# The Copeland Review

Fourth Quarter 2015

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


# The Wait is Over!

"The waiting is the hardest part."- Tom Petty, "The Waiting", 1981

**The Wait is Over!**

Following their weak performance in the third quarter, global equities staged a solid recovery to close out the year. In the US, large caps, as represented by the S&P 500 Index, posted a 7.0% total return for the fourth quarter, outpacing their small and mid cap peers. Helped by that strong performance, large caps were the only segment of the market to post a positive total return for the year.

Remarkably, this strength came against a backdrop that was little changed versus the prior quarter, in which global equities experienced broad based declines. In particular, commodity prices fell sharply, the dollar strengthened and analysts' earnings estimates moved lower. Meanwhile, geopolitical tensions remained heightened following the Paris and San Bernardino attacks. Nevertheless, performance benefitted from the combination of strong snapbacks in some of the weakest sectors in the third quarter, including Materials and Health Care, as well as on-going strength in the consumer sectors, bolstered by a solid employment and spending environment. When including dividends, all sectors recorded positive returns for the first time since the second quarter of 2014.

The one big difference in the fourth quarter was that the Federal Reserve finally pulled the trigger on a 25 basis point increase in the Fed Funds rate, moving the benchmark interest rate off its lower bound for the first time in seven years. In conjunction with the move, the Committee remarked that the economy had "expanded at a moderate pace," while noting that slack in the labor market, "had diminished appreciably since early this year." Still, they made clear that the path of any future rate hikes was likely to be gradual, repeating a sentiment they have expressed numerous times in the past.[1]

**Godot Arrives!**

In Samuel Beckett's 1953 play, *Waiting for Godot*, the two main characters wait in vain for a third man, Godot, who never arrives. While interpretations of the popular absurdist work are myriad, the gist of its plot is so well known that the title has taken on a life of its own in the English lexicon.

When the Federal Reserve initially moved interest rates to zero in 2008, most market participants expected this unprecedented extreme in policy to be short-lived before market stabilization and reinvigorated growth allowed the Fed to move away from its unorthodox stance. As the period of zero interest rates dragged on however, financial pundits trotted out the play's title repeatedly to describe the interminable wait. Some investors questioned whether we'd ever see higher interest rates again, or if we were perpetually destined to repeat Japan's experience, with paltry growth and insignificant inflation supporting years of quantitative easing. In that context, however modest the recent shift in policy might appear, it puts the waiting to rest and sets up an interesting backdrop for 2016.

Ironically, just as "Godot has finally arrived," there is more debate than ever over whether he is too late, too early or right on time. Last quarter, as we have before, we opined that global investors and consumers were addicted to cheap money. Bearing that in mind, we expect that reversing the direction of monetary policy presents a formidable challenge. The Fed must balance its desire to keep inflation in check with the need to avoid disruption in the global economy and financial markets. In a very real sense, we're about to learn whether the waiting really is the hardest part, or if there is a tougher road ahead.

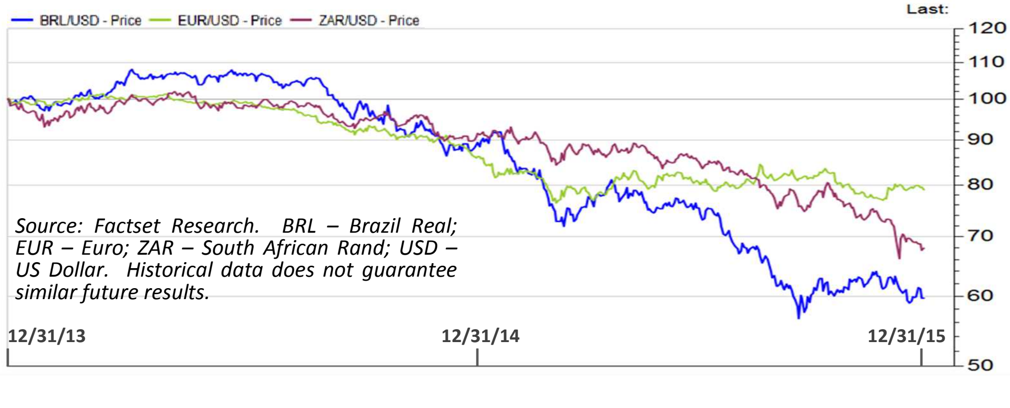
Of course, global markets wait for no man, Godot or otherwise. Around the world, they have been preparing for the "Fed liftoff" for a long time. Currencies ranging from the Euro to the Brazilian Real and the South African Rand had already depreciated significantly versus the dollar long before the Fed hike (Chart 1). In large part this synchronized depreciation reflects superior US growth, both actual and anticipated, which market participants correctly assumed would eventually cause a policy divergence.

