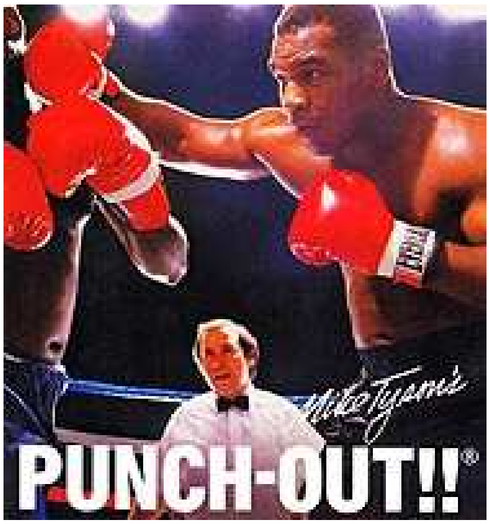
Second Quarter 2017

The Copeland Review

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

PUNCH-OUT!!

"Everybody has a plan until they get punched in the mouth." - Mike Tyson



A financial time capsule from 1999 would surely contain a slew of misguided admonishments regarding the technology bubble. The capsule would probably include advertisements for day-trading from home, claims that value investing was dead, and a push to "fire your broker and open an online account!" Another might read: "Don't worry about justifying valuations, just buy large cap tech stocks and prepare to retire." Depending upon how closely one had heeded them at the time, one would either laugh or cringe.

We find similarities to that thinking today. You can't pick up a financial publication without finding articles calling for the death of active money management. Exchange Traded Funds (ETFs) in countless flavors suiting every supposed need could be today's equivalent. The prevailing plan is to buy the cheapest or smartest beta exposure and prepare to retire.

What happens though when stock markets ultimately decline, and investors take a "punch in the mouth?" Will passive index strategies that provide market-like performance on the upside be the best place to hide when they also deliver 100% of the downside? What percentage of newfangled ETF products will deliver substantially greater than 100% of the downside? How many investors who fired their brokers in 1999 to buy tech stocks online wish they had instead stayed with a diversified portfolio of high-quality, reasonably valued companies?

In this Review, we discuss the ongoing bull market, where we are in the cycle, and – as in 1999 – the importance of always pursuing a disciplined investment process in the face of a pervasive, contagious, and dangerous worldview that there is "a new, simpler way of doing things." In particular, we highlight the lower risk profile of Copeland's differentiated dividend growth fishing pond.

From Fear to Complacency!?

Exactly five years ago, in "The World Seems Upside Down," we shared Scarlett O'Hara's quote from *Gone With the Wind*: "Where shall I go? What shall I do?" After a strong start to 2012, the US equity markets declined abruptly in the second quarter on a host of concerns: investors were worried about multiple European countries engulfed in crisis, US state and local budget deficits, political gridlock in the US capital, and slowing growth in emerging markets. At the time, we wrote that "a certain despondency has settled over the investment scene as investors contemplate a troubled world."

Nevertheless, our answer to Ms. O'Hara was that, despite "crosscurrents and sour investor sentiment, it is wise to consider that equities are exceptionally inexpensive" and "that, in the long run, it is better to be buying companies at friendly valuations when the world seems upside down and when investors 'don't give a damn' than after a period of exceptional investment returns when all seems well in the investment world."

History proved this counsel accurate and timely. Five years later, the S&P 500 Index had surged 78% through quarter-end, while dividends per share rose 70% – consistent with our view that share prices tend to track dividend growth over time.

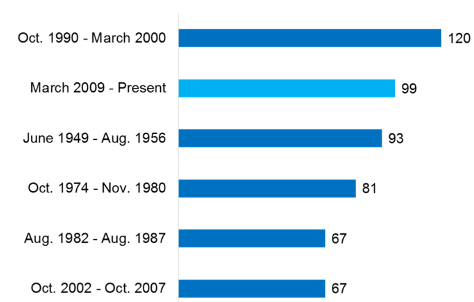
Today, market sentiment has clearly shifted towards the other end of the spectrum: quite bullish, supported by robust investor, consumer and business confidence readings, record high household net worth, low unemployment, and expectations for improving business conditions. At the same time, rampant creative destruction, most noticeably in areas such as brick and mortar retail and traditional media, appears to be acting as a disinflationary force, keeping inflation and interest rates low, despite recent tightening actions by the US Federal Reserve Bank. While the market cycle and valuations have not reached the euphoric levels of the late 1990s, we sense a heightened level of complacency, where equity prices only move in one direction – upward – and there is minimal market reaction to bad news or the risks that continue to lurk amongst this frustratingly subdued global economy.

