The Copeland Review

Fourth Quarter 2020

"We believe that stocks with sustainable dividend growth consistently outperform the market with less risk."

(Let's Not) Party Like It's 1999

"History doesn't repeat itself, but it rhymes."
Commonly attributed to Samuel Clemens (aka Mark Twain)

To say that 2020 was difficult on many levels, both in terms of the human toll of the virus and its attendant economic impacts, is a gross understatement. To say that it was strange, with stock indexes plunging into a brutal bear market in the spring and yet reaching all-time highs by year-end seems an equally inadequate adjective.

In considering what transpired while also looking forward, we share three significant observations in this Review:

1. Unprecedented fiscal and monetary support, combined with rapid vaccine development, enabled global markets to recover well ahead of the economy, earnings, and the taming of the virus.
2. Speculative investment behavior is widespread as evidenced by low quality stocks leading the dramatic market rally since March and commanding excessively high valuations.
3. While the timing of any reversal in market leadership is uncertain, some of the best periods of relative performance for Dividend Growers have followed challenging periods such as the last year.

2020 Hindsight

In our fourth quarter 2019 edition of the *Copeland Review* ("Meet the 20s"), we remarked: "It's our belief…[that] both earnings momentum and a supportive Federal Reserve" are "prerequisites to sustain[ing] the bull market going forward."

As it turns out, however, the latter factor – in combination with a heavy dose of fiscal support – provoked significant multiple expansion, actually offsetting negative earnings momentum in order to push indices higher.

Last quarter, we spoke about the near doubling of the assets on the Federal Reserve's balance sheet since late February 2020, an effort designed to support financial markets and corporate access to capital. This pace is consistent with the expansion experienced during the Great Financial Crisis of 2008-2009, but in absolute terms, the $3.2T advance in 2020 is far larger than the $1.2T jump at that time. Moreover, several initiatives designed to support American workers and companies impacted by the COVID-19 pandemic – in combination with far lower consumer spending – wound up padding consumer balance sheets significantly (Chart 1). Indeed, in April, the savings rate, which normally vacillates between 6% and 8%, spiked to almost 34%, the highest level ever recorded.[1]

While the savings rate has since come down from its peak, it remained historically elevated at year-end.[2] Much of this consumer balance sheet improvement appears to have found its way into the stock market, evidenced by a huge jump in newly opened brokerage accounts.[3]

On the other hand, while there were certainly pockets of fundamental strength – particularly among technology and biotechnology stocks – COVID-19 significantly impaired earnings in both US and international markets (Chart 2).

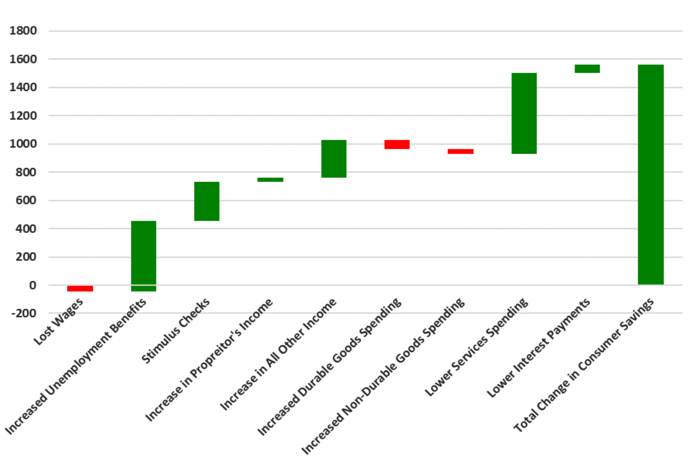
Never Say Never Again

In our experience, many investors have a habit of claiming that they will avoid the mistakes of their forebearers or even their own past misguided behaviors, while instead being gripped by fear or greed at just the wrong times.