Allow us to clarify the extended Godot metaphor. Given the unusual policy stance that the Fed held for the last seven years, there are certainly some members of the FOMC, who were clamoring for an earlier hike, fearing that low rates would eventually result in an unhealthy level of inflation as the economy expanded. Throughout the recovery, this camp has been supported primarily by consumer-related data, such as strong auto sales, rebounding home prices and low unemployment. Jeffrey Lacker, President of the Richmond Fed, counts himself among this "too late" group, having advocated for a hike since at least the June meeting. Said Lacker after the Fed voted not to raise rates in September, "With the steady growth in output and household spending…the real rate of interest should be higher than its current level of less than negative 1 percent."[2]

In the same interview, Lacker went on to say, "My assessment was also supported by…my confidence that inflation will return to our two percent objective after the temporary effects of low energy and import prices have passed." For those in the "too early" group however, Lacker's use of the word "temporary" is significant and highly questionable. Following four relatively stable years – bouncing between $75 and $110 – oil began to break down sharply in late 2014 and has not yet stabilized, sitting under $40 as of year end.

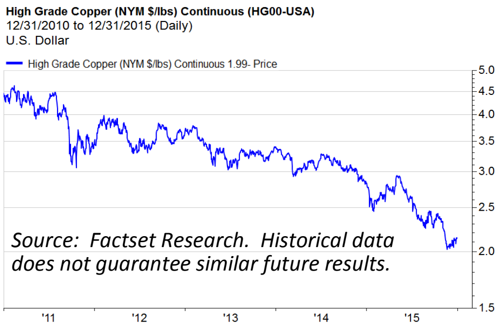
The focus for many pundits is on the supply side, which is historically self-correcting. Indeed, when the downturn began, it appeared it was driven primarily by Saudi Arabia's commitment to pump oil as aggressively as possible; a strategy that most people assumed was a direct effort to curtail the boom in US shale production. Once the Saudis crushed the weaker players in the shale revolution, it was widely assumed that prices would find a higher base and the Saudis could go back to pumping less aggressively.

**Chart 1. Global currencies have fallen sharply relative to the US dollar (Two year price performance – indexed to 12/31/13)**




*Source: Factset Research. BRL – Brazil Real; EUR – Euro; ZAR – South African Rand; USD – US Dollar. Historical data does not guarantee similar future results.*

**Chart 2. Copper prices have been in continuous decline for nearly five years**




*Source: Factset Research. Historical data does not guarantee similar future results.*

That response has been exceptionally slow to materialize however. The current downturn marks the seventh decline of at least 40% over the last 30 yrs and only one – from January 1997 until December 1998 – lasted longer. Most observers attribute the longevity of the current trend to two factors: 1) shale producers have not been aggressive in cutting production because their high sunk costs make it more economical to continue pumping, and 2) many projects have proven to be more productive than expected, partially due to continually improving technology. Both of these factors seem irrefutable.[3]

Still, there is a third potential factor in the decline; namely, global demand. Looked at in the context of other global commodities, from agricultural products to metals, the extent to which the price of oil held up between 2010 and 2014 is actually remarkable. Chart 2 shows copper, often considered an economic bellwether, sliding steadily for the better part of the last five years.

