Fourth Quarter 2016

The Copeland Review

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

Never Tell Me the Odds!

C-3PO: Sir, the possibility of successfully navigating an asteroid field is approximately three thousand, seven hundred and twenty to one.

HAN SOLO: Never tell me the odds!

- *Star Wars: Episode V - The Empire Strikes Back*, 1980

Last year was horrendous for all types of odds-makers. In January, Citigroup put the odds of a 2016 US recession at 65%, although the consensus view was 18% and the Federal Reserve Bank's view was 10%.[1] In June, the UK voted to leave the EU even while prominent betting outfits placed the odds of "Brexit" at less than 10% as polls were closing.[2] And, in November, Donald Trump's surprise US Presidential election victory defied great odds. According to the website of statistician and pollster Nate Silver, not long before the election – on October 17th – the likelihood of Trump winning sagged to a low of 12% before recovering to only 29% on Election Day.[3]

In the latter two cases, as each unlikely outcome came to fruition, the initial market reaction was sharply negative. However, even someone who had successfully predicted these unexpected results ultimately would have been wrong to be bearish on global equities. Through February 11th, largely because of recession fears, both the S&P 500® Index and the MSCI ACWI ex-US Index were down more than 10%. Yet, for the year, the S&P 500 Index closed up 12% on a total return basis, having recovered an impressive 20% from its February low, while the MSCI ACWI ex-US Index also finished in positive territory.

The lesson in all of this? As Han Solo exclaimed to C-3PO, "Never tell me the odds!" We agree with Han that predicting outcomes is typically a futile exercise. As we've shared in prior versions of *The Copeland Review*, our crystal ball is hazy, at best. Rather than laboring over uncertain future events to seek investment success, our research process has always, and will continue to, identify companies with strong future dividend growth potential. In this *Review*, we further explain our rationale in the context of recent developments.

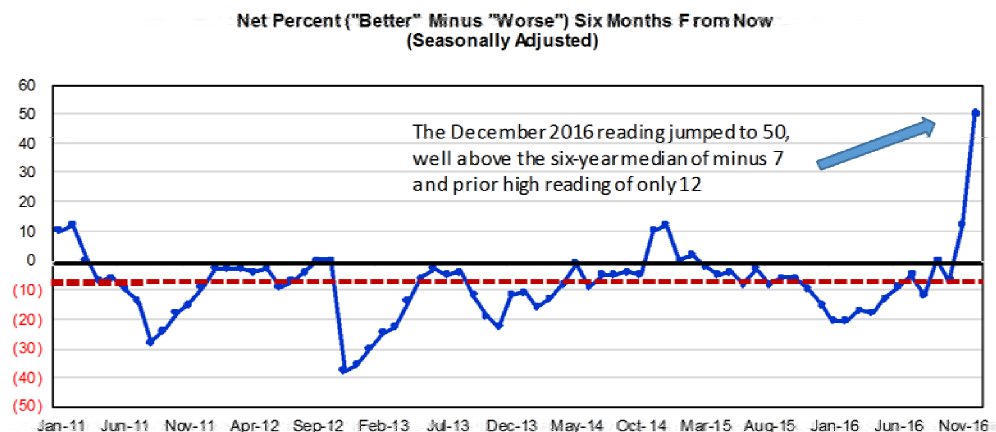
Animal Spirits Overwhelm Policy Uncertainty

As US poll results showed Trump taking the lead on election night, international markets and US futures plummeted out of fear of what a Trump Presidency might actually mean. However, the next day, market psychology suddenly shifted to optimism from doom. The doubly unexpected result of a unified Republican White House and Congress introduced the possibility of less political gridlock, reduced regulation, lower taxes, and a generally more pro-business climate in Washington. The rally turned into an aggressive surge in the days and weeks that followed, with investor moods further buoyed by improving domestic economic statistics.

Psychology is everything, it seems. The post-election market rally coincided with large upward moves in a range of confidence readings. Consumer confidence, as measured by the University of Michigan's Index of Consumer Sentiment, jumped in December to its highest reading since January 2004. Likewise, business confidence, as measured by the Institute for Supply Management's United States Purchasing Managers Index (PMI), bounced to its highest level since December 2014. Finally, the National Federation of Independent Business (NFIB) released data showing that 50% of small business owners expect the economy to improve six months from now (see Chart 1).[4] This marked a whopping 38-point increase from the November reading, and is, by far, the most favorable reading in at least six years. Hence, "animal spirits," defined by John Maynard Keynes as "a spontaneous urge to action rather than inaction," are alive and well in the United States.[5]

We concur that human psychology can drive real economic activity. When businesses are more optimistic about the future, they are more prone to make investments in employees and physical plant. Likewise, when consumers are more optimistic, they'll loosen their purse strings and spend more, increasing demand for goods and services. The happy theoretical result: a virtuous cycle of growth with higher employment and wages, higher company earnings and dividends, higher equity prices and greater overall wealth. By con-