Underneath the Hood: Sluggish Earnings Growth and Multiple Expansion

As noted, since 2012, dividend growth has been quite strong along with index performance. This relationship is no surprise to us. However, operating earnings per share increased only 13% over the period, or a pathetic 2.5% per year.[1]

The net result of strong stock performance and weak earnings has been a rising price to earnings (PE) multiple – up 54% to 21 times trailing earnings from 14 times earnings. The current valuation compares to a 10-year median PE of 18 times earnings. As for divi-

Chart 1. The Six Longest Bull Markets (in months) as of 6/30/17



Source: S&P Capital IQ/WSJ.com

dends, they increased largely because of a rising payout ratio – up to 43% in 2016 from an admittedly low 27% in 2011. Still, readers will recall that our approach emphasizes rising dividends, underpinned by higher earnings and not rising payout ratios. Sustainably higher earnings are necessary to support sustainably higher dividends.

We now find ourselves in the midst of the second longest bull market in modern history (Chart 1 on page 1). Sure, there have been intermittent pullbacks, but they've been short-lived and relatively shallow – one may be hard-pressed to recall the brief pain post-Brexit last June. Market volatility has faded to multi-decade lows (Chart 2), and investors, particularly of the passive variety, seem to be patting themselves on their backs for receiving surprisingly strong equity index performance.

The Good News:
Earnings Growth is Accelerating

Of course, even if the market is approaching the latter rounds of a title bout, doesn't mean that the knockout punch is necessarily about to be landed. There are some data points that support sustained strength.

Namely, after the sluggish earnings period described above, S&P 500 operating earnings are expected to surge 21% year over year in 2017 and another 14% in 2018, with broad-based strength across most sectors, including earnings from energy and materials companies that have receded in recent years.[1] First quarter S&P 500 operating earnings were up 20% year over year, lending credence to the optimistic 2017 forecast, even allowing for the typical estimate reductions as the year progresses. Using the current full-year consensus estimate, the 2017 PE is 19 times earnings – only one turn above the aforementioned 10-year median.

The growth outlook is also better for small to mid-sized companies. Aggregate earnings for small and mid-cap companies are expected to increase 19% and 12% this year, respectively, both after weak results in 2016.[2]

The Bad News: The Market Does Not Reward Complacency in the Long Run

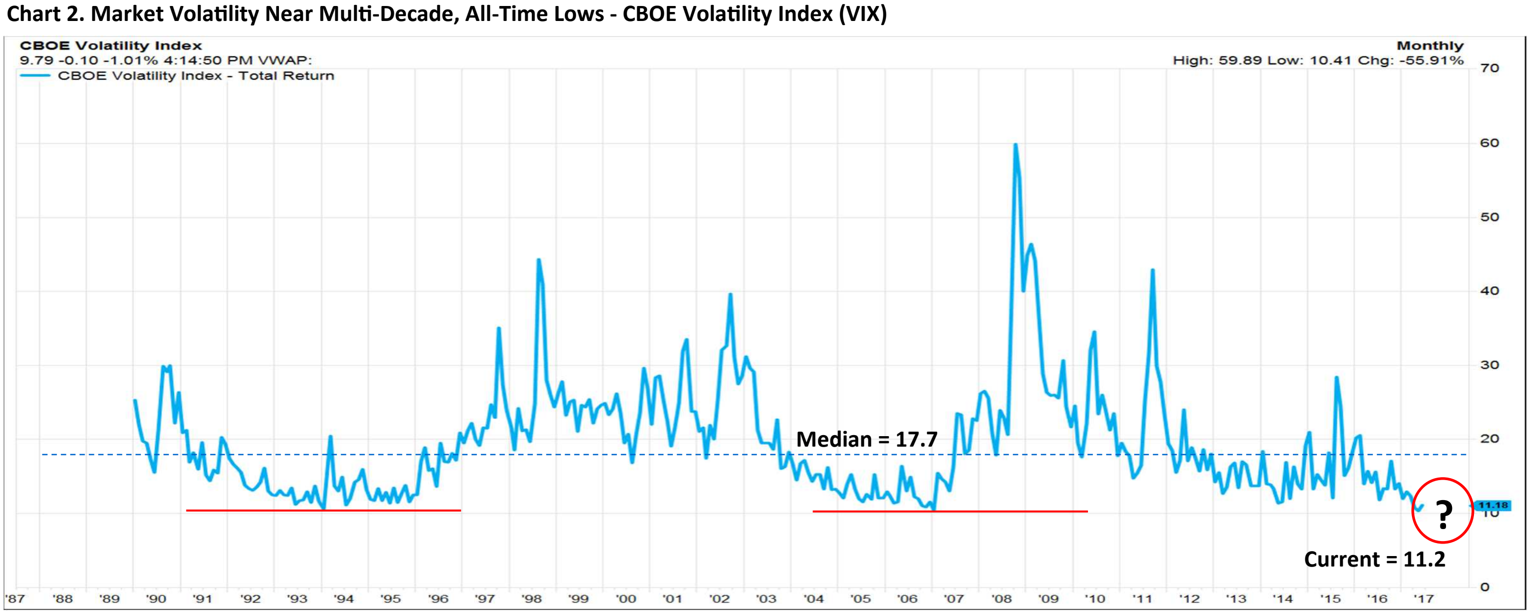
Concurrent with the bull market, massive amounts of money have flowed into ETF and smart beta investment products. A recent *Barron's* cover story, "Man vs. Machine," noted that "passive and quantitative strategies now account for 60% of equity assets, up from less than 30% a decade ago."[3] The same piece put the passive component at 37% of total US fund assets and also noted that "there are nearly 6,000 indexes today, up from 1,000 a decade ago," while the number of stocks in the Wilshire 5000 Total Market Index has more than halved since 1998 to under 3,500.[4] To have more indexes than stocks is striking. A source in the story estimates that "just 10% of trading volume originates from fundamental discretionary traders."

