

The Icing on the Cake in Stock Selection

The managers of Heartland Select Value are seeing more value in small and large caps, and their technical analysis helps them know when to pull the trigger.

Fund Manager Q & A | 08-17-11 | by Liana Madura

Ted Baszler, Hugh Denison, David Fondrie, and Will Nasgovitz are co-managers of Heartland Select Value (HRSVX). They recently explained why small- and large-cap stocks currently offer greater opportunities in the marketplace over mid-cap stocks, as well as competitive advantages, also known as a “catalyst for recognition,” that certain securities have, which make them valuable.

They also talked to us about the pockets of the financials sector that hold many undervalued and neglected stocks, the slow pace of economic expansion, and why it’s important to use both fundamental and technical analysis in stock selection.

1. Where across the market-cap spectrum are you finding value today?

Small- and large-cap stocks currently offer better value than mid-cap stocks, which are coming off a strong run, as illustrated in the chart below showing the price/earnings ratio of mid-cap stocks relative to the S&P 500 Index as a whole. During the last 18 months, mid-cap valuations have climbed against the broader index to a factor of 1.2 times. Large-cap stocks, on the other hand, have yet to proportionately participate in market increases. As for the small-cap space, we are nearly always able to find value, given our history of fundamental research in that area.

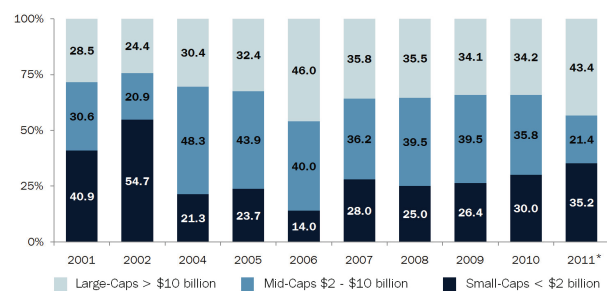
S&P 400 (Mid) 6/19/1991 to 9/1/2011



Source: FactSet Research Systems, Inc. and Standard and Poor’s

It’s important to note that our process begins with bottom-up stock selection, not top-down decisions about where to find value across capitalization ranges. We are first stock-pickers, and our disciplines and team structure are built to reflect this approach. Therefore, when we sell a stock, the natural effect on the portfolio is generally to reduce our exposure to an overvalued part of the market. That capital will then be reallocated to a more undervalued range. So the weightings across the capitalization ranges are directly a function of valuations among individual names, and that natural process does cause meaningful variation over time across capitalization ranges as shown in the chart below, which provides a history of capitalization-range concentrations over time in the Select Value Fund. Note that our current posture is light on mid-cap stocks, which represent only 21% of the Fund.

December 31, 2001 to June 30, 2011



Source: Heartland Advisors, Inc.

2. One of your 10 Principles of Value Investing™ is to identify catalysts that could drive stock prices higher. What do you expect will help close the value gap in your holdings like Cloud Peak Energy (CLD) or Lowe’s (LOW)?

When we apply the 10 Principles to any stock—which we do for every stock, every time—we look for what we call a catalyst for recognition. We ask what could happen to this company or its industry that will make investors take note. That’s the discipline that helps avoid value traps, where a company may indeed be undervalued but just keeps trading that way indefinitely. In the case of Cloud Peak Energy, a coal

mining company, the catalyst might be increased prices for coal and access to new markets. With an enterprise value/EBITDA ratio of 4.3 times, the stock currently trades at a discount to its peers.

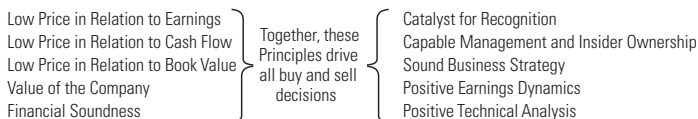
Cloud Peak is the only pure play in the Powder River Basin, and though some investors might react negatively to this concentration of assets, we believe the company would ultimately benefit from an increase in prices given the potential for a West Coast coal outlet. Also, Cloud Peak's coal deposits have the environmental advantage of relatively low sulfur. Test burns are being conducted in Europe now with Cloud Peak coal shipped through the St. Lawrence seaway. Also, Cloud Peak management has recently had success in extending the reserve life for the company.

For Lowe's, the catalyst is clearly a recovery in the housing market; when that will happen, we don't know. New household formation continues, and eventually demand for housing will turn the market.

But Lowe's stock represents a relatively inexpensive way to participate in that recovery, and the company is undoubtedly a world-class retailer. In the meantime, Lowe's will likely use its massive free cash flow—estimated to be almost \$3 billion—to aggressively repurchase its shares. We also believe Lowe's will benefit from the do-it-yourself crowd ramping up home improvement activity.

We have been using the 10 Principles as the analytical framework for our fundamental research since our firm's founding in 1983. They guide every buy and sell decision. A catalyst for recognition can only be rightly considered together with the other principles, listed here.

HEARTLAND'S 10 PRINCIPLES OF VALUE INVESTING™



3. What are the reasons behind your hesitancy in investing in the financials sector (compared with your benchmark of the Russell 3000 Value)?

