Third Quarter 2022

The Copeland Review

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

The Costanza Market

George Costanza: "Every decision I've ever made, in my entire life, has been wrong...Every instinct I have, in every aspect of life... It's all been wrong."

- "The Opposite." Seinfeld, 1994

It's often said that the equity market is a discounting mechanism. That is, stock prices discount, or reflect, expected future outcomes, including earnings results, changes in the economic backdrop, interest rate changes, and many other potential variables. When the market has been trending in one direction for a long time, however, it can be easy to lose sight of this. Given that each quarter tends to look a lot like the last, investors begin to believe that the market mostly reflects the present. At cyclical peaks and troughs though, the discounting mechanism becomes clear again, as market action and economic news, like George Constanza, go against every instinct that seems obvious.

In this edition of *The Copeland Review*, we address:

1. **Every instinct is wrong:** Why good economic news is currently bearish for stock prices, but eventually bad economic news should create a bullish set up for the future.
2. **Going against the grain:** Non-US markets are facing acute challenges, and have seen very weak performance. We believe, however, that employing a dividend growth approach gives investors the best chance for outperformance over time.
3. **The dividend signal:** Not only does the universe of dividend growth stocks remain robust, both internationally and domestically, but dividend actions so far this year suggest that many companies will successfully navigate this difficult environment.

Every Instinct Is Wrong

While the third quarter got off to a strong start, with the Russell 2000, Russell Mid Cap, and S&P 500 indices each erasing more than half of its year-to-date losses, investor enthusiasm for stocks proved short-lived as all three indices reversed course sharply to close at or near their June lows.[1] Not to be outdone, bond prices – which move inversely to interest rates – also slid as interest rates continued their ascent, driving the Bloomberg Intermediate US Government/Credit Index down 3.1%.[2] Further, the spread between the yield on ten-year US Treasury bonds and the yield on two-year US Treasury bonds – which is normally positive – flipped into steeply negative territory, a condition known as "yield curve inversion," which is often a harbinger of recession.[1]

But wait, isn't the economy actually hanging in there pretty well?

Yes, though we have addressed recession risks (White Rabbit) and the current elevated level of inflation (You've Lost that Lovin' Feeling) extensively in recent pieces, there are still some indicators demonstrating strength, including:

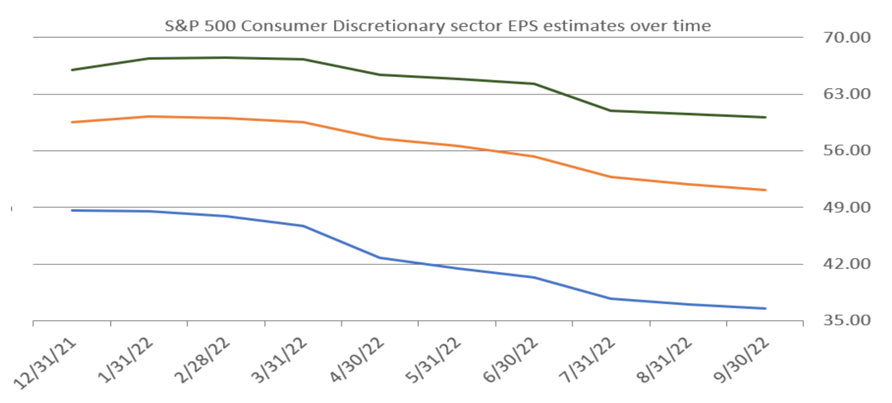
- The US unemployment rate of 3.5% in September tied a record low and marked its tenth consecutive monthly reading at or below 4.0%.[3]
- Earnings expectations for S&P 500 companies, though off modestly from their June peaks, continue to call for approximately 8% year-over-year growth in both 2022 and 2023.[1]
- Both August and September's ISM Manufacturing Index readings – presented by the Institute for Supply Management – were over 50.0, indicating expansion within the manufacturing segment of the US economy.[4]

Enter the Costanza Market however, with equities plunging, as every instinct that most investors have about the traditional connection between the economy and stock prices feels wrong.

