

The Wonk-onomy

*There's no earthly way of knowing
Which direction we are going
There's no knowing where we're rowing
Or which way the river's flowing*

*"The Wondrous Boat Ride"
Willy Wonka & the Chocolate Factory
1971*

While reading economic tea leaves has always been a challenging vocation, with competing indicators offering diametric insights at every point in the cycle, there has been, through the years, a general playbook on which investors could rely for guidance. It has usually gone something like this: the economy starts out growing at a moderate pace, with limited inflation and steady, relatively low unemployment; gradually, as consumers and businesses become more confident that this situation will persist, the pace of spending and hiring accelerates; with aggregate demand for workers outstripping supply, wages increase, and competition for goods and services ushers in inflation; the central bank then steps in and begins to increase interest rates, hoping to stem the tide of inflation; when rates get high enough, the incentive to save and the inability to finance purchases constrict both consumer and commercial demand, unemployment begins to rise again and inflation fades; the economy softens until the central bank feels compelled to reduce interest rates to spur growth and the cycle repeats. Or so we have always believed.

Today however, with increased globalization, asynchronous policy responses, and perhaps most significantly a global fiscal morass, decades in the making, increasingly coming to a head, this sine wave pattern appears to be in jeopardy of being permanently put out to pasture. Indeed, one might argue the pattern has demonstrated little relevance since the

Federal Reserve first lowered the Fed Funds rate to 1% in 2003, with no obvious signs that 2012 is the year that it will return to prominence as the expected pattern for economic behavior. Instead, over the aforementioned eight year span, we have witnessed increasingly volatile growth with higher highs, lower lows and shorter macro cycles.

It comes as no surprise to us then, only one quarter after the world appeared to be on the precipice of economic collapse (again), with the S&P 500 Index suffering its worst quarterly return in more than a decade, that the Index should rally sharply to finish 2011. Several economic indicators, most notably the apparent improvement in US employment, support this bullish tone. At the same time though, long-term challenges, led by the European debt problem and the need for both simultaneous austerity and stimulus, remain in the back of investors' minds, leaving many to wonder how they should be positioned in a world where favorable cyclical and destructive secular forces are likely to continue to clash.

At Copeland, we feel fortunate not to be torn by this argument, as our em-

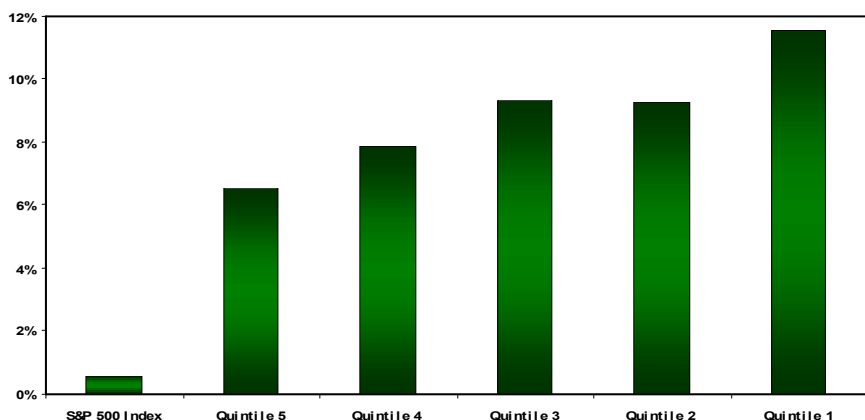
phasis on companies that consistently increase their dividends over time gives us great confidence that we can participate in strong market cycles, but avoid much of the pain associated with downturns, due to the inherent financial strength of these names. ***We believe that a company's dividend growth rate is the single most significant driver of its total return.*** We touched on this topic last quarter, but in this piece we will further flesh it out, demonstrating the strength of our conviction on the subject and the data that underpin this simple but powerful investing philosophy.

Dividend Growth: An Investor's Golden Ticket

Intuitively, the concept that growing dividends drive rising equity prices is appealing. But, it is reasonable to ask, "What convinced Copeland to pursue dividend growth investing over all other potential investment disciplines?" The link between dividend growth and stock price performance was first explained in a 1959 paper by Dr. Myron Gordon of MIT. Dr. Gordon's research demonstrated mathematically that a stock's value could be estimated by

Chart 1.