The fact that the rise of thousands of new products coincides with an aging bull market may be sheer coincidence. However, it is also a fact that many of the specialized, leveraged, and/or concentrated ETF vehicles are not time tested. As for purely passive index vehicles, these strategies can contribute to "greater fool theory" stock valuations since inflows are directed to purchase shares without regard to valuation or fundamentals. As active investors, we at Copeland find pleasure in taking advantage of purchase and sale opportunities that occur as a result of the shrinking pool of fundamental, price sensitive competitors.

This brings us back to Mike Tyson's famous quote: "Everybody has a plan until they get punched in the mouth." We wonder how the thousands of new products will perform should markets experience a more volatile and down-trending environment. Remember that aside from differences in valuation levels, underlying fundamental characteristics of companies can produce a wide range of upside and downside risk attributes for individual stocks and portfolios. Many new products haven't "lived" through periods of pronounced volatility.

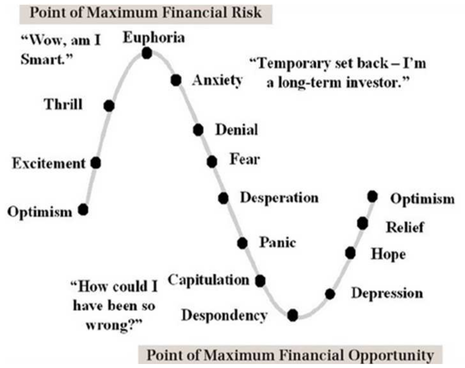
When we'll see a shift in the current complacent mindset is difficult to say. However, we are certain that it will occur, and we strongly believe that the investment cycle is not a relic of the past. In observing the emotions that are depicted over the investment cycle, as shown in Chart 3, we estimate that today

Chart 2. Market Volatility Near Multi-Decade, All-Time Lows - CBOE Volatility Index (VIX)



Source: FactSet.

Chart 3. Behavioral Psychology Over Investment Cycle



Sources: Ritholtz.com.

we are approaching the "Thrill" phase. While "Euphoria" could still be coming around the bend, we believe investors should always be prepared for the inevitability of more painful phases in the cycle.

Back to the Future: Watching for "Taper Tantrums"

A substantial unknown today is the impact of monetary tightening by the US Federal Reserve Bank. Fed actions include not only raising short-term rates, but also plans to start unwinding more than four trillion dollars of open market account holdings. We have long wondered how the market would react when the liqueur of easy money is removed from the market.

To-date, Fed hikes have brought the upper end of its target federal funds to 1.25%, a historically low level, but one, nevertheless not witnessed since 2008.[5] Despite the upward shift in short-term rates, the yield on the ten-year US Treasury slipped by 15 basis points during the first half of 2017, to settle at 2.30%. The moves have resulted in a marked flattening of the yield curve, an occurrence which often presages equity market turbulence. Another worrisome trend is equity market breadth which has narrowed as the number of stocks hitting new highs continues to wane.[6]

Tightening monetary policy, coupled with a lackluster economy and political gridlock, could prove an unpleasant mix for the equity markets in the months ahead. Oddly, the mere mention of tightening in years past brought heightened market volatility, but now that the long anticipated unwind is happening, investors are sanguine. Does passivity breed complacency?

Time Proven Downside Protection and Upside Participation

Mark Twain is credited with having said, "History doesn't repeat itself but it often rhymes." While acknowledging that today's valuations are lower than where they were in 1999, the overwhelming conviction in the so-called "new way of doing things," rhymes quite a bit with what we saw then. The graves that were being dug for value investors are similar to those being dug for active investors now.