During the bearish portion of a Constanza Market, strong economic reports aren't cause for celebration. Instead, they lead investors to worry, and stock prices to reflect, that inflation – already at multi-decade highs – is not going away any time soon, and that the Federal Reserve will continue to raise interest rates, seeking to bring aggregate demand under control. Eventually, this will force companies to slash their profit outlooks and cut employees, putting further downward pressure on consumer spending. This is already apparent in the Consumer Discretionary sector – often considered to be "early cycle" – as earnings expectations have fallen sharply (Chart 1), including a 25% reduction in 2022 estimates since the beginning of the year.[1]

Exacerbating the market weakness are

Chart 1. Earnings expectations for the Consumer Discretionary sector falling much faster than for the market overall



Source: Factset

memories of recent tightening cycles, which have not been calm affairs, instead triggering the implosion of the dotcom and housing bubbles and all their attendant after-effects. At this point, we have not seen significant signs of the types of risks that raise questions about potential "financial accidents." For example, valuations are far more reasonable than they were in 1999 and early 2000, and corporate, bank, and consumer balance sheets are all better situated than they were preceding the financial crisis. Still, crisis or not, after several years of government stimulus that has now receded, and several decades of steadily declining interest rates – a trend which has now been broken – it's no shock that the market is anticipating choppier waters and weaker fundamentals ahead, nor that they could persist for an extended period so long as the Federal Reserve is committed to its current approach.

If there's a silver lining however, it's that the Constanza Market works both ways – eventually. Indeed, this likely won't be obvious until sometime after it has already begun, but equity prices will ultimately begin to stabilize or even rise despite economic weakness. For example, it was far from obvious in March 2009 – as bad news on layoffs and corporate profits continued to roll in – that the market had set its low for that cycle. In fact, the US unemployment rate of 8.7% when the market bottomed, reached 10.0% in October of that year.[5] By that time however, the market was already up more than 50% from its low.[1]

Presumably the current bear market will end the same way…at some point.

Going Against the Grain

Jerry Seinfeld: Well…try the opposite. If every instinct you have is wrong, then the opposite would have to be right.
George Costanza: Yes, I will do the opposite!

Make no mistake, while the US economy is currently challenged, international problems are even more pronounced. While there are many concerns – including the potential impact of China's sustained commitment to its Zero-COVID-19 policy – the greatest, of course, is the toll of Russia's war in Ukraine. With the European Union relying on Russia for nearly 40% of its natural gas consumption, sanctions against Russia, and Russia's counter-move to turn off the flow of gas through the Nord Stream pipeline, have created public health

Chart 2. European Natural Gas Prices Have Risen Substantially Over the Last Year

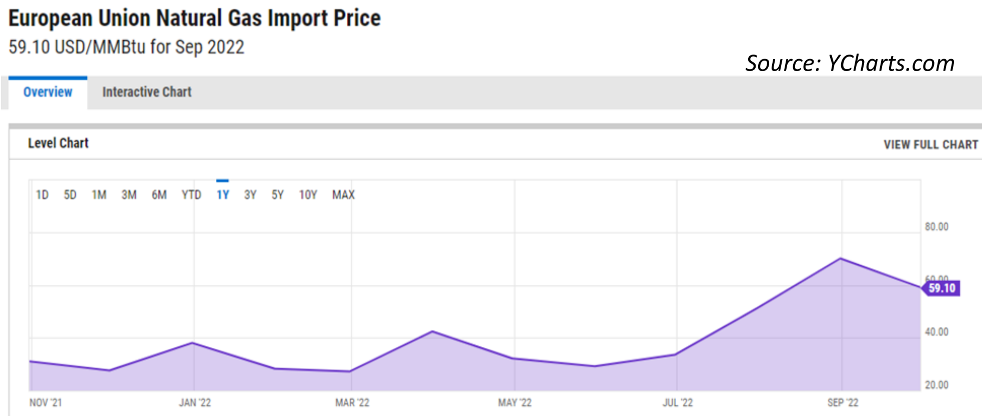
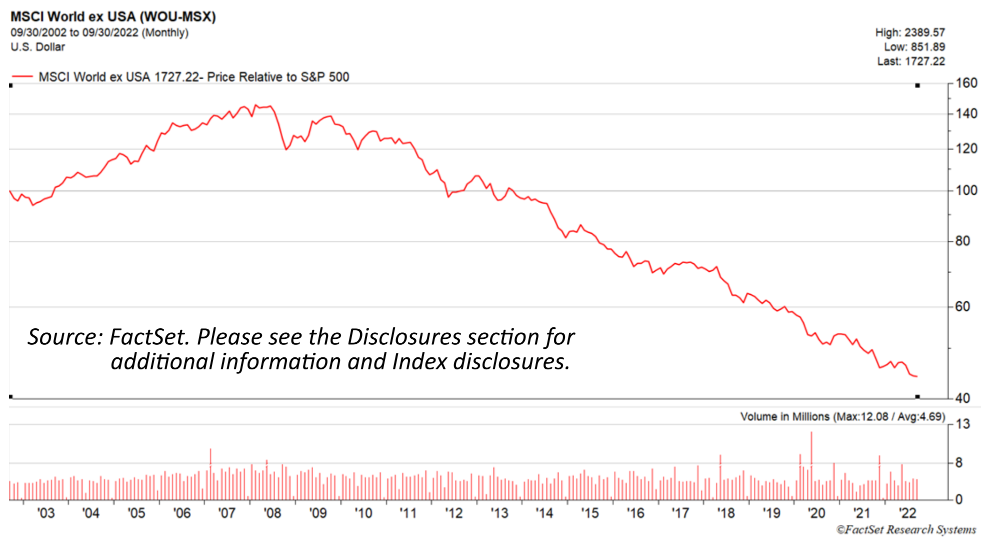


