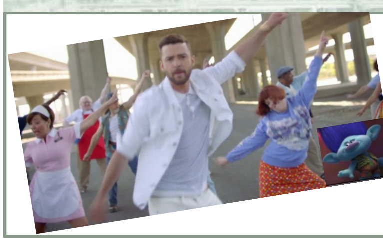
Second Quarter 2021

The Copeland Review

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



Can't Stop the Feeling!

I got this feeling inside my bones
It goes electric, wavey when I turn it on
All through my city, all through my home
We're flying up, no ceiling, when we in our zone

- "Can't Stop the Feeling!" by Justin Timberlake, from DreamWorks Animation's "Trolls," 2016

In the face of widely publicized COVID-19 induced supply chain and labor disruptions, as well as rising inflation, the US economic recovery accelerated during the second quarter. Strong economic data was underpinned by a receding number of COVID cases thanks to rising vaccinations and increased confidence in a more normalized summer and beyond.

Correspondingly, investors stateside and abroad were exceedingly optimistic. Net inflows into global equity funds during the first half were the largest on record (Chart 1)[1] and the S&P 500 Index recently "notched its 36th record close of the year."[2] As the title song continues, "I got that sunshine in my pocket… I can't stop the feeling, So just dance, dance, dance."

However, concern around virus "variants" is mounting and case numbers are on the rise in numerous parts of the US and world. At the same time, year-over-year growth is poised to moderate.

In this *Review*, we highlight:

1. The massive economic recovery driving both the broader market and our dividend growth stocks.
2. Rising risks and clear signs of exuberance – both rational and irrational – that pervade the market.
3. The incredible risk/reward opportunity that both domestic and international dividend growth stocks offer, in our view, as Copeland's selected companies afford better growth and trade at historically inexpensive valuations.

"We're flying up, no ceiling, when we in our zone"

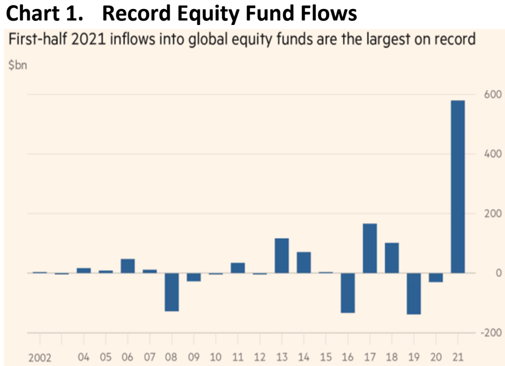
A chorus of economists, including those at the Federal Reserve[3] and the International Monetary Fund[4] recently raised 2021 real GDP forecasts for the US, with growth now projected at 7.0% for the year, which would mark the fastest pace in almost 40 years.[5] Corporate and personal balance sheets are flush, access to low-cost capital abounds, wages are rising, and jobs are plentiful. Unemployment is going down and expected to be 4.5% at year-end.[6] In this context, it is no wonder that the equity markets are euphoric.

Numerous companies have taken advantage of these high equity prices to sell stock aggressively (Chart 2). Perhaps most emblematic is AMC Entertainment Holdings Inc. (NYSE: AMC), which raised over $2.2 billion via seven stock sales in the last nine months.[7] Make hay while the sun shines, right?

With hindsight that the vaccines are effective, the speedy recovery and strong stock prices are well justified. Considering that global economic activity was essentially halted in spring 2020 and reopened gradually through the balance of last year and into 2021, a wide array of companies are facing "easy" year-over-year revenue and earnings comparisons, leading to a record number of beat-and-raise results and massive earnings growth.[8]

As a result, even with cost headwinds related to supply chain and labor constraints, underlying earnings power for 2022 is broadly near or above the level expected just before the pandemic surge in spring 2020 (Chart 3). Importantly, dividend growth companies are also experiencing similar tailwinds. Their strength is best illustrated by looking at the rising trendline of dividend hikes and the declining trend of dividend cuts quarter by quarter.

