THE ROLE DIVIDENDS CAN PLAY IN INTERNATIONAL EQUITY INVESTING

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SUMMARY

- ***Dividend yielding stocks can make a meaningful contribution to a portfolio in international markets as well as domestic.***
- ***Higher returns are not always associated with higher risk.***
- ***High dividend investing has been beneficial over most years and investment horizons.***
- ***An emphasis on dividends appears to contribute across cycles, sectors and markets.***

Introduction

Domestic equity investors have long understood the importance of dividends. A dividend policy can be valuable over and above the income it provides as investors can gain confidence in the company's financial strength.

What may be overlooked is that dividends can play at least as important a role on a global scale.

Dividends Clearly Matter

To explore the contribution dividends make in global markets, we studied the performance of equity securities from outside the U.S. from 12/31/1993 through 6/30/2017,[1] focusing on companies with market capitalizations greater than or equal to $100 million, and less than or equal to $5 billion. This study demonstrates that non-U.S. small- to mid-capitalization stocks with dividend yields have historically produced higher levels of total return than non-dividend payers. The level of dividend yield also played a role in the results.

HEARTLAND INTERNATIONAL VALUE FUND (HINVX)

Heartland Advisors, Inc. serves as advisor to five mutual funds, including the Heartland International Value Fund. It invests in small- and mid-cap stocks with an emphasis on dividend-paying securities from both emerging and developed markets.

Heartland's time-tested 10 Principles of Value Investing™ drive the Fund's research-driven stock selection discipline.

[1]This paper utilizes data sourced from the FactSet Fundamentals global database from 12/31/1993 through 6/30/2017. Statistical tests were run in FactSet Alpha Testing software. Stocks with dividend yields above 100% and below 0% were classified as not available, but are included in the Universe. In total, there were 772,837 possible data items.

Companies in the resulting data set were segmented as divided payers and non-dividend payers. Dividend payers were further grouped into three fractiles based on yield, with fractile 1 representing the highest payers and fractile 3 representing the lowest. Dividend yield was calculated as annual dividends divided by the current share price, and fractiles were rebalanced every three months. Equal-weighted total returns for each fractile and the universe were computed for three, six, 12, 24, and 36 months.

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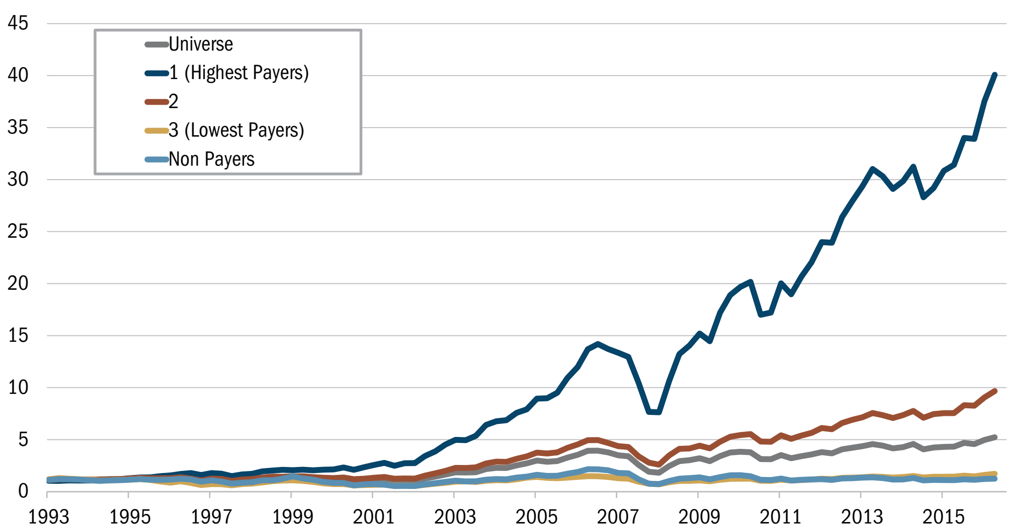
The graphics below show returns for this universe grouped into thirds by dividend yield, as well as a separate category for companies that don't pay any dividend. Over the entire period, the equal-weighted annual returns for the universe of securities averaged 6.95%. In contrast, stocks that paid dividends averaged a 8.85% total return. Returns on stocks that didn't pay any dividend were 2.09%.

