The Copeland Review

Fourth Quarter 2019

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

Kevin: How's your portfolio?

Meet the 20s

- Meet the Parents, 2000

Greg: I'd say strong…to quite strong

It may be hard for investors today to recall the broad-based trepidation that remained in the market as the 2000s gave way to the 2010s. At the time however, the crushing impacts of the financial crisis and the ensuing recession remained fresh in people's minds on both Wall Street and Main Street. Indeed, despite the S&P 500 posting a total return of 26% in 2009, the annualized total return for the decade was down -1% [1] – the Index's worst decade since the Great Depression.[2]

Yet, we enter the 2020s in an entirely different frame of mind. Stocks – again measured by the S&P 500 – have now been in a sustained uptrend for more than ten years. As a result, backed by both expanding earnings and valuations, global equities are at or near all-time highs, and the S&P 500 remains in the midst of its longest and strongest recorded bull market (on a total return basis), having surpassed the 1990s boom.[1,3]

Within this strong decade-long run, 2019 was a particularly robust period, marking only the second year in more than two decades that the S&P 500 Index posted a total return of greater than 30%. Meanwhile, although they failed to keep pace with large cap peers, small cap, mid cap and international stocks, as represented by the Russell Mid Cap, the Russell 2000 and the MSCI EAFE Indices respectively, all recorded gains of greater than 20%.[1] Accordingly, it's no shock that many investors currently echo Greg's sentiment.

Profits Trending Down

The year's broad-based gains are remarkable when set against the framework of earnings expectations, which came under pressure during the last twelve months (Table 1). Indeed, the constituents of the S&P 500 Index – once expected to generate 8% year-over-year profit growth in 2019 – are now barely projected to exceed a 1% lift for the year. Moreover, 2020 estimates declined 7% for large caps, 11% for international stocks as represented by MSCI EAFE and MSCI EAFE Small Cap Indices, and 22% for small caps. Within the S&P 500, economically sensitive sectors, including Energy (with estimates down 30%), Materials (-19%) and Industrials (-9%), were most prominent in driving those numbers lower, though virtually all sectors saw estimates fall. In fact, only the Healthcare sector saw its profit prospects improve, climbing a modest 2%.

This poor earnings momentum, in combination with the strength of the market, led the next twelve-month price-to-earnings (P/E) ratio for the Index to bounce from 14.6x – slightly below the prevailing ten-year median at the time – to 18.1x at year-end.[1]

Looking down the market cap spectrum and around the world as well, the trend of declining estimates and rising P/E multiples is just as pronounced, if not more so (Table 2).

Of course, it's not uncommon for estimates to moderate throughout any given year. Still, 2019 stands in stark contrast to 2018. Whereas this year saw the market climbing while estimates fell, last year finished very weakly even as estimates rose, helped in part by the tax cut. Playing no small part in this phenomenon were the actions of the Federal Reserve. The sharp market pullback in the waning months of 2018 was heavily influenced by the four interest rate hikes over the course of that year, and hawkish commentary suggesting there were more hikes to come even as many investors feared an impending recession. When the monetary authority reversed course – ultimately cutting rates three times over the course of 2019 – it soothed market sentiment even as earnings deteriorated, in part due to the lagged effect of the earlier hikes. It's our belief that given the magnitude of the market rally and valuation expansion in recent

Table 1. Changes in projected Index earnings estimates, by year, between 12/31/18 and 12/31/19

	2019 EPS Estimates as of:			2020 EPS Estimates as of:		
	12/31/2018	12/31/2019	%Chg	12/31/2018	12/31/2019	%Chg
S&P 500	$172	$162	-6%	$191	$177	-7%
Russell Mid Cap	$335	$303	-9%	$373	$337	-10%
Russell 2000	$187	$130	-30%	$227	$177	-22%
MSCI EAFE	$145	$129	-11%	$155	$138	-11%
MSCI EAFE Small Cap	$16	$14	-13%	$18	$16	-11%

Source: FactSet. See Disclosures for important information and a description of the Indexes mentioned above.