Chart 1. Gigantic Bounce for NFIB's Outlook for General Business Conditions



Source: NFIB, Copeland Capital Management.

trast, if businesses and consumers feel more pessimistic, then demand shrinks and economic activity is diminished. Per Keynes, "enterprise will fade and die."[5]

The importance of "animal spirits" is not merely Econ 101 theory. Historical data support a very strong connection between psychology and economic activity. Research from the Federal Reserve Bank shows a 75% correlation between the manufacturing PMI and gross domestic product growth.[6] Others have shown a similar 75% correlation between daily consumer confidence readings and consumer spending.[7] Since personal consumption expenditures make up nearly 70% of US gross domestic product, the positive year-end confidence readings bode well for economic growth headed into 2017.

However, as we move from the abstract of Trump's campaign rhetoric to the concrete realities of "getting things done" in Washington, the policy path forward and timing are quite unclear.

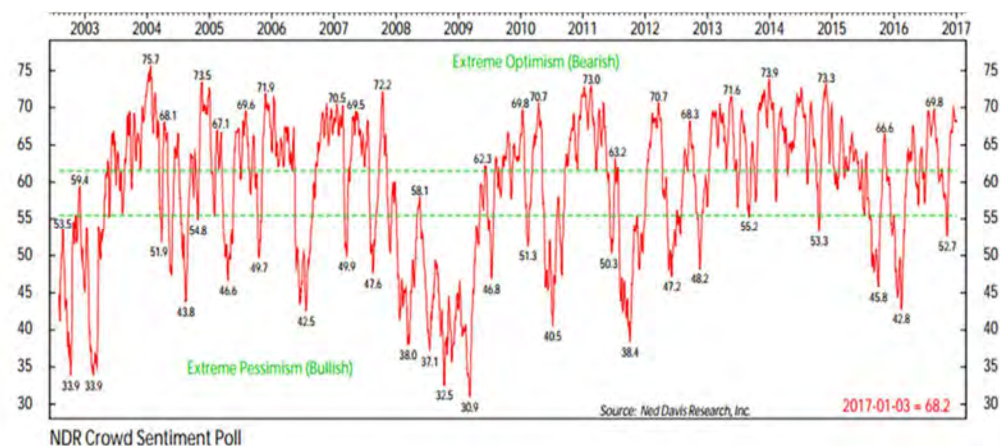
Possible Asteroid Fields

Despite unified party control, gridlock could still emerge as a headwind to infrastructure spending and tax reforms, including any changes related to trade policy and the proposed border adjustability tax. The latter, for example, is likely to be subject to considerable debate given its potentially significant negative impact on a wide range of import-oriented companies.

Aside from working through complicated nuances of fundamental tax reforms, paramount concerns include how to fund new infrastructure spending and tax cuts amidst ongoing budget deficits and a rising cost of borrowing. Deficit hawks will certainly fight hard against any proposal expected to add meaningfully to the country's mounting debt burden. Further, if tax rates are reduced, will the economy accelerate enough to drive the same or more tax revenue? Also, trade policy changes may be construed as protectionist and could possibly lead to trade wars with foreign partners.

Whether, and in what form, new policy measures come to pass will remain a significant factor in the sustainability of the market's Han Solo-like confidence, in our view. Beyond policy uncertainty, a host of other risk factors lurk that could impact near-term economic activity and profits: tighter credit conditions

Chart 2. NDR Crowd Sentiment Poll Suggests Caution



due to rising interest rates, higher energy prices after a doubling in oil since early 2016, rising wage pressures, higher health care expenses, and reduced export demand because of a stronger US dollar. In addition, the US economy has been in recovery mode for nearly eight years since the 2008-09 downturn, today yielding late cycle economic conditions with very low unemployment and increasingly challenging year over year growth comparisons.

To top all of this off, the recent market rally has been fueled by an expansion in price-to-earnings ratios and not increased earnings forecasts. In fact, aggregate US earnings expectations for 2017 across all capitalization ranges – small, mid, and large cap companies – were revised downward over the last three months.[8] Meanwhile, the current "bull market" is now the third longest in modern history, only trailing the bull markets of the "Roaring 1920s" and technology-driven 1990s.[9]

Given uncertain policy changes and their timing, as well as other headwinds, we would not be surprised to see the equity markets pause and even retrace some recent gains. We do not wish to throw a wet blanket on the party, but we cannot, nor will we ever be pollyannaish about what the future might bring, especially given curveballs that frequently come into play. Often, extreme optimism is a bearish indicator (see Chart 2).