Given the extraordinary performance of certain market segments over the last year we believe it's important to revisit this concept today. At the risk of being redundant, we can't help but remind investors of the unusual confluence of factors that we noted in our report last quarter. First, the percentage of unprofitable small cap companies remains near all-time highs. Second, most of these companies aren't expected to be profitable any time soon. Third, issuance of new IPOs and SPACs continues briskly, even as most aren't expected to be profitable for years. To these red flags we now add three more clues that suggest that speculative excess abounds today:

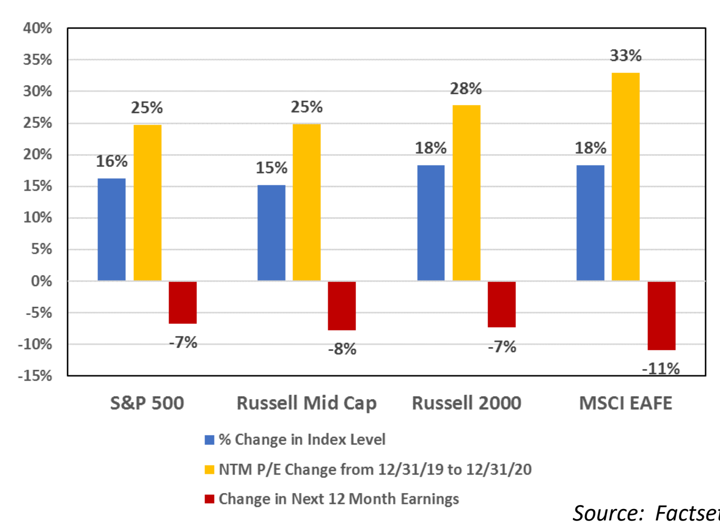
Clue #1: Individual investors have become more aggressive.
Driven by a combination of increased free time and increased liquidity among potential investors during the pandemic, online brokers have seen a massive acceleration in new account openings. Take Charles Schwab (Ticker: SCHW). Not including accounts secured through Schwab's merger with TD Ameritrade, the company added 3.2M new relationships in the nine months ended November 2020 – approximately the time of the pandemic. Yet over the preced-

Chart 1. Consumer savings exploded (data from March through November, 2020 versus 2019)



Source: Bureau of Economic Analysis

Chart 2. Major global stock indices reached new highs in 2020 backed by valuation expansion



Source: Factset

ing nine months, Schwab added barely a third of that amount.[4]

This rash of newly opened accounts was accompanied by an extraordinary jump in trading activity – including in the options market. Normally the exclusive purview of professionals trading large lots, the options market has seen an eight-fold boom in retail call option activity (a call option allows holders to benefit from rising asset prices without owning the underlying asset) relative to 2019 levels – and 2019 was already well above the long-term average level.[5]

Clue #2: An unusual number of stocks have gone nuts.

"Gone nuts" isn't a technical term, but we think it's fair to say that when a stock has more than tripled in a year, it has "gone nuts" by most people's standards, no matter how excited they may be about the company's future prospects. In 2020, 136 stocks with market caps of greater than $250M have tripled. This is the highest level since 2009, but there are two big differences between then and now.[6] First, 2009 marked a huge recovery from the crushing bear market of 2008 while this year followed a massive decade-long bull run. Second, of course, we don't need to remind anyone that 2020's performance took place in the midst of a still-ongoing pandemic.

Consider: Numerous ETFs focusing on themes ranging from genomics to clean energy, online retail and cloud computing all rose more than 100%. Bitcoin jumped more than 300%. Against these bogeys, even the NASDAQ Composite's 44% return – its best in more than a decade – looks rather pedestrian (Chart 3).

Clue #3: Valuations have run to levels not seen in decades.

There are, of course, many different ways to consider valuations. In the current environment however, the inputs make little difference to the flavor of the output – namely, valuations have risen sharply and now stand at historically high levels. For example, as shown in Chart 4, the S&P 500 P/E multiple is approaching levels last seen at the peak in 2000.

The fuel for much of the valuation expansion has been a huge re-rating of non-dividend paying stocks, particularly evident within the universe of smaller capitalization companies. Given the large number of unprofitable companies in this cohort, we look at the price-to-sales ratio rather than their price-to-earnings levels. Today, non-dividend paying SMID cap stocks command a collective price-to-sales ratio of approximately 4x, above their dotcom era peak (Chart 5).

And From the Viewpoint of a Dividend Growth investor?

