The Copeland Review

Fourth Quarter 2024

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

Red Light, Green Light

"There's this saying in investing, 'Try not to keep your eggs in the same basket.'"

- "The Most Stressful Tug-o-War Game," Squid Game, 2023

In the popular horror-thriller series, Squid Game, players in financial hardship participate in simple games, hoping to reverse their luck, but suffering brutal consequences when they lose.

Over the last two years, the US stock market has felt like a simple game too, but – unlike in the show – this "game" has been played seemingly without risk. Investors who built portfolios exclusively of technology stocks, have watched as any concern of financial hardship has quickly melted away.

Against this euphoric backdrop, we address three important considerations moving forward as investors contemplate whether the market is flashing a red or green light:

1. The Federal Reserve (Fed) has so far managed a "soft landing," as inflation has moderated considerably and unemployment has remained relatively subdued. This exercise, along with excitement surrounding a more business-friendly political backdrop, has spurred an aggressive rally in the "Magnificent Seven" stocks, but also in smaller, lower quality names.

2. Meanwhile, despite rate cuts from the Fed, yields on longer term bonds are rising, a condition that is typically inconsistent with speculative stock market rallies, and could present a significant hurdle to further gains.

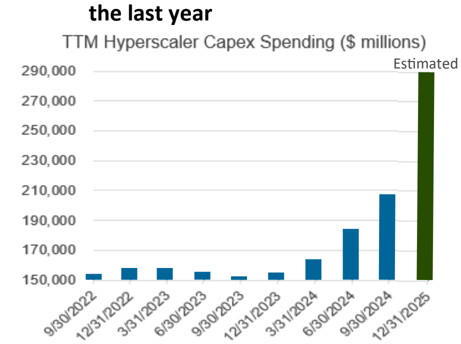
3. By contrast, after a challenging period for dividend growth stocks, valuations have never been more attractive and the dividend growth gap versus the index is unusually wide. Should the market become more discerning, as it often does when interest rates are elevated, these characteristics would seem well-suited to support dividend growth outperformance.

Tug-of-War

As we've addressed before, the Fed has been playing a precarious game of tug-of-war for three years – aiming to slow inflation (*White Rabbit*), while avoiding a potential recession (*Surprise!* and *Double Vision*) - as its target interest rate moved from zero to more than 5%.

Remarkably, the Fed appears to have successfully achieved its goal. Since peaking at 6.6% in September 2022, the year-over-year growth of US core CPI – a measure of inflation that removes volatile food and energy prices – has fallen consistently, finishing 2024 at 3.2%.[1] Meanwhile, over the same period, unemployment has only ticked modestly higher – from 3.5% to 4.1%.[2]

Chart 1. Hyperscaler capex has exploded over the last year



Source: For periods through 9/30/24, as well as the 2025 estimate for Alphabet all data comes from FactSet. The 2025 estimates for the remaining companies are based on company commentary.[6] Note: Hyperscalers are cloud service providers that offer computing power and storage capacity to enterprises and individuals on a large scale. The chart represents the capital expenditures at five of the largest such companies: Alphabet (GOOGL), Amazon (AMZN), Meta (META), Microsoft (MSFT), and Oracle (ORCL).

Table 1. None of the top 10 performing stocks in the Russell 2500 during 4Q24 are expected to be profitable in '24-26

Company	Return in Q4 2024
Rigetti Computing, Inc.	*1,848.67*
D-Wave Quantum Inc.	*754.61*
Scholar Rock Holding Corp.	439.58
IonQ, Inc.	*377.92*
SoundHound AI, Inc Class A	*325.75*
Kodiak Sciences, Inc.	281.23
RealReal, Inc.	248.09
SES AI Corporation Class A	*242.29*
Poseida Therapeutics, Inc.	235.66
Archer Aviation Inc Class A	221.78

Source: FactSet, CCM; Italicized names have direct exposure to AI and quantum computing trends

This "Goldilocks" outcome led 2023 and 2024 to be the first back-to-back years of greater than 20% returns for the S&P 500 Index since 1998-1999.[3]

