First Quarter 2018

The Copeland Review

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

Taper Tantrums Revisited

"Go ahead, make my day." - Clint Eastwood as "Dirty" Harry Callahan in *Sudden Impact,* 1983

Through most of 2017 and into 2018, thanks to improving economic data and expectations for accelerated growth post tax reform, equity performance was strong and investor attitudes toward rising rates were sanguine. But, on February 5th the CBOE Volatility Index (VIX) suddenly spiked 116% and the S&P 500 Index sank 4% on concerns of higher interest rates and mounting inflation. By quarter-end, the US ten-year Treasury yield had climbed to 2.74%, up more than one-third of a point from year-end.[1]

The market is concerned on a few fronts. First, there's the risk that the Federal Reserve throws too much water on the fire, if it believes that the economy is overheating. Likewise, a mounting federal budget deficit – exacerbated by tax reform – may become increasingly difficult to finance at higher borrowing costs, while also crowding out private investment. Finally, recently announced US trade policies could result in a trade war that slows economic growth for the US and world.

In some ways, we've been here before. Almost five years ago, in "Taper Tantrums" (3Q 2013), we discussed heightened market volatility in the face of a rising ten-year US Treasury yield and widely held concerns related to the Federal Reserve backing away from its easy money policies, or quantitative easing (QE). At the time, some investors expressed concern that "dividend strategies" were likely to underperform as rates moved higher. We provided evidence that dividend growth can outperform during such periods, whereas high dividend yield strategies are prone to underperform as they are more akin to bonds.

Now, in the midst of a rising rate environment, and with investors again questioning whether dividend growth is the right strategy for this backdrop, we revisit these topics. We share new evidence that dividend growth is well-positioned to weather differing market environments, including a prolonged period of rising interest rates and heightened volatility. Also, we emphasize that a dividend growth approach is not equivalent to a high dividend yield strategy. Therefore, as we stare down the threat of higher interest rates, we confidently say, "Go ahead, make my day!"

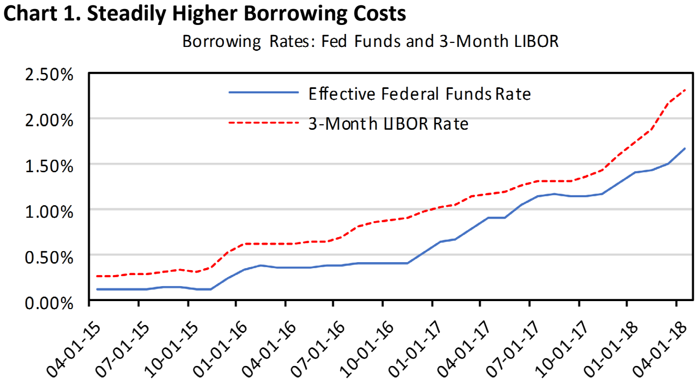
Steadily Higher Interest Rates

Back in May 2013, when then Federal Reserve Chairman Ben Bernanke merely hinted that tapering was possible, the ten-year US Treasury yield shot up to near 3.0% in September from a low of 1.7% in April. Yet, history shows that the ten-year US Treasury yield reversed course and trended largely downward, reaching a cyclical low in 2016. Moreover, while expectations for rising rates remained omnipresent, the Federal Reserve did not actually begin raising the federal funds rate until December 2015, more than two years later. But, after the first hike, the Federal Reserve raised four more times and expectations are for continued increases, potentially doubling the rate between now and year-end 2019.[2]

The US Treasury movements notwithstanding, other key interest rates have moved in only one direction over the last few years: upward. For example, the prime rate and the London Inter-Bank Offered Rate (LIBOR) have followed the federal funds rate higher. Over the past year, the three-month LIBOR rate has doubled, rising to 2.32% at quarter-end (see Chart 1). These rates are bound to move still higher, resulting in higher borrowing costs for a wide range of enterprises and consumers (e.g. mortgages, auto loans, student loans).