We were afraid you'd never ask. Let us continue our focus on SMID cap stocks. Since September 1982, when Ned Davis Research first began recording monthly returns by dividend policy, the

Chart 3. Numerous thematic ETFs have risen 100% or more

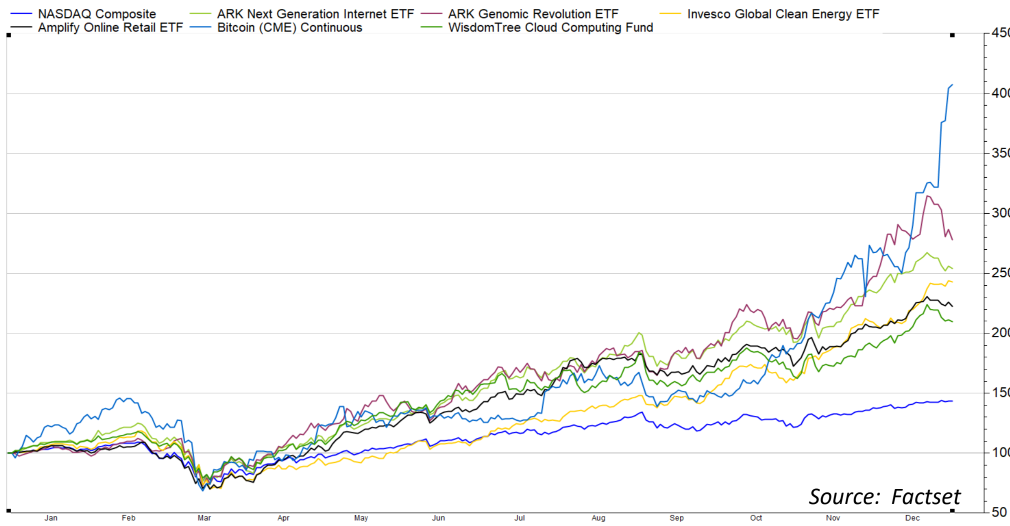


Chart 4. The S&P 500 Index is now at a price-to-earnings multiple modestly below its March 2000 peak, and well above its 20-year median

annualized performance of SMID cap non-dividend payers was 9.2%. Not surprisingly though, as long-time readers might already have guessed, SMID cap Dividend Growers performed far better, posting an annualized return of 14.7% and outpacing non-dividend payer returns more than two-thirds of the time.

Still, the relative performance of Dividend Growers versus non-dividend payers can vary widely. For example, investors who recall the dotcom bubble probably won't find it hard to believe that SMID cap Dividend Growers trailed SMID non-dividend payers by an extraordinary 57% during the final nine months of that euphoric period.

What might surprise readers however is that we just lived through the second worst such period of relative performance.

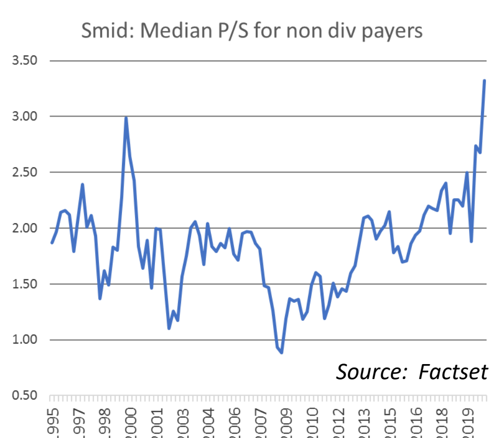
Yes, from March 31st, 2020 – nearly the pandemic period low in the market – through year-end of the year, SMID cap non-dividend payers rose over 102%. Moreover, as is often the case when non-dividend payers lead the market, they were accompanied by other low quality names. For example, unprofitable SMID cap companies bounced 115% and stocks in the highest quintile of debt to market cap gained 122%.

Alternatively, SMID cap Dividend Growers, despite jumping 46% during the same timeframe, found themselves lagging behind nearly as badly as in early 2000, just before the dotcom bubble burst.

When the Music Stops

Following a period of such incredible returns for non-dividend payers, particularly when earnings are down as called out above, we are reminded of Herbert Stein. While Dr. Stein, an economist by trade, had a notable career in public service, he is perhaps best known for propounding

Chart 5. Non-dividend paying SMID cap stocks are valued above their dotcom era peak



Stein's Law, which states: "If something cannot go on forever, it will stop."[7]

In the short run, obviously anything can happen. Looking at Chart 6 one can see that the final months of the dotcom bubble were marked by strong relative returns for non-dividend paying stocks, even amidst slowing GDP growth, peaking manufacturing activity, and climbing interest rates.[8]

Eventually though, that period of speculative excess ran out of steam, as all such periods do. Demand for fundamentally weak, low or no profit, long-shot growth stories couldn't go on forever and thus stopped – just as predicted by Stein's Law. Meanwhile, companies with track-records of dividend growth – a good proxy for fundamental strength – which had been overlooked during the bubble – went on to outperform considerably over the next year, returning 38% while non-dividend payers fell 29%.