At the risk of sounding like a broken record though, it's important to remember that, as we've described in prior pieces (*Ant-Man and the Hulk*), much of this strength can be traced to the so-called "Magnificent Seven."[4]

Of course, this performance is not necessarily unwarranted. After all, the group is populated with high returning, highly cash generative companies. Still, their run over the last two years is striking, as these seven names have:

- Accounted for approximately 60% of all gains in the S&P 500 Index
- Seen their weighting in the benchmark explode from 20% to nearly 34%
- Experienced a substantial increase in their collective valuation, from 21x next 12 month earnings at the end of 2022 to 32x earnings today[5]

Yet much of their recent strength is not just a reflection of these admirable qualities noted above, but also of extreme excitement about their aggressive investments in "moonshot" AI and quantum computing projects (Chart 1).

This enthusiasm has leaked into supposed ancillary beneficiaries of these investments, leading them to boom as well, even those with no expectation of profitability through at least 2026 (Table 1).

Moreover, the outperformance of lower quality names is not exclusive to this eye-popping list. Indeed, non-dividend paying SMID Cap stocks outpaced SMID Dividend Growers by over 600bps in the quarter, while the lowest quintile of SMID Cap stocks arranged by profitability (ROIC, return on invested capital) trounced the highest ROIC quintile by more than 1000bps (Charts 2a & 2b, next page).

Which way are interest rates going again?

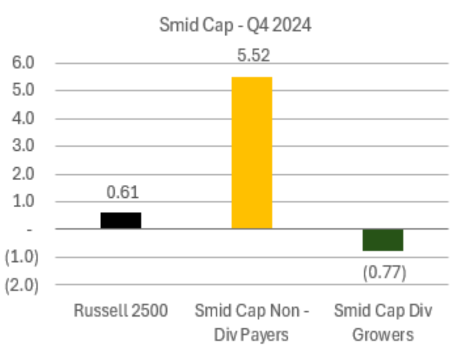
If you ask most people which way interest rates are moving, they are likely to think of the trend in the Fed Funds rate. Even sophisticated investors can fall into this trap.

Consequently, with the Fed recently announcing its third rate cut in as many meetings, you could be forgiven for assuming that interest rates have moved lower over that time. Yet, policy rates, which the Fed dictates, are different from market rates, which frequently determine borrowing costs for consumers and businesses.

Since mid-September 2024, though the Fed Funds rate has fallen from 5.50% to 4.50%, the two-year US Treasury yield has actually bumped higher by 65 basis points and the ten-year US Treasury yield has spiked upward by 93 basis points (Chart 3).[3]

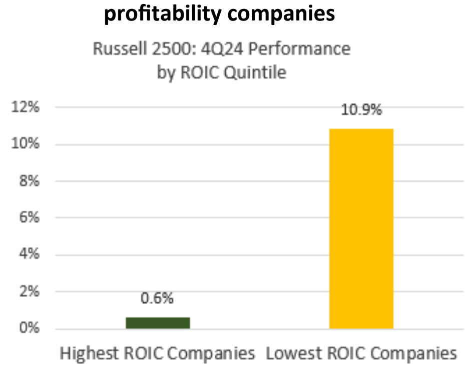
Similarly, from their late September 2024 lows through the end of the year, both the average 30-year fixed mortgage rate and the cost of single A-rated corporate debt, have increased significantly.[7,8]

Chart 2a. Non-dividend paying SMID Cap stocks led the market in Q424



Source: 2024 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved. The information presented is intended to illustrate performance of Smid Cap stocks according to their dividend policy in Q4 2024. 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. There is no guarantee that companies will declare dividends or, if declared, that they will remain at current levels or increase over time. You cannot invest directly in an Index.

Chart 2b. Low profitability names crushed high profitability companies



Source: FactSet, CCM; chart presents total returns by highest and lowest ROIC quintiles. Within the quintiles, stocks are equal weighted and sector neutral.