Chart 1. Record Equity Fund Flows



Source: Financial Times

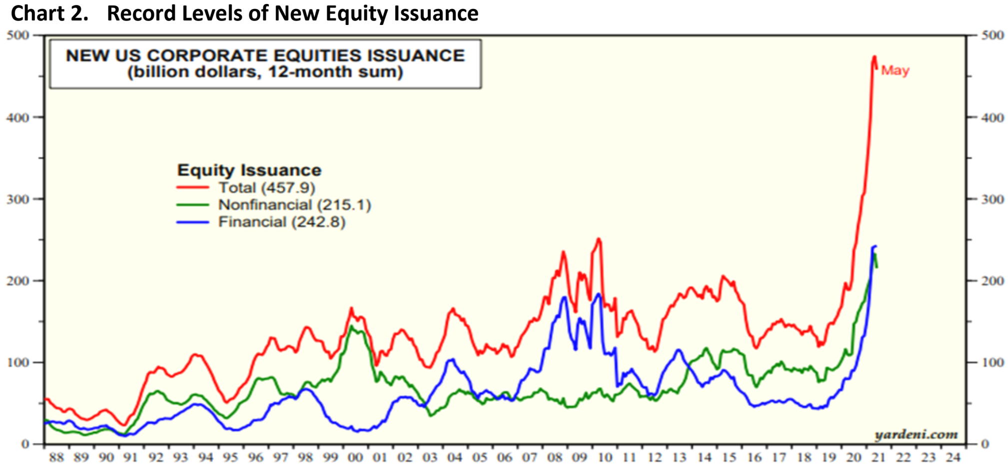
Among Russell 2500 Index constituents, there were 198 dividend increases and only 11 cuts during the second quarter (Chart 4, left panel). The number of hikes was 30% above the second quarter 2019 level (pre-COVID) and more than double the trough number of hikes in the second quarter of 2020. On the "cutter" side, the number of cuts was less than one-sixteenth the peak number of cuts in 2020, which also occurred in the second quarter. Among large cap S&P 500 constituents, the upward trend in hikes and reduction in cuts is similar (Chart 4, right panel). An analogous pattern is evident for international companies, too, albeit with some lag.

The combination of recovering fundamentals and a resurgence in dividend growth is leading to healthy returns for both the domestic and international dividend growth stocks.

Potential Party Spoilers

Notwithstanding the many positive drivers of recovery, there are numerous things askew that could, at minimum alter, or entirely "stop the feeling." For example, in the last two *Re-*

Chart 2. Record Levels of New Equity Issuance



Source: Yardeni Research/Federal Reserve Board

Chart 3. 2022 EPS Estimate History for Select US and World (ex. US) Benchmarks Since 2/28/2020

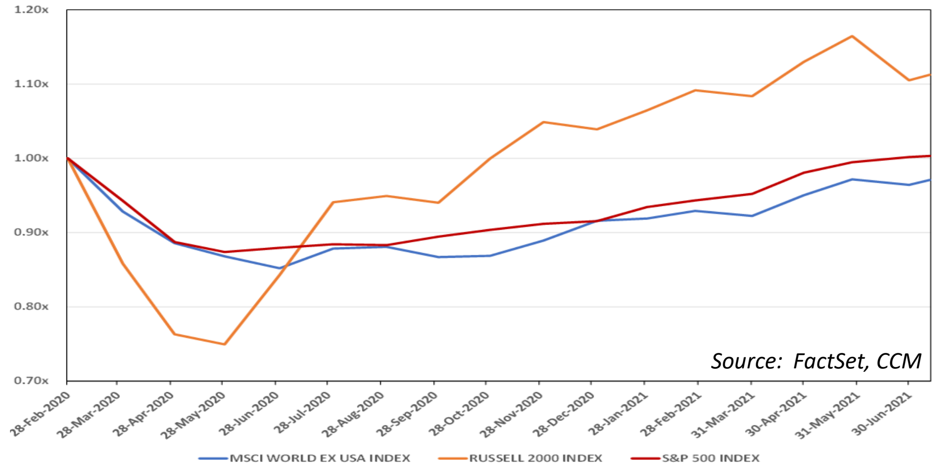
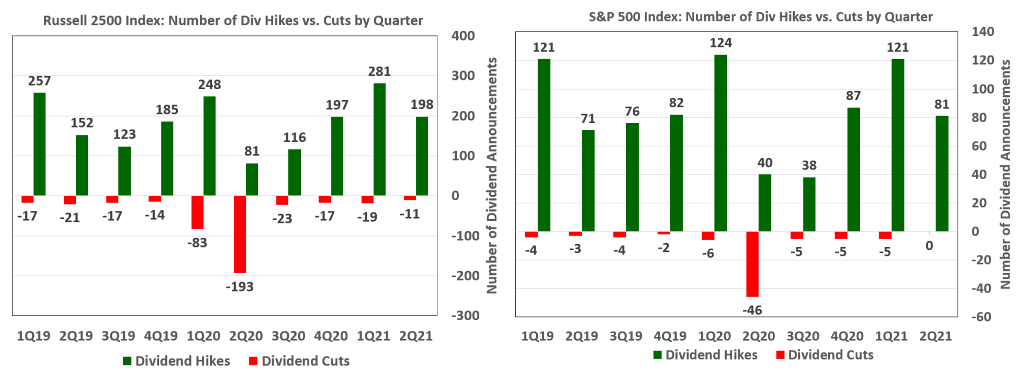


