The Copeland Review

Fourth Quarter 2022

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

Flying the Plane

Elaine Dickinson: *Ladies and gentlemen, this is your stewardess speaking... We regret any inconvenience the sudden cabin movement might have caused, this is due to periodic air pockets we encountered, there's no reason to become alarmed, and we hope you enjoy the rest of your flight... By the way, is there anyone on board who knows how to fly a plane?*

Airplane! Paramount, 1980

Thankfully, the scenario in *Airplane!*, in which all three pilots succumb to food poisoning and cannot fly the plane, is entirely comedic. When flight attendant Elaine Dickinson makes the announcement and asks for help, panic understandably ensues in the cabin.

Like the airplane in the movie, global equity markets encountered significant turbulence in 2022, with many markets suffering double digit declines.[1] The Russian invasion of Ukraine was a major negative shock early in 2022. As the year continued, investors were consistently surprised by more aggressive than expected monetary policy tightening by the Federal Reserve (Fed).

In addition to seven upward rate actions, the Fed steadily and materially revised its key economic projections to reflect worsening conditions. While hindsight is 20/20, the Fed was so far off in its diagnosis of what was happening – and what would happen – in the economy, that it struggled to enact the correct prescription to manage inflation. Hence, the Fed is now playing a game of catch-as-catch-can, begging the question, can anyone reliably "fly" this plane?

In this *Review*, we highlight the following:

1. 2022 provides a reminder that professional forecasts – whether economic, market, or other – frequently miss the mark and should be used with caution.
2. Sentiment is dour with consensus generally predicting a recession and negative earnings surprises.
3. History shows that investors have been well served by following one very trustworthy pilot through good and bad times: dividends.

Forecasters Miss by a Mile

Across professions, countless hours are expended each day creating, updating, and analyzing all sorts of models and forecasts in order to make decisions. However, more information frequently feeds an illusion of control and may lead to overconfidence in predictions. This is compounded by the fact that, even in the best models, input data is often imperfect. "Garbage in, garbage out," as the saying goes.

In 2012, the *New York Times* published a piece about forecasting.[2] While the article focuses primarily on improvements in meteorological predictions, it also cites difficulties making predictions in economics. Specifically, "In November 2007, economists in the Survey of Professional Forecasters — examining some 45,000 economic-data series — foresaw less than a 1-in-500 chance of an economic meltdown as severe as the one that would begin one month later."

Fast forward to the beginning of 2022. Recall that, despite conspicuous evidence that broad-based inflation was ramping throughout 2021, the target Fed Funds Rate (FFR) was still between zero and 0.25%— where it had been since the onset of the COVID-19 pandemic. Surprisingly, the Fed had only just pivoted from expecting its first hike in the first quarter of 2023 to June 2022.

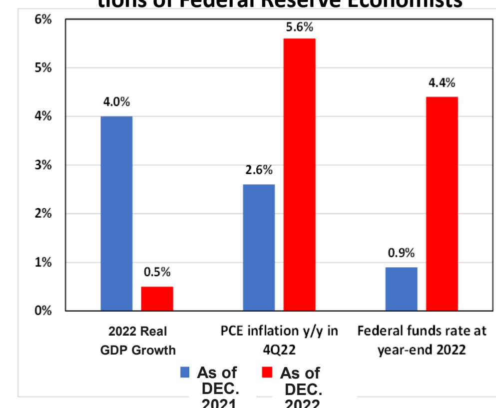
Meanwhile, the median year-end 2022 forecast of Fed economists pegged the FFR at only a middling 0.9% and other projections were decidedly optimistic.[3] Bond market investors were following the Fed's lead, pricing in a target FFR of 0.75% to 1.00% by year-end.[4]

Now, the world knows that the Fed's original expectations were dashed many times over (Chart 1). The first hike was pulled forward to March from June, and then followed by six more, leaving the actual year-end FFR nearly five times higher than originally expected![3] Likewise, the Fed's other major macro-economic projections experienced material negative revisions. Forecasts for 2023 and 2024 were also subject to considerable changes. For their part, market pundits did no better.[4]

Expectations for corporate earnings estimates also experienced variations throughout the year, as is usually the case (Chart 2, next page). The "squiggles" chart shows how the EPS forecast for any given year changes dramatically over time, particularly in years when economic activity changes direction. The current 2022 estimate for S&P 500 Index operating earnings is down 9% from one year prior, with many sectors down far more (Chart 3). For 2023, various strategists believe that current estimates for S&P 500 Index and Eurozone companies are too high by anywhere from 10% to 30%.[5]

Finally, at the beginning of 2022, market strategists attempted to forecast the year end S&P 500 Index price level, an annual exercise in futility. Their average forecast missed the mark by a whopping 26%.[6] In addition to lower than originally expected earnings, valuation multiple compression drove a large portion of the market decline. So, even if short-term earnings forecasts are 100% accurate, multiple

Chart 1. Significant Revisions to 2022 Projections of Federal Reserve Economists



Source: Federal Reserve https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm

expansion or compression can lead to large price variances. The net result suggests that efforts to forecast both near-term price and earnings levels are of little value to investors.