The Yield and Beta Rally

In our Third Quarter *Copeland Review*, we shared certain drivers of 2016 returns through September, noting the strong performance of high dividend yield stocks as well as high beta stocks (beta is a popular measure of a stock's sensitivity to market moves). Now that the year is complete, we conducted a follow-up analysis using data from FactSet to evaluate the performance of all US stocks with market capitalizations greater than one billion dollars. According to the data, on a market capitalization weighted basis in 2016, high dividend yield stocks were up 28%, high beta stocks rallied 20%, and high dividend growth stocks rose 8%, all compared to the average return of 12% for the all-capitalization universe.

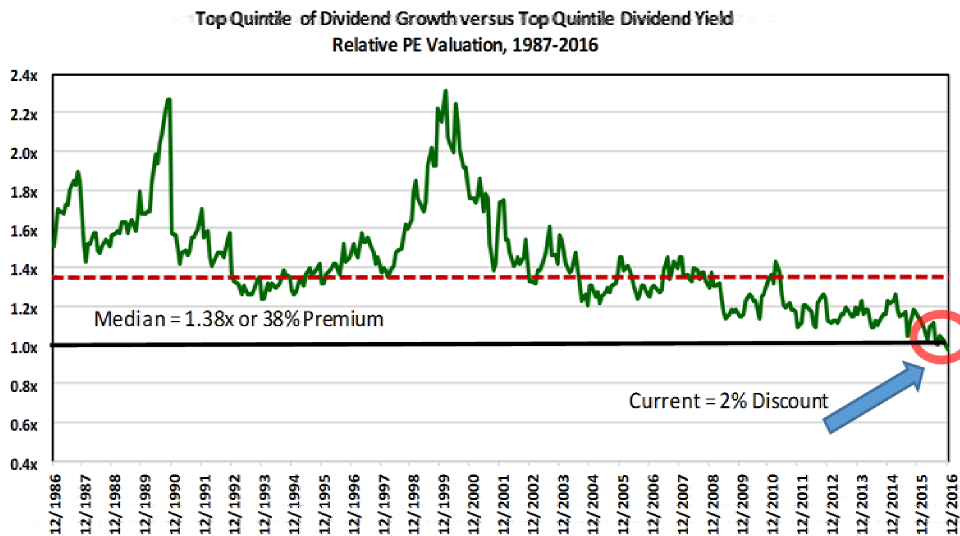
Typically, the most challenging relative performance environment for dividend growth stocks is during an aggressive "beta rally," a period where the market's most sensitive stocks move rapidly upward, often with no regard for their fundamentals, such as cash flow growth or valuation. This reflects what occurred during the second half of 2016. Still, the good news is that dividend growth stocks can deliver favorable performance in most types of market environments, offering healthy upside participation in upward moving markets and providing substantial downside protection in falling markets. While dividend growth stocks lagged in 2016, we believe the group could be poised for better performance in 2017 given an unprecedented valuation discount versus the broader market and high dividend yield stocks.

Valuation Matters!

After the strong rally in high dividend yield stocks, now is the only time in at least the last 30 years that these stocks have ever been more expensive than high dividend growth stocks (see Chart 3).

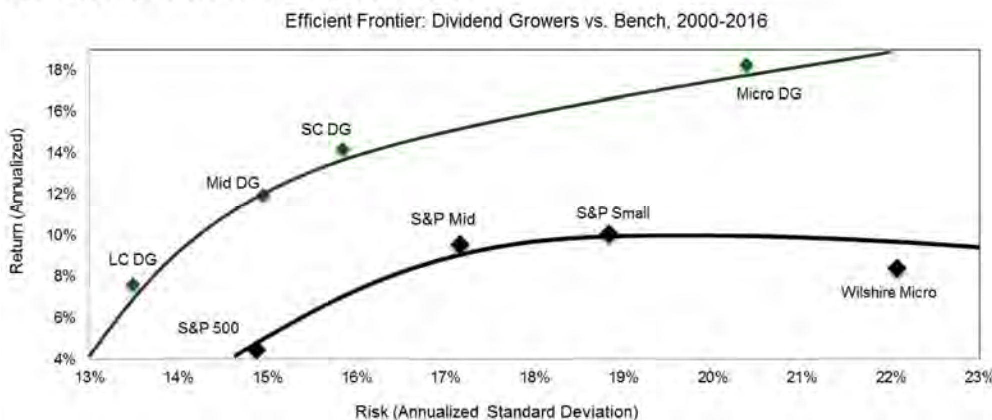
As a reminder, dividend growth companies historically garner premium valuations because they generate strong and growing cash flows, and are led by management teams com-

Chart 3: Dividend Growth Stocks are at a Historic Discount Relative to High Dividend Yield Stocks



Source: FactSet, Copeland Capital Management. Past performance is no guarantee of future results.