Chart 4. SMID- and Large-Cap: Dividend Hikes versus Cuts by Quarter, 1Q19 – 2Q21



Source: FactSet, CCM

views, (Let's Not) Party Like it 1999 and Running Hot, we expressed our concerns about investor speculation backed by the easy money policies of the Federal Reserve (monetary) and the US Congress (fiscal).

Specifically, last quarter, we pointed to the explosion of issuance activity by special purpose acquisitions companies (SPACs), the extraordinary valuations assigned to certain non-fungible tokens (NFTs) and the dramatic acceleration in the growth of margin leverage. Our *Review* further emphasized heated US macroeconomic conditions and evidence of mounting inflation, all while the government remained hyper-stimulative.

Since then, the US government has continued to stoke the bonfire and is, arguably, bucking the basic teachings of Economics 101. Extraordinary levels of monetary and fiscal stimulus are usually reserved for severe downturns, not utilized in an economy poised to grow at the fastest pace in 40 years. If "the patient" has more than recovered, why overdose with more "medicine" and risk the introduction of avoidable market distortions?

After trillions of dollars in stimulus, we believe numerous public and private asset values are inflated, in many cases compounded by an elevated level of debt used to support merger, acquisition and leveraged buyout activity, which is going gangbusters.[5] Against this backdrop, we suspect that many investors are ill-prepared for changes in access to, or the cost of, that capital – as well as a moderating growth environment – which could lead to a range of unpleasant outcomes.

A non-exhaustive list of potential party spoilers includes:

1. **Renewed pandemic related fear and government mandated curbs on economic activity.** While evidence to-date suggests that vaccines are highly effective at preventing hospitalizations from COVID variants,[9] parts of Europe and Asia remain locked down as the pandemic lingers and "Delta" variant case infections flare upward. Government, corporate, and consumer reaction to the next spike is unpredictable.

2. **Elevated inflation persists:** Many industries are struggling to rebuild inventories drawn down during the pandemic while production was put on temporary hold. Bottlenecks range from a lack of shipping containers to difficulty finding workers. At the same time, surging demand created upward pressure on prices for a wide range of goods and services, as well as on labor costs. Annual US inflation ticked upward to 5.4% in June from 2.6% in March and 1.4% or lower in prior months.[10] The impact of markedly higher inflation could crimp forward operating results and lead to negative earnings surprises, especially if prolonged.

3. **"Early" monetary tightening by the Federal Reserve via tapering or rate hikes.** Current inflationary pressures are presumed by the Fed to be "transitory" and the Fed still expects only 3.0% for full-year 2021, followed by 2.1% in 2022 and 2023.[3] Likewise, real GDP growth is expected to moderate to 3.3% in 2022. Given this stance, the Fed plans to continue purchasing US Treasury securities and mortgage-backed securities, in addition to keeping the Federal funds rate effectively at zero until sometime in 2023. Through gigantic balance sheet expansion, the central bank has effectively absorbed new supply that might otherwise cause Treasury rates to drift upward. Yet, higher-than-expected inflation may force the Fed's hand and accelerate the pace of tightening.

