The Copeland Review

Second Quarter 2018

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

Caffeinated Market

"I'm so excited! I'm so…scared!"
- Elizabeth Berkley as Jessie Spano in "Saved by the Bell," Jessie's Song

Readers who can recall "Saved by the Bell," the campy comedy about a stereotypical group of high school friends attending fictional Bayside High, will no doubt remember the show's most dramatic episode: "Jessie's Song."

In the episode, Jessie Spano – the ultra-driven straight A student – finds herself struggling to keep up with her studies, while also meeting the demands of her new singing group. As the pressure mounts, she turns to caffeine pills to stay alert and becomes addicted to them. With the episode racing toward its thrilling conclusion, Zack Morris, the uber-popular leader of the group, goes to see his friend, concerned for her safety. Though she tries to mask the effects of the pills, casually singing along to the hit song, "I'm So Excited," she ultimately breaks down crying and issues her famous follow on line: "I'm so…scared."

With another quarter of strong returns now behind us, many investors seem to be struggling with their own Jessie Spano moment of sorts.

"I'm So Excited!"

Make no mistake, even as we work our way through the ninth year of a bull market, excitement certainly abounds, evidenced by investors' sustained appetite for higher volatility, non-dividend paying stocks over Dividend Growers in recent times.

Given the considerable real estate that we have devoted in earlier editions of this piece to demonstrating the historically superior returns and lower risk profile of Dividend Growers relative to other types of stocks, this underperformance may come as a surprise. However, we have frequently reminded readers that this advantage should not be confused with an ironclad guarantee that Dividend Growers will outperform every month, every quarter or even every year. Instead, we note that the Dividend Growth universe is typically most advantaged in normalized upward trending markets, low return periods, and especially during bearish times when volatility is on the rise.

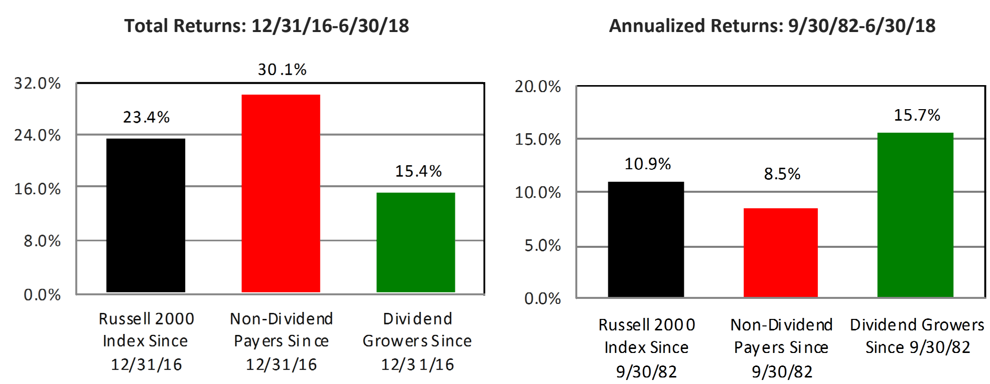
Alternatively, Dividend Growers tend to lag during aggressive rallies, when investors show little concern for potential future risks. The past 18 months have been such a period. Consider the small cap space, in which returns have been particularly robust as investors seek safe haven from trade concerns impacting large cap multi-nationals. Small cap Dividend Growers have lagged non-dividend payers by nearly 1500 basis points since the end of 2016 (Charts 1 and 2).

Double-digit headwinds against Dividend Growers over 18 months are rare, having occurred only 10% of the time since 1982, whereas double-digit tailwinds have happened more than 50% of the time over the same period.

Thankfully, Copeland's alpha solution is not solely reliant on the long-term outperformance we expect from the Dividend Growth universe. We are also proud to have both significant quantitative tools and a fundamental research team that we believe can enhance those returns. As a result, we are gratified to have overcome this headwind and to have outperformed the Russell 2000 index during the period from December 31, 2016 to June 30, 2018 (Chart 3). We believe that success reflects the three sources of potential outperformance working as designed, with the latter two offsetting the recent weakness of the universe.