Chart 4. Dividend Growth Shifts Efficient Frontier



Source: Ned Davis Research, Copeland Capital Management. ***Past performance is no guarantee of future results.*** *The above chart intends to represent the historical risk and return of dividend growth stocks by market capitalization alongside comparable market benchmarks.* ***Dividend Growers*** *included stocks that raised their existing dividend, or initiated a new dividend during the previous 12 months. You cannot invest directly in an Index. For information on the Indices shown above as well as other important information, please refer to the Disclosure Section.*

mitted to returning excess cash to shareholders in the form of steady and increasing dividend streams. As a result, based on price-to-earnings (trailing) valuations over the three decades ended 2016, the top quintile of dividend growth stocks traded at a median premium of 5% over the S&P 500 Index's valuation AND an even greater median premium of 38% over high dividend yield stocks, which offer far less potential for growth and, hence, capital appreciation. Yet, as of December 31st, the top quintile of dividend growth traded at 17% discount to the S&P 500 Index's PE valuation AND a slight discount to the top quintile of dividend yield. Furthermore, with respect to their own historic valuation ranges, the highest dividend growth stocks were trading at an 8% discount while high dividend yield stocks were trading at a 23% premium.

Now that US Treasury yields are advancing upward and incremental Federal Funds rate hikes are likely forthcoming, the chase for dividend yield may be poised for a negative reversal. The apparent valuation disconnect could prove a very attractive entry point for dividend growth stocks, especially should interest rates continue on an upward trajectory.

We're NOT Playing the Odds

In our view, the political and economic reality of what unfolds will likely be somewhere in between the extreme market fears of a Trump Presidency – manifested in the market plunge on election night – and the post-election euphoria to-date. While many managers are speculating over the odds of President Trump's impact on the market and various sectors, the new administration will have very little impact on how we manage our dividend growth strategies at Copeland.

Our experience and research suggests that dividend growth companies offer investors a "best of both worlds," all-weather investment solution that should come out ahead after all the ebbs and flows of animal spirits across cycles. Strong competitive advantages and market positions typically support robust earnings growth that simultaneously enables a rising dividend and prudent reinvestment to sustain growth. In addition, in falling markets, these attributes mitigate downside risk. As a result, portfolios of dividend growth stocks tend to deliver attractive risk adjusted returns over time, and exhibit a superior historical efficient frontier relative to market benchmarks as illustrated in Chart 4.

With above average growth profiles, currently discounted valuations, and typically lower volatility, we believe our Dividend Growth approach offers an excellent blend of "offensive" as well as "defensive" characteristics. This combination should put clients in a strong position to outperform benchmarks over time, even while taking on considerably less risk and not perpetually relying on beating uncertain odds.

January 2017

[1] CNN, http://money.cnn.com/2016/01/26/news/economy/us-economy-recession-chance/
[2] WSJ, http://www.wsj.com/articles/big-london-bets-tilted-bookmakers-brexit-odds-1466976156
[3] Silver, Nate. FiveThirtyEight, https://projects.fivethirtyeight.com/2016-election-forecast/.
[4] NFIB http://www.nfib.com/surveys/small-business-economic-trends/.
[5] Keynes, John Maynard. The General Theory of Employment, Interest and Money, 1936.
[6] Chien and Morris. "PMI and GDP: Do They Correlate for the United States? For China?" Federal Reserve Bank of St. Louis, March 2016.
[7] Lazar, Nancy. "2017 Global Eco Outlook." Cornerstone Macro Research, December 2016.
[8] Factset.
[9] Ritholtz, http://ritholtz.com/2016/09/bull-markets-dow-jones-industrials-1900-present/

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

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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 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.

Charts 2 and 4: *© 2016 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved. See NDR Disclaimer at www.ndr.com/copyright.html. For data vendor disclaimers refer to www.ndr.com/vendorinfo/. Ned Davis Research adjusted its calculation method as of December 31, 2014 to capture only those names that meet a certain liquidity threshold in order to better represent the investable universe. As a result, historical performance information may differ from previously disseminated performance information for stocks according to their dividend policy. This is not the performance of the firm and there is no guarantee that investors will experience the same type of performance.*

Chart 3: *© 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* ***MSCI ACWI ex-US® Index*** *is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI® Index is maintained by Morgan Stanley Capital International, and is comprised of stocks from both developed and emerging markets. The* ***S&P MidCap 400® Index*** *is a market-capitalization-weighted index of the stocks of 400 medium-sized U.S. companies. The* ***S&P Small-Cap 600® Index*** *is a market-capitalization-weighted index of the stocks of 600 small-capitalization U.S. companies.* The **Wilshire US Micro-Cap Index**℠ is a benchmark of the micro-sized (based on capitalization) companies in the U.S. equity market and is a float-adjusted, market capitalization-weighted index of the issues ranked below 2,500 by market capitalization of the Wilshire 5000 Total Market Index ℠.

Definitions

Beta *is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole.*

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.

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