4. **Higher borrowing costs as credit spreads normalize.** As we discussed in the third quarter of 2019, How Low Can You Go?, bond yields are typically a function of three things: inflation expectations, the risk-free rate, and the perceived risk of the investment (the credit spread). Even absent a quite plausible scenario where inflation is moving higher (see 2 and 3 above), the third factor may be long overdue for an upward "correction." Today, the perceived risk of corporate bonds, as expressed by the US Corporate BBB Index Spread is very low at 1.08%, or more than 90 basis points below the 25-year average.[11] Given the explosion in debt on corporate balances over the last four decades, the mere perception of higher risk, regardless of inflation concerns would have real consequences for corporate profitability.

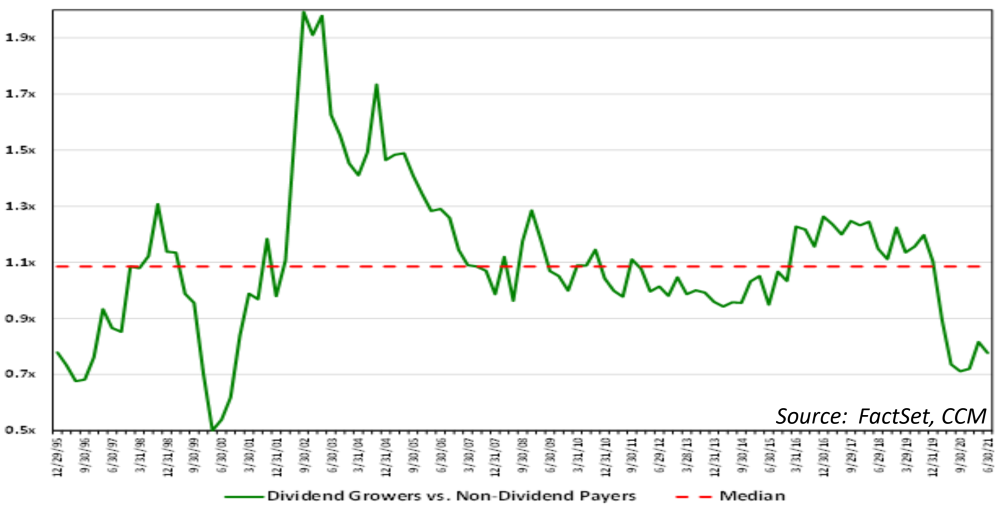
5. **Rising tax rates and stagflation.** Amidst widening current account deficits and a rising government debt to GDP level,[12] the Biden Administration is proposing new, expansive government spending programs. In an effort to partially fund the proposals, the administration is also planning significant revisions to corporate and personal tax policy. Further, the Finance Ministers of "G20" member countries recently agreed to a new 15% minimum global corporate tax framework that is expected to begin in 2023.[13] Higher taxes could arrive at a time of simultaneously decelerating economic growth and continued input inflation – or stagflation – all of which would make year-over-year earnings comparisons more difficult and likely curtail capital investment as well as consumer spending. This combination would not be favorable for equity prices.

Chart 5. Less Expensive with Better Growth and Lower Leverage - CCM US Smid Cap, Global Small Cap, and International Small Cap Strategies

Summary As of 06/30/21	CCM SMID CAP	R2500 INDEX	CCM GLOBAL SMALL CAP	MSCI WORLD SMALL CAP INDEX	CCM INTL SMALL CAP	MSCI WORLD EX US SMALL CAP INDEX
One-Year Dividend Growth Rate (Median)	9.1%	1.3%	10.6%	0.0%	10.0%	0.0%
One Year EPS Growth (Median)	12.4%	7.5%	5.3%	-5.9%	8.5%	-4.4%
NTM P/E Ratio	18.3	20.1	18.4	21.6	17.8	17.9
Net Debt to EBITDA	0.9	1.5	0.5	1.0	0.6	0.7

