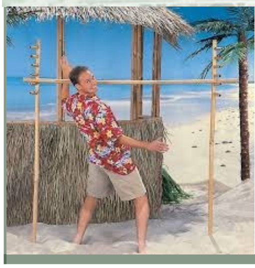
The Copeland Review

Third Quarter 2019

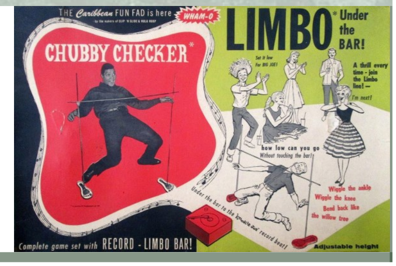
"We believe that stocks with sustainable dividend growth consistently outperform the market with less risk."



How Low Can You Go?

Jack be nimble, Jack be quick
Jack goes under the limbo stick
All around the limbo clock
Hey, let's do the limbo rock

Chubby Checker, "Limbo Rock," October 1962



Fifty-seven years ago this month, "Limbo Rock" topped the pop music charts and the ten-year US Treasury bond yielded approximately 3.9%. By September 1981, less than 20 years later, that yield had spiked to an eye-popping all-time high of nearly 16%![1]

Today, however, we've come full circle and then some, as global interest rates have generally trended downward for the better part of four decades, leaving nearly one third of global investment-grade bonds – $17 trillion in market value – with negative yields (Chart 1).[2] Lenders are literally paying borrowers to take their money! Even US government interest rates, despite having managed to remain in positive territory across the yield curve thus far, have also fallen sharply.[3]

We believe this environment creates perverse incentives for both debt and equity investors and therefore presents three significant hazards:

1. Expensive, low-yielding bonds may no longer present the same risk protection that they have historically.
2. The availability of cheap debt could cause companies to take on risky projects that they'd have otherwise avoided.
3. High yield stocks, which have been bid up in a desperate search for income, likely share more in common with bonds than buyers realize.

Alternatively, we believe Dividend Growers offer an attractive and uncommon balance of capital appreciation and downside protection potential, along with a growing income stream in this uncertain environment.

Sub-Zero

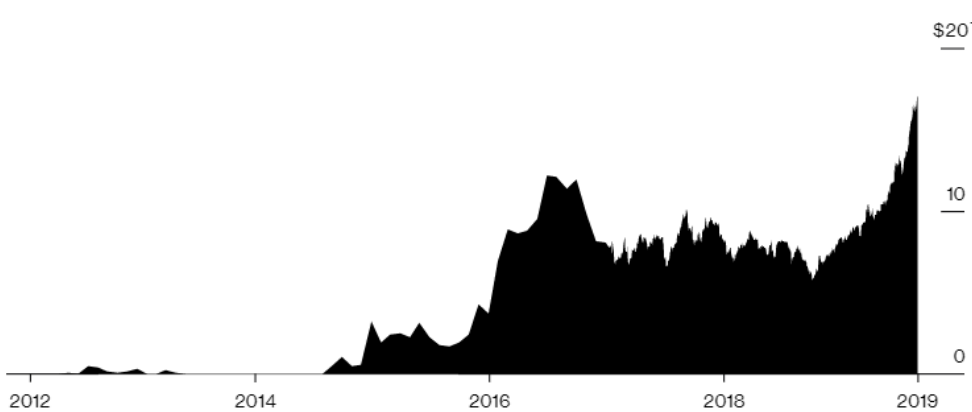
The interest rates that bondholders demand are typically determined by three things[4]: the risk-free rate, the perceived risk of the investment and inflation expectations.

The risk-free rate component is designed to measure the time value of money, and therefore should not change significantly regardless of market conditions; and, while the risk of any debt instrument may vacillate depending on the economic backdrop, it should also always be additive to the equation.