We were fortunate to be greatly underweighted in this sector during the difficult period of the last several years. Although our financials weighting is still below our benchmark, we have actively been adding to our exposure not only with commercial banks but also with insurers, and most recently, with a REIT we believe is significantly undervalued compared with its peers.

At this point, we believe pockets of the financials sector hold many undervalued and neglected stocks, and our hunch is that our weighting will move closer to the benchmark. We are especially interested in holdings that might be able to avoid the bulk of regulatory oversight that could become a real burden for major lenders and Wall Street firms in coming months. For now, we are of course pleased that our underweight posture has served investors well, as financials were the worst-performing sector in the benchmark for the second quarter of 2011.

4. Do you think the U.S. economy is at risk of slipping back into recession? What sectors look like the best defensive plays right now?

As bottom-up value investors, we select stocks based on the merits of individual companies rather than taking a singular macroeconomic view. However, as we look for catalysts that could affect individual stocks, we do gain insight into macro trends. Right now, we're very conscious that global economic conditions are more fragile than normal. As a result we're focusing even more intensely on each stock's potential margin of safety. So-called old-fashioned metrics like net-net working capital and price/book value ratios are more important to us now than ever.

This kind of analysis has led us recently into more defensive areas such as health care and utilities, though it's important to note our positions in these areas, too, are driven by decisions about individual stocks rather than a defensive role in the overall macroeconomic scene. We do believe the economic expansion will continue, just at a slower pace than we'd all like to see. In our research, we see compelling reasons to expect top-line growth driven by factors including excellent pricing disciplines, distribution strength, and new products.

5. Why do you use technical analysis in addition to fundamental analysis in your stock selection?

If selecting stocks is like making cake, then technical analysis is the icing. We rely on our fundamental parameters to carefully examine potential additions to the portfolio. As a last step—the icing—we also look at the stock from a technical perspective. Technical analysis can provide confidence that the stock has found a bottom price, which in turn contributes to downside protection. Technical analysis also informs trading decisions, and this is one factor among many contributing to decision-making about entry and exit points.

An investor should consider the Funds' investment objectives, risks, and charges and expenses carefully before investing or sending money. This and other important information can be found in the Funds' prospectus. To obtain a prospectus, please call 1-800-432-7856 or visit www.heartlandfunds.com. Please read the prospectus carefully before investing.

As of September 30, 2011, the average annual total returns for the 1, 5, 10-years and since inception (10/11/96) periods of the Select Value Fund Investor Class were -3.74%, 1.13%, 7.89% and 9.03% respectively. As of September 30, 2011, the average annual total returns for the 1, 5, 10-years and since inception (10/11/96) periods of the Russell 3000 Value Index were -2.22%, -3.50%, 3.58% and 6.14%, respectively.

In the prospectus dated May 1, 2011, the gross expense ratio for the Select Value Fund Investor Class is 1.23%.

Past performance does not guarantee future results. Performance represents past performance; current returns may be lower or higher. 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 www.heartlandfunds.com.

In addition to stocks of large companies, the Select Value Fund invests in small and mid-sized 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 60) than the average mutual fund. The performance of these holdings generally will increase the volatility of the Fund's returns. **Value investments are subject to the risk that their intrinsic values may not be recognized by the broad market.**

Russell 3000 Value Index measures the performance of those Russell 3000 Index companies with lower price-to-book ratios and lower forecasted growth values. The **S&P MidCap 400 Index** is a group of 400 domestic stocks chosen for their market size, liquidity and industry group representation. **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 mentioned are unmanaged. It is not possible to invest directly in an index. **Enterprise Value** is a measure of a company's value, often used as an alternative to straightforward market capitalization. Enterprise value is calculated as market cap plus debt, minority interest and preferred shares minus total cash and cash equivalents. **EBITDA** is equal to earnings before interest, tax, depreciation and amortization and can be used to analyze and compare profitability between companies and industries. **Net Net Working Capital** is equal to Cash plus Short Term Marketable Investments plus Accounts Receivable times 75% plus Inventory times 50% minus Total Liabilities. **Price/Earnings Ratio** of a stock is calculated by dividing the current price of the stock by its trailing 12 months' earnings per share. **Price/Book Ratio** of a company is calculated by dividing the market price of its stock by the company's per-share book value. A **real estate investment trust (REIT)** is a closed-end investment company that owns assets related to real estate such as buildings, land and real estate securities.

Heartland Advisors, Inc. considers large-cap companies to be larger than \$10 billion in market cap, mid-cap companies to be between \$2 billion and \$10 billion, small cap companies to be between \$300 million and \$2 billion, and micro-cap companies to be less than \$300 million. The above breakdown does not include short-term investments.

The statements and opinions expressed in the article are those of the author. Any discussion of investment and investment strategies represents the Funds' investments and portfolio managers' views as of the date of the article, and are subject to change without notice, and discussions of portfolio holdings are intended as illustrations of investment strategy, not as recommendations.

As of September 30, 2011, Cloud Peak Energy (CLD) represented 1.87% of the Fund's total net assets. Lowes Companies was not held in the portfolio as of September 30, 2011.

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