We actively tilt the odds of investment success in our favor by owning only dividend growth stocks, which tend to outperform on the downside while providing healthy participation in rising markets. As noted in last quarter's *Review*, for All Cap dividend growers from 1981 through 2016, downside capture was only 79% versus 150% for non-dividend payers, 100% for flat payers, and 117% for dividend cutters (Chart 4). The low downside capture for dividend growers helps explain why shares of this select group of companies consistently outperform over market cycles with far less risk. As we also noted last quarter, during rolling periods from March 1981 through December 2016, dividend growth stocks outperformed the benchmark the majority of the time over one, three, five and ten-year rolling periods.[7] Notably, dividend growth stocks even outperformed in the robust return environment of 1990s, as well as during the volatile 2000s and the upward trending (so far) 2010s.

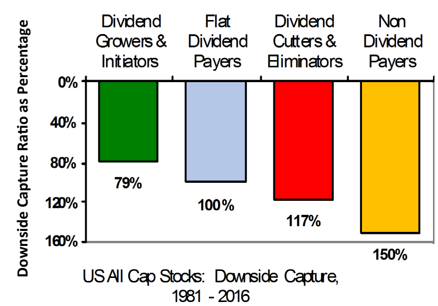
Please forgive us if we sound like a broken record. It is only because the data illustrates that the odds of beating the market are much better when owning only dividend growth stocks.

We remain as diligent as ever selecting stocks for our portfolios. We continue to find companies with levels of both dividend and earnings growth that are meaningfully above market levels, while also trading at reasonable valuations. We remain confident that dividend growth is the primary determinant of long-term capital appreciation and we believe that our disciplined implementation can deliver very favorable risk adjusted returns over full market cycles. As such, we believe our portfolios are not only positioned to participate in any incremental market gains, but most importantly we believe that they can provide protection when the market delivers a "punch in the mouth" and rampant complacency is interrupted.

July 2017

[1] *S&P Down Jones Indices, http://us.spindices.com/indices/equity/sp-500.*
[2] *FactSet.*
[3] *Barron's, "Man vs. Machine: How Has Indexing Changed the Market," July 2017.*
[4] *Wilshire.com, Wilshire 5000 Total Market Index, June 2017 Fact Sheet.*
[5] *The Federal Reserve https://www.federalreserve.gov/newsevents/pressreleases/monetary20170614a.htm.*
[6] *SPDR Blog http://blog.spdrs.com/post/charting-the-market-5-charts-i-look-at-for-todays-complex-markets.*
[7] *Ned Davis Research and CCM.*

Chart 4: Dividend Growth Stocks Tend to Decline Less During Market Drawdowns



 The information presented is intended to illustrate performance of stocks according to their dividend policy. 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. Flat Dividend Payers included stocks that pay a dividend but have not raised or lowered their existing dividend during the previous 12 months. Non Dividend Payers included stocks that have not paid a dividend during the previous 12 months. Dividend Cutters included stocks that lowered their existing dividend or eliminated their 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.

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.

Disclosure Section:

The views expressed herein represent the opinions of Copeland Capital Management and are subject to change based on market, economic or other conditions. These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. All data referenced is from sources deemed to be reliable, but cannot be guaranteed as to accuracy or completeness. All investments are subject to risk including possible loss of principal.

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. Returns for periods of greater than one year are annualized. The r*eturns shown in the Charts herein include dividends reinvested. The historical data are for illustrative purposes only and do not represent the performance of any strategy overseen by Copeland strategy 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 payer** if it paid a cash dividend any time during the previous 12 months, a **dividend grower** if it initiated or raised its cash dividend at any time during the previous 12 months, and a **non-dividend payer** if it did not pay a cash dividend at any time during the previous 12 months.

Chart 2: *© FactSet Research 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.

*The Indexes mentioned are unmanaged, are not available for investment and do not incur expenses. 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 **Wilshire 5000 Total Market Index**SM is widely accepted as the definitive benchmark for the U.S. equity market, and measures performance of all U.S. equity securities with readily available price data. You cannot invest directly in an index.*

<u>Definitions</u>

Dividend Yield *is a company's total annual dividend payments divided by its market capitalization, or the dividend per share, divided by the price per share.*

Dividend Growth Rate *is the annualized percentage rate of growth that a particular stock's dividend undergoes over a period of time.*

The material in this letter is for informational purposes only. It represents an assessment of the market environment at a specific point in time and is intended neither to be a guarantee of future events nor as a basis for any investment decisions. It should also not be construed as advice meeting the particular needs of any investor. Neither the information presented nor any opinion expressed constitutes a solicitation for the purchase or sale of any security.

Copeland Capital Management, LLC

www.CopelandCapital.com
www.CopelandFunds.com

Corporate Headquarters
Eight Tower Bridge
161 Washington St., Suite 1325
Conshohocken, PA 19428
484-351-3700

Atlanta Regional Office
1230 Peachtree St., NE, Suite 1900
Atlanta, GA 30309

Boston Regional Office
62 Walnut St., Fl 3
Wellesley, MA 02481