Considering the abundance of negative yielding debt, this might lead one to conclude that we must be suffering through a bout of aggressive global deflation, more than offsetting the other components in the calculation, which are inherently neutral to positive. In reality however, no OECD (Organization for Economic Cooperation and Development) country recorded a negative inflation reading in 2018.[5]

Regardless of any unusual factors that explain this phenomenon, some may wonder: "Is there really a downside?"

Chart 1. Market Value of Negative-Yielding Bonds In the Bloomberg Barclays Global-Aggregate Index



Data: Compiled by Bloomberg

After all, low or negative interest rates have improved housing affordability, allowed corporations to secure inexpensive financing and driven investment gains.

At the risk being a buzzkill, we believe it is vital to balance such positivity with a dose of harsh reality.

Nowhere to Hide

First, the obvious. Traditionally, investors – whether individual or institutional – have used their bond allocations to help dial-down risk and/or meet income needs.

Today, we argue that such opportunities are largely off the table. Investors are faced with a fixed income market offering little yield compensation regardless of how much credit or duration risk bond buyers are willing to assume.

Credit risk, or the "credit spread," is expressed as the percentage difference in yield between any bond and a similarly structured US Treasury, which is widely considered to have no credit risk given that it is backed by the government. When the spread is wide, investors are being well compensated for taking risk and vice-versa.

Currently, the commonly followed US Corporate BBB spread, which reflects the difference in yields between investment grade rated corporate debt and US Treasury bonds, stands at only 1.50% - modestly above the extreme lows of the last cycle (1.15%), but far below either the peak spread in 2008 (8.05%) or even the long-term average spread of 2.15% (Chart 2).[6] Should investors' risk appetites moderate and the spread reverse to the long-term average, BBB-rated bonds, which now account for nearly 50% of the investment grade market, could suffer meaningful losses.[7,8]

While duration risk is a more esoteric mathematical concept, it boils down to the idea that, all else equal, a bond with a longer term to maturity carries more risk, and therefore normally commands a higher yield, than a similar bond maturing sooner. Today however, the percentage difference between ten-year Treasury yields and two-year Treasury yields is nearly zero[9], providing investors with little to no en-

Chart 2. The US BBB Corporate Spread Has Been Trending Downward

Source: St. Louis Fed, ICE Benchmark Administration Limited (IBA)

ticement to lock up their funds in long-term bonds (Chart 3).

Even locking up capital for 100 years is often not sufficient to generate much incremental yield. Consider that Austria has sold two tranches of identical 100-year bonds – the first in 2017 and the most recent in June of this year. At the time of the original issuance, the bonds provided a rather meager 2.10% yield. As a result of price appreciation however, the yield of the second tranche was an even more pitiful 1.17%. Note Barron's expression of concern:

> *"Much could happen by the time the century bonds are paid off...Austria, after all, was annexed by Nazi Germany in the 20th century. More immediate is the risk to a bondholder if, in the near term, there simply is a reversion to the price of 100 at which Austria's original century bonds were issued. The resulting one-third loss in value would be roughly equivalent to this year's drop in Tesla stock (ticker: TSLA), hardly anyone's idea of a blue-chip investment."* [10]

This comment mirrors our own apprehension that investors who hold these securities, whether for protection of principal or for incremental income, are dramatically underestimating their risk profiles. The "low-rate limbo" is not a contest you want to win!