Dour Mood with New Predictions

Today, the mood is downbeat, with the University of Michigan consumer sentiment gauge bouncing along all-time lows previously reached during the 1970s (Chart 4). Further, according to the 2023 Gallup outlook poll of Americans, "about eight in 10 foresee economic struggles" – including concerns about higher taxes and the budget deficit – with a majority predicting "negative conditions in 12 of 13 arenas."[7] Among economists, the mood is equally gloomy, with the latest Bloomberg monthly survey of economists showing a 70% probability of a recession in 2023.[8] Globally, the World Bank recently lowered its global growth forecast to 1.7% this year, down from a prior estimate of 3%, which – if accurate – would be "the third weakest pace of global growth in nearly three decades."[9]

These economic predictions may prove correct… or not. It is important to remember that the "Market" is forward looking and, as we described last quarter, in "The Costanza Market," bad economic news should ultimately create a bullish setup for stocks. As always, however, exact timing is unknown and there are multiple plausible scenarios.

Will the Fed pause or even reverse course later in the year? Will the economy fall into recession or muddle through? No one really knows.

On one hand, the dampening effects of higher interest rates are increasingly evident across the economy, from areas such as real estate and construction, to spending on technology and consumer products. A strong case can be made that the full impact of higher borrowing costs is likely to be felt with a lag, leading to decelerating activity and corporate earnings as 2023 progresses. Finally, the Treasury yield curve remains significantly inverted, whereby long-term yields are lower than short-term yields.[10] The World Economic Forum notes that "an inverted yield curve has emerged roughly a year before nearly all recessions since 1960."[11]

At the same time, unemployment remains low, hourly wage gains are strong, and job openings are plentiful, even with many headlines of mounting job layoffs.[12] Plus, even if

Chart 2. History of Earnings Squiggles

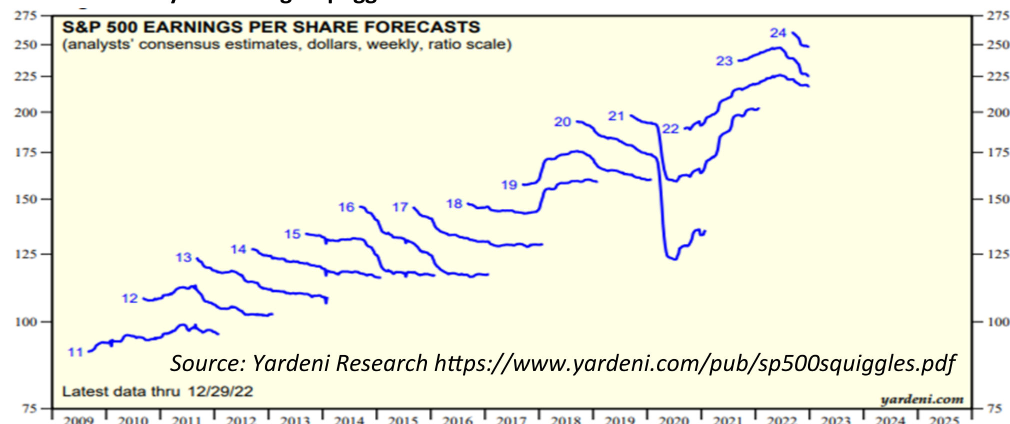


Chart 3. Earnings Revisions Over the Past Year Show Wide Variance Across Sectors

Estimated Operating Earnings Per Share 2022 Estimate as of:	"PRIOR" 1/5/2022	"CURRENT" 1/13/2023	% CHANGE
S&P 500 Index	$220	$200	(9%)
Consumer Discretionary	$51	$36	(30%)
Consumer Staples	$37	$33	(11%)
Energy	$39	$83	112%
Financials	$44	$33	(25%)
Health Care	$94	$80	(15%)
Industrials	$43	$40	(8%)
Information Technology	$108	$94	(13%)
Materials	$33	$33	(1%)
Communication Services	$13	$10	(20%)
Utilities	$17	$16	(6%)
Real Estate	$6	$8	24%

Source: S&P Down Jones https://www.spglobal.com/spdji/en/indices/equity/sp-500/#overview and CCM

moderating, inflation remains well above the Fed's target level of 2% and Federal Reserve Chairman Powell has emphasized multiple times that the Fed will "keep at it."[13] This information supports a view that interest rates may follow a higher-for-longer scenario. Time will tell.