Table 2. Next twelve-month price-to-earnings ratios by date

	S&P 500	Russell Mid Cap	Russell 2000	MSCI EAFE	MSCI EAFE Small Cap
12/31/2018	14.6	14.2	17.9	11.9	13.7
12/31/2019	18.2	18.2	23.4	14.8	14.8
Multiple Expansion (pts)	3.7	3.9	5.5	2.9	1.1
Multiple Expansion (%)	25%	27%	31%	24%	8%

Source: FactSet, CCM. See Disclosures for important information, definitions and a description of the Indexes mentioned above.

months, both earnings momentum and a supportive Federal Reserve are prerequisites to sustain the bull market going forward.

You've Gotta Strike While the Iron is Hot

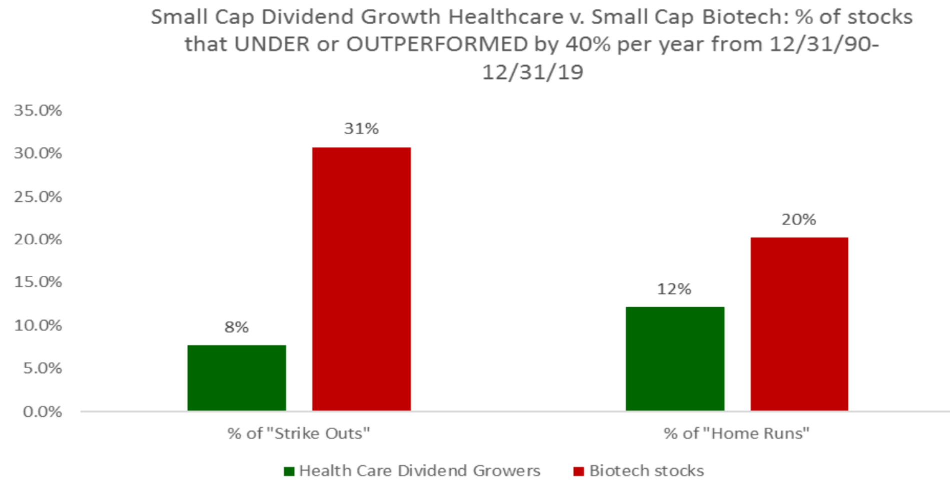
Kevin: *What about you, Greg? What line of work are you in?*

Greg: *I'm in health care.*

Kevin: *Yeah, so you know what I'm talking about. There are a lot of Benjamins to be made now with biotech stuff. I don't have to tell you that…You've gotta strike while the iron's hot.*

Despite our steadfast belief that dividend growth stocks will outperform the market over a full economic cycle, investors cannot realistically expect them to outpace their benchmarks every day, month or quarter. Indeed, even in a year like 2019, during which dividend growers saw robust absolute returns (Table 3), there can be wide variation across periods.

Chart 1. A Few More Homeruns, But MANY More Strike Outs



Source: FactSet. 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.*** *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. Please see the Disclosures section for definitions and other important information.*

Take, for example, third versus fourth quarter results for small cap stocks. After a risk-off third quarter, in which small cap dividend growers rose while non-dividend payers and the Russell 2000 Index fell, the relative performance balance flipped in the fourth quarter as risk appetites grew. Though all three buckets reported positive absolute returns in the final frame, dividend growers were up 7.5%, while non-dividend payers spiked 16.4%, carrying the benchmark to a 9.9% return.[4]

Much of this gap can be traced to the recent strength of biotech stocks – which account for more than 10% of the Russell 2000 Index, but which are not represented within the small cap dividend growth opportunity set. If ever there were an industry that represents the polar opposite of dividend growth stocks, small cap biotech is it. Whereas the dividend growth universe is commonly characterized by established businesses with strong earnings, cash flows and balance sheets, small biotech companies are often unprofitable, and are therefore forced to raise money in both the debt and equity markets to support capital investment and the expensive personnel required to perform their research. While they all hope to make significant scientific discoveries, only a small percentage of them will succeed and become economically viable; an even a smaller percentage will see their stocks take off given the dilution they face along the road to scientific success.