Annualized Total Return of Dividend Growth Stocks Passing the Copeland Screens
Ranked by Quintile v. the S&P 500 Index (12/31/99-12/31/11)



Source: Copeland Capital Management (Data from FactSet)

calculating the present value of all expected dividends and that, by extension, companies with higher dividends and higher expected dividend growth, should be expected to trade at higher valuations. Since then, the empirical evidence for the concept has been overwhelming. For example, Ned Davis Research shows that from 1972 through 2011, companies that grew or initiated dividends returned an average of 9.4% per year, beating companies that held their dividends flat, as well as the S&P 500 Index, by an average of 2.4% per year. To put that in perspective, \$10,000 invested in Ned Davis' dividend growth universe in 1972 would now be worth over \$332,000, while the same investment in companies that didn't grow their dividends would be worth just \$140,000. Even more striking, a \$10,000 investment in non-dividend paying stocks would be worth a paltry \$17,200.

The goal of our research however is not to reinvent this wheel, but to take the concept further. We've looked back, year by year since 1999, at performance data for all US-traded companies that have increased their dividends for at least five consecutive years. We then applied the same strict rules that govern our own portfolio decisions with regard to acceptable maximum dividend payout ratios and minimum free cash flow levels as a percentage of dividends. Ranking all remaining companies according to the output of our proprietary quantitative model, which focuses on return on capital and cash flow growth, we divided the qualifying names into five groups, or quintiles, each consisting of 20% of the total universe. Though we started with six years of backward looking data giving us great confidence in our strategy from day one, with six additional years now passed, we are gratified that we have continued to observe four things: 1) the top ranked quintile outperformed all others, 2) the performance declined across quintiles (Chart 1), 3) the top ranked quintile returned 271.8%, outperforming the S&P 500 index, which returned only 6.8%, in 11 of the last 12 years and 4) even the

worst ranked quintile in Copeland's dividend growth universe outperformed the S&P 500 index total return by 5.9% on average per year for the period.

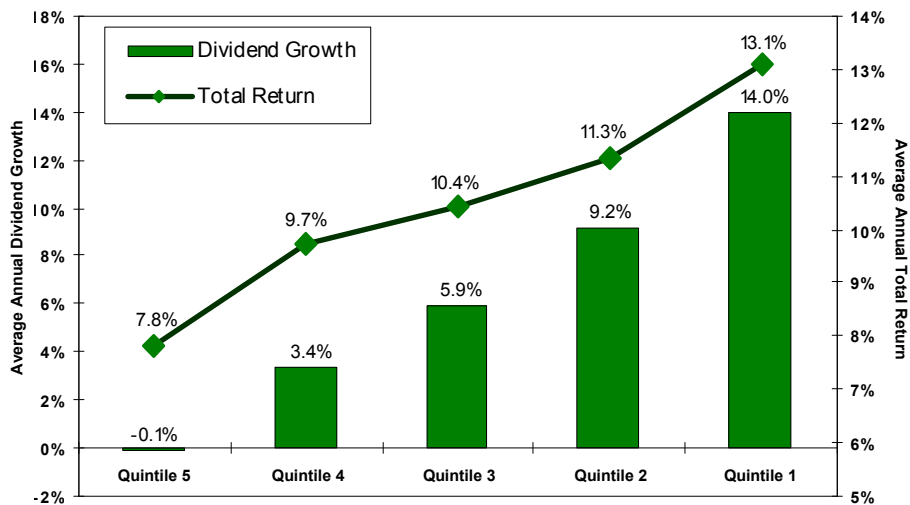
Another angle, which we have explored extensively, is the relationship between the rate of dividend growth and stock price performance. Although intuition

among the subsequent quintiles, as lower rates of dividend growth drove progressively smaller total returns (Chart 2).

These results have, of course, raised additional questions. For example: 1) what is the best balance of current yield versus dividend growth in order to maximize total returns, 2) does the effectiveness of

Chart 2.