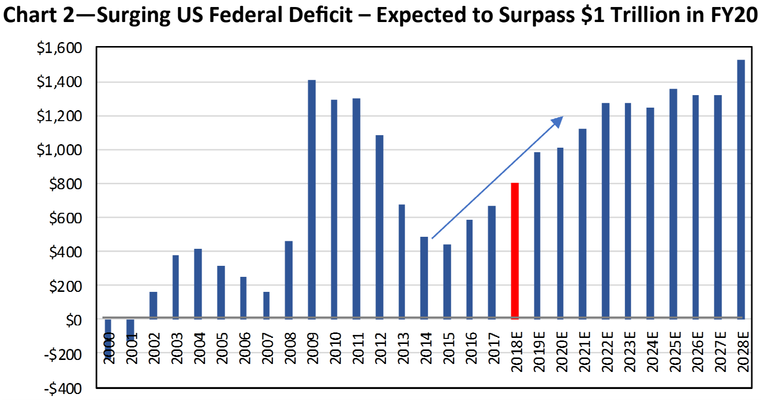
Meanwhile, corporations and consumers are not the only market participants impacted by higher rates. To the extent US Treasury yields continue upward, the US government also faces higher borrowing costs on a growing debt load that is compounded by rising annual operating deficits. The US Congressional Budget Office (CBO) estimates that the government's net interest costs will increase 20% year over year in fiscal 2018 to $316 billion. Further, 80% of the increase to the CBO's new deficit forecast for 2018 is because of an anticipated reduction in collections due to tax reform.[3] The CBO now forecasts a deficit surpassing one-trillion dollars in fiscal 2020, a 50% increase from 2017's $665 million deficit (see Chart 2).

Chart 1. Steadily Higher Borrowing Costs



Sources: FRED St. Louis Fed and New York Fed.

Chart 2—Surging US Federal Deficit – Expected to Surpass $1 Trillion in FY20



Source: Created by CCM using data from the Congressional Budget Office.

Broadly Accelerating Growth with Some Signs of Inflation

Coming on the back of tax and regulatory reforms, strong macro-economic measures are plentiful, providing the Federal Reserve with ample fodder for higher interest rates and likely alleviating the higher interest expense burden for many market participants. In its March 22nd Leading Economic Index® Report, the CBO commented that the "LEI points to robust economic growth throughout 2018" and that "its six-month growth rate has not been this high since the first quarter of 2011."[4] The overall LEI is at record levels, with material improvement over the past year (see Chart 3).

For another angle into economic vigor, we can look to The Cass Freight Index™, a measure of North American freight volumes and expenditures.[5] The March report revealed significantly higher year over year freight shipments and expenditures for the first two months of 2018, which we see as an indication of robust underlying US trends. However, the report also noted that capacity has "become extraordinarily tight" with pricing power rising to levels that "spark overall inflationary concerns in the broader economy."

In addition to macro-level indicators, strength is evident in underlying corporate fundamentals, capital spending plans, and outlooks, with both earnings and dividends buoyed by tax reform. For the All Cap Russell 3000 Index, expected earnings growth for 2018 is now 20% year over year, compared to 11% growth in 2017.[6] In addition to earnings acceleration, we posited in our last *Review* that the pace of dividend growth would also increase. With three months in the books, for companies that have announced dividend increases during the last three months, we estimate that the median one-year pace of growth increased to 13% from 7% for the Russell 3000 Index, and to 19% from 14% for Copeland's All Cap Dividend Growth Strategy.[7]

Dividend Growth Tends to Outperform in Rising Rate Periods

Given broad underlying strength, simmering inflation, and rising deficits, we fully expect rates will bump upward over the intermediate term. Fortunately, as we shared in the Third Quarter 2013 *Review*, dividend growth

