The Copeland Review

Fourth Quarter 2017

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

Jelly of the Month Club

***Clark**: It's a one-year membership in the Jelly of the Month Club.*
***Eddie**: Clark, that's the gift that keeps on giving the whole year.*
***Clark**: That it is Edward. That it is indeed.* *National Lampoon's Christmas Vacation, 1989*

Regardless of one's political leanings, it's fair to say that the markets have adjusted well to President Trump's, shall we say, "unorthodox style." While he has engaged a variety of adversaries through the Twittersphere – where a global media frenzy can be conjured up in 280 characters or fewer – corporate America and the equity markets have all but tuned out the noise. Instead, they've hung their hats on expectations that he will follow through on two of his core campaign promises: significant regulatory rollbacks and tax reform. Both factored heavily in his campaign and, ultimately, his election.

On the first promise, there is no doubt he's had some success. While all agencies have been tasked with reducing regulations and considering the cost of any new rules, two of the most notable results have been the delayed implementation of the Department of Labor (DOL) Fiduciary Duty Rule[1] shortly after his inauguration and the more recent reversal of Obama-era "net-neutrality" rules by the FCC.[2]

However, with respect to the latter promise, the market's apparent confidence throughout 2017 that tax reform would eventually be achieved belied the difficulties that the administration had in establishing support for other key initiatives. Nevertheless, as the year wound down, the GOP managed to pass the most sweeping tax reform bill since the Reagan era – The Tax Cuts and Jobs Act of 2017 (TCJA) – with the biggest gift of all appearing to go to corporate America.

Having been stuck between 34% and 35% since 1987, the US corporate tax rate has been a point of particular contention for the government and US corporations alike in recent years.[3] As globalization has increased over time, so too has the ability of companies to avoid paying that high rate. Indeed, investors have seen companies move their operations to lower tax domiciles, retain their foreign earnings outside the US and, in some cases, even move their headquarters abroad. This activity, and the related loss of tax revenues and jobs that followed, caused so much angst that the government actually issued regulations in 2014 and 2015 to prohibit so-called tax inversions.[4]

With the passage of the recent tax bill, however, the government shifted its strategy to one of rewarding companies for keeping their earnings in the US, from one of penalizing companies for generating and holding them elsewhere. Goodbye stick, hello carrot!

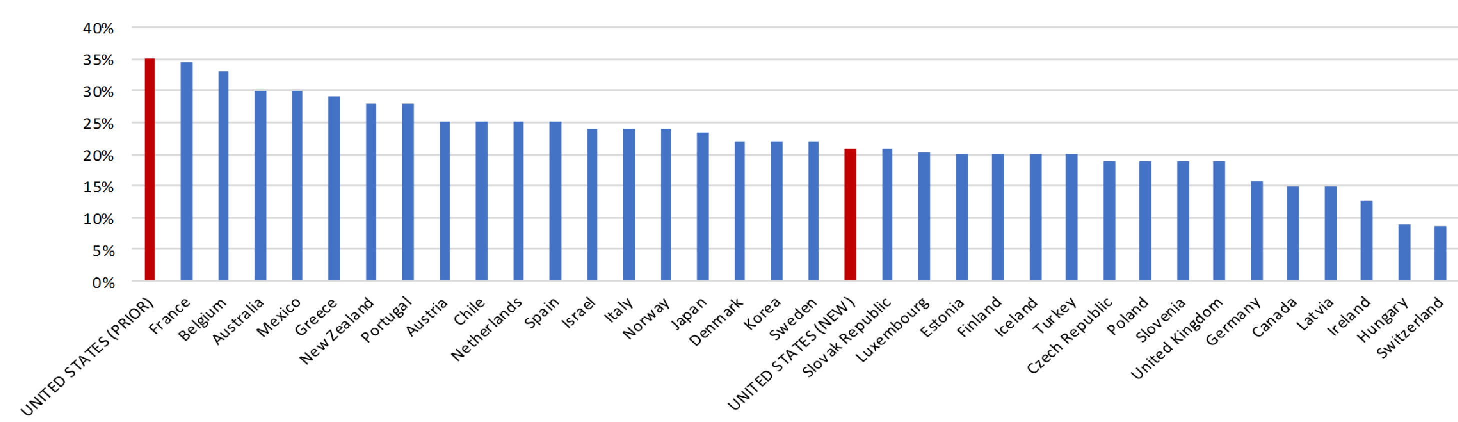
Under the TCJA, starting in 2018, the statutory corporate tax rate will drop from 35% to 21% –its lowest level since 1939 – making the US more competitive with other global markets (see Chart 1).[5] Much like a child holding a crisp $20 bill from Grandma on Christmas morning, we believe that the key elements of the new tax law will substantially enhance capital availability for American corporations in 2018 and beyond. Talk about a gift that keeps on giving!!