The level of dividend yield also was tied to returns. The top third yielding stocks produced a return of 14.95% compared to a return of 1.91% for the bottom third.

Figure 1: Hypothetical Growth of 1 from 12/31/1993 through 6/30/2017



Source: FactSet Research Systems Inc., 12/31/1993 to 6/30/2017, based on Average 3-Month Forward Rolling Returns
Past performance does not guarantee future results.
These hypothetical examples are for illustrative purposes only and do not represent the returns of any particular investment.

A NEARLY 15 PERCENTAGE POINT ADVANTAGE

The highest-yielding stocks significantly outperformed all other groups over the period studied.

High Dividend Yielding Stocks Produced Better Risk-Adjusted Returns

Fractile	12-month Returns	Standard Deviation	Beta	Sharpe Ratio	Information Ratio	Median Yield
1	14.95%	22.59	1.00	0.55	0.71	4.82
2	9.07	20.61	0.97	0.32	0.02	2.21
3	1.91	23.38	1.03	-0.02	-0.77	0.98
No Dividend	2.09	28.57	1.23	-0.01	-0.47	0.00
Universe	6.95	22.68	1.00	0.20	n/a	1.64

Source: FactSet Research Systems, Inc., 12/31/1993 to 6/30/2017, based on Average 12-Month Forward Rolling Returns
Beta and Information Ratio calculated vs. the dataset universe.
Past performance does not guarantee future results.

RETURNS VS. RISK

The standard deviation of returns for the highest-payers is significantly less than non-dividend payers. However, the highest payers returned on average 14.95% compared to 2.09% for non-dividend payers.

These results are similar to studies demonstrating long-term outperformance among domestic value strategies, including a focus on stocks with low price/earnings (P/E) ratios, as well as those with low price/book (P/B), and low price/cash flow (P/CF). A high dividend yield indicates a low price relative to a financial fundamental (dividends), and low P/E, low P/B, and low P/CF also imply a low price relative to financial fundamentals.

Value strategies may outperform because investors become too pessimistic about the prospects for stocks trading at cheap valuations, with the result that prices are driven down even further until they become oversold. Value investors capitalize on this excess concern by identifying unduly inexpensive stocks in anticipation the market will eventually recognize the overreaction. This is not to say that all inexpensive stocks are sound investments. Low multiples are warranted for some companies. As with any singular screening mechanism, additional research is called for to further assess the potential outlook for a stock.

Greater Efficiency

Efficient market theory suggests that higher returns should be accompanied by higher risk. Dividend paying stocks, despite higher levels of return, had lower risk (standard deviation) than the broader universe as well as lower beta than non-dividend paying companies.

Further, stocks that didn't pay dividends had much higher risk to go along with their lower returns. Therefore, on a risk-adjusted basis, dividend payers were better with higher yielding names outperforming those with low or no-yield. Stocks in the top third had a Sharpe ratio of 0.55, versus 0.20 for the broader universe. Also, the information ratio for stocks in the top third was 0.71, versus -0.77 for those in the bottom third. In sum, dividends contribute to total return while also helping to create a more attractive risk profile for a stock.

Holding Period Impact

Since many investors do not have the over 20-year investment horizon shown in our first table, we also considered the impact of dividend investing over various shorter spans. The table below shows the percentage of periods in which the stocks in a particular grouping based on yield outperformed the broader stock universe.

The results are compelling. High yielding stocks outperformed in 100% of the three-year time periods. Even over the shortest time period considered (three months), the top group outperformed nearly 77% of the time. These results demonstrate dividend investing's viability over both longer and shorter time frames.

Figure 2: High Dividend Yield Investing Over Various Holding Periods

	Percentage of Forward Rolling Periods Fractile Outperformed the Universe				
Fractile	3-Months	6-Months	12-Months	24-Months	36-Months
1	76.60%	84.95	89.01	95.40	100.00%
2	62.77	67.74	80.22	85.06	91.57
3	36.17	29.03	27.47	14.94	18.07
No Dividend	35.11	32.26	23.08	18.39	6.02

Source: FactSet Research Systems, Inc. 12/31/1993 to 6/30/2017

Past performance does not guarantee future results.

