The Copeland Review

First Quarter 2023

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

Won't Get Fooled

A change, it had to come
We knew it all along…
And the world looks just the same
And history ain't changed…
- The Who, Won't Get Fooled Again 1971

In our experience, successful investors must also be strong students of history. Whether one follows the admonition of Santayana that failing to remember history will condemn you to repeat it, or the softer – but no less relevant – take by Twain that "history doesn't repeat itself, but often rhymes", the outcome is the same as far as the markets are concerned. Namely, if one sticks around long enough, he or she will surely live to see similar mistakes repeated by investors, central banks, companies, and even regulators again and again.

This is not to say that these folks are incapable or incompetent, but simply that after some period of success they often begin to lose sight of the downside risks in economic cycles. Regrettably, today, we are working our way through just such a situation.

In evaluating what's happened so far this year, while also looking forward, we highlight three important points in this *Review*:

1. After more than a decade of historically low interest rates, it should not – in our opinion – come as a surprise that the Federal Reserve's on-going rate hiking campaign drove a violent outcome. In fact, the experience of prior tightening cycles suggests that some sort of market "break" is a near certainty. Now, the key question – after recent bank failures – is, "Is that as bad as it gets?"
2. Whether or not there is a crisis, rising interest rates and shrinking deposit balances are driving down both the willingness and ability of banks to lend. This puts further pressure on economic growth, increasing the already-high likelihood of recession, as called out in our second quarter 2022 commentary, "You've Lost that Lovin' Feeling".
3. Our suggested approach for investors to improve the chances that they "won't get fooled again," is to focus on dividend growth stocks, which have historically outperformed their benchmarks during periods of weakness and recessions.

Meet the New Boss, Same as the Old Boss

Given the Federal Reserve's monetary policy response to the current bout of inflation, one might assume the "new boss" is Jay Powell and the "old boss" is Alan Greenspan. After all, both have been criticized for responding too slowly to their respective economic challenges.[1,2]

The difference though, is that whereas Greenspan (and Ben Bernanke after January 2006) actually raised interest rates slowly in response to the housing boom – taking more than two years to lift them 425 basis points – Powell's approach is better described as late, as he stuck with his claim that inflation was "transitory," even after eight straight months of core CPI readings above 3.0% (year-over-year), and three straight months of sequential acceleration.[3,4]

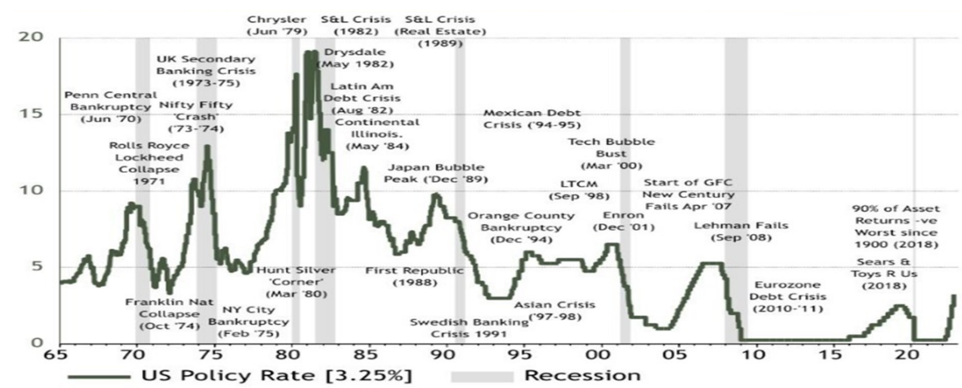
Yet, upon succumbing to reality, Powell has been anything but slow, raising rates by 475 basis points in only 13 months – more than twice the pace of Greenspan/Bernanke's response to the housing bubble.[4] We foresaw this possibility in our first quarter piece from last year, "White Rabbit," noting that when he eventually began increasing rates, Powell would likely need to be aggressive to reign in rising prices.

Consequently, one year in, both the pace and the magnitude of the current tightening cycle evoke faint memories not of Greenspan, but of another of Powell's predecessors, Paul Volker. Though today's Federal Funds (Fed Funds) rate is modest by comparison, the current cycle is the most aggressive the economy has experienced since Volker famously boosted rates to 20.0% in 1981 to crush the inflation that had lingered since the mid-1970s. The rapid hikes should improve Powell's prospects for bringing inflation under control.

