share that is calculated by dividing the total value of all the securities in its portfolio, less any liabilities, by the number of fund shares outstanding. Operating Income Margin is a ratio used to measure a company's pricing strategy and operating efficiency. 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. Price/Earnings Ratio (Forward) for the account is based on actual earnings to date and future estimates made by Heartland Advisors, Inc. Securities with negative earnings or per share earnings greater than or equal to 100 are excluded from the calculation. Estimates made by Heartland Advisors, Inc. are based on factors such as management guidance, historical performance of the company and its peer group, industry growth rates, street estimates and other factors as deemed appropriate. Real Estate Investment Trust (REIT) is a security that sells like a stock on the major exchanges and invests in real estate directly, either through properties or mortgages. 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 Investment Group is the source and owner of the trademarks, service marks and copyrights related to the Russell Indices. Russell® is a trademark of the Russell Investment Group. 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. 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. Yield is the income return on an investment. 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.

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