Chart 3. Non-US stocks have trailed US names for most of the last 14 years



concerns going into the winter heating season, and considerable economic damage throughout Europe.[6] Indeed, even after pulling back a bit in September, European Union Natural Gas prices finished the third quarter at nearly two times the prior year's level and nearly ten times the comparable US level (Chart 2).[7]

Therefore, it may come as a surprise to some that the MSCI World Ex US index, down 18.2% in local currency terms year-to-date, has outperformed the 23.9% decline in the S&P 500 index. For US-based investors in international securities though, it's critical to account for the substantial dollar appreciation so far this year, which serves as an incremental drag on local currency returns. Consequently, with the US dollar up more than 15% against both the euro and the yen (which account for much of the foreign currency exposure in the MSCI World Ex US index), the dollar-denominated return of the Index is considerably worse.[1]

Tougher still, for US investors in international stocks, this trend is not exclusive to 2022. In fact, since a nearly five-year run of outperformance ended in early 2008, international equities have steadily underperformed the US market (Chart 3).[1]

However, there is hope for US investors exposed to non-US stocks. First, while US stock valuations have moderated this year, non-US stocks are far cheaper.[8] Second, the US dollar is relatively expensive versus history, which could create a reversion to more normal levels (Chart 4).[9] Should that occur, depreciation in the dollar would be additive to local currency returns for US investors in non-US securities. Finally, in a rare turn of events -- especially for a period of pronounced market weakness – non-US dividend growers, which have historically provided strong downside protection, have only kept pace with the benchmark so far this year (Chart 5), in contrast to the greater resiliency of their US counterparts.[10] We believe this unusual dislocation provides investors in non-US

Chart 4. With the US dollar near prior peak levels, it could be primed for reversion to normal

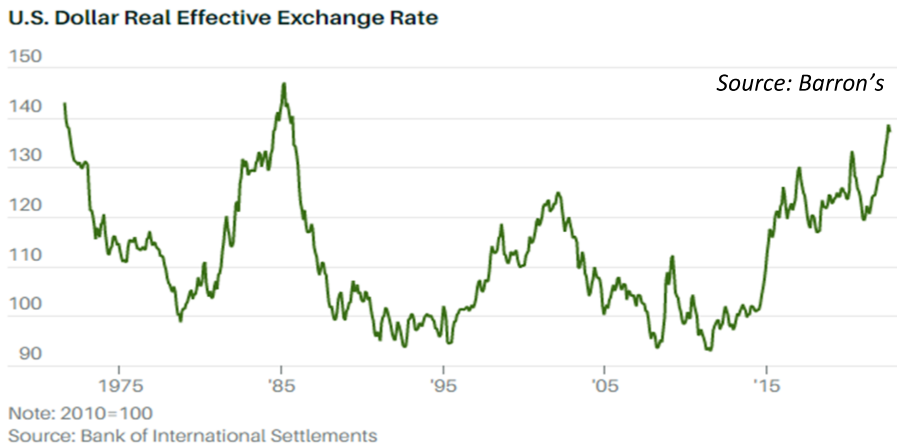
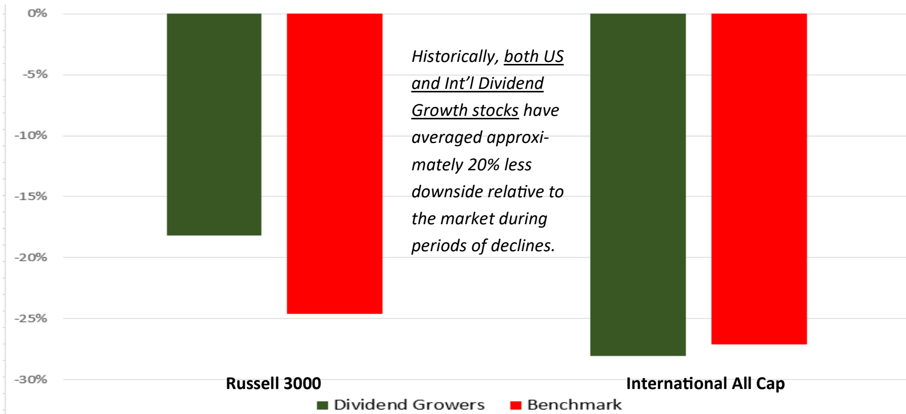