Still, we take particular comfort in knowing that after periods like this, the deck is likely to be stacked in our favor going forward, based on past results. Indeed, following the 13 prior periods of double digit underperformance[1], small cap Dividend Growers have outperformed dramatically, returning an average of

Charts 1 and 2: Small Cap Dividend Growers Have Recently Lagged Non-Dividend Payers, In Sharp Contrast to History



Sources: Russell, NDR © 2018 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/. The information presented is intended to illustrate performance of Small 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. Ned Davis Research adjusted the universe used for the domestic study as of December 31, 2017, from the Ned Davis Investable Universe to a universe based on the applicable Russell benchmarks. As a result, historical performance information may differ from previously disseminated performance information for stocks according to their dividend policy. 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. 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. 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. Past performance is no guarantee of future results.

30% versus only 3% for non-dividend payers and 12% for the Russell 2000, over the subsequent 18 months.

Of course, it is difficult to know when the market's preference will shift from high volatility stocks toward high quality stocks, which we believe commonly populate the Dividend Growth universe. For the moment, there are a few persistent reasons investors could remain "so excited."

First, even more so than in the last several years, macro-economic data are supportive for equities. During the second quarter we observed the US unemployment rate falling to 3.8% in May – a level it hadn't touched since April 2000[2] – while at the same time, we saw the Small Business Optimism Index reach its sixth highest reading in history in June[3]. Not to be outdone, the Federal Reserve's Industrial Production Index also climbed to an all-time high as the quarter closed.[4]

Secondly, as one might imagine, this favorable macro backdrop has helped to push corporate earnings estimates higher as well. In fact, since the end of last year, 2018 earnings estimates for the companies in the S&P 500 Index have jumped nearly 9%. Even adjusting for the benefit of tax cuts, bullish estimate revisions of this magnitude have been non-existent in recent years. Instead, since 2010, analysts have consistently started each year with unrealistically rosy profit projections only to ratchet them downward as growth failed to achieve initial forecasts. Given not just the level, but the trajectory, of earnings estimates, it's perhaps no surprise that the market has continued to climb.

Finally, in a perverse twist, some market pundits have referred to the current run in stocks, despite its length, as "the most hated bull market ever,"[5] noting how bond allocations have remained robust and investor sentiment has generally remained measured, rather than euphoric, as is often seen near market tops.[6] While it would be naïve to count on pure contrarianism to carry the day in terms of future market performance, these readings are especially notable when married with reasonable valuation levels, such as we are experiencing currently. For example, the S&P 500 Index is trading at 16.9x 2018 expected earnings, nearly in-line with its ten-year median of 15.9x, even as investors expect 33% earnings growth over 2018 and 2019 – similar to the prior six years combined.[7]

I'm so…scared!

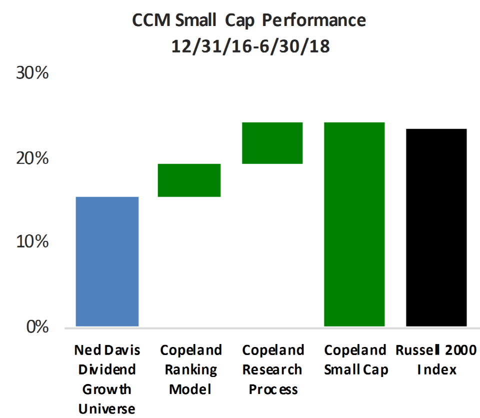
Nevertheless, potentially ominous themes have developed more recently, which could ultimately present significant hurdles to continued strength.

First, as we've talked about before, interest rates have started to rise, and the Federal Reserve expects to continue its current campaign of gradual hikes through 2020. Higher interest rates can be an albatross to both earnings and valuation multiples, and while we have seen valuations moderate, the major indexes have largely shrugged this off to move higher. On some level, this is not unreasonable given the extraordinarily low starting point for rates in this cycle, and the aforementioned strength of earnings. Still, if history is a guide, vigilance is warranted.

Secondly, interest rate spreads have compressed, with two-year rates – driven by near-run inflation concerns – rising more quickly than ten-year yields, which have been constrained by questions about longer-term growth and persistently low yields abroad. Historically, even though the reaction has often been delayed, following an "inversion" in the 2-10 spread (short-term bonds commanding higher rates than longer-term bonds), equities have ultimately fared poorly and recessions have frequently ensued. While we have yet to even dip into negative territory, the shrinking spread is not an encouraging sign.

