The Copeland Review

Fourth Quarter 2023

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

Feeling down n' dirty, feeling kinda mean
I've been from one to another extreme
This time I had a good time, ain't got time to wait
I want to stick around till I can't see straight

Double Vision

Fill my eyes with that double vision,
no disguise for that double vision
Ooh, when it gets through to me, it's always new to me
My double vision gets the best of me
Foreigner, 1978

One year ago, in "Flying the Plane," we highlighted that market and economic forecasts are frequently inaccurate. 2023 was no exception. At year-end, the WSJ observed, "Market Forecasts Missed the Mark in 2023 – US Stocks end a topsy-turvy year near records despite bearish predictions."[1] That is an apt, nutshell version of what unfolded.

Recall that, in late 2022, consumer sentiment was in the dumps and a majority of economists expected a recession.[2] Yet, as the year progressed, US employment conditions remained stable as did consumer spending, and real GDP growth surprised to the upside.[3] A mixed corporate earnings bag emerged, with five of eleven S&P 500 Index sectors seeing flat to slightly upward revisions, including – shockingly – the Consumer Discretionary sector (+6%).[4] The other six sectors saw negative revisions with the most pronounced in Health Care (-26%), Energy (-14%), and Materials (-17%). Astonishingly, banking crisis aside, Financial sector earnings estimates fell only 10%. All the while, investor sentiment – and major equity indices – oscillated between fear and greed, like a sine wave (Chart 1).

As the year progressed, market participants and pundits increasingly seemed to let double vision get the best of them, fixating on Federal Reserve ("Fed") policy and the so-called "Magnificent Seven," at the expense of most other considerations.

In this *Review*, we highlight the following:

1) Despite the euphoric rally that started in November, sparked by a potential peak in interest rates, current and forecast short-term borrowing rates are higher than expected at this time last year.
2) Though many equity indices were near all-time highs at year-end, much of their appreciation was attributable to outsized gains among the "Magnificent Seven." This unusually narrow leadership left US and international small cap stocks behind, creating a compelling opportunity.
3) Copeland's investable universe of US and International dividend growth stocks is expanding, enabling us to select companies with both elevated earnings and dividend growth. The historical growth differential for our International Small Cap strategy is striking (Chart 6).

Progress "Flying the Plane"

During the last two months of the year, investor sentiment flipped to extremely bullish from extremely bearish and a supercharged "Santa Claus" rally took hold.[5] Global equity markets issued a sigh of relief, celebrating the end of the most aggressive monetary tightening spree in decades.[6] Apparently, the crowd did not trust the Fed's "dot plot," which – since June 2022[7] – had always suggested that rates would top out in 2023 and begin to recede in 2024.

Interestingly, though the Fed and other forecasters widely missed GDP and market forecasts in 2023, to the central bank's credit, two of its three key year-end targets came in near the bogeys established in December 2022 (Chart 2).

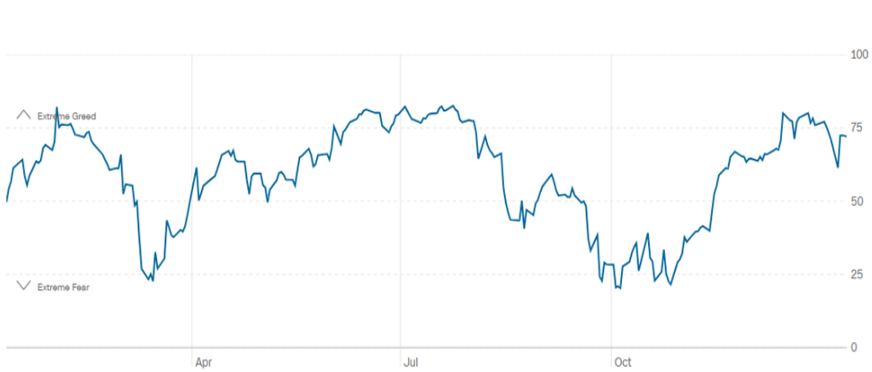
As the Fed hoped at the outset of its tightening campaign, inflation is lower. For the month of December 2023, headline inflation for "all items" was 3.4%, down from a peak of 9.1% in June 2022.[8] In fact, the level projected by the Fed for the fourth quarter of 2023 is marginally lower than the median forecast one year ago.[9]