Still, Chart 1 demonstrates the potential downside. Historically, market weakness, recessions, and financial crises have consistently followed interest rate spikes – including a 28% pullback in the S&P 500 Index from late 1980 through the summer of 1982.[5]

To be fair, some "crises" are more dramatic than others. While most readers will remember – perhaps with a shudder – the near-collapse of the global banking system in 2008, some may not be as familiar with the Orange

Chart 1. Fed Tightening Cycles Always "Break" Something



Source: https://www.linkedin.com/pulse/three-hard-truths-next-financial-crisis-st%C3%A9phane-renevier-cfa/?trk=public_post

County (CA) bankruptcy of December 1994. While those holding local municipal bonds suffered severe losses, the S&P 500 Index rose more than 9% over the next quarter and US GDP (Gross Domestic Product) continued to rise unabated.[5,6,7]

Today, investors are left wondering whether the recent bank failures are canaries in the coal mine of economic contagion, or isolated incidents with few long-term implications for the market at large.

The good news is that, as the first quarter drew to a close, there was no further evidence of bank runs or capital-raising actions that ultimately doomed Silicon Valley Bank and others. The bad news is that neither had many banks shared updated data on their deposit balances or their credit metrics. Moreover, when we divide prior Fed tightening cycles into two baskets – those that ended with a soft landing, and those that ended with a hard landing – and compare the current tightening cycle to each one, both the magnitude and the steepness of the ascent of the current cycle look more like the latter (Chart 2) suggesting more turmoil lies ahead.

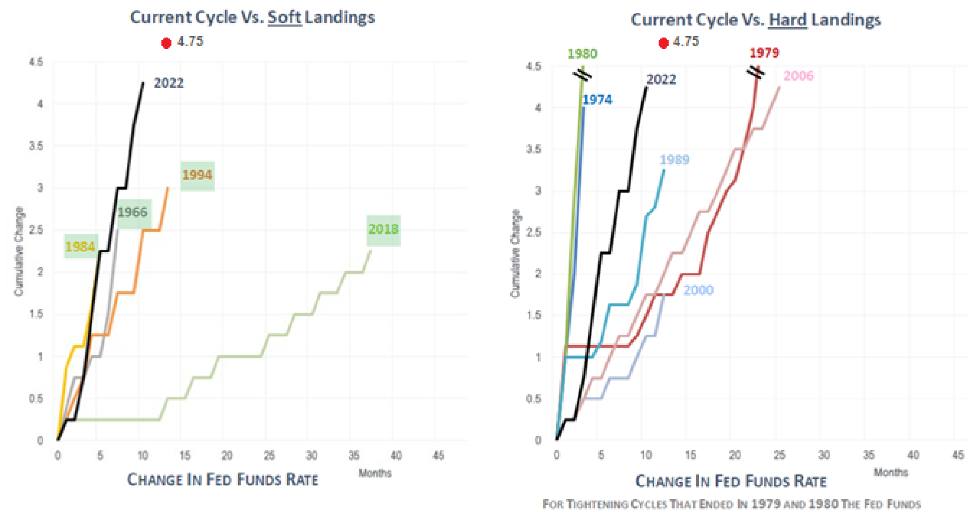
Easy Come, Easy Go

There were many beneficiaries of the extremely low interest rates that prevailed from the end of the Great Financial Crisis until early 2022. Home buyers benefitted from attractive mortgage rates, while many existing homeowners were able to refinance and secure lower payments. At the same time, equity investors were generally rewarded handsomely for plunging headlong into the market, as the S&P 500 Index returned more than 800% from the March 2009 low through the end of 2021 versus only 39% over the preceding 13 years.[5]

For most of this period, one asset class that was not rewarded was cash. With banks offering no interest checking and low yield savings accounts, customers were disincentivized from holding much liquidity beyond their working capital needs. Thus, deposits grew at a modest 4.5% annualized rate from the first quarter 2009 through the end of 2019, barely matching nominal GDP growth over the same period.[8]