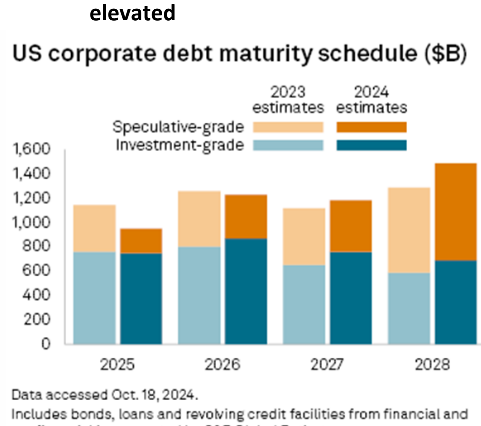
Therefore, while certain companies were fortunate enough to refinance a portion of their borrowings and push their maturities out beyond 2025 when rates were lower earlier in the year, those that failed to do so are likely to see interest costs rise materially, perhaps even to levels that threaten their on-going viability. Indeed, after falling to a level not seen since at least 1980, trailing twelve-month bankruptcies in the US have risen for nine consecutive quarters, including a 34% year-over-year increase in the third quarter of 2024.[9] Further, should market rates stagnate at this level or, worse yet, continue to drift higher, an even larger cohort of corporate bonds will need to be refinanced in each of the next three years (Chart 4); and, all of this is to say nothing of the $9T of government debt that will also need to be rolled throughout 2025.[10,11]

In this landscape, it's difficult to reconcile the continued speculative behavior in the marketplace with the potential risks. Contrast, for example, the current environment with 2020, another period of substantial risk-taking. At that time, the Fed cut rates aggressively and the government flooded the economy with trillions of dollars to support both consumers and businesses. Today, not only are interest rates considerably higher, but the Trump administration plans to implement additional tariffs and to empower the Department of Government Efficiency to slash spending.

Chart 3. Since September 2024, despite three Fed Funds rates cuts, Treasury rates have moved higher

Source: FactSet.

Chart 4. While companies reduced their 2025 maturities over the last year, the debt maturing in 2026-2028 remains elevated



Source: S&P Global.

Further, though inflation has moderated, it remains stubbornly high and economic growth continues to surprise on the upside—feeding concerns that the Federal Reserve will pause future interest rate reductions.

"Business-friendly" administration or not, we believe that with investors ignoring risk even as the market froth builds, the odds of a "red light" have certainly increased.

Finding Other "Eggs"

Unfortunately, wedged between the extreme concentration of returns in the large cap space and a fervor for low profitability momentum stocks in the SMID cap universe, dividend growth stocks did not perform up to their typical standard in 2024.

As a result of this irrationality though, dividend growth stocks now trade at their steepest discount versus the benchmark in 20 years Chart 5).

Notably, the last time they traded so inexpensively relative to the market was at the end of 2020. Though past performance is no guarantee of future results, it is worth noting that that period was followed by a three-year window during which Dividend Growers outpaced the benchmark and crushed the returns of non-dividend paying stocks (Chart 6).

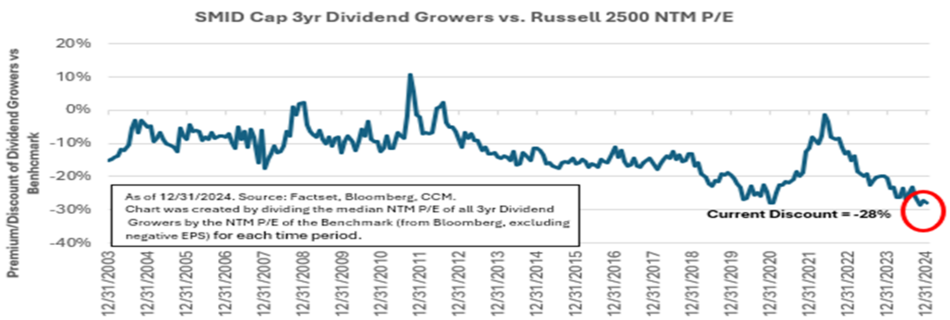
Performance during 2022 is particularly interesting to call out. Though it was only two years ago, it seems to have been long forgotten by many investors who are convinced that the Magnificent Seven's ascent is unassailable and will persist in lifting ancillary plays as well. On average though, with interest rates climbing rapidly that year, those stocks plunged more than 45%. Even more remarkable, the AI and quantum computing stocks called out in Table 1 crashed between 68% and 93% (Table 2)!![3] None of this is to say that history will perfectly repeat, but it tends to have a way of rhyming over time.