Significant Expected Earnings and Capital Boost

While most companies are not likely to see the full earnings benefit of a reduction in the corporate tax rate to 21%, Wall Street analysts and companies themselves across many industries are increasing their forward earnings outlooks materially.[6] According to Evercore ISI Research, the lower corporate tax rate will provide a 7% lift to the aggregate earnings expected for all S&P 500 Index companies in 2018, relative to what they would have earned under the prior tax code. This brings the expected 2018 earnings per share (EPS) growth rate to a robust 20% compared to an estimated 10% increase in 2017.[7]

Moreover, many companies, and in particular large technology companies such as Apple Inc. (Ticker: AAPL) with a $252 billion foreign cash pile, have long retained their foreign earnings overseas because of reluctance to pay high US taxes to bring them home. Now, such companies will be required to pay a one-time tax on past earnings, but will be able to repatriate them any time they wish. Further, future foreign earnings will be taxed at a modest rate of approximately 11% to 13% and will be available for use in the US as desired.[8] Taken together, these factors appear to have created a

Chart 1. OECD Corporate Tax Rates – US Moves from Highest to Middle of Pack



Source: Organization for Economic Cooperation and Development ("OECD").

substantial new pool of capital for many companies to invest as they see fit. Robert Pozen of MIT's Sloan School of Management and The Brookings Institution recently estimated that, "American companies will have $2.6 trillion of additional cash over the next five years" from these sources![9]

As conveyed in past Copeland Reviews, when allocating capital, companies have the following choices: internal investment in areas such as employee wages, capital expenditures or research and development, external investment via mergers and acquisitions, debt reduction or returning the cash to shareholders via buybacks or dividends. The basic inputs in deciding among these options are: 1) the amount of capital available for investment, which includes cash, as well as access to equity and debt financing, 2) the expected return on invested capital – or profits generated for every dollar of capital investment, 3) the cost of capital – or the combined costs of raising equity and debt, and 4) demand for the company's goods or services. When capital is available and the expected return exceeds the cost of capital, it makes sense to pursue growth investments so long as customers demand more output. When those hurdles aren't met, projects get passed over.

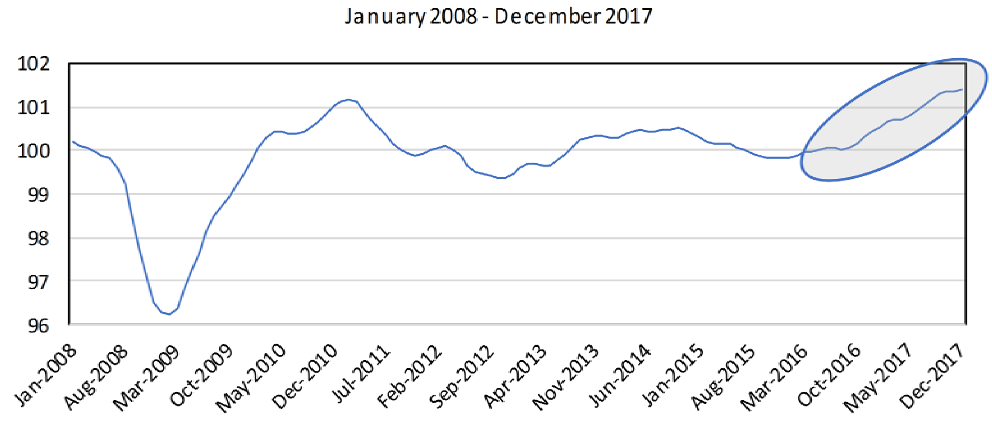
Lower Taxes = Increased Investment?

We've already established that capital availability is about to surge. In addition, a lower tax rate should increase the after-tax profitability of both existing and potential opportunities, thus making it economically viable for companies to pursue projects or even acquisitions they would previously have passed over. Further, outside of market-related factors that could influence the cost of both equity and debt, we would argue that the cost of borrowing could fall. In a competitive industry such as lending, we suspect the theoretical benefit of the lower tax rate will be competed away as banks can earn the same profits despite tighter margins. Finally, there needs to be demand for more goods and services that supports investment. With global business confidence surging over the past year (see Chart 2), there certainly appears to be an environment brewing where both internal and external investment opportunities see more green lights in the near future.

Not All Companies Benefit Equally

Many pundits are drooling over these greater earnings estimates for 2018, as they presumably add fuel to power the market's persistent upward march. Yet, the opportunity is different in every industry and for every company.