Chart 3 – LEI Climbing to New Records

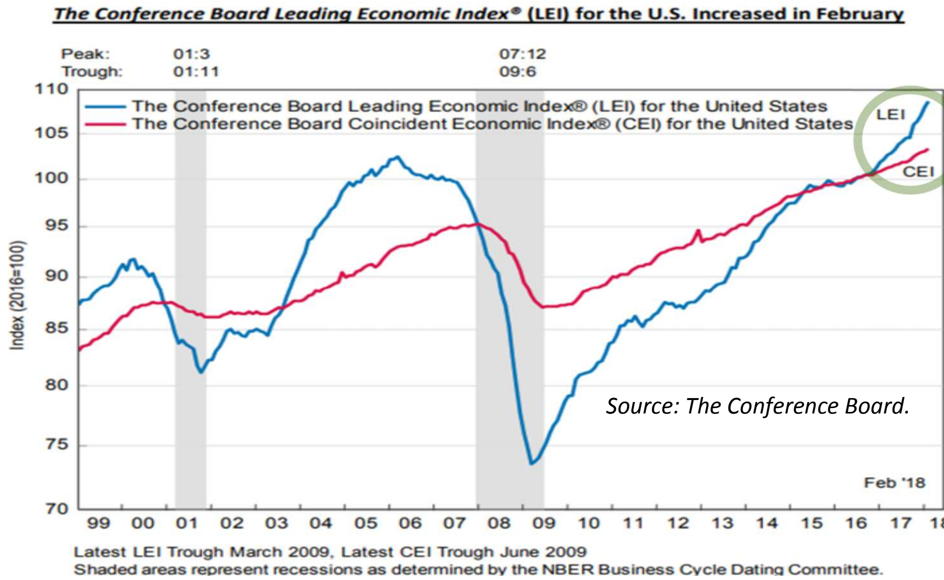


Chart 4. Average Annual Performance of All Cap Stocks During Rising Rate Periods, September 30, 1982 through March 31, 2018

Performance by Dividend Policy	Dividend Growers & Initiators	R3000 Index (total return)	Flat Dividend Payers	Dividend Cutters or Eliminators	Non Dividend -Paying Stocks
Annualized Return	12.1%	11.0%	10.0%	6.0%	4.9%
Relative to Div Growth		-1.1%	-2.1%	-6.1%	-7.3%

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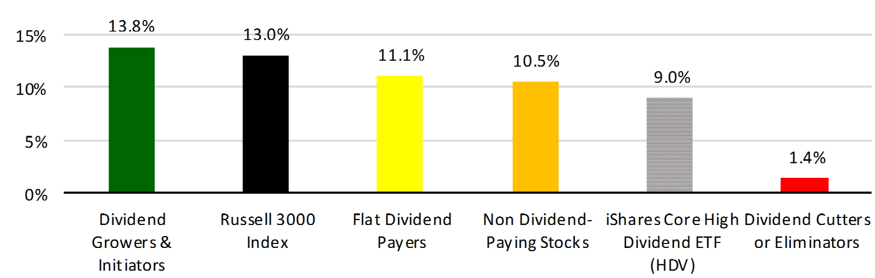
Chart 5. Historical Average Annual Performance - Last Five Years through March 31, 2018



Copyright 2018 Ned Davis Research, Inc., except FactSet sourced for information on HDV. The information presented is intended to illustrate performance of All 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.*** *FactSet was utilized for monthly performance information for the iShares Core High Dividend ETF (HDV).*

Charts 4 & 5: ***Past performance is no guarantee of future results.*** *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. There is no guarantee that companies will declare dividends or, if declared, that they will remain at current levels or increase over time. You cannot invest directly in an Index. For information on the Index shown above as well as other important information, please refer to the Disclosure Section. Further distribution prohibited without prior permission. All Rights Reserved.*

stocks have historically outperformed during rising rate environments (see Chart 4). Even during the 2013 rate scare, for instance, dividend growth outperformed both the S&P 500 Index and high dividend yield stocks during the first nine months of 2013. Yet, admittedly, that was a short time frame.