Relationship Between the 25 Year Dividend Growth Rate of All Constant Dividend Payors & Their 25 Year Total Return (12/31/86-12/31/11)



Source: Copeland Capital Management (Data from FactSet)

Data above is based on a universe of all stocks that have paid a dividend for 25 years through 12/31/11. The stocks were ranked by their rate of dividend growth and put into quintiles. The median dividend growth rate of each group is compared to the median annualized total return of each group.

and Dr. Gordon's research suggest that faster dividend growth should translate into higher returns, we set out to confirm that there wasn't a risk that some high dividend growth names were outpacing their ability to fund other important company initiatives, such as capital improvements or brand building, which would ultimately prove detrimental to their success. Looking at 25 years of data, we ranked all 379 US-traded companies that continuously paid a dividend over that period by the growth rate of that dividend. That group was again divided into quintiles. Confirming our expectations, the quintile with the highest rate of dividend growth, 14.0% compound annual growth at the median, was also the quintile with the highest compound annual total return at the median, up 13.1%. Equally impressive was the serial decline in returns

this analysis vary across economic sectors or different parts of the market cycle and 3) can this research be extrapolated globally? Even as we explore these questions however, our findings reiterate that we are not only picking from the right pool of stocks (dividend growers), but that we have effectively instituted screens and ranking systems that direct us toward companies likely to be among the best performers in that already elite group. We look forward to sharing additional insights with you as we continue our research. In the interim, like most investors, we are closely watching economic and political developments, both domestically and abroad, but take great solace in our emphasis on buying companies that consistently grow their cash-flows and dividends, which should serve our investors well.

January 1, 2012

Company Spotlight: J&J Snack Foods Corp.

Held in the Copeland Small Cap Dividend Growth portfolio, J&J Snack Foods Corp. (NASDAQ: JJSF) is a classic example of the type of company we seek for our portfolios. Although we've previously attempted to dispel the common misconception that buying "dividend stocks" necessarily leads investors into slow growth, large capitalization, "boring" names, J&J again disproves this notion. The company is a \$1 billion manufacturer, marketer and distributor of a variety of niche snack and beverage products with nearly \$750 million in annual sales. Our ownership illustrates the key difference between Copeland's emphasis on dividend growth and other managers who focus primarily on securing high yields. Beyond J&J's current six year track record of annual dividend growth—during which management more than doubled the payout to shareholders—we find J&J's competitive market position, track record, and operating fundamentals very attractive, and believe they point to further cash flow and dividend growth.

Entrenched, durable niche food business. The company's origin dates to 1971, when CEO Gerald Shreiber acquired the then bankrupt J&J Soft Pretzel Company for \$72,000. At the time, this business generated annual sales of approximately \$400,000. Today, J&J's soft pretzel business generates more than \$130 million in annual sales and garners an estimated 70% of the US market. In addition to strong brand recognition, the company's scale and proprietary pretzel production processes bring difficult to replicate competitive advantages to J&J. Over the past four decades, management expanded J&J's product portfolio to churros, frozen beverages and other snacks by applying the same principles that drove success in soft pretzels. Specifically, management concentrates on

niches that are unlikely to attract the largest food companies as competitors, establishing scale in production and distribution, and cultivating relationships within key sales channels. With over 82,000 frozen beverage dispensers serving J&J's ICEE and Slush Puppie products throughout the US, Canada and Mexico, for example, it would be exceedingly difficult for another company to displace J&J.

Snack food always popular. Even with the secular movement toward healthier lifestyles, Americans remain drawn to "comfort" foods such as J&J's ICEEs, soft pretzels, cookies, and donuts, regardless of where we are in a given economic cycle. In a down economy, J&J's products might be viewed as small but affordable treats relative to higher ticket snack foods or desserts.

Consistent track record of growth and margin expansion. Fiscal 2011 marked J&J's 40th consecutive year of revenue growth, with the fiscal fourth quarter marking the 160th straight quarter of sales growth. Over the past decade, sales more than doubled and earnings quadrupled, as J&J's operating margins expanded to 10% from 6%. The performance is especially impressive considering the input cost headwinds—such as higher wheat prices—J&J encountered in fiscal 2011. Management continuously strives to offset cost pressures through a long held commitment to efficient manufacturing and low overhead. Importantly, J&J's return on invested capital is an attractive 16% (excluding balance sheet cash), enabling shareholder equity to compound at approximately 10% per year, without the use of leverage or additional equity offerings.

