The Copeland Review

Third Quarter 2021

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

Same as it Ever Was?

And you may ask yourself, "Where is that large automobile?"

- "Once in a Lifetime," The Talking Heads, 1980

Although enormous global Central Bank stimulus and expectations for a post-COVID economic recovery powered both the S&P 500 and MSCI EAFE indices to blistering gains of more than 27% in the twelve months ended September 30th, cracks in the ebullient sentiment began to emerge toward the end of the most recent quarter. After years of crying wolf on inflation, Wall Street's latest concerns finally began to look legitimate, with so-called "transitory" inflation proving to be more persistent than originally anticipated.

Widely flagged coverage of supply-chain bottlenecks and the brewing energy shortages overseas coincided with September pullbacks in both benchmarks, with the S&P 500 Index posting its worst monthly performance since March of 2020 – during the height of COVID concern. As longtime readers of the Copeland Review will know, we don't typically attempt to forecast macroeconomic trends. That said, we do believe inflation is here to stay for the foreseeable future. As a result, we expect higher input costs to weigh on profit margins, and we wouldn't be surprised if the recent upward pressure on global interest rates were to persist into 2022.

While investors are often admonished to avoid the view that "this time is different", the current circumstances are truly unusual. The global economy is struggling to restart after a near complete shutdown because of the pandemic, while governments across the globe try to determine when to reduce stimulus even as COVID-19 still lingers. It is certainly a "Once in a Lifetime" event from our perspective, and one that has presented us with particularly exciting opportunities among dividend growth stocks in many regions of the world.

You May Ask Yourself, "Well, how did I get here?"

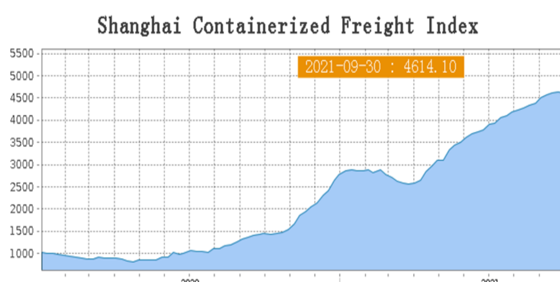
Amidst the ebb and flow of the global economy during the pandemic, supply-chain bottlenecks were one of the early indicators of higher inflation. Remember in March when the 220k ton tanker ship, the Ever Given, got stuck in the Suez Canal, stranding hundreds of shipping vessels on either side of the 120-mile canal? While more than 10% of all global trade passes through the Suez , the shutdown of more than a week was quickly forgotten by most.[1] That's not entirely surprising given that the period barely registers as more than a blip in a chart of global shipping rates. In fact, ocean freight transportation prices, as reflected by the Shanghai Containerized Freight Index (SCFI), began to rise in the latter half of 2020, and are now up four-fold over the past 18 months (Chart 1). The culprit: booming consumer demand combined with limited global tanker and port capacity – especially in Asia – as well as an inability to find workers, particularly in the US.

Further supply-chain disruptions ensued this summer due to COVID-driven lockdowns in the apparel manufacturing hubs of Vietnam and Indonesia.[2] With up to 3 months of lost production, global retailers – already facing exceptionally tight inventories – found themselves scrambling to meet consumer demand in the important back to school season, or to load their warehouses ahead of the even-more-critical holiday selling window. Elsewhere, semiconductor shortages within the auto sector have caused major production cuts by the OEMs: the IHS Markit global auto production forecasts were recently lowered by 5% in 2021 to 75m units, and by 9% in 2022 to 82m units – the largest such cuts in history.[3] The diminished availability of new cars – causing higher prices in the new and used vehicle markets alike – reflects in part COVID-related plant shutdowns in Malaysia, a hub responsible for 10% of auto-related semiconductor manufacturing.[4] Where is that large automobile, indeed?