Risky Business

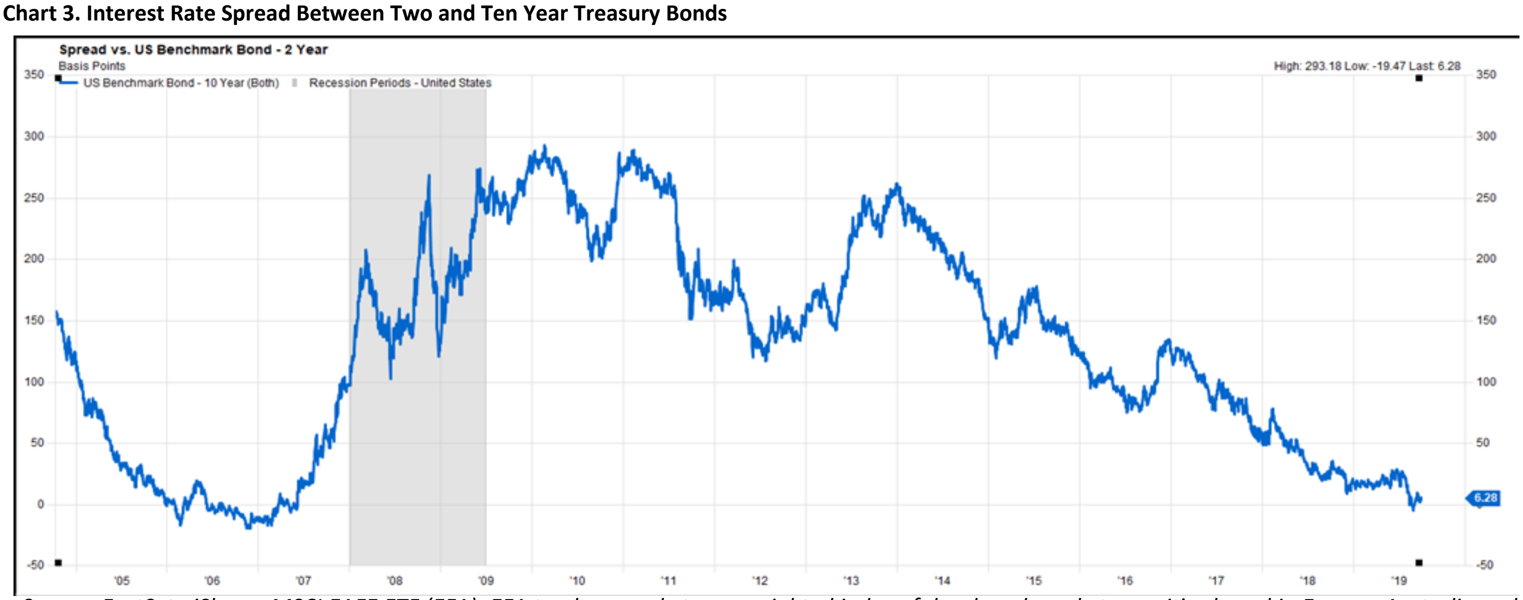
As challenging to navigate as that backdrop is though, we would argue that the second potential pitfall of extremely low rates presents an even greater risk.

Companies considering investment opportunities must compare their expected risk-adjusted return to their cost of capital. When the former exceeds the latter, the project is considered "economically profitable." As the cost of debt declines, so too does the total cost of capital. To a point this can be beneficial as economically profitable investment opportunities expand. However, there is a dark side of this equation as rates approach (or fall below) zero.

At the supposed lower bound, virtually every project starts to look compelling regardless of risk. This creates an incentive for CFOs to lever up balance sheets to fund mergers and acquisitions, stock buybacks and corporate expansion beyond levels that would make sense under normal interest rate conditions. Chart 4, showing the ratio of US non-financial corporate debt to GDP reaching a new high, provides evidence that this phenomenon is developing in the US.

It's no accident that the prior two highs in the ratio were established near cyclical peaks in the economy and the stock market. In a vacuum, taking on unusually risky projects may prove viable. When the margin for error is so thin though, the slightest hiccup in execution or change in risk appetites can have disastrous consequences. We saw this in 2008, when liquidity suddenly dried up. Many entities that

Chart 3. Interest Rate Spread Between Two and Ten Year Treasury Bonds



Source: FactSet, iShares MSCI EAFE ETF (EFA). EFA tracks a market-cap-weighted index of developed-market securities based in Europe, Australia and the Far East. It excludes the US and Canada, and small-caps.

were heavily reliant on debt – whether corporate, governmental or otherwise – found themselves hard-pressed to refinance maturing bonds or lines of credit as they expired. Instead, they were forced to offer much higher rates on new debt or, in the case of many corporations – who weren't willing or able to access the debt markets at all – to dilute shareholders severely by issuing shares at depressed prices. How low can you go, indeed?