Chart 2 – OECD Business Confidence Surged to a Ten-Year High over the Past Year



Note: OECD data; Amplitude adjusted, Long-term average = 100, Jan 2008 – Nov 2017.

For many companies, there is a real risk that the full benefit of lower taxes will not flow through to the bottom line. Whether it does is, first and foremost, a function of the competitive advantage (if any) enjoyed by the company.

Why is competitive advantage so important in this discussion?

In highly competitive industries, it's likely that any potential increase in after-tax profits will be competed away in the form of price reductions and higher spending to retain and attract customers. We briefly mentioned banking above. Consider also apparel retail, where switching costs are low for customers. While many US clothing retailers may appear primed to benefit from the tax cut given typically high tax rates and largely domestic sales exposure, it's not hard to envision competitors ramping up advertising and/or lowering prices in an effort to take share as they can now earn the same after-tax profit selling merchandise at a lower price point than before. Under that scenario, retailers must respond with their own initiatives or risk losing market share. Either way, the main beneficiaries of the corporate tax cut are customers who now pay less.

This phenomenon extends to other areas as well. Regulated utilities are another industry where the benefit of lower tax rates will accrue to customers rather than companies. For utilities, pricing is a direct function of the after-tax return on capital that the regulators will allow those companies to earn.

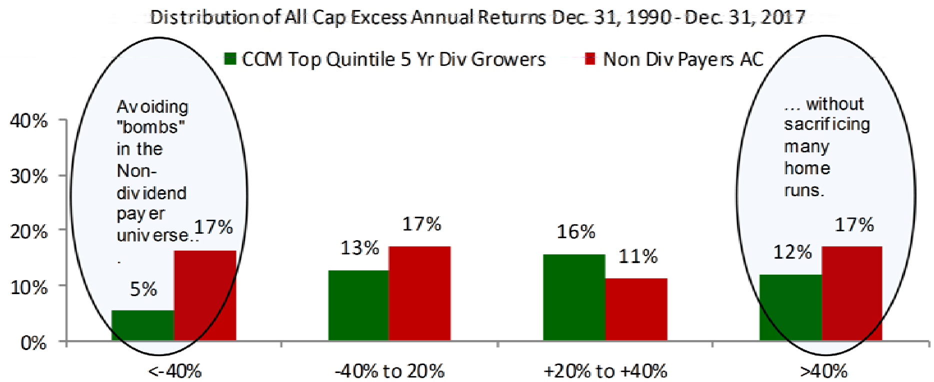
Finally, we've also seen a certain portion of the benefit of the tax cut being absorbed by personnel costs. While this may be perceived as goodwill gesture toward employees on the part of companies, this is also a function of the competitive landscape. For example, in the airline industry, it's notable that four major competitors have announced identical $1,000 bonuses to non-executive employees, as they battle for talent in a low unemployment economy. We think a related WSJ article titled, "Will Airlines Blow Their Tax Windfall?" asks an appropriate question.[10] The bonuses may be great news for employees, but they drag against the potential for higher earnings estimates in the near run. All that said, we surmise that higher employee compensation should lead to both increased spending and saving at the household level, which should have a positive multiplier effect for the macroeconomy.

Beyond the question of whether companies will see a windfall, there is also a question of whether they should be entrusted with such windfall if they do see it. The answer comes down to demand for their products and services.

Should a manufacturer build a new plant to produce products no one wants? Of course not. Should acquisitions be made at any price? No again. Sadly, however, many people, from politicians to seasoned investors, have made demands that companies spend any incremental capital on investment or mergers and acquisitions as if it's their civic duty. We strongly reject this view!

Companies should invest only in projects that will drive future cash flow growth. If none is available, they should return capital to shareholders, preferably in the form of dividends, so that it can be recycled into more attractive

Chart 3 – Dividend Growth Stocks Experience Far Fewer Severe Downside Events



- The chart above illustrates the lower error rate via the distribution of relative returns for Smid Cap Dividend Growth Stocks relative to non-dividend paying Smid Cap stocks
- We gladly accept the likelihood of slightly fewer home runs in exchange for dramatically minimizing our exposure to "blow ups"

Source: FactSet and Copeland Capital Management. The information presented is intended to illustrate the performance of Smid Cap 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. Non Dividend Payers included stocks that have not paid a dividend during the previous 12 months. Five year dividend growers are stocks that have raised their dividends for five consecutive years, while Copeland's top quintile five year dividend growers are a subset of this group of stock that rank highest in Copeland's stock raking model. There is no guarantee that companies will declare dividends or, if declared, that they will remain at current levels or increase over time.*

investment opportunities.