Executing on additional growth op-

portunities. Management is actively seeking to expand portfolio brands as well as to enter new snack food segments. In May 2011, J&J acquired the \$50 million (sales) frozen handheld business of ConAgra Foods for \$10 million. While the unit is expected to be dilutive to near-term earnings, the acquisition expands J&J's offerings into breakfast and dessert menus for restaurant and food service customers. We expect J&J will continue to find attractive opportunities to augment organic growth.

Stable free cash flow and low capital intensity support dividends and share repurchases. With no debt obligations, J&J is free to use excess cash flow to (1) reinvest in the business, (2) make acquisitions, (3) pay dividends, and (4) repurchase shares. Since initiating a \$0.0625 quarterly dividend in 2004 (\$0.25/year), J&J has increased the payment each year to the current \$0.13 quarterly rate (\$0.52/year), resulting in 11% average annual growth. Even after these increases however, J&J's payout ratio is only 20% and actions to-date suggest this six-year dividend achiever is poised for further boosts. Cash returns are supplemented by opportunistic share repurchases.

Business model and management track record support J&J's valuation. The stock is currently trading at 18.0x the fiscal 2012 consensus EPS estimate of \$2.85, in line with its five-year average P/E multiple. Given the company's desirable niche business model and management's long record of success building the durable, cash generating product portfolio, we believe J&J should command a premium valuation. Steady sales growth and modest operating margin leverage, combined with slight multiple expansion, should push shares of J&J to meaningfully higher levels over time.

The information presented is intended to illustrate the performance of a single stock. There is no guarantee that investors will experience the type of performance reflected.

This is not the performance of the firm and

OUR STRATEGIES

Dividend Growth Strategies

Large Cap Dividend Growth

30-40 stocks, with market capitalizations of \$2 billion and above, restricted to companies that have increased their dividends for at least five consecutive years.

Mid Cap Dividend Growth

30-45 stocks, with market capitalizations of \$1 billion - \$15 billion, focused on companies that have consistently increased their dividends.

Small Cap Dividend Growth

30-45 stocks, with market capitalizations of \$250 million - \$2 billion, focused on companies that have consistently increased their dividends.

Risk Managed Dividend Growth

Generally 30 to 45 stocks with market capitalizations of \$250 million and above, restricted to companies that have increased their dividends for at least five consecutive years. The strategy also employs a tactical sector weighting methodology where we have the ability to completely avoid certain sectors and raise cash based on quantitative signals.

Relative Value Strategies

Large Cap Equity Relative Value

30-40 stocks, with market cap \$5 billion and above, restricted to companies trading at a discount to their historical average relative valuation.

Concentrated All Cap Equity Relative Value

25-30 stocks, with a market cap \$250 million and above, restricted to companies trading at a discount to their historical average relative valuation.

Fixed Income/Balanced

Approximately 15-20 issues of investment grade securities, with an intermediate term focus. Balanced allocation flexible based on market activity and client objectives.

About Copeland Capital Management

Copeland Capital Management is an employee owned, registered investment adviser with offices in Conshohocken PA and Wellesley MA. The firm specializes in managing dividend growth and relative value equity strategies for both institutions and high net worth individuals. For more information, please contact Chuck Barrett, Director of Sales and Marketing at (484) 351-3665 or cbarrett@copelandcapital.com.

Disclosures:

Past performance is not indicative of future results.

S&P 500 Index consists of 500 stocks chosen for market size, liquidity and industry group representation. It is a market value weighted Index with each stock's weight in the Index proportionate to its market value. Standard and Poor's is the owner of the trademark service marks and copyrights of the S&P 500 Index. You cannot invest directly in an Index.

The information presented in Charts 2 is intended to illustrate the performance of S&P 500 stocks according to their dividend policy. This is not the performance of the firm and there is no guarantee that investors will experience the type of performance reflected in this table.

The material in this letter is for informational purposes only. It represents an assessment of the market environment at a specific point in time and is intended neither to be a guarantee of future events nor as a primary basis for investment decisions. It should also not be construed as advice meeting the particular needs of any investor. Neither the information presented nor any opinion expressed constitutes a solicitation for the purchase or sale of any security.

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