A Wolf in Sheep's Clothing

Finally, the dearth of yield opportunities in bonds has led an unusual number of investors to seek incremental income from traditional bond proxies in the equity market, such as utilities and REITs (Real-Estate Investment Trusts). While a certain cohort has always bought these names for their bond-like characteristics – such as above market yields and supposed stability – today's outsized demand is evident based on:

1. The outperformance of both REITs (represented by the Vanguard Real Estate ETF, ticker: VNQ) and Utilities (represented by Utilities Select Sector SPDR Fund, ticker: XLU) versus the S&P 500 Index for the 12 months ending September 30, 2019. Over that time, while the S&P 500 Index rose only 2.2%, Utilities were up 15.6% and REITs climbed 23.0%.[9]
2. The substantial valuation premiums that REITs and Utilities command relative to their historical median levels, including near all-time low yields.[9]

Lighthouse in the Fog

In last quarter's Copeland Review ("To Infinity and Beyond") we noted…" some macroeconomic risks, and thought earnings estimates were too high. One quarter later, the outlook has indeed soured broadly, as 2019 profit estimates for the Russell 2000 Index have fallen 16%, and now call for earnings to be down 10% year-over-year.[9]

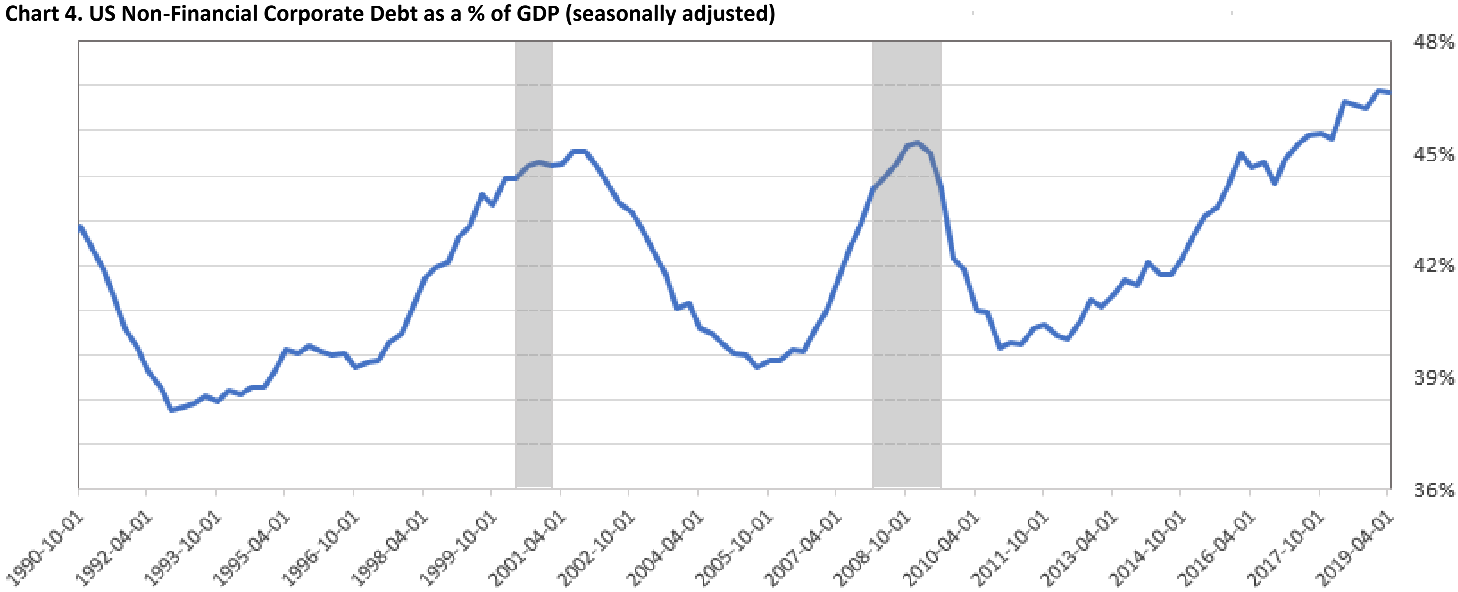
Still, from here – though weakening global manufacturing and other risks persist – we acknowledge that our crystal ball is decidedly fuzzy.[11] Perhaps in a year yield investors will have been rewarded if inflation remains in check, weak growth unfolds, and interest rates move even lower. Nevertheless, for the reasons laid out above, we believe they are ignoring real potential pitfalls – whether chasing low or negative yielding bonds for capital gains or traditional high-yield stocks for income.