Our experience suggests, however, that many companies will find the temptation to reinvest the incremental capital too hard to resist. Instead, they will make poor investments right when the economy is hot and potential risks are more easily ignored. Recall Time Warner's ill-fated decision to merge with America Online (AOL) in January 2000, just prior to the technology bubble crashing, or GE's poorly timed choice to ramp up its energy investments in 2014, just before oil and gas prices plummeted.[11]

The Way Forward

By owning only Dividend Growers[12], we believe that Copeland implicitly emphasizes companies that enjoy significant competitive advantages and allocate capital wisely, typically leading to pricing power, healthy returns on invested capital, and reduced risk of major downside events. The dividend, and especially the commitment to growing it year after year, is – in our experience – a useful constraint that leads management to think twice before putting shareholder capital to work in risky opportunities. With that dividend growth guardrail in place, companies have historically been far less likely to make costly errors that harm operating performance and cause their stocks to decline – an occurrence that we have observed all too frequently among companies without such a guardrail (see Chart 3).

We believe these factors have particular implications in terms of Dividend Growers sustaining profit increases as their tax rates fall. As an example, using historical tax rate data and projected 2018 earnings, we estimate that the average company currently held within Copeland's Smid Cap Dividend Growth portfolio could see a 13% incremental lift to year-over-year profit growth strictly due to the tax law change, rather than having such benefits competed away.

For these reasons, we believe that members of the dividend growth universe as a whole will experience an above average lift to their earnings – a far superior gift for their shareholders than a membership to the "Jelly of the Month Club." Moreover, we expect that Dividend Growers are more likely to invest this gift wisely, which we believe will translate into an above average lift to future dividends. These factors should be supportive of higher stock prices and we believe that they will put Copeland's portfolios in a strong position to outperform looking forward while also mitigating any potential market stumbles.

January 2018

1 *"Conflict of Interest Final Rule." United States Department of Labor, 27 Nov. 2017, www.dol.gov/agencies/ebsa/laws-and-regulations/rules-and-regulations/completed-rulemaking/1210-AB32-2.*

2 *"Restoring Internet Freedom." Federal Communications Commission, 4 Jan. 2018, www.fcc.gov/restoring-internet-freedom.*

3 *"Corporate Top Tax Rate and Bracket." Tax Policy Center, 14 Feb. 2017, www.taxpolicycenter.org/statistics/corporate-top-tax-rate-and-bracket.*

4 *Goulder, Robert. "U.S. Chamber of Commerce Files Suit Over Anti-Inversion Regs." Forbes, Forbes Magazine, 30 Aug. 2016, www.forbes.com/sites/taxanalysts/2016/08/30/u-s-chamber-of-commerce-files-suit-over-anti-inversion-regs/#52f9c59b734d.*

5 *"Federal Corporate Income Tax Rates, Income Years 1909-2012." Tax Foundation, 16 Jan. 2017, taxfoundation.org/federal-corporate-income-tax-rates-income-years-1909-2012/.*

6 *Copeland Capital Management: If companies secured the full benefit of a tax rate reduction from 35% to 21%, all else equal, earnings would mathematically increase by 22% based on the following calculation: New after tax income divided by Old after tax income - 1; in this case (1-.21)/(1-.35) – 1 = 22%.*

7 *Evercore ISI Research, "S&P Rallying in Response to Positive Incoming Developments." January 2018.*

8 *Deutsche Bank Research, "The US Tax Cuts & Jobs Act." January 2018.*

9 *Pozen, Robert C., and Robert K. Steele. "Commentary: Public Companies Are About to Be Flooded With Cash. How Will They Spend It?" Fortune, 10 Jan. 2018, fortune.com/2018/01/10/trump-new-plan-bill-tax-cuts-jobs-act/.*

10 *WSJ, "Will Airlines Blow Their Tax Windfall?" January 2018.*

11 *Egan, Matt. "How Decades of Bad Decisions Broke GE." CNNMoney, Cable News Network, 20 Nov. 2017, money.cnn.com/2017/11/20/investing/general-electric-immelt-what-went-wrong/index.html.*

12 *Dividend Growers include stocks that raised their existing dividend or initiated a new dividend during the previous twelve (12) months.*

13 *©FactSet Data Systems, Inc., Copeland Capital Management. The collective earnings benefit to Copeland's portfolio companies based on analysts' consensus estimates for 2018 tax rates before the passage of TCJA, compared to a projected 21% tax rate across all companies post-TCJA.*

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

Chart 3: *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.*** 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.

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.

Definitions

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.

Earnings Per Share Growth (EPS) illustrates the growth of earnings per share over time.

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