However, the median Fed Funds rate of 5.4% remains higher than expected. This means short-term borrowing rates tied to the Federal Funds rate – such as corporate term loans and credit facilities – will remain costly for borrowers relative to levels of recent years. Moreover, that pressure is expected to moderate only slightly in 2024, with the Fed forecasting the Federal Funds rate at 4.6%, one-half percentage point higher than the same forecast 12 months earlier.

Simultaneously, investors still don't trust the current Fed projections, which imply only three cuts this year compared to the consensus calling for six cuts starting in March.[10] The consensus scenario is based upon the latest three-month and six-months' core inflation readings which, on an annualized basis, are already running near the Fed's 2% target.[11]

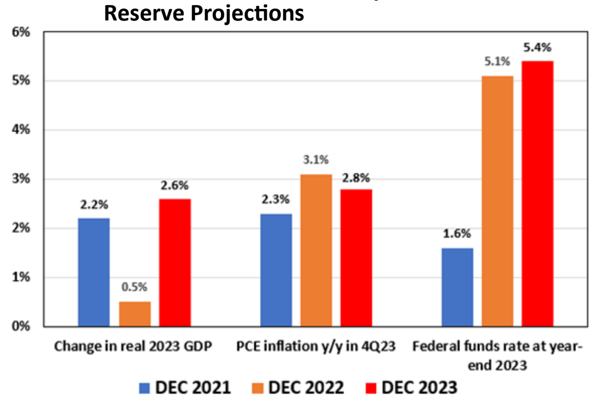
Yet, such hopes may prove optimistic. Sizable pockets of inflation remain, including in items such as food away from home, medical care, shelter, and transportation.[12] In addition, the ongoing Middle East conflicts recently caused a massive spike in ocean and air freight shipping rates, which will impact costs for all kinds of goods and services if they persist.[13] Finally, the US labor market and consumer spending remain reasonably strong. Taken together,

Chart 1. Emotional Roller Coaster - CNN's Fear & Greed Index for the Past 12 Months



Source: https://www.cnn.com/markets/fear-and-greed as of 1/11/2024

Chart 2. Multi-Year Evolution of Key 2023 Federal Reserve Projections



Source: https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm these items align with the Fed's messaging that any monetary policy shifts are likely to be gradual.[14] We are not holding our breath either way.

"Magnificent Seven" to the Moon?

Joining the Fed mania, is a current obsession with the "Magnificent Seven," which refers to the mega-capitalization stocks Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla. The Magnificent Seven harkens back to groups of the past, such as the Nifty Fifty (1970s), the Four Horsemen (late 1990s), and the more recent FANGs (2010s).

Perhaps this fixation is no surprise. After all, given the outsized concentration of these names within the Index – more than a 25% weighting at year end — they accounted for roughly 60% of the S&P 500 Index return for the year.[15] Further, unlike the "dotcom bubble" of yore, the robust performance of this group may well be justified, as it has been propelled by the rapid top-line growth and strong cash generation of most of these businesses. Indeed, those factors may allow the outperformance to continue.

A closer look reveals, however, that – over trailing three- and five-year periods – the return of the S&P 500 Index capitalization weighted benchmark is much closer to that of the S&P 500 Index equal-weighted return than the most recent year (Chart 3). This narrower performance gap suggests a more balanced contribution from the other 493 stocks in recent years.

As a result, while we'll pass on making any formal predictions, it certainly wouldn't come as a shock to us if the Index experienced a reversion toward more balanced return contributions going forward.