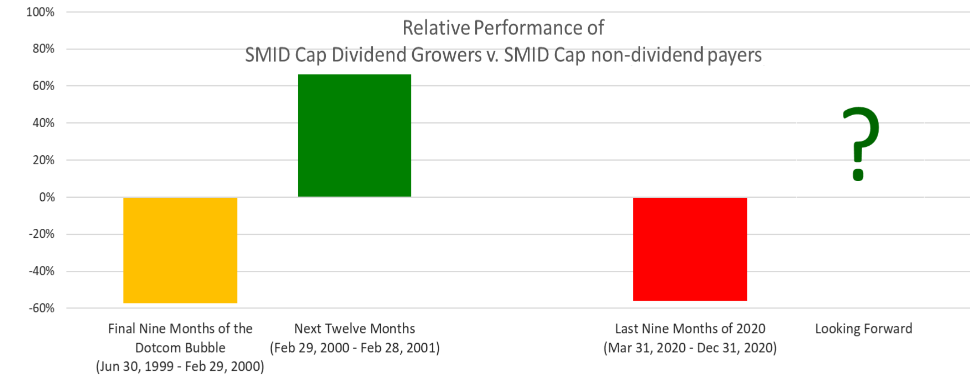
The carnage was not done after a year, however. ***The growth and momentum laden Nasdaq Composite fell by more than 75% from its March 2000 peak to its October 2002 bottom.*** And, while a small handful of dotcom darlings survived and even flourished, many were relegated to the dustbin of history.

Take for instance Booking Holdings Inc (Ticker: BKNG), previously known as Priceline.com. Today, Booking is the leading online travel agency, operating in over 200 countries and 40 languages and commanding a market cap of nearly $90B. By almost any measure, a success story. Along the way however, the stock, which traded at nearly $1000 per share (split-adjusted) in April 1999, plunged to under $7 per share, suffered through years of losses and failed to establish a new high for over 13 years.

Other household names weren't even that lucky: Cisco Systems' market cap today is barely half of its peak; AOL, once taken out by Time Warner for $165B, was subsequently sold to Verizon for $4.5B in 2018; and JDS Uniphase (later renamed Viavi Solutions; ticker: VIAV), a one-time poster child for the potential of the internet, lost 99.8% of its value from its 1999 high to its 2008 low. The list goes on and on.

Nor are these stories exclusive to the dotcom bubble. In the Nifty Fifty era (1960-70s), many blue-chip stocks traded at 50x earnings before being unceremoniously cut in half.[9] During the housing bubble, capital flowed freely to companies like Countrywide Financial and Washington Mutual…until it didn't with shareholders paying the price.

Chart 6. After underperforming during the dotcom bubble, Dividend Growers went on to outperform significantly in the year that followed. Will such a rebound repeat this time?



Source: Ned Davis Research

A Very Attractive Opportunity

We have just shared a number of data points that demonstrate the risk in the stock market today. That said, all stocks are not created equal. From time to time, when market participants overlook risk and instead focus strictly on "potential," we know that Dividend Growers with their "boring" histories of consistent success, are likely to have a tough time keeping pace. However, we have found that over time Dividend Growers and Initiators tend to outperform their benchmarks with far greater regularity than all other categories of stocks organized by dividend policy.

Further, their track-record of outperformance improves significantly following periods of severe underperformance. Specifically, since September 1982, non-dividend payers have outpaced Dividend Growers by 40% or more in only 3% of all rolling twelve-month periods, including the period just ended. <u>In every case however, Dividend Growers went on to outpace non-dividend payers by a significant margin over the subsequent three years.</u>[10]

We don't know when the market will begin to discern more carefully between companies with strong fundamentals and those of lower quality. Nor do we know what the catalyst will be to engender such a shift in psychology. However, we vividly remember the massive financial losses suffered by those who were ultimately burnt by the end of irrational exuberance two decades ago. We believe, based on experience, that Dividend Growers will afford investors a very attractive opportunity for strong performance bolstered by their currently favorable valuation levels. In the meantime, we are committed to delivering portfolio exposure and results to our clients that best reflect the favorable attributes of dividend growth investing. Accordingly, we will continue to look for those names with strong competitive advantages, high returns on invested capital, and commitments to returning capital to shareholders. We believe these attributes have supported the long-term success of Dividend Growers and are likely to be particularly in favor looking forward.