DIVIDENDS CAN PLAY A KEY ROLE IN RISK ADJUSTED RETURNS

Heartland views dividends as a source of discipline that helps management teams focus on prudent use of capital, which can help a stock achieve higher multiples.

We are generally less interested in the magnitude of the yield than we are in the management team's effective deployment of capital.

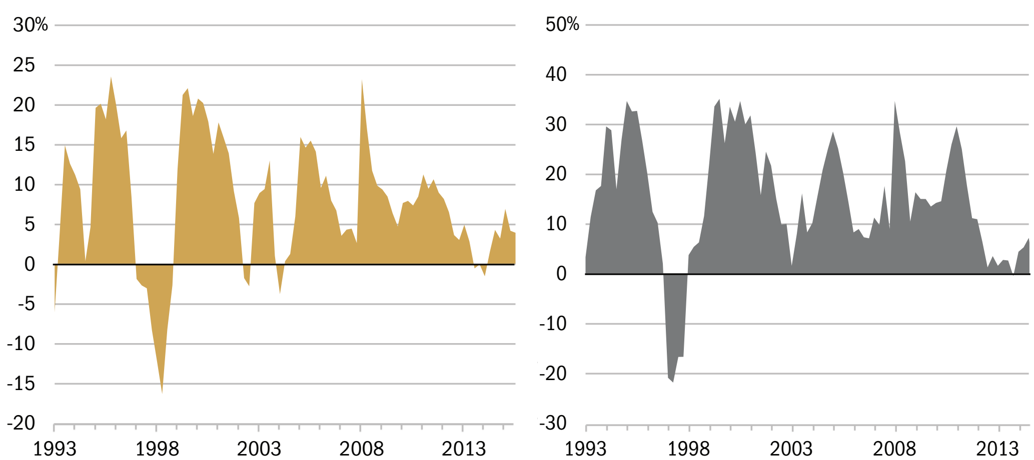
The Impact of Market Cycles

Since investing does not take place in a static environment, we examined how high dividend yield stocks perform in a variety of market cycles. The following graphs show the excess returns of stocks in the top third by yield versus their broader universe over one- and two-year holding periods, from 1994 to the present.

Figure 3: Excess Returns from High Dividend Yield Investing Over Time

12-Month Excess Forward Return (Fractile 1 - Universe)

24-Month Excess Forward Return (Fractile 1 - Universe)



Source: FactSet Research Systems, Inc., 12/31/1993 through 6/30/2017
Past performance does not guarantee future results.

High Dividend Yielding Companies Perform Well in Up and Down Markets

Category	Number of Quarterly Periods	Percent of Respective Periods
Up Markets	58	61.70%
Down Markets	36	38.30
Fractile 1 Outperforms	72	76.60
Fractile 1 Underperforms	22	23.40
Up Market & 1 Outperforms	38	65.52
Up Market & 1 Underperforms	20	34.48
Down Market & 1 Outperforms	34	94.44
Down Market & 1 Underperforms	2	5.56

Source: FactSet Research Systems, Inc., 12/31/1993 through 6/30/2017
Past performance does not guarantee future results.

During the internet bubble, financial bubble, and the beginning phases of economic expansion in the early 1990s and 2000s, relative returns from yield investing waned. High yield investing showed better returns, however, during most other market periods.

The table in the bottom of Figure 3 shows the efficacy of yield strategy during quarters representing various market environments. Over the time period considered, there were 58 quarters when the universe was up, and 36 when the universe was down. During down markets, dividend paying stocks in the top fractile outperformed 94% of the time. This appears to align with performance of value-investing

EXAMINING SHORTER TIME HORIZONS

- Many investors' time horizons are shorter than the 20 years shown on the previous page.
- The charts at left examine excess returns of the highest-paying group compared to the universe over 1- and 2-year periods.
- In both cases, the highest payers outperformed in nearly all periods.
- The table at left details how the highest-paying group performed during even shorter (quarterly) periods, separated by general Up Markets and Down Markets.