Sifting Through the Noise and Following the Signal

We also follow macroeconomic conditions and how they impact our portfolio holdings.

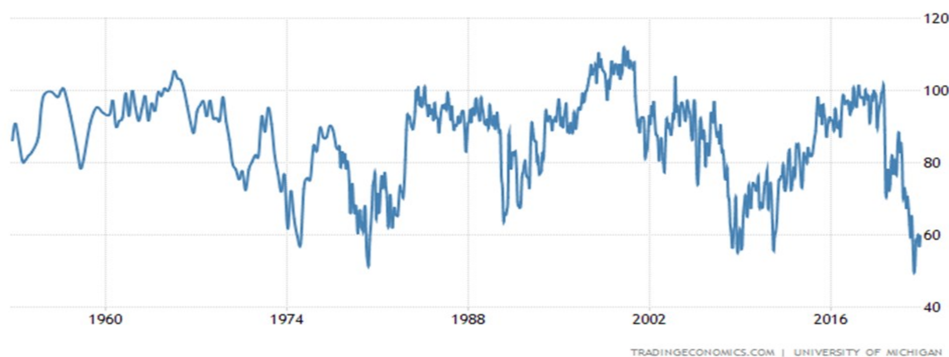
Two years ago, in "Let's Not Party Like It's 1999" (4Q 2020 *Review*), we flagged widespread speculative investment behavior and extreme valuations. One quarter later, in "Running Hot" (1Q 2021), we noted concern that "the supercharged US economy begets potential for both higher inflation and interest rates," while again expressing concern that speculative activity was likely to end badly. One year ago, in "Reality Bites" (4Q 2021), we highlighted that (1) broad-based inflation was expected to lead to tighter monetary conditions, (2) support for speculative assets was dwindling, and (3) the outlook for high quality, profitable, and reasonably priced assets was bright.

Importantly, those were structural calls based on historical experience, as opposed to point predictions. For example, exiting the fourth quarter of 2020, the market had just gone through the second worst period of relative performance for dividend growers versus non-dividend growers ever. Yet, the long-term track record showed that such dislocations were exceedingly rare and, that in every previous case, dividend growers went on to outpace non-dividend payers by a meaningful margin over subsequent periods.[14]

Shortly thereafter, the environment shifted. During 2021, dividend growers outpaced non-dividend payers by 25% and, through 2022, the performance gap widened to +49% over the two-year period.[15] History continues to suggest that the outlook for quality dividend growers remains favorable.

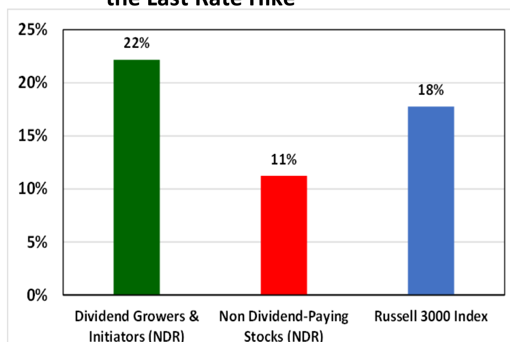
Why? More stringent interest rate and funding conditions suggest further stress for non-profitable, unproven business models. Warren Buffett's popular quote, "you only find out who is swimming naked when the tide goes out," seems especially apt today.[16]

Chart 4. Consumer Sentiment in the Doldrums



Source: Trading Economics https://tradingeconomics.com/united-states/consumer-confidence

Chart 5. Average Performance One-Year After the Last Rate Hike



Source: NDR, CCM, Russell. Past performance is no guarantee of future results. There is no guarantee that companies will declare dividends or, if declared, that they will remain at current levels or increase over time. The returns shown above include dividends reinvested. The historical data is for illustrative purposes only and does not represent the performance of any strategy overseen by Copeland or any particular investment, and there is no guarantee that investors will experience the type of performance reflected in the information presented. Strategies managed by Copeland's investment team are subject to transaction costs, management fees, trading fees or other expenses not represented in the information presented. A stock is classified as a Dividend Grower if it initiated or raised its existing cash dividend at any time during the previous 12 months. Please see the Disclosures section for additional information and Index disclosures.

Further, using data from Ned Davis Research, we evaluated the historical performance of dividend growth stocks relative to non-dividend paying stocks and the Russell 3000 Index for the one-year period after the Fed stopped raising the FFR. We felt this analysis best captured the current point in the economic cycle because the Fed is widely expected to make this "pivot" in the near term. There have been six such periods since 1982 with the first occurring in 1984-1985 and the latest in 2018-2019.

The results reveal that dividend growers and initiators outperformed non-dividend paying stocks by an average of more than 10% and the benchmark by more than 4% (Chart 5).