1 *https://www.nytimes.com/2021/01/01/upshot/why-markets-boomed-2020.html*
2 *https://www.statista.com/statistics/246268/personal-savings-rate-in-the-united-states-by-month/#:~:text=Monthly%20personal%20saving%20rate%20in%20the%20U.S.%202015%2D2020&text=In%20October%202020%2C%20the%20personal,saving%20to%20disposable%20personal%20income*
3 *https://www.cnbc.com/2020/05/12/young-investors-pile-into-stocks-seeing-generational-buying-moment-instead-of-risk.html*
4 *https://pressroom.aboutschwab.com/press-releases/press-release/2020/Schwab-Reports-Monthly-Activity-Highlights/default.aspx*
5 *https://www.gmo.com/americas/research-library/waiting-for-the-last-dance/?utm_source=Reading+List&utm_campaign=68bc02809a-EMAIL_CAMPAIGN_9_13_2020_12_27_COPY_01&utm_medium=email&utm_term=0_325454c9ab-68bc02809a-513794757*
6 *FactSet*
7 *https://en.wikipedia.org/wiki/Herbert_Stein#cite_note-5*
8 *https://tradingeconomics.com/united-states/business-confidence, https://tradingeconomics.com/united-states/gdp-growth-annual, FactSet*
9 *https://www.marketwatch.com/story/why-facebook-amazon-apple-and-other-highfliers-will-end-up-like-the-soaring-nifty-fifty-stocks-of-the-1970s-2020-06-22*
10 *Ned Davis Research, CCM*

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Currency - Unless otherwise specified or disclosed, the currency used for data in the report is US Dollar (USD).

Charts 2, 3, 4 & 5: FactSet is a company that offers financial industry analysis, financial data, analytics, and analytic software for investment professionals. The information contained herein: (1) is proprietary to FactSet Research Systems Inc. and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither FactSet Research Systems Inc. nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results. ***This is not the performance of any strategy overseen by Copeland and there is no guarantee that investors will experience the type of performance reflected in the information presented.***

Chart 6: See NDR Disclaimer at www.ndr.com/copyright.html. For data vendor disclaimers refer to www.ndr.com/vendorinfo/. Ned Davis Research adjusted the universe used for the domestic study as of December 31, 2017, from the Ned Davis Investable Universe to a universe based on the applicable Russell benchmarks. As a result, historical performance information may differ from previously disseminated performance information for stocks according to their dividend policy. This is not the performance of the firm and there is no guarantee that investors will experience the same type of performance.

The Indexes mentioned are unmanaged, are not available for investment and do not incur expenses. With respect to the comparison of the Copeland strategies to their comparative benchmarks, the number of holdings and volatility of an unmanaged Index is different from that of an actively managed portfolio of Dividend Growth stocks. The S&P 500® Index is a market-capitalization-weighted index of the stocks of 500 leading companies in major industries of the U.S. economy. The Russell Mid Cap Index is comprised of the 800 smallest companies in the Russell 1000 Index. This index measures the performance of the 800 smallest companies in the Russell 1000 Index, which represent approximately 25% of the total market capitalization of the Russell 1000 Index. The Russell 1000 Index is comprised of the largest 1000 companies in the Russell 3000 index. The Russell 2000® Index is comprised of the smallest 2000 companies in the Russell 3000® Index. The Russell 3000® Index measures the performance of the 3000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. The MSCI EAFE Index® is an equity index which captures large and mid-cap representation across 21 developed markets countries around the world, excluding the US and Canada. The NASDAQ Composite is a stock market index that includes almost all stocks listed on the Nasdaq stock market.

<u>Definitions</u>

EPS Growth – Earnings Per Share Growth illustrates the growth of earnings per share over time.

IPO – Initial Public Offering.

NTM P/E Ratio - The Next Twelve Months Price-to-Earnings Ratio of a stock is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share.

SPAC - A special purpose acquisition company (SPAC) is a "blank check" shell corporation designed to take companies public without going through the traditional IPO process. SPACs allow retail investors to invest in private equity type transactions, particularly leveraged buyouts.

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