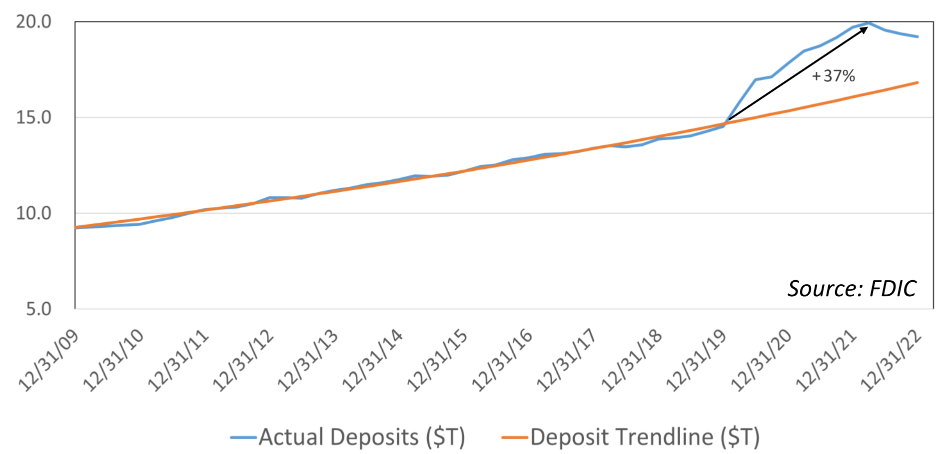
With the onset of the pandemic however, and the arrival of government stimulus for corporations and individuals alike, bank deposits exploded, leaping 37% by March

Chart 2. Current Fed Tightening Cycle Versus Prior Fed Tightening Cycles



Source: Piper Sandler

Chart 3. Though Down from Their Peak, Bank Deposits Remain Far Above the Historical Trend



2022.[9] (Chart 3)

Now, with banks opting to lift deposit rates very slowly, as customers have withdrawn funds to deal with rising expenses or to secure higher yields in low-risk vehicles like U.S. Treasuries, balances are reversing rapidly.

From their peak at $19.9 trillion in the first quarter of 2022, aggregate deposits at FDIC insured institutions fell almost 4% by year end – the fastest such decline since at least 1984. Though the banks' commitment to keeping rates low protects industry-wide margins in the near run, it has pushed their loan-to-deposit ratio up from 56% to 63%, diminishing lending capacity moving forward.[9]

The trend only worsened in the most recent quarter, exacerbated both by additional Fed hikes and the aforementioned bank failures, which drove heightened concern among large clients that their uninsured deposits were in jeopardy. Unfortunately, the reversal of the outsized growth experienced in recent years seems likely to persist, as deposits remain well above the historical trend line.

Concurrently, given the rising rate environment, some banks have suffered significant losses in their bond portfolios. Due to accounting rules, these unrealized losses may not officially reduce regulatory capital positions that govern banks' ability to lend. Yet, in combination with shrinking deposit balances across the industry, and rising credit risk as the economy softens, they are certainly weighing on their willingness to make loans (Chart 4).[10]

History Ain't Changed

As noted above, many businesses benefited from more than a decade of very low interest rates. There is, however, a difference between benefiting from the Fed's once accommodative

Chart 4. Net Percentage of US Banks Tightening Lending Standards at Highest Level Since COVID-19

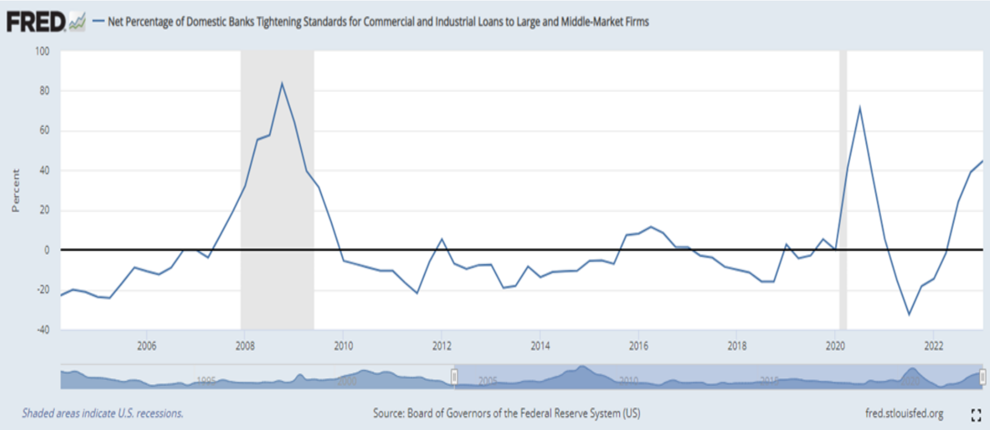
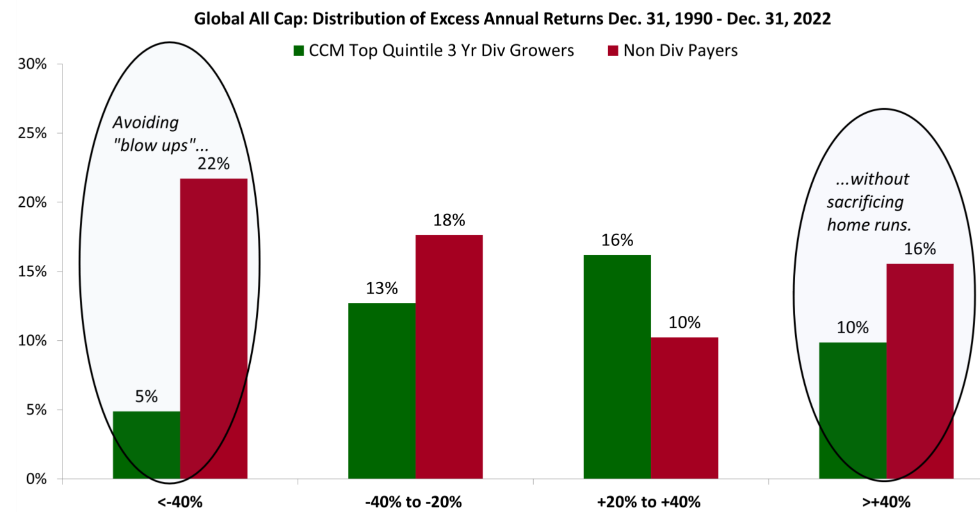