The severe energy shortages that have recently emerged abroad are another source of cost pressures.[5] Chart 2 (below) tracks the price of European imported natural gas, which has increased to $22.84 per million British Thermal Units, almost five-fold higher than a year ago and similarly elevated versus the recently prevailing North American spot rates.[6]

Following the cold 2021 winter heating season, the European Union ("EU") entered the seasonal refill period of April to October with gas inventories 11% below the 5-year

Chart 1. Shipping rates have been climbing for over a year



Source: Shanghai Shipping Exchange; https://en.sse.net.cn/indices/ccfinew.jsp

Chart 2. The rise in European natural gas prices is a more recent phenomenon

Source: Ycharts

average and 44% lower than the record supplies available at the same time in 2020.[7] With Europe in a virtual bidding war with Asia for tight liquid natural gas (LNG) cargo supplies, the Continent's best hope for moderation in gas prices is the newly completed Nordstream 2 pipeline from Russia to Germany. Already providing about 40% of EU gas imports, Russia's new pipeline will roughly double the capacity exported from the Baltic Sea.[8] While Germany supports this expansion, full EU approval has been delayed owing to political pushback given that Russian control of the new infrastructure bypasses existing Ukrainian capacity. Meanwhile, ahead of the Winter Olympics in Beijing, China has been seeking to enforce emission targets in a show of its commitment to green climate initiatives. To contain emissions, the government has temporarily restricted certain manufacturing capacity. At the same time, it has instructed state owned enterprises to secure the necessary energy supply (including natural gas), regardless of price, to avoid unwanted power outages in the upcoming winter. Individually any of these issues would put upward pressure on gas prices, but collectively they have been a perfect storm.

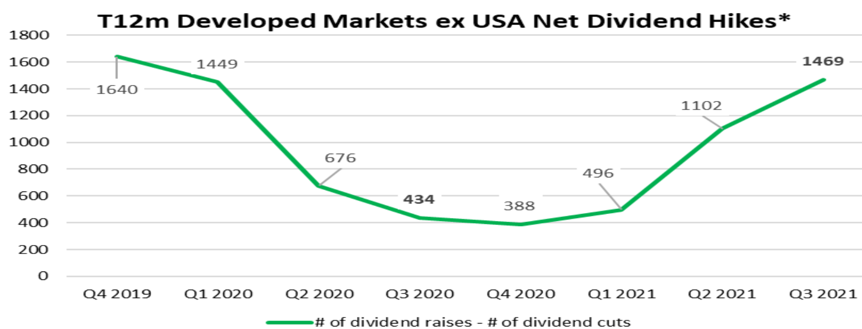
Thus far, these inflationary pressures have had a limited negative effect on overall earnings expectations with 2021 estimates for the S&P 500 and the MSCI EAFE indices both up nearly 5% from the end of the second quarter.[9] Harbingers of a more challenging future are showing however. FedEx (FDX, $225) missed Wall Street estimates for the most recent quarter due to rising labor costs and increased transportation expenses. PPG Industries (PPG, $146), a dominant coatings manufacturer, lowered guidance due to rising raw material prices and supply shortages. But, Dollar Tree (DLTR, $98), the dollar store operator, may be the company most clearly impacted so far, as it announced at the end of September that it would introduce new price points above its historical $1 limit in order to protect margins.

In a similar vein, 10-Year US Treasury yields rose over the late summer to the current rate of approximately 1.60%, up about 100 basis points from the COVID lows of 2020.[9] Inflation expectations have played an important role here, although for the moment, it appears that Central Bank purchases of Treasuries and other bonds may have the upper hand, as yields remain well below the pre-COVID levels (Chart 3). As the Fed begins to formalize its "tapering" of bond purchases however, price support could easily disappear with yields ascending further.