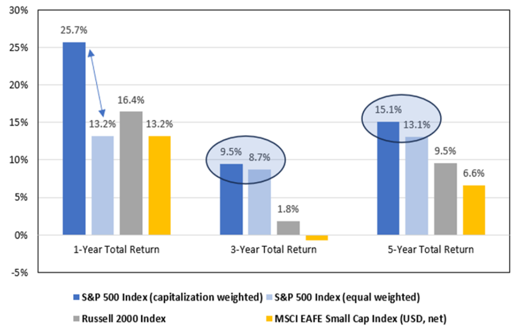
An Unappreciated Outlier

Meanwhile, though the Magnificent Seven has captured paparazzi-like fanfare, decidedly little attention has been given to the lagging relative performance of smaller capitalization equities. Looking again to Chart 3, the returns of the Russell 2000 and MSCI EAFE Small Cap Indices are also presented relative to the S&P 500 Index, and reveal an extreme shortfall in performance over the same time periods.

Conceptually, smaller capitalization companies are perceived to be more vulnerable than their larger counterparts to more challenging macroeconomic and interest rate conditions. Let's check this notion by looking at earnings trends.

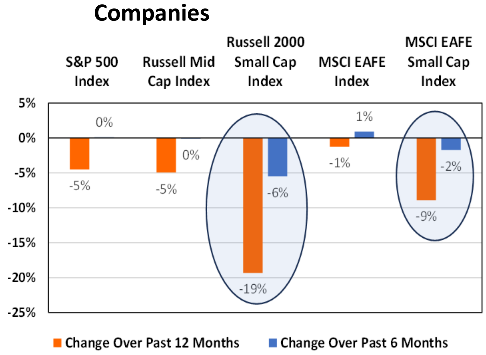
Notwithstanding the very strong equity market performance, companies of all sizes experienced downward 2023 earnings revisions over the past year (Chart 4). Still,

Chart 3. Large Caps Outperformed Small Caps through December 2023



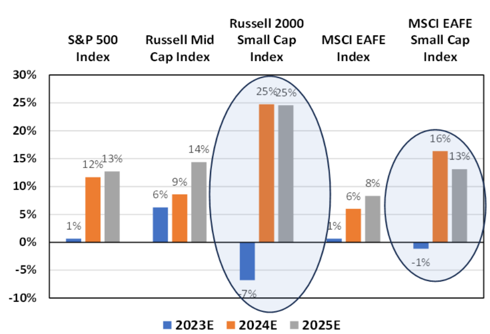
Source: FactSet. The Indexes mentioned are unmanaged, are not available for investment, and do not incur expenses. ***Past performance is no guarantee of future results.*** *Please see the Disclosure section for important information about the Indexes mentioned herein.*

Chart 4. Negative 2023 Earnings Revisions Most Pronounced Among Smaller Companies



Source: FactSet and CCM. The Indexes mentioned are unmanaged, are not available for investment, and do not incur expenses. ***Past revisions are no guarantee of future results.*** *Please see the Disclosure section for important information about the Indexes mentioned herein.*

Chart 5. Significant Expected Recovery in Smaller Cap Earnings Growth



Source: FactSet and CCM. The Indexes mentioned are unmanaged, are not available for investment, and do not incur expenses. ***Earnings forecasts may be inaccurate and are no guarantee of future results.*** *Please see the Disclosure section for important information about the Indexes mentioned herein.*

negative revisions weighed far more heavily on smaller capitalization companies last year, both in the US and abroad. The visible downtrend supports the idea that smaller companies have less financial flexibility, higher financing costs, and less global reach. Alas, investors might often favor the greater size, liquidity, and stability of US large capitalization stocks during uncertain market environments.

Of course, future earnings, cash flow, and dividend growth matter most for equity valuation and performance. Moving beyond the 12-month revisions, Chart 4 also shows that the degree of negative revisions for smaller companies moderated materially over the last six months. Moreover, current consensus expectations for 2024 and 2025 portend a significant recovery in earnings for smaller companies (Chart 5). Notably, the expected pace is meaningfully higher than that expected for larger companies, and relative valuations are attractive, too. Using the benchmarks included in Chart 4, on a forward 12-month price-to-earnings basis, US small cap stocks were valued at 17 times and international small cap stocks at 13 times compared to US large cap stocks at 19 times and the Magnificent Seven at 32 times.[15] Thus, coupled with recent underperformance, investing in small cap stocks, domestically or abroad, could be very timely.