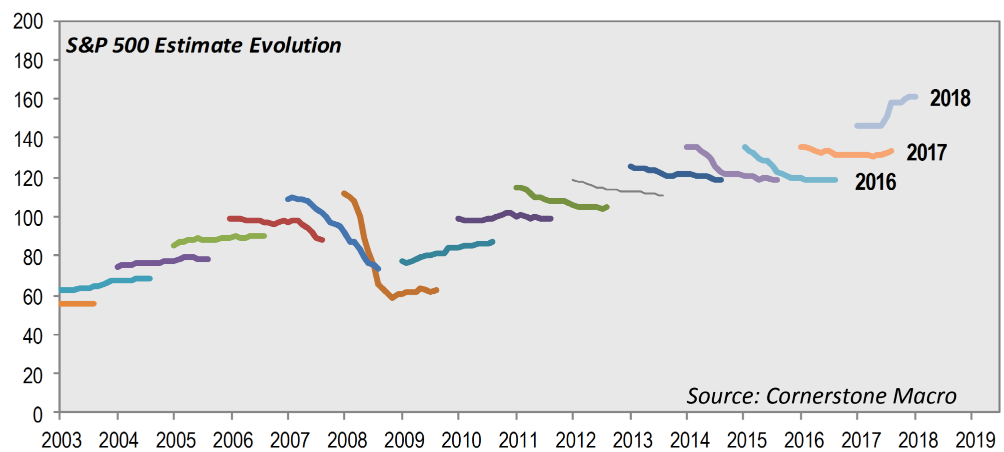
Thirdly, and in our view *by far* most importantly, strong market performance has accrued in the face of a burgeoning trade war. Last quarter, we mentioned the concern that newly announced US trade policies could lead to slower global growth. At the time, we think

Chart 3—Despite the Dividend Growth Headwind, Copeland's Small Cap Portfolio Outperformed



Sources: NDR, FactSet, Russell, CCM. The data quoted represents past performance and does not indicate future returns. Gross returns include transaction costs, but do not reflect the deduction of investment advisory fees. A client's return will be reduced by the advisory fees and any other expenses it may incur in the management of its investment advisory account. Copeland's management fees are available in Copeland's ADV Part 2A. Total return is calculated assuming reinvestment of all dividends, interest and capital gains. After-tax results will vary from the returns presented here for those accounts subject to taxation. The Ned Davis information presented herein 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 Ned Davis 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.

Chart 3—S&P 500 Index Earnings Estimates Start High Then Retreat…Until 2018!



most investors believed the commentary coming out of Washington was simply a negotiating tactic designed to achieve specific objectives with key trading partners, such as tackling long-documented intellectual property theft and technology piracy by Chinese companies.[8]

Now, with key deadlines having passed, and no joint agreements having been reached, the stakes are considerably higher. We have a prisoner's dilemma that could continue indefinitely as both the US and China have dug in, and the list of items subject to new tariffs numbers in the thousands. Further, while investors may once have believed that the US would reach individual or collective agreements with other important trading partners that aren't engaged intellectual property theft, there are few signs of that type of compromise. Instead, our European and North American allies are also participating in the "game," with some retaliating and others launching efforts to have the tariffs struck down through the World Trade Organization.

In fairness, there is no question that, even beyond the well-documented challenges of doing business in China, some of our other key trading partners also make it near impossible to achieve the Trump Administration's stated aim of engaging in "free, fair and reciprocal trade."[9] For example, India maintains its own high tariffs, while Japan has erected considerable non-tariff barriers to dissuade any non-native companies from doing business on its shores.

Much as these observations might afford the US the moral high ground from which to launch its trade offensive, we must acknowledge the potential downsides of these actions – as we learned in Econ 101. First, because of the elasticity of demand, trade barriers lead to higher prices and lower aggregate demand, thus resulting in slower economic growth. Secondly, though the President has expressed concern over the US trade deficit, we would argue that deficits are a normal and necessary part of a global trading system, and that the US – which has run deficits since the 1970s – has benefitted immensely from having done so. This is reflected in our rising standard of living and derives from the comparative advantages of global production.

