

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



Heads I Win, Tails You Lose

"Things are gonna change. I can feel it." Beck, "Loser," 1994

In last quarter's review (*The Wait is Over!*), we speculated that the volatility that marked 2015 might continue, and so far the prediction looks prescient. Though the S&P 500 Index wound up with a total return of 1.3% for the first quarter, this masks a sharp decline to start the year followed by a furious rally to close out the period.

In this piece, we tackle this fickle environment and address the emerging "Growth versus Value" debate. On the latter, we conclude that our Dividend Growth approach offers the equivalent of a two-headed coin, allowing investors to win even if "things are gonna change" and the environment pivots from leadership by growth stocks to value stocks. Finally, we cover recent dividend growth trends by sector and what they might mean for the future performance of our Dividend Growth strategies.

The Talking Points Market

The culprits behind current market volatility are a veritable "Murderers' Row" of CNBC talking points: commodities, the dollar, OPEC, the Fed, China, corporate earnings and the US consumer. None are easy to forecast and all played a part in first quarter's performance, but oil in particular warrants comment.

When commodities are trending steadily higher, modest declines are often met with enthu-

siasm. They ease inflation concerns, pad consumer wallets and lift profits for companies that rely on commodity inputs. However, prolonged or dramatic price weakness – such as oil has suffered since late 2014 – can usher in commodity company instability, reductions in capital budgets, questions about credit, weaker bank loan growth, and even deflation. In that light, it's not shocking that stocks followed commodities higher when prices snapped back recently.

Going forward, while we are encouraged by US employment and credit trends, as well as the possibility of commodity price stabilization, we counsel cautious optimism for investors. Through the end of 2015, the US equity market (as measured by the S&P 500 Index) posted seven consecutive years of positive total returns. Over the period, dividends rose 54%, earnings per share expanded by 65%, and the trailing 12 month price-to-earnings multiple jumped from 12.7x to 17.5x.^{1,2} Certainly, the exceptionally accommodative monetary policy stance employed since the Great Recession supported that valuation expansion. Without incremental monetary policy help however, continued valuation expansion potential seems limited. In our view, meaningfully higher equity prices must be driven by dividend and earnings increases.

In that regard, up until this point in the cycle, rapidly expanding profit margins and aggres-

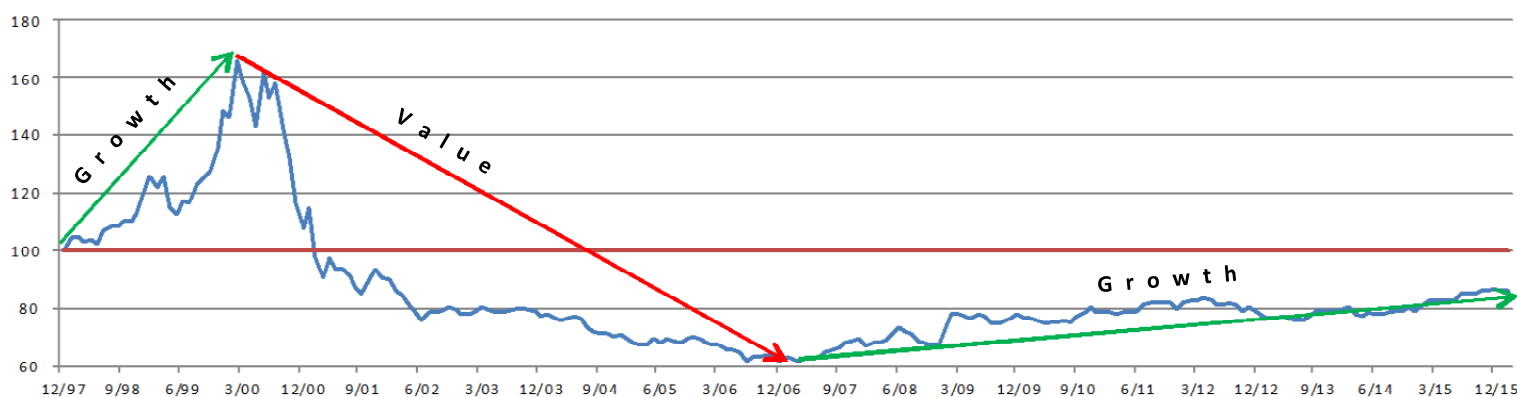
sive stock buybacks have indeed sustained both solid dividend and earnings growth. As impressive as they have been though, cost-cutting and financial engineering have practical limits. Once companies trim all their fat, they must grow sales to grow profits. Unfortunately, revenue growth has been limited both in magnitude and scope throughout this cycle.³

Historically, slow economic growth has lifted the performance of growth stocks relative to value stocks.⁴ While the current recovery may continue at a very gradual pace, after a period of strong outperformance by growth stocks that has now stretched nearly ten years, a number of investors have raised the prospect that the market is ready to transition to new leadership by value stocks. Barron's even ran a cover story to this effect not long ago.⁵