Focus on International Small Cap Dividend Growth

Looking through the lens of our dividend growth methodology, we believe the opportunity set, growth profile, and valuation remain as compelling as ever.

The investable US SMID cap universe of three-year dividend growth companies grew 20% year over year to 631 at the end of 2023. Even more pronounced, the investable universe of non-US international small cap three-year dividend growth companies increased by 47% year over year to 696. The international trend is especially favorable and continues a sharp recovery from a retrenchment that occurred during the first year of the pandemic. Notably, even through the pandemic and its aftermath, a very large number companies weathered the triple whammy of demand destruction, inflation, and rising interest rates, and continued hiking their dividends.

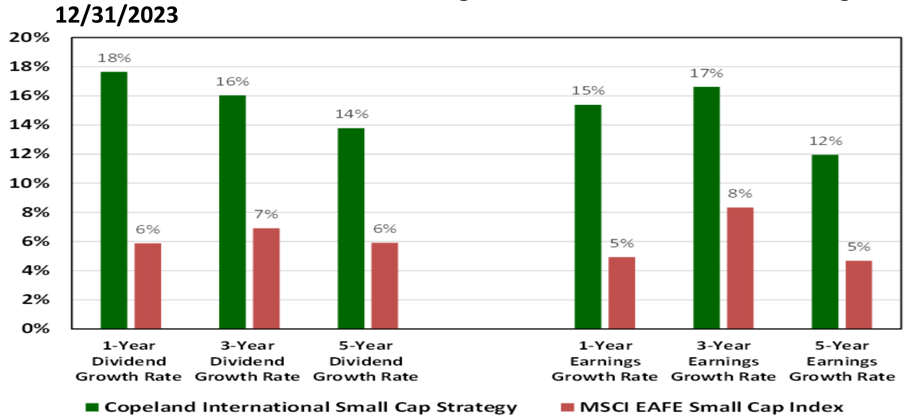
A healthy universe size enables Copeland to actively research and become owners of companies that we deem best positioned to sustainably increase their dividends at an above average pace. Importantly, our research and experience supports our belief that a rising dividend correlates highly with share price performance.

As detailed earlier, consensus earnings expectations for smaller cap benchmarks suggest a significant earnings recovery in 2024 and beyond. For our part, rather than place undue weight on forecasts that could be off the mark, we can look at historical trends for our portfolio holdings, in addition to each company's most recent dividend action as a signal of confidence in the future.

Chart 6 highlights the historical one-, three-, and five-year median earnings and dividend growth rates for Copeland's International Small Cap Strategy versus the MSCI EAFE Small Cap Index. A marked differential in the pace of earnings growth visibly translates into elevated dividend growth for Copeland's holdings. We believe the differential can be attributed to typically more resilient business models for dividend growth companies. Though past results do not always indicate future results, track records can be informative. Amazingly, despite much higher historical growth, at year-end 2023, Copeland's International Small Cap Strategy was valued at just 16 times forward earnings.[15]

Likewise, we believe that shareholders of these companies should also benefit from greater return consistency over time. Using Ned Davis Research data, Chart 7 shows the percentage of time International Small Cap dividend growth stocks have outperformed the MSCI EAFE Small Cap Index over rolling periods relative to other types of stocks based on dividend policy. The track record speaks for itself.

Chart 6. Historical Median Dividend and Earnings Growth Rates for Portfolio Holdings as of 12/31/2023



Source: FactSet and CCM. There is no guarantee that investors will experience the type of earnings growth 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. Dividend Growers included stocks that raised their existing dividend or initiated a new dividend during the previous 12 months. One-, Three-, and Five-year dividend growers are stocks that have raised their dividends for three, four, or five consecutive years respectively in which Copeland has invested. There is no guarantee that companies will declare dividends or, if declared, that they will remain at current levels or increase over time. The Indexes mentioned are unmanaged, are not available for investment, and do not incur expenses. Please see the Disclosure section for important information about the Indexes mentioned herein.