Should the Trump Administration ultimately be successful in employing this version of "economic chicken" to tear down key trade barriers, it would certainly be considered a win, and would likely be well-received by the market. In the meantime, however, there is a real possibility that a global trade war has already begun. This leaves earnings and margins, already facing increased risk from the aforementioned higher interest costs, under additional pressure as the cost of imports rise and sales to foreign countries decline.

Finally, as noted above, the CBOE Volatility Index (CBOE: VIX), also known as the "fear gauge," has remained stubbornly low by historical standards.[10] While a low reading in concert with market strength is not atypical, it confirms investors' ongoing willingness to take substantial risk even at this late point in the cycle, aiding the outperformance of higher risk non-dividend paying stocks, as noted above. If one or more of the noted risks, or even an unforeseen event of some sort, were to cause a sustained change in investors' mindsets, the downside risk for higher volatility stocks could prove especially significant.

What to do if you're excited, but maybe a little scared, too

It probably goes without saying that we believe our Dividend Growth strategies represent the best way to navigate these competing forces. In addition to the near-run potential for a relative performance recovery, we cannot overemphasize the long-term consistency with which Dividend Growers have outpaced both other buckets of stocks, as well as the market. For example, in the past we have shown how Dividend Growers have outperformed in both growth and value-oriented markets (http://www.copelandcapital.com/pdf/Copeland_Review_1Q16.pdf), and in periods of both rising and falling interest rates (http://www.copelandcapital.com/pdf/Copeland_Review_1Q18.pdf).

We think this consistent outperformance derives from three common traits that are broadly shared by Copeland's Dividend Growers. First, they have *sustainable* competitive advantages, helping them to maintain and grow market share and expand margins. Secondly, those benefits are often accompanied by secular growth drivers such as an expanding market opportunity or geographic expansion. Finally, they are led by shareholder-focused management teams which are less likely than peers to pursue value destructive investment opportunities.

By creating a portfolio of stocks that share these attributes, we believe we are in a strong position to outperform going forward, and are excited, NOT scared to face whatever surprises the market throws in our path in the coming quarters.

July 2018

[1] *Based on Ned Davis data, since 9/30/1982, Small Cap Dividend Growers, have experienced 14 six quarter periods of double digit underperformance relative to Small Cap non-dividend payers. In addition to the current period, 12/31/16-6/30/18, prior periods covered: 6/30/1998-9/30/2000, 6/30/2002-9/30/2004, 3/31/2008-9/30/2009 and 9/30/2008-12/31/2010.*

[2] *https://data.bls.gov/pdq/SurveyOutputServlet*

[3] *https://www.nfib.com/surveys/small-business-economic-trends/; The small business optimism index is compiled from a survey that is conducted each month by the National Federation of Independent Business (NFIB) of its members. The index is a composite of 10 seasonally adjusted components based on the following questions: plans to increase employment, plans to make capital outlays, plans to increase inventories, expect economy to improve, expect real sales higher, current inventory, current job openings, expected credit conditions, now a good time to expand, and earnings trend.*

[4] *https://fred.stlouisfed.org/series/INDPRO; The Industrial Production Index (INDPRO) is an economic indicator that measures real output for all facilities located in the United States manufacturing, mining, and electric, and gas utilities (excluding those in U.S. territories).*

[5] *https://www.cnbc.com/2018/05/01/investors-continue-buying-bonds-amid-the-most-hated-bull-market.html*

[6] *https://money.cnn.com/data/fear-and-greed/*

[7] *FactSet*

[8] *"The IP Commission Report," The National Bureau of Asian Research, May 2013 http://www.ipcommission.org/report/IP_Commission_Report_052213.pdf*

[9] *https://www.wsj.com/articles/why-the-white-house-worries-about-trade-deficits-1488751930*

[10] *FactSet; The CBOE Volatility Index® (VIX® Index) is a leading measure of market expectations of near-term volatility conveyed by S&P 500 Index (SPX) option prices.*

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.

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

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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 **CBOE Volatility Index® (VIX® Index®)** is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. The **Russell 3000® Index** measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. The The **Russell 2000® Index** is comprised of the smallest 2000 companies in the Russell 3000® Index.

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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