A Reliable Pilot to Lead the Way

Rather than making or following unreliable predictions to guide our investment decisions, we focus on something tangible: corporate dividend actions.

Clearly, the broad environment can and does impact individual, "micro" purchase decisions by customers for a given company, thereby impacting revenue, earnings, cash flow, and dividends. Thus, a real-time dividend action – which few other investors seem to track – provides a read on the confidence of corporate management and its board of directors in the company's fundamental business outlook.

If a board is not overly confident in the outlook, it may decide to marginally increase the company's dividend, hold it flat, or – in a dire scenario – reduce it. However, once a track record of dividend growth is established, management teams and boards are loath to perform the latter actions for fear of losing their jobs. In turn, that fear brings steadfast attention to capital allocation and places a governor on making poor decisions that destroy value.

Moreover, as shared in prior *Reviews*, dividend growers tend to outperform their benchmarks with far greater regularity than all other categories of stocks organized by dividend policy.[17] Shareholders and companies both benefit as better share price performance underpinned by a rising dividend can lead to a lower cost of capital, a larger shareholder base, better stock liquidity, and improved employee retention. This is dividend growth at work, leading the way.

In *Airplane!*, passenger Ted Striker – a former US Air Force pilot who developed a fear of flying – ultimately takes the controls and makes a bumpy landing, saving the day. While hesitant and uncertain, he did his job with assistance from Elaine and guidance from ground control. Today, investors might also be hesitant and uncertain as to the best course of action. Rather than fret or even panic – particularly in the face of dire predictions – Copeland follows the cues that dividends provide. They are the most reliable pilot.

January 25, 2023

[1] *The S&P 500 Index was down 18%, the Russell 2000 Small Cap Index down 20%, the MSCI World Ex-US Index down 14% and the MSCI World Ex-US Small Cap Index down 21%*

[2] *NYTs https://www.nytimes.com/2012/09/09/magazine/the-weatherman-is-not-a-moron.html*

[3] *NY Fed https://www.newyorkfed.org/markets/reference-rates/effr*

[4] *Barron's https://www.barrons.com/articles/stock-market-economy-inflation-performance-outlook-51639782340?mod=past_editions*

[5] *Raymond James and Liberum 2023 Strategy Outlook Presentations 01/19/2023*

[6] *Bloomberg using the ANR function for the S&P 500 Index*

[7] *Gallup https://news.gallup.com/poll/467528/americans-largely-pessimistic-prospects-2023.aspx*

[8] *Fox Business https://www.foxbusiness.com/economy/is-us-economy-headed-recession-2023-majority-economists-say-yes*

[9] *WSJ https://www.wsj.com/articles/world-bank-cuts-2023-global-growth-projection-as-inflation-persists-11673356337*

[10] *Bloomberg*

[11] *World Economic Forum https://www.weforum.org/agenda/2022/12/inverted-yield-curve-signal-economy-euro-dollar/*

[12] *WSJ https://www.wsj.com/articles/tech-layoffs-are-happening-faster-than-at-any-time-during-the-pandemic-11672705089*

[13] *Federal Reserve https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20220921.pdf*

[14] *See "Let's Not Party Like It's 1999," 4Q 2020 Copeland Review*

[15] *NDR and CCM*

[16] *Berkshire Hathaway https://www.berkshirehathaway.com/2001ar/2001letter.html*

[17] *See "Running Hot," 1Q 2021 Copeland Review*

Disclosure Section:

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

Chart 5: © 2022 Ned Davis Research, Inc (NDR). Further distribution prohibited without prior permission. All Rights Reserved. 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 Copeland and there is no guarantee that investors will experience the same type of performance.**

Certain charts herein contain publicly available data, but the data has been formatted by Copeland to allow for ease of reading.

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 2000® Index** is comprised of the smallest 2000 companies in the Russell 3000® Index. The **Russell 2500® Index** is comprised of the bottom 2500 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 World ex USA Index** captures large and mid-cap representation across 22 of 23 Developed Markets (DM) countries excluding the United States. With 887 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. The **MSCI World Ex-US Small Cap Index** captures small cap representation across 22 of 23 Developed Markets (DM) countries (excluding the United States). With 2,504 constituents, the index covers approximately 14% of the free float-adjusted market capitalization in each country.

Definitions

Dividend Growth Rate - The annualized percentage rate of growth that a particular stock's dividend undergoes over a period of time.

Dividend Yield - The company's total annual dividend payments divided by its market capitalization, or the dividend per share, divided by the price per share.

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

Gross Domestic Product (GDP) – GDP measures the monetary value of final goods and services produced in a country in a given period of time.

Personal Consumption Expenditures (PCE) Price Index - A measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

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