Source: FactSet, FTSE Russell, MSCI, CCM

Chart 6. Pronounced Valuation Discount in Price to Next-Twelve-Month Sales for US Smid Cap Three-Year Dividend Growers versus Non-Dividend Payers



Find Sunshine with Better Growth, Historically Low Valuations, and Lower Leverage

Aside from a few modest jumps in the CBOE Volatility Index (VIX) during the second quarter, market participants remained relatively complacent. The party spoilers are either not acknowledged or perceived to be far off in the future, and the idea that stocks "only go up" is pervasive. After all, akin to Pavlovian conditioning,[14] many types of new investors are emboldened by the string of better-than-expected earnings results over the past year. *Barron's* even ran a cover story on June 11th entitled, "Here Come the Teens: They Can't Vote, but They're Old Enough to Buy Stocks."[15] Yikes!?

Of course, as we have written before, not all stocks are created equal. Forecasting the timing of the next equity sentiment shift or credit move is impossible. All is well until it is not.

Ultimately, but especially when things go awry, earnings, cash flow, and dividends matter most. Dividend growth companies have all three in spades relative to other categories of companies, especially non-dividend payers, which are most prone to "blow-ups." We continue to expect that speculative fervor and investment approaches that feed on or otherwise participate in that fervor, may encounter further volatility and downside risk.

The good news is that dividend growth stocks, after a period of relative underperformance in last year's final quarter, are actively participating in the current upward market move as they tend to do through most market cycles. Moreover, Copeland's selected domestic and international dividend growth stocks continue to trade at historically inexpensive valuations but offer better earnings and dividend growth, and lower debt burdens versus benchmarks (Chart 5). We view this dynamic as both comforting for current clients and compelling for new investors. Further, as an example of the extreme valuation discount relative to more speculative non-dividend paying companies, Chart 6 illustrates that shares of three-year dividend growth companies are trading at the widest discount in more than 20 years.

Higher growth among dividend growers is normal and supports upside market participation, yet discounted valuations are abnormal and provide downside protection should the market reverse course. Notably, with strong business models and market positions, shares of dividend growth companies should be well positioned should the party spoil and markets cool. From our vantage point, as the song goes, "I got that sunshine in my pocket."

July 19, 2021

[1] *FT https://www.ft.com/content/85b06040-1993-4752-bf4f-7964fed3fe26*
[2] *WSJ https://www.wsj.com/articles/retail-investors-power-the-trading-wave-with-record-cash-inflows-11625477401*
[3] *Federal Reserve https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20210616.pdf*
[4] *Reuters https://www.reuters.com/business/imf-raises-us-2021-growth-forecast-7-fastest-pace-generation-2021-07-01/*
[5] *PWC https://www.pwc.com/us/en/services/deals/capital-markets-watch-quarterly.html*
[6] *Evercore ISI*
[7] *WSJ https://www.wsj.com/articles/amc-scraps-plans-for-vote-on-25-million-share-sale-11625577728?mod=searchresults_pos6&page=1*
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[14] *https://www.simplypsychology.org/pavlov.html*
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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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Definitions

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

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

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

IPO – Initial Public Offering.

Net Debt EBITDA - The net debt-to-EBITDA (earnings before interest depreciation and amortization) ratio is a measurement of leverage, calculated as a company's interest-bearing liabilities minus cash or cash equivalents, divided by its EBITDA.

Net Income – Net Income is equal to net earnings (profit) calculated as sales less cost of goods sold, selling, general and administrative expenses, operating expenses, depreciation, interest, taxes and other expenses. This number appears on a company's income statement and is an important measure of how profitable the company is.

NTM P/E Ratio - The Next Twelve Months Price-to-Earnings Ratio of a stock is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share.

SPAC - A special purpose acquisition company (SPAC) is a "blank check" shell corporation designed to take companies public without going through the traditional IPO process. SPACs allow retail investors to invest in private equity type transactions, particularly leveraged buyouts.

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