Chart 3. Although not back to pre-COVID levels, the 10-year US Treasury yield has risen significantly

Source: FactSet, CCM

Chart 4. Net dividend hikes in developed markets ex USA over the trailing 12 months



Source: FactSet, CCM

Same as it Ever Was

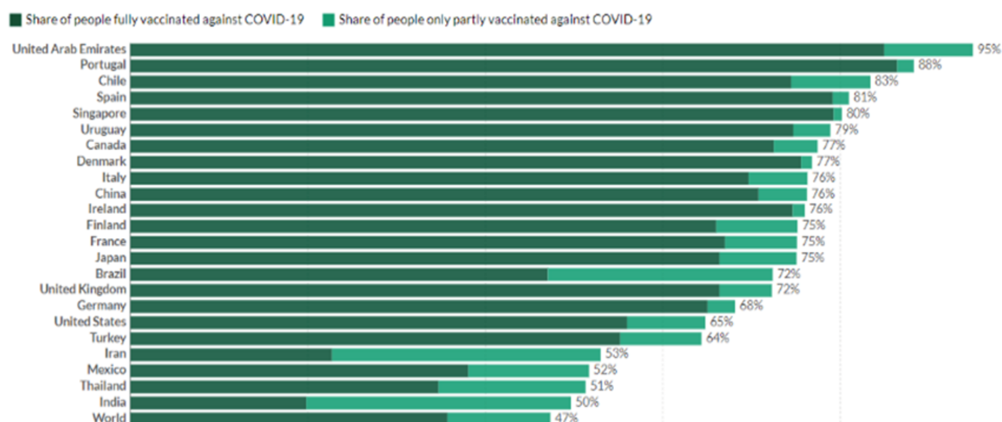
Painting a clear picture of market prospects in this environment is a difficult exercise. Nevertheless, we remain excited about the breadth of good investment opportunities within the Dividend Growth universe, across global markets, economic sectors, and the capitalization spectrum.

Dividend Growth opportunities overseas look especially timely at present. After the effects of COVID in 2020, including government-imposed dividend constraints in certain countries, the number of net dividend hikes (dividend increases less dividend cuts) in developed markets ex USA has more than tripled versus twelve months ago, almost fully recovering to the pre-pandemic levels (Chart 4).

Further, in contrast to the 15.9% year-to-date return of the S&P 500 Index through 9/30/21, the MSCI World ex-US Index has posted only a 9.2% return over the comparable period, continuing an extended stretch of lagging performance. In part, we believe this reflects the more stringent use of lockdowns and travel constraints overseas to combat the pandemic, as well as appreciation of the US Dollar. Nonetheless, as of October 2021, most European and Asian developed markets have now surpassed the vaccination levels achieved in the United States (Chart 5).

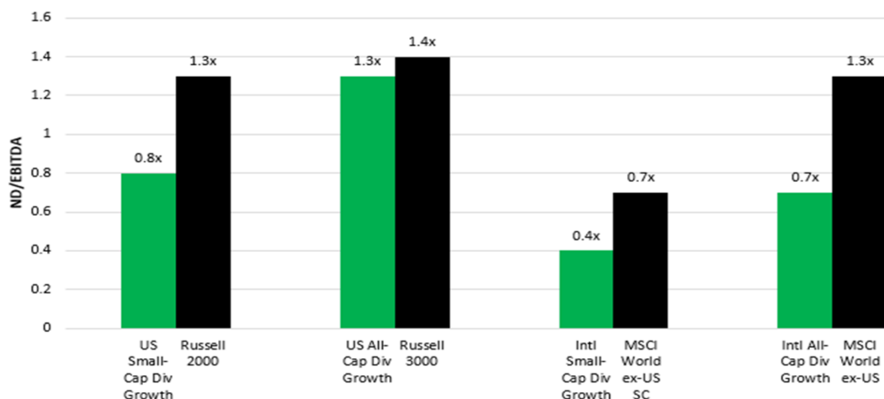
Accordingly, Copeland's methodology looks particularly well suited to benefit from the rising cost and yield environment that appears to be accompanying the return of the global economy to a normalized, post-pandemic state. Our confidence stems from two key characteristics of the Dividend

Chart 5. The percentage of vaccinated individuals in many developed countries has surpassed that of the United States as of mid-October



Source: https://ourworldindata.org/covid-vaccinations

Chart 6. Copeland's portfolios have lower leverage than their benchmarks



Source: Morningstar, *CCM*

Growth universe.