Table 2. RED LIGHT! As interest rates rose, 2022 was a brutal year for growth stocks

	2022 Total Return
S&P 500	-19%
"Magnificent Seven"	
Microsoft Corporation	-28%
Meta Platforms Inc Class A	-64%
Apple Inc.	-26%
Amazon.com, Inc.	-50%
Alphabet Inc. Class A	-39%
NVIDIA Corporation	-50%
Tesla, Inc.	-65%
AI & Quantum Stocks	
Rigetti Computing, Inc.	-93%
D-Wave Quantum Inc.	-85%
IonQ, Inc.	-79%
SoundHound AI, Inc Class A	-76%
SES AI Corporation Class A	-68%

Source: Factset.

Chart 5. Dividend growth stocks have only been this cheap one other time in the last 20 years



Source: FactSet, CCM as of 12/31/2024. Benchmark data is sourced from Bloomberg and Dividend Grower data is sourced from FactSet. Both calculations exclude companies with negative earnings and use a weighted harmonic average NTM P/E. Dividend Growers include all Smid Cap companies that have raised their dividend for three consecutive years. Valuation discounts or premiums do not guarantee future returns will be greater or lower than the benchmark. There is no guarantee that companies will declare dividends or, if declared, that they will remain at current levels or increase over time. You cannot invest directly in an Index. For information on the Index shown above as well as other important information, please refer to the appendix.

Chart 6. After outperforming in 2020, speculative stocks underperformed Dividend Growers for three years

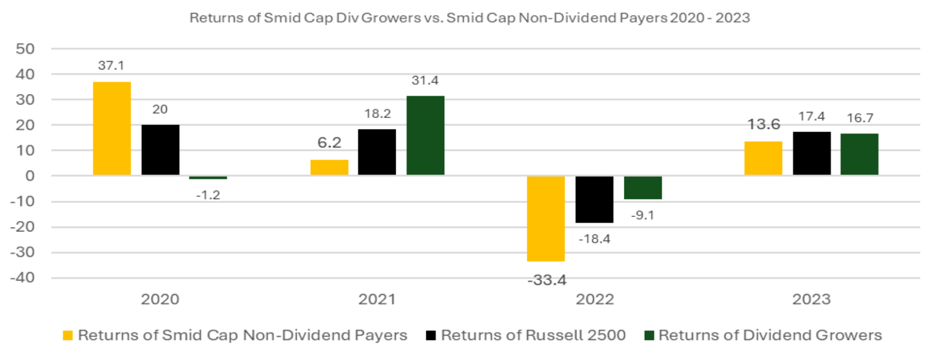


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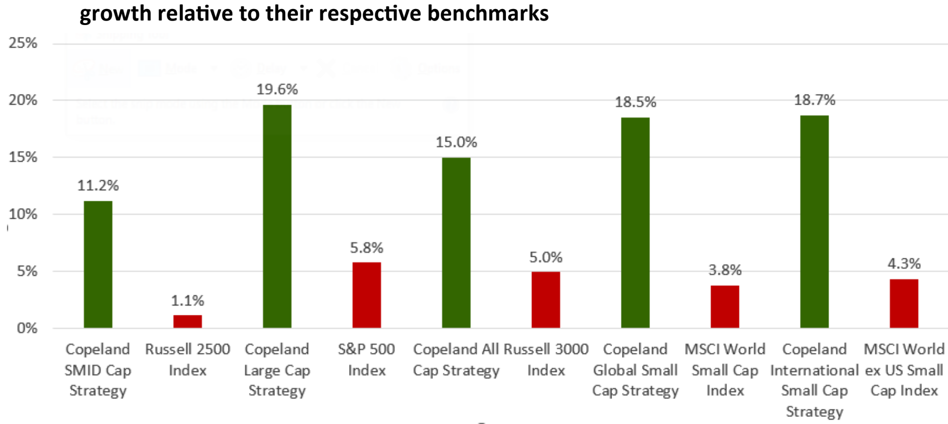
Chart 7. Copeland's portfolios continue to enjoy a double-digit gap in their pace of dividend growth relative to their respective benchmarks