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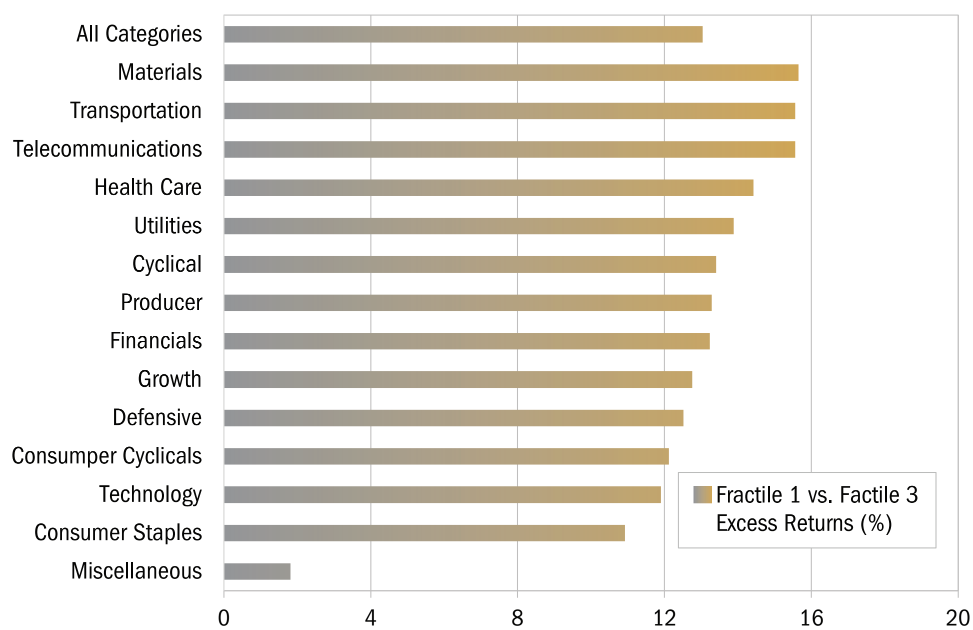
strategies in general, which typically perform better when markets are depressed. During markets with positive returns, the high dividend stocks still outperformed a respectable 66% of the time.

High Dividend Investing has Worked in Most Sectors

High yield stocks are often associated with specific sectors, and these results could be skewed by over- or under-weights among them. To explore this impact, we examined dividend investing specific to individual areas of the market. We first bundled the stocks in our universe into a number of different groups, which included industries categorized into sectors, and industries combined to form growth, defensive, and cyclical super-sectors. Within each group—as well as the broader universe—we then subtracted the returns of the low- yielding stocks in the bottom third of dividend payers from those in the top third.

Figure 4: 12-Month Excess Returns by Area of Market



Source: FactSet Research Systems, Inc., 12/31/1993 to 6/30/2017, based on Average 12-Month Forward Rolling Returns
The graph shows the excess returns of fractile 1 over fractile 3 for the universe, sectors, and growth, defensive, and cyclical super sectors.
Sector and super sectors are created by combining various FactSet industries.
Past performance does not guarantee future results.

The results shown in the graph above indicate that investing with a focus on higher yielding stocks can be an effective strategy irrespective of sector.

Improving the Model

While there is a great deal of evidence supporting the benefits of high dividend yield investing, it is prudent for portfolio managers to rely on more than just this factor when making decisions. Some stocks pay attractive dividends because of their financial stability, robust earnings, and commitment to shareholders. Others may produce high yields while undergoing extreme and

ABOUT HEARTLAND

- Throughout its 30-year history, Heartland has consistently applied its 10 Principles of Value Investing™.
- We believe there are pricing inefficiencies in the market that represent opportunity for the patient and diligent investor.
- Our focus is identifying and analyzing mispriced securities using our 10 Principles™. This process gives us greater confidence in the risk/reward profile of our portfolio holdings.

perhaps irreversible duress, or may only be achieving them with unsustainably high payout ratios. So while a dividend screen seems to be a useful component in the evaluation process, we are not suggesting that it stand alone.