The Misguided Growth versus Value Debate and Dividend Growth as a Two-Headed Coin

We don't profess to know whether "things are gonna change," but in our view the growth-value paradigm creates a false dichotomy in which investors are forced to choose one approach or the other. Our experience, in combination with over four decades of research, shows that Dividend Growth, when married with a "quality" focused approach emphasizing high returns on capital and strong free cash flow generation, offers a "third way" – an

Chart 1. Relative Performance of Growth v. Value



Source: Bloomberg LP. Historical data does not guarantee similar future results. You cannot invest directly in an Index. For information on the Index shown as well as other important information, please refer to the Disclosure Section.

alternative that we believe can outperform the market with less risk, regardless of growth or value biases in the marketplace.

Chart 1 (on page 1) shows the performance of the Russell 1000 Growth Index plotted relative to the performance of the Russell 1000 Value Index since December 31, 1997. An uptrend in the chart represents a period of growth out-performance, while a downtrend represents a period of value outperformance.⁶

In Table 1, using Factset, we compared the historical performance of the large cap dividend growth universe, as well as the top two scoring quintiles of Dividend Growers in Copeland's ranking model, to both the Russell 1000 Growth and Value indices. We break the time frame into the corresponding three sub-periods shown in Chart 1.

We have frequently noted that a pure beta rally in low quality, high growth stocks can present a challenge for our strategy. We see this in Period A, as Dividend Growers failed to keep pace with the Russell 1000 Growth Index during the dot com boom, a beta rally for the ages. Still, Dividend Growers outperformed the Russell 1000 Value Index by a meaningful margin during that time.

However, in Periods B and C, the dividend growth universe, and especially the top ranking stocks therein, performed in-line with or better than both the Russell 1000 Growth and Value Indexes, regardless of the prevailing "flavor" of the market. Hence, over the full term, Dividend Growth outperformed robustly.⁷

This gives us great confidence that Dividend Growth is not beholden to one or the other of these artificial distinctions to deliver favorable results. Instead *we believe we win no matter which way the coin falls* – even if market leadership shifts toward value.

Dividend Growth by Sector

When commodity prices plunged last year, earnings in the Materials and Energy sectors followed. Without the support of broad-based revenue growth, this thrust earnings growth for the whole market (as measured by the S&P 500 Index) into negative territory.⁷

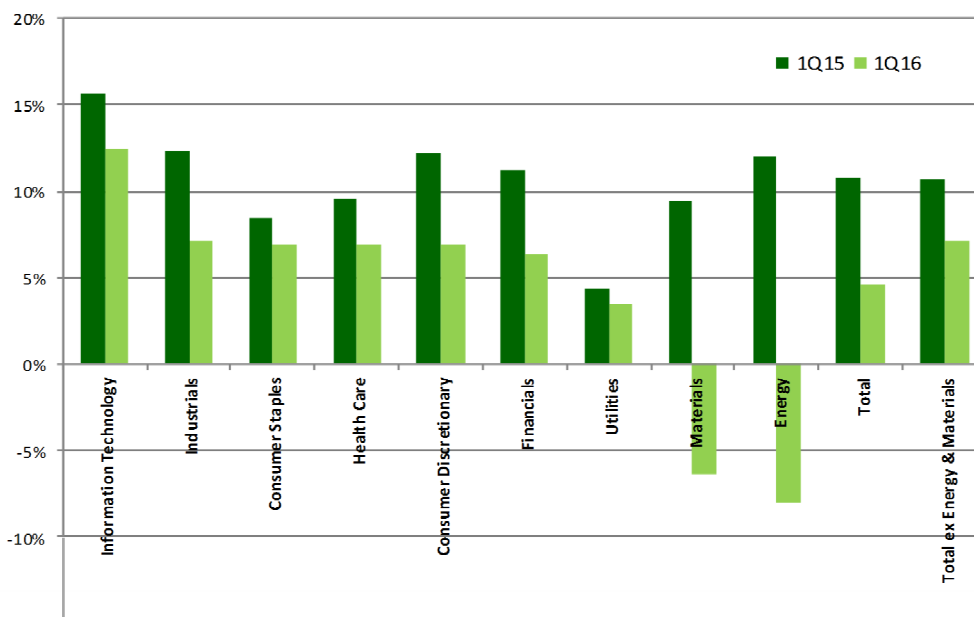
Weak revenues, and the potentially diminished earnings that follow, understandably

Table 1. Performance of Copeland's Dividend Growth Universe in Growth and Value Periods

	Period	Prevailing Trend	Russell 1000 Value Index	Russell 1000 Growth Index	Russell 1000 Index	Large Cap Dividend Growth Universe	CCM Model - Top Two Quintiles
A	12/31/1997 to 2/29/2000	Growth	11%	85%	47%	16%	23%
B	2/29/2000 to 7/31/2006	Value	53%	-40%	-2%	88%	133%
C	7/31/2006 to 3/31/2016	Growth	58%	120%	88%	90%	116%
	Full Period		168%	146%	171%	316%	520%

Source: Bloomberg and FactSet Research. The information presented is intended to illustrate performance of large cap stocks according to their dividend policy. 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. Historical data does not guarantee similar 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. You cannot invest directly in an Index. For information on the Index shown as well as other important information, please refer to the Disclosure Section.