Chart 7. Consistency of Dividend Growth – International Small Cap through 12/31/2023

	Initiation Date	Index (total return)	One Year Rolling	Three Year Rolling	Five Year Rolling	Ten Year Rolling
International Small Cap Dividend Growers	9/30/1995	MSCI EAFE Small Cap® Index	70%	75%	80%	100%
International Small Cap Flat Dividend Payers	9/30/1995	MSCI EAFE Small Cap® Index	39%	47%	53%	53%
International Small Cap Non-Dividend Payers	9/30/1995	MSCI EAFE Small Cap® Index	27%	21%	6%	0%
International Small Cap Dividend Cutters	9/30/1995	MSCI EAFE Small Cap® Index	51%	46%	44%	36%

Source: Ned Davis Research. 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. 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 Payer if it paid a cash dividend any time during the previous 12 months, a Dividend Grower if it initiated or raised its existing cash dividend at any time during the previous 12 months, and a Non-Dividend Payer if it did not pay a cash dividend at any time during the previous 12 months. Flat Dividend Payers included stocks that pay a dividend but have not raised or lowered their existing dividend during the previous 12 months. Dividend Cutters included stocks that lowered their existing dividend or eliminated their dividend during the previous 12 months. The Indexes mentioned are unmanaged, are not available for investment, and do not incur expenses. Past performance is no guarantee of future results. Please see the Disclosure section for important information about the Indexes mentioned herein.

No Double Vision

Investing can be an emotional roller coaster, like the Foreigner song, moving "from one to another extreme." Currently, many participants are squinting so intently at the actions of the Federal Reserve and the Magnificent Seven, that they may not be seeing straight. Often, when narrow fascinations such as these develop in the market, the best returns have already been achieved. Investors who are willing to pull back and look elsewhere though can – at times – be handsomely rewarded for going against the tide. Today, such an opportunity may reside in smaller cap companies.

As flagged here and in prior *Reviews*, we're not big believers in, or followers of, market or economic forecasts. Unlike the subject of the song, at Copeland – despite market volatility and conflicting signals that abound – we will not allow double vision to get the best of us. Instead, we will steadfastly hang our hats on the dividend actions of our companies, which we believe provide certainty in an uncertain world, both domestically and abroad.

January 2024

1 WSJ https://www.wsj.com/finance/stocks/what-did-wall-street-get-right-about-markets-this-year-not-much-7d4368fe

2 Bankrate https://www.bankrate.com/banking/federal-reserve/economic-indicator-survey-recession-risks-july-2023

3 Goldman Sachs https://www.gspublishing.com/content/research/en/reports/2024/01/01/69b8a33b-2e98-4d2a-a3e3-3ebecfbf7c30.html

4 S&P Global https://www.spglobal.com/spdji/en/indices/equity/sp-500/#overview and Copeland analysis

5 AAII https://www.aaii.com/sentimentsurvey/sent_results

6 Statista https://www.statista.com/chart/28437/interest-rate-hikes-in-past-tightening-cycles/

7 FOMC projections, June 2022 https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20220615.htm

8 BLS https://www.bls.gov/charts/consumer-price-index/consumer-price-index-by-category-line-chart.htm

9 FOMC projections, December 2022 and December 2023 https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm

10 Yahoo Finance https://finance.yahoo.com/news/how-new-inflation-numbers-complicate-the-feds-next-move-on-rates-154209367.html

11 WSJ https://www.wsj.com/livecoverage/stock-market-today-dow-jones-12-22-2023/card/pce-report-by-this-measure-inflation-is-back-to-2-by-one-measure-JQ2iYVTGN9ndCZBNYQox

12 BLS https://www.bls.gov/news.release/cpi.nr0.htm

13 SSE https://en.sse.net.cn/indices/scfinew.jsp

14 Federal Reserve, Chair Powell's 11/1/23 commentary https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20231101.pdf

15 FactSet

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

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

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Definitions

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

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