The tables below show how combining dividend yield with a number of other fundamental criteria might help further refine stock selection. Criteria we considered are P/B (to look for modest valuations), one-year dividend growth (an indicator of earnings growth), and payout ratio (a potential measure of safety). Each panel shows a total of nine fractiles: three for dividend yield, times three for the additional factor, within the dividend payer universe. Generally, fractile one represents the best third—the highest yield, lowest P/B, highest growth, and lowest payout ratio—while fractile three represents the less desirable end of the spectrum.

Figure 5: High Dividend Yield, Low P/B, High Dividend Growth, and Low Payout Stocks Generally Provided Better Returns

Panel A	(Lowest P/B)	P/B	(Highest P/B)
Dividend Yield	Fractile 1	Fractile 2	Fractile 3
Fractile 1 (Highest Payers)	16.79%	14.00%	13.90%
Fractile 2	9.77	7.95	8.50
Fractile 3 (Lowest Payers)	5.13	1.76	0.14

Panel B	(Highest Growth)	1-Year Dividend Growth	(Lowest Growth)
Dividend Yield	Fractile 1	Fractile 2	Fractile 3
Fractile 1 (Highest Payers)	17.60%	13.27%	12.43%
Fractile 2	10.82	8.85	7.38
Fractile 3 (Lowest Payers)	3.11	2.34	1.51

Panel C	(Lowest Ratio)	Payout Ratio	(Highest Ratio)
Dividend Yield	Fractile 1	Fractile 2	Fractile 3
Fractile 1 (Highest Payers)	19.50%	16.68%	13.67%
Fractile 2	12.23	9.22	5.67
Fractile 3 (Lowest Payers)	2.86	1.17	-0.18

Source: FactSet Research Systems, Inc., 12/31/1993 to 6/30/2017, Average 12-Month Forward Rolling Returns
Past performance does not guarantee future results.

The data illustrates that adding low P/B, high dividend growth, or low payout to the selection criteria in each case appears to improve the model over a dividend yield only approach. These are certainly not the only quantitative screens that can be used, but they aptly illustrate that the employment of a combination of factors may have an even greater potential to outperform than using the dividend component alone.

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Definitions

Beta is a measure of the sensitivity of a portfolio's rates of return against those of the market. A beta less than 1 indicates volatility less than that of the market.

Dividend Payout Ratio is the percentage of dividend earnings paid to shareholders. It is calculated by dividing yearly dividend per share by earnings per share.

Dividend Yield is a ratio that shows how much a company pays out in dividends each year relative to its share price.

Efficient Market Theory is an investment theory that assumes market efficiency causes existing share prices to always incorporate and reflect all relevant information. Therefore, stocks always trade at their fair value on stock exchanges, making it impossible for investors to either purchase undervalued stocks or sell stocks for inflated prices.

Heartland Advisors' 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.

Information Ratio of a manager series vs. a benchmark series is the quotient of the annualized excess return and the annualized standard deviation of excess return. The Information Ratio measures the consistency with which a manager beats a benchmark.

Price/Book Ratio (P/B) of a company is calculated by dividing the market price of its stock by the company's per-share book value.

Price/Earnings Ratio (P/E) 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/Cash Flow (P/CF) represents the amount an investor is willing to pay for a dollar generated from a particular company's operations. It shows the ability of a business to generate cash and acts as a gauge of liquidity and solvency.

Sharpe Ratio is the average return, less the risk-free return, divided by the standard deviation of return. The ratio measures the relationship of reward to risk in an investment strategy.

Standard Deviation is a measure of volatility of returns and is computed as the square root of the average squared deviation of the returns from the mean value of the return.

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The International Value Fund invests primarily in small foreign companies selected on a value basis. Such securities generally are more volatile and less liquid than those of larger companies. Foreign securities have additional risk, including but not limited to, exchange rate changes, political and economic upheaval, and relatively low market liquidity. These risks are magnified in emerging markets. Value Investments are subject to the risk that their intrinsic values may not be recognized by the broad market.

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