Chart 5. Only 5% of companies in the top quintile of Copeland's model underperform the benchmark by 40%+ in any given year versus more than 20% of non-dividend payers that suffer the same fate



Source: : FactSet and Copeland Capital Management. The information presented is intended to illustrate the performance of Global stocks according to their dividend policy. The chart above illustrates the lower error rate via the distribution of relative returns for Global Dividend Growth Stocks relative to non-dividend paying Global stocks. Returns shown include dividends reinvested. 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. Dividend Growers included stocks that raised their existing dividend or initiated a new dividend during the previous 12 months. Non-Dividend Payers included stocks that have not paid a dividend during the previous 12 months. Three-year dividend growers are stocks that have raised their dividends for three consecutive years, while Copeland's top quintile three year dividend growers are a subset of this group of stock that rank highest in Copeland's stock ranking model. There is no guarantee that companies will declare dividends or, if declared, that they will remain at current levels or increase over time.

policy and fooling yourself into relying on it as a part of your business model or investment strategy. Since the third quarter of 2020 we've highlighted the proliferation of low profitability companies ("Great Expectations," "Running Hot"). Unfortunately, for these, and other businesses dependent on capital access, the world won't "look just the same" going forward, as zero interest rate policies (ZIRP) that prevailed in recent years are unlikely to return.

True, some market prognosticators have mistakenly forecast the end of ZIRP before only to be stymied as central banks and debt markets reverted to extremely accommodative levels. However, after the recent spate of hikes, even if rates moderate somewhat, any near-term hope for a return of "free money" seems misguided given the already explosive growth of the Fed's balance sheet following the Great Financial Crisis and then again during COVID-19. In combination with persistent inflation, we expect these conditions will give Powell, like Volcker, cover to keep rates higher for longer.

Nevertheless, at Copeland we feel confident that at least one element of "history ain't changed." Namely, we believe that our dividend growth strategy remains a favorable approach to providing downside protection in periods of tumult (Chart 5). The current environment has invited major declines in both individual stocks and high-risk investment strategies, regardless of geography. We believe, however, that companies with business models capable of producing resilient cash flows, and management teams carefully allocating capital with their next promised dividend hike in mind, are far less likely to "blow up" than non-dividend paying companies and the market as a whole.

April 27, 2023

[1] *https://www.reuters.com/article/us-usa-fed-greenspan/greenspan-says-fed-did-not-fuel-the-housing-bubble-idUSTRE62H3OO20100318*
[2] *https://www.wsj.com/articles/behind-the-feds-slow-pivot-to-tackling-inflation-11644930180*
[3] *https://fred.stlouisfed.org/series/CPILFESL*
[4] *https://www.forbes.com/advisor/investing/fed-funds-rate-history/*
[5] *FactSet*
[6] *https://www.ocregister.com/2019/12/06/heres-how-orange-county-went-broke/*
[7] *https://fred.stlouisfed.org/series/GDP*
[8] *https://fred.stlouisfed.org/series/GDP*
[9] *https://www.fdic.gov/analysis/quarterly-banking-profile/*
[10] *https://fred.stlouisfed.org/series/DRTSCILM*

About Copeland Capital Management

Copeland Capital Management is an employee owned, registered investment adviser headquartered in Conshohocken PA. The firm specializes in managing Dividend Growth strategies for both institutions and high net worth individuals.

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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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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.

Definitions

Consumer Price Index (CPI) – A measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas.

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

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