We believe the common investor expectation beginning in 2013 was that the Federal Reserve was going to move to a tightening stance by reversing QE and raising rates. In fact, the Federal Reserve first released monetary policy "normalization principles" in June 2011, and announced in late 2013 that it would begin to taper its open market purchases of various securities.[8] Thus, the experience of the past five years provides a very recent performance "laboratory" in which to assess dividend growth versus the market and other types of strategies, such as high dividend yield, during a period of monetary tightening. Notably, this time frame also represents a period of generally upward trending equity prices as part of the long running bull market.

Chart 5 demonstrates how All Cap equities, broken down by dividend policy using Russell 3000 Index constituents, have performed during the last five-years. Despite a period marked by expectations for and actual rising interest rates, as well as a bull market offering double digit returns, dividend growers were the best performer. Meanwhile, over the same period, the iShares Core High Dividend ETF (HDV), a passively managed fund that owns US common stocks having relatively high dividend yields, posted only 9.0% annualized returns, falling well short of the dividend growth universe returns, as well as the Russell 3000 Index.[9]

Chart 6. Copeland's Pace of Dividend and Earnings Growth: Small Cap, Mid Cap, and Large Cap versus Relevant Benchmarks

	Small Cap		Mid Cap		Large Cap	
Summary As of 03/31/18	CCM	R2000	CCM	RMID	CCM	SP500
Five-Year EPS Growth (% CAGR)	11.7%	7.8%	10.7%	6.9%	10.7%	6.2%
Five-Year Div Growth Rate (% CAGR)	14.6%	-3.3%	14.9%	4.4%	17.9%	9.2%

Sources: FactSet and CCM. Compound annual growth rates (CAGRs) calculated using aggregate ordinary dividends and aggregate earnings on a trailing twelve-month basis compared to the same figure for the prior period. For information on the Indexes shown above as well as other important information, please refer to the Disclosure Section.

Go Ahead, Make Our Day!

The five-year performance outcome may surprise some investors given a common misperception that higher interest rates are negative for "dividend strategies." We believe investors who hold this view, however, are incorrectly lumping high yield and dividend growth strategies into one bucket. Whereas high yield companies often lack an engine for consistent growth, dividend growth companies typically benefit from competitively advantaged business models, which help them to establish strong market positions that support favorable returns on capital through economic cycles.

In contrast to many high dividend yield companies, the companies that we hold tend to post outsized dividend and earnings per share growth versus their benchmarks. Chart 6 shows the five-year average annual pace of dividend and earnings growth for the quarter-end holdings of Copeland's Small Cap, Mid Cap, and Large Cap domestic strategies relative to their respective benchmarks.

Although past performance is no guarantee of future performance, the historical record of dividend growth is solid. Therefore, as the paradigm of sustained higher rates unfolds, we expect that Copeland's Dividend Growth portfolios will remain well equipped to grow cash flow and dividends at a healthy pace, which should support share prices. Go ahead, make our day!

April 2018

[1] *FactSet.*
[2] *"Economic projections of Federal Reserve Board members and Federal Reserve Bank Presidents." FOMC, March 2018, https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20180321.pdf.*
[3] *"The Budget and Economic Outlook: 2018 to 2018." Congressional Budget Office, April 2018, https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/53651-outlook.pdf.*
[4] *"Leading Economic Index® Report." The Conference Board, March 2018, https://www.conference-board.org.*
[5] *"The Cass Freight Index™ Report." Cass Information Systems, Inc., March 2018, https://www.cassinfo.com/Transportation-Expense-Management/Supply-Chain-Analysis/Cass-Freight-Index.aspx.*
[6] *FactSet using iShares Russell 3000 ETF (IWV) as Proxy for Russell 3000 earnings estimates.*
[7] *FactSet and CCM.*
[8] *"Fed to taper bond buying by $10 billion a month." CNBC, December 2013, https://www.cnbc.com/2013/12/18/fed-begins-taper-program.html.*
[9] *Product information for iShares Core High Dividend ETF (HDV) via ishares.com*

Disclosure Section:

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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 (continued):

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

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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.

Compound Annual Growth Rate (CAGR), is the return on investment over a period of time. It measures a true return on an investment by calculating the year over year returns, compounding them, and considering the investment values.

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