Source: FactSet, Bloomberg and Copeland Capital Management. The information presented is intended to compare the holdings by dividend policy of Copeland strategies and their respective benchmarks. For US companies, the bars represent the weighted last-twelve-month pace of dividend growth. For international companies, the bars represent the weighted pace of dividend growth during the most recently completed fiscal year. Dividend Growers included stocks that raised their existing dividend or initiated a new dividend during the previous 12 months. There is no guarantee that companies will declare dividends or, if declared, that they will remain at current levels or increase over time. You cannot invest directly in an Index.

At the same time as dividend growth stocks are attractively valued, their growth advantage remains real (Chart 7).

At times like this, when market concentration is high, valuations have expanded, and risky investments have been handsomely rewarded, it's easy to assume that "dividends don't matter," and a "green light" for speculation will persist in perpetuity. Through several decades however, dividend growth stocks have outperformed their respective benchmarks while taking on less risk, particularly when unforeseen circumstances, or foreseen interest rate headwinds, cause a "red light" to emerge.[12]

At Copeland, we believe the long-term success of our Dividend Growth strategies is a function of the strong competitive advantages that Dividend Growers enjoy, ranging from favorable economies of scale to high switching costs to strong network effects. Whether individually, or collectively, these attributes engender pricing power and structural margin benefits that are difficult to unseat. In turn, they allow our companies to press their superiority through reinvestment in their businesses, even as they provide a burgeoning stream of cash returns to shareholders, which serves as a reminder of management's confidence in their outlook. For all these reasons, while there may be a number of risks and warning signs in the market, we continue to believe the light is green for our Dividend Growth approach.

January 2024

[1] *https://fred.stlouisfed.org/series/CPILFENS*
[2] *https://fred.stlouisfed.org/series/UNRATE*
[3] *FactSet*
[4] *The Magnificent Seven stocks are a group of the most influential companies in the U.S. stock market. This term has been popularized to describe a set of dominant companies, particularly in the technology sector. The group comprises Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla.*
[5] *FactSet, CCM*
[6] *https://www.nytimes.com/2025/01/24/technology/meta-data-center.html, https://www.theinformation.com/briefings/amazon-plans-capex-increase-to-over-75-billion-next-year, https://www.cnbc.com/2025/01/03/microsoft-expects-to-spend-80-billion-on-ai-data-centers-in-fy-2025.html, https://www.thestack.technology/oracle-ok-cloud-gluttons-were-doubling-capex-again/#:~:text=Katz%20said%20%E2%80%9CI%20expect%20fiscal,was%20just%20~%242%20billion.*
[7] *https://fred.stlouisfed.org/series/MORTGAGE30US*
[8] *Bloomberg*
[9] *https://tradingeconomics.com/united-states/bankruptcies*
[10] *https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/us-speculative-grade-firms-tackle-debt-maturity-wall-shifting-focus-to-2028-85824103*
[11] *Bank of America Global Research*
[12] *Ned Davis Research, Inc.*

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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. The **S&P 600® Index** is an Index of small-cap stocks that tracks a broad range of small-sized companies that meet specific liquidity and stability requirements. 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 **Russell 2000® Index** is comprised of the smallest 2000 companies in the Russell 3000® Index. The **Russell 2500™ Index** measures the performance of the small to midcap segment of the US equity universe, commonly referred to as "smid" cap. The Russell 2500 Index is a subset of the Russell 3000® Index. It includes approximately 2500 of the smallest securities based on a combination of their market cap and current index membership. 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 Small Cap® Index** captures small cap representation across 23 Developed Markets (DM) countries. With 3,979 constituents, the index covers approximately 14% of the free float-adjusted market capitalization in each country.

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.

Return on Invested Capital (ROIC) – A calculation used to determine how well a company allocates its capital to profitable projects or investments.

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Copeland Capital Management, LLC

www.CopelandCapital.com www.CopelandFunds.com

Corporate Headquarters

161 Washington St., Suite 1325
Conshohocken, PA 19428
484-351-3700