Chart 2. Year-over-Year Dividend Growth by Sector: 1Q16 vs 1Q15

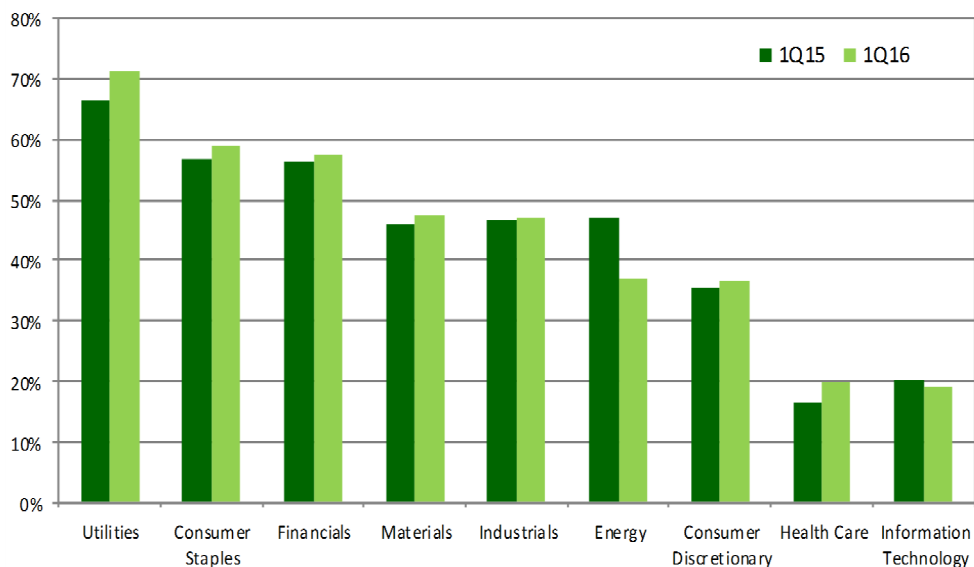


Source: FactSet Research. Copeland considers the Telecommunication sector to be part of the Utilities sector. Historical data does not guarantee similar future results. There is no guarantee that companies will declare dividends or, if declared, that they will remain at current levels or increase over time. Please refer to the Disclosure Section for additional information.

raise questions about dividend growth. To wit, since peaking at 17% in 2012, aggregate dividend growth for S&P 500 companies slipped to only 5% in the first quarter.^{2,7} Moreover, at 43%, the dividend payout ratio for the Index hit its highest level in 20 years – outside of 2008, when earnings were decimated by the recession.² In this context, it seems inevitable that dividend growth across the market will be more measured going forward.

Excluding Energy and Materials however, the deceleration in dividend growth was less dramatic, falling from 11% to 7%. In Chart 2, we detail the one-year rate of dividend growth for nine S&P sectors as of March 31, 2016 versus March 31, 2015. Though all nine sectors decelerated, one can quickly see that weakness in Energy and Materials had an outsized impact as dividend growth in these sectors unsurprisingly flipped into negative territory. Further,

Chart 3. Percentage of Dividend Growers by Sector in 1Q16 v. 1Q15



Source: FactSet Research. Copeland considers the Telecommunication sector to be part of the Utilities sector. Historical data does not guarantee similar 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. Please refer to the Disclosure Section for additional information.

while companies cutting their dividends constituted a small portion of the market, Energy and Materials were again over-represented in this basket accounting for 32% of all cutters, despite making up only 12% of all names. ConocoPhillips (-66%), Kinder Morgan (-75%) and Freeport-McMoran (-100%), for example, all slashed their dividends in response to low commodity prices and weak cash flows.

Additionally, the percentage of the overall market that grew its dividend actually rose slightly from 41% in the first quarter of 2015 to 42% in the first quarter of this year, with broad-based participation across sectors outside of Energy (see Chart 3).

What if Dividend Growth gets worse?

While the pace of dividend growth for the market could reaccelerate given the current earnings outlook for 2016, we are well aware that Street projections often tend to be overly rosy. As a result, we think it is important for our investors to understand that our success does not bank on a broad-based macro recovery.