We have confidence that our Dividend Growth discipline offers an attractive alternative and improves investors' chances of outperforming the market with less-than-benchmark risk for two simple, but important reasons.

First, in order to establish a track-record of consistent dividend growth, a company must have a commensurate track-record of earnings and cash flow growth supported by strong competitive advantages that prevent peers from eroding its profitability. Secondly, though there are some non-dividend growth companies that share those characteristics, what they lack is a constraint on poor decision-making by management. At this late point in the cycle, it's common for companies to stretch – levering up their balance sheets or loosening their risk standards in hopes of juicing earnings. We believe that a company with a history of dividend growth, however, is less likely to engage in these behaviors because putting that track-record at risk is tantamount to putting management's jobs at risk. Instead, executives at dividend growth companies are likely to pass on the riskiest opportunities, in exchange for a margin of safety that protects long-term economic profitability – regardless of how low rates go!

1 *https://www.investing.com/rates-bonds/u.s.-10-year-bond-yield-historical-data*
2 *https://www.bloomberg.com/graphics/negative-yield-bonds/*
3 *https://www.bloomberg.com/news/articles/2019-08-21/fed-saw-july-rate-cut-as-insurance-for-growth-and-inflation*
4 *https://www.finpipe.com/interest-rate-components/*
5 *https://data.oecd.org/price/inflation-cpi.htm*
6 *https://fred.stlouisfed.org/series/BAMLC0A4CBBB*
7 *https://ycharts.com/indicators/us_corporate_bbb_effective_yield, CCM*
8 *https://www.marketwatch.com/story/these-5-charts-warn-that-the-us-corporate-debt-party-is-getting-out-of-hand-2018-11-29*
9 *FactSet*
10 *https://www.barrons.com/articles/100-year-bonds-51561744996*
11 *https://www.markiteconomics.com/Public/HomePressRelease/6d5ffb41584d4c08a54706d85d3580b3*

Chart 4. US Non-Financial Corporate Debt as a % of GDP (seasonally adjusted)



Source: FactSet, St. Louis Fed, CCM; shaded periods reflect US economic recessions

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

Charts 3 and 4: © FactSet Data Systems Inc. All Rights Reserved. *FactSet is a company that offers financial industry analysis, financial data, analytics, and analytic software for investment professionals.* The information contained herein: (1) is proprietary to FactSet Research Systems Inc. and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither FactSet Research Systems Inc. nor its content providers are responsible for any damages or losses arising from any use of this information. 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.***

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 **Russell 2000® Index** is comprised of the smallest 2000 companies in the **Russell 3000® Index. 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.

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.

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.

NTM P/E Ratio - The Next Twelve Months 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.

Copeland's fees can be found in our ADV Part 2 which is available by calling (484) 351-3700 and requesting a copy, or on our website at www.copelandcapital.com.

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