First, we believe that Dividend Growers have strong competitive advantages that engender structural pricing power, helping to absorb cost increases. Brenntag (Ticker: BNR-DE), an 11-year dividend grower based in Germany – and a leading global chemical distributor – is a good example. The company increased its cash flow guidance for 2021 by 7% in mid-September, even as freight and labor pressures weighed on other sectors.

Second, because of their above-average cash flow generation potential, Dividend Growth stocks can fund reinvestment in their businesses, external investment – including M&A – and return capital to shareholders, without sacrificing the quality of their balance-sheets or causing funding costs to rise. An example is DNB (Ticker DNB-NO), the leading Norwegian bank. It has used its excess capital (Tier 1 Equity Capital ratio of 19.2%) and dominant market position to grow its dividend during 2019 and 2020, nimbly working around the European Bank regulator's dividend payout constraints. The cash generation capability of Dividend Growth stocks is further evidenced by the lower Net Debt/EBITDA ratios as of 9/30/21 of Copeland's Dividend Growth strategies vs. their respective benchmarks (Chart 6).

Therefore, while the world may be changing – with many investors facing inflation and rising interest rates for the first time in their investing lives – we believe the potential for Copeland's Dividend Growth approach to be successful remains the "same as it ever was."

October 21, 2021

[1] *https://www.usnews.com/news/business/articles/2021-03-29/suez-canal-blockage-adds-to-pressure-points-in-global-trade#:~:text=The%20disruption%20from%20the%20Suez,South%20Africa%20to%20avoid%20it.*

[2] *https://www.wsj.com/articles/vietnams-factory-shutdowns-tug-at-apparel-industrys-seams-11630661403*

[3] *https://ihsmarkit.com/research-analysis/major-revision-for-global-light-vehicle-production-forecast.html*

[4] *https://www.cnbc.com/2021/07/21/used-car-prices-have-surged-how-to-make-that-work-to-your-advantage.html*

[5] *https://www.bloomberg.com/news/articles/2021-09-27/europe-s-energy-crisis-is-about-to-go-global-as-gas-prices-soar*

[6] *https://ycharts.com/indicators/europe_natural_gas_price*

[7] *https://www.eia.gov/naturalgas/weekly/archivenew_ngwu/2021/04_22/*

[8] *https://www.reuters.com/business/energy/russias-gazprom-says-it-has-completed-nord-stream-2-construction-2021-09-10/*

[9] *FactSet*

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 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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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 **MSCI EAFE Index** is an equity index which captures large and mid-cap representation across 21 Developed Markets countries around the world, excluding the US and Canada. With 845 constituents, the index covers approximately 85% of the free float adjusted market capitalization in each country. Developed Markets countries in the MSCI EAFE Index include Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the UK. The **Shanghai Containerized Freight Index** is the most widely used index for sea freight rates for import China worldwide. This index has been calculated weekly since 2009 and shows the most current freight prices on the spot market for container transport from the Chinese main ports, including Shanghai. The **Russell 2000® Index** is comprised of the smallest 2000 companies in the **Russell 3000® Index**. The **Russell 2500® Index** is comprised of the bottom 2500 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. The **MSCI World Ex-US® Index** is a market capitalization-weighted index designed to provide a broad measure of stock performance throughout the developed world, excluding U.S. stocks. The **MSCI World ex-US Small Cap® Index** captures small cap representation across 23 Developed Markets (DM) countries, excluding U.S. stocks. With 4,320 constituents, the index covers approximately 14% of the free float-adjusted market capitalization in each country.

Definitions

Net Debt EBITDA - The net debt-to-EBITDA (earnings before interest depreciation and amortization) ratio is a measurement of leverage, calculated as a company's interest-bearing liabilities minus cash or cash equivalents, divided by its EBITDA.

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