Nevertheless, for the most recent period, the S&P Small Cap Biotechnology Industry Index rallied more than 29% – its best quarterly result in more than 10 years! Suffice to say, that left steady dividend growers in an unusually disadvantageous position.[1]

Still, while frustrating in the near run, our conviction in the long-term benefit of applying a dividend growth approach to investing in the health care sector is unchanged. The historical advantages of such an approach are evidenced by comparing the distribution of annual returns of small cap biotech stocks to small cap dividend growth health care stocks (Chart 1).

Much as "striking while the iron is hot" may feel great for investors when it happens, the potential for "homeruns" (i.e. stocks that outperform the benchmark by 40% or more) is only modestly higher in small cap biotech – at 20% in any given year – than in dividend growth health care stocks at 12% per year. On the other hand, the potential for "striking out" in biotech (i.e., investing in stocks that underperform the benchmark by 40% or more) is nearly four times greater than in dividend growth health care names – at 31% versus only 8%, respectively.

The outperformance of high-risk, low profitability stocks played out across all sectors, market caps and regions in Q419, making for a tough relative performance period for Copeland's dividend growth strategies. Thankfully, the full year results were more favorable for dividend growers and particularly for Copeland, despite robust benchmark returns. With total returns of 23% or greater across all market caps and geographies (Table 3), the sub-segments of the dividend growth universe broadly finished only slightly behind these challenging benchmarks in 2019. As a reminder, regardless of market capitalization or region, we believe that our dividend growth approach can provide resilience during market downturns and has the potential to keep up better than most defensive strategies in strong upward moving markets. This certainly was the case not just in 2019, but for the full decade of the 2010's as well (Chart 2).

We are particularly gratified to see the strong absolute results within each dividend growth bucket – and the corresponding results for our Dividend Growth portfolios – as they did not benefit from the same level of multiple expansion as the benchmarks. Instead, our portfolios relied upon stronger earnings results to drive their returns.

Consider the Copeland Small Cap portfolio versus the Russell 2000 Index. On 12/31/18, our portfolio sported a next twelve-month price-to-earnings ratio of 15.7x. Since then, the multiple has expanded 23% to 19.3x. However, over the same period, the Index saw its valuation balloon from 17.9x to 23.4x next twelve-month earnings, representing a 31%, jump. Alternatively, the median EPS growth rate for companies in our portfolio over the last year was 10%, outpacing the meager 3% result posted for the Index.[1]

Some investors may find our earnings growth advantage surprising as we occasionally hear the rejoinder that companies that issue dividends – especially those in the small cap space – must lack attractive investment opportunities for their capital. We reject that notion.