Chart 5. Non-US Dividend Growers Have Surprisingly Not Offered a Safety Net YTD (9/30/2022)



Source: CCM, Ned Davis Research, Russell, MSCI. Past performance is no guarantee of future results. There is no guarantee that companies will declare dividends or, if declared, that they will remain at current levels or increase over time. The returns shown above include dividends reinvested. The historical data is for illustrative purposes only and does not represent the performance of any strategy overseen by Copeland or any particular investment, 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. A stock is classified as a Dividend Grower if it initiated or raised its existing cash dividend at any time during the previous 12 months. Please see the Disclosures section for additional information and Index disclosures.

dividend growth stocks with a fantastic opportunity for outperformance going forward.

Dividend Growth Can Cushion the Landing, Regardless of the Outcome

As we have noted in these pages before, while we follow economic data closely to the extent it influences our companies' dividends and earnings, we always attempt to create all-weather portfolios that offer substantial downside protection and upside participation, regardless of the whims of global markets.

In recent editions of this piece, we highlighted how dividend growers outperformed the market at large – and especially non-dividend paying stocks – leading up to and during prior recessions (You've Lost that Lovin' Feeling), as well as during earlier periods of rising interest rates and elevated inflation (White Rabbit). We believe these return patterns reflect the structural advantages enjoyed by quality dividend growers, when they possess pricing power, growing cash flows and low leverage balance sheets. Alternatively, in times like these, lower quality companies in weaker competitive positions, see sales dry up and costs rise, often causing them to seek expensive external capital.

Despite these historical benefits, one question we are often asked during periods of market turbulence, is whether the investable universe of dividend growers will remain robust in a protracted downturn. From an empirical perspective, having managed investments through both the Great Financial Crisis and COVID-19, we feel confident that even under very difficult circumstances, Copeland will have a substantial opportunity set from which to construct well-diversified portfolios of high-quality, consistent dividend growers. Nevertheless, as every bear market is unique, we continue to monitor global dividend actions daily.

As such, we are gratified to see that, even amidst this year's market weakness, over 1,000 US companies within the Russell 3000 index and more than 2,500 companies in non-US developed markets have raised their payouts over the trailing 12 months. To put these numbers in perspective, while the US result is right in line with the same period in 2019, non-US hikes are an impressive 26% above pre-COVID-19 levels. As striking as the number of hikes in each group is their respective magnitude. The median US dividend hike accelerated from 9% in 2019 to 10% today, and the median non-US hike stepped up from 7% to 10%.[1]

Companies do not tend to raise their dividends, nor accelerate the rate of such growth, if management teams don't have confidence in their outlooks. These results demonstrate the differentiated attributes inherent within the dividend growth universe noted above, and continue to instill confidence that a dividend growth approach can help both US and non-US investors outperform the market, especially during periods of economic turmoil.

October 28, 2022

1 *FactSet*
2 *Bloomberg*
3 *https://www.bls.gov/news.release/pdf/empsit.pdf*
4 *https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/pmi/september/, https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/pmi/august/#:~:text=The%20Production%20Index%20reading%20of,June%202020%20(51.3%20percent).*
5 *https://data.bls.gov/pdq/SurveyOutputServlet*
6 *https://www.iea.org/news/how-europe-can-cut-natural-gas-imports-from-russia-significantly-within-a-year*
7 *https://ycharts.com/indicators/europe_natural_gas_price*
8 *https://www.barrons.com/articles/strong-us-dollar-invest-foreign-markets-51665173738?st=by1uqxcmvivjx4h&noredirect=y*
9 *https://www.barrons.com/articles/strong-us-dollar-invest-foreign-markets-51665173738?mod=past_editions*
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Currency - Unless otherwise specified or disclosed, the currency used for data in the report is US Dollar (USD).

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 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 **Russell Mid Cap® Index** is a market capitalization-weighted index comprised of 800 publicly traded U.S. companies with market caps of between $2 and $10 billion. The 800 companies in the Russell Midcap Index are the 800 smallest of the 1,000 companies that comprise Russell 1000 Index. The **Russell 1000 Index** is a compilation of the largest 1,000 publicly traded U.S. companies. 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 **Bloomberg Intermediate US Government/Credit Index** is an index composed of U.S. dollar-denominated government, government-related and investment-grade U.S. corporate bonds with remaining maturities between one and ten years.

The **ISM Manufacturing Index**, commonly known as the ISM Manufacturing Purchasing Managers Index (ISM PMI), is a monthly gauge of the level of economic activity in the manufacturing sector in the United States versus the previous month.

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.

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