In 2007, nearly 60% of the names in the S&P 500 Index raised their dividends. By 2009 that number had been slashed almost in half. The small and mid cap indices also saw the per-

centage of Dividend Growers fall over the same period. One might assume that that would wreak havoc on Copeland's investment strategy given our strict requirement for consistent year-over-year dividend growth from all of our holdings. To the contrary, we successfully navigated that treacherous time frame, benefitting from the application of our Dividend Growth philosophy in three significant ways.

First, while Dividend Growers spanned all sectors, they shared two common attributes: strong competitive advantages and a heavy emphasis on repeat business. As a result, these companies were able to exercise pricing power, accrue market share, and sustain margins. This led to above-average returns on capital and robust cash flow generation, all of which are generally rewarded by the market, but especially in tumultuous times.

Second, we search for companies with dividend growth in their DNA. The growth is expected by shareholders, often represents a significant piece of management compensation, and will likely result in top brass being fired if it isn't sustained. Despite incredible macroeconomic challenges, dividend growth companies showed an iron-clad commitment at precisely the time when investors ascribed the highest value to consistency and stability.

Finally, we believe a company's decision to issue and raise its dividend has a strong signaling effect with regard to management's cash flow allocation framework. Following from the second point, companies that consistently raise their dividends are very reticent to stall those increases in order to pursue risky projects, such as large M&A deals or moves into unrelated businesses. We believe those companies that raised during the downturn can be trusted above most others not to engage in such value-destroying behavior.

Bearing all of the aforementioned points in mind, we are not unnerved by the recent deceleration in dividend growth. To the contrary, we expect to successfully employ our Dividend Growth philosophy in the current environment, just as we have in past cycles. In fact, as of the end of the first quarter, the one-year rate of dividend growth across Copeland's domestic and international strategies exceeded the dividend growth of their respective benchmarks by anywhere between 36 and 175%.⁷

Other managers may say that they seek to identify companies with similar characteristics to our Dividend Growers, but without the constraint of dividend growth. We wish them luck, but for the reasons outlined above, we are much more confident in our future with a two-headed coin in our pocket.

March 2016

¹ FactSet, "Earnings Insight," April 1, 2016

² http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/spearn.htm

³ <http://realinvestmentadvice.com/analyzing-earnings-as-of-q4-2015/>

⁴ Copeland Capital Management, LLC internal research

⁵ <http://www.barrons.com/articles/move-over-facebook-and-netflix-value-investing-is-rebounding-1457758660>

⁶ Bloomberg

⁷ FactSet

Copeland Capital Management's Strategies

Domestic Strategies

<u>Domestic Strategies</u>	<u>Benchmark</u>	<u>Vehicle</u>
Large Cap	S&P 500®	SMA, Model
Mid Cap	Russell Mid Cap®	SMA, Model
Smid Cap	Russell 2500®	SMA, Model
Small Cap	Russell 2000®	SMA, Model
Micro Cap	Russell Micro Cap®	SMA
All Cap	Russell 3000®	SMA, Model
Risk Managed	Russell 3000®	SMA, Mutual Fund
Risk Managed Long-Short	Credit Suisse Hedge Fund® Index	Limited Partnership

Global Strategies

<u>Global Strategies</u>	<u>Benchmark</u>	<u>Vehicle</u>
International All Cap	MSCI ACWI Ex-US®	SMA
International Small Cap	MSCI World Ex-US Small Cap®	SMA, Mutual Fund
International Risk Managed	MSCI ACWI Ex-US®	Mutual Fund
Global Equity	MSCI ACWI®	Limited Partnership

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

Market Risk: Overall securities market risks may affect the value of individual securities in which the Copeland strategies invest. Factors such as foreign and domestic economic growth and market conditions, interest rate levels, and political events affect the securities markets.

Dividend Growers included stocks that raised their existing dividend or initiated a new dividend during the previous 12 months.

Dividend Cutters included stocks that lowered their existing dividend or eliminated their dividend during the previous 12 months.

Past performance is not a guarantee of future results. Results shown are not the performance of the firm and there is no guarantee that investors will experience the type of performance reflected. There is no guarantee that companies will declare dividends or, if declared, that they will remain at current levels or increase over time.

Index Disclosures – You cannot invest directly in an Index.

The **S&P 500 Index** consists of 500 stocks chosen for market size, liquidity and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.

The **Russell 1000 Index** measures the performance of the 1000 large cap U.S. companies based on total market capitalization, which represents approximately 90% of the investable U.S. equity market.

The **Russell 1000 Growth Index** measures the performance of the large-capitalization growth sector of the U.S. equity market. It is a subset of the Russell 1000 Index.

The **Russell 1000 Value Index** measures the performance of the large-capitalization value sector of the U.S. equity market. It is a subset of the Russell 1000 Index.

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