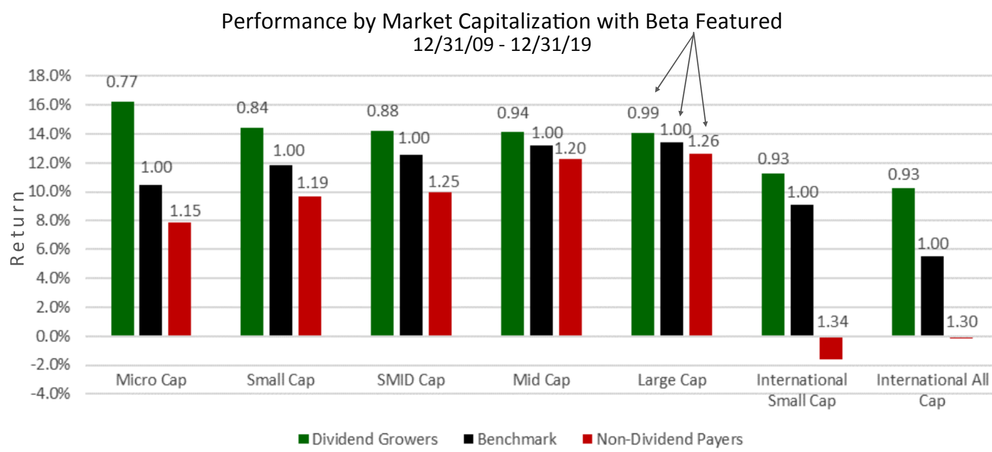
Instead, we highlight that in order to grow dividends on a consistent year-over-year basis, companies must also grow their earnings and cash flows, or they will quickly become saddled with high payout ratios and find themselves unable to continue the practice. Further, while acknowledging that any capital returned to shareholders via a growing dividend cannot be reinvested into the business, our experience shows that a balanced capital allocation philosophy – including an emphasis on a modest but consistently growing dividend – provides an important governor on management while supporting expansion of the core business. Rather than pursuing unnecessarily risky projects that often wind up being capital destructive, we believe that management teams of companies with track-records of consistent dividend growth are more likely to walk away from those types of "opportunities." They know that their shareholders will be severely disappointed, and their stocks will be punished in the event that they fail to provide a dividend hike in response to an investment that goes awry.

Table 3: Despite Strong Absolute Returns, Dividend Growers Broadly Fell Short of the Benchmarks

Style	Benchmark Index	Dividend Growth Universe Return	Benchmark Return	+/-
Micro Cap	Russell Micro Cap	24.1%	22.4%	1.7%
Small Cap	Russell 2000	23.4%	25.5%	-2.1%
SMID Cap	Russell 2500	24.8%	27.8%	-2.9%
Mid Cap	Russell Mid Cap	29.1%	30.5%	-1.4%
Large Cap	S&P 500	29.7%	31.5%	-1.7%
International Small Cap	MSCI World Ex US Small Cap	24.3%	25.4%	-1.1%
International All Cap	MSCI World Ex US	25.4%	22.5%	2.9%

Source: NDR, Bloomberg. 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.*** *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. Please see the Disclosures section for information about the Indexes referenced above and other important information.*

Chart 2: Dividend Growers Outperformed With Less Risk, Even During a Decade of Strong Returns



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Indeed, even as we look back on the 2010s – a decade marked by strong global equity returns – we believe this phenomenon helps to explain the success of dividend growth stocks (Chart 2) even as they offered significantly lower risk, despite our good fortune to have avoided a bear market for the entire period.

With this construct in mind, though we've heard wide-ranging market prognostications, we feel confident that our dividend growth approach offers our clients strong potential to outperform regardless of whether the next decade winds up being known as the Roaring 20s, the Snoring 20s or even something more nefarious.

January 2020

1 *FactSet*

2 *Morningstar, https://www.slickcharts.com/sp500/returns*

3 *https://www.cnn.com/2019/04/23/investing/bull-market-history/index.html*

4 *Ned Davis Research*

About Copeland Capital Management — Copeland Capital Management is an employee owned, registered investment adviser with offices in Conshohocken PA, Wellesley MA and Atlanta GA. The firm specializes in managing Dividend Growth strategies for both institutions and high net worth individuals. For more information, please contact Chuck Barrett, Senior Vice President - Director of Sales and Marketing at (484) 351-3665, cbarrett@copelandcapital.com or Robin Lane, Marketing Manager at (484) 351-3624, rlane@copelandcapital.com.

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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.

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.

P/E Ratio - The 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.

Net Income – Net Income is equal to net earnings (profit) calculated as sales less cost of goods sold, selling, general and administrative expenses, operating expenses, depreciation, interest, taxes and other expenses. This number appears on a company's income statement and is an important measure of how profitable the company is.

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