At least some of this weakness can be attributed to China's slowing economic growth, and the spillover impact that's having in other emerging markets, which count on export demand from China to support their economies. No doubt oil demand growth among China and its "dependents" is slowing, or even falling, given this situation.

For the Fed to continue raising rates in the face of these declines is either an implicit nod toward decoupling or an indication that they believe improving global economic results are near at hand. As we indicated last quarter, we do not believe that the US economy can persistently or significantly decouple from the direction of the global economy. We'd like to think this is why the FOMC has been explicit in its commitment to raise rates gradually – an artful attempt to walk the line between "too early" and "too late."

In her press conference announcing the increase in the Fed Funds rate however, Chairwoman Janet Yellen noted that overseas headwinds are currently offset by domestic strength. Therefore, though we find it encouraging that she left open the door for an extended hiatus between the first and second hike (saying, "Gradual does not mean mechanical, evenly timed, equally sized, interest-rate changes."), we think it is important to at least consider the *possibility*, however remote, that the Fed will enact an incorrect policy response and raise more quickly than it should.[4]

Should such a scenario come together, we are gratified to be invested only in dividend growth stocks. As we have explained in these pages before, history shows that while dividend growers outperform other classes of stocks in falling rate environments, their relative advantage only expands during times of rising rates (Chart 3).

One might assume that given the weakness in commodities and foreign currencies detailed herein that we are bearish on non-US markets at Copeland. This view is misguided. While there are certainly plenty of risk factors to consider and there are likely to be significant performance divergences between countries and regions, we expect that certain global markets will afford opportunities for attractive returns in the coming years. It's worth pointing out that the bull market in US equities, which started in 2009, has been supported by extremely loose monetary policies, including three bouts of quantitative easing. While the specifics of their strategies differ, economic policy authorities in Japan, China and the Eurozone among others are all currently employing measures designed to achieve the same effects as those employed earlier in the US.

As those strategies begin to take hold, we are excited to announce the launch of Copeland's International Small Cap Dividend Growth Strategy, available in both separately managed account and mutual fund formats. Evidence presented on page three supports our belief that a Dividend Growth approach can be even more effective in non-US small cap stocks than it has been domestically.

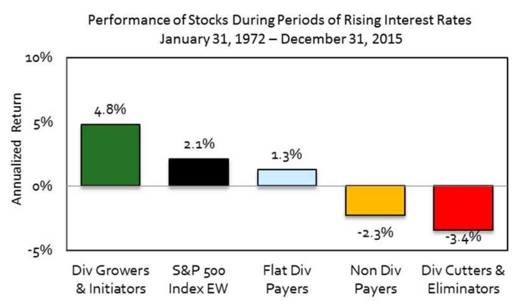
We attribute this historical success to the message that a consistent dividend grower sends to investors. Given language barriers, differing accounting standards and varying expectations regarding internal controls across international markets, there is a perception that one must take on considerable risk in order to gain global exposure, particularly in small cap companies. At Copeland, we're fond of saying that "you can't fake cash." This refers to the need for dividend growers to generate increasing cash flows to support returning cash to shareholders. We believe investors in international markets ascribe significant value to growing dividends, specifically because they demonstrate management's careful stewardship of the capital with which they are entrusted, something that cannot be assumed implicitly overseas.

The phrase, "May you live in interesting times," is sometimes referred to as the Chinese curse. Whether the provenance of that aphorism is valid or not, it seems probable that 2016 will fit the bill. As we head into the New Year, we feel confident that competing forces in the global economy will afford some opportunities, but will not fail to throw some curveballs at the markets as well. This reminds us of another Tom Petty lyric: "Even the losers, get lucky sometimes." While this may be true in love, in investing we prefer to avoid depending on luck and instead to hang our hats on the tried and true Dividend Growth approach that we have successfully employed since 2005. We expect that in combination with rigorous research, our universe of Dividend Growers gives our investors their best chance to outpace the markets, both foreign and domestic, with less risk over time.

December 2015

1 *http://www.cnbc.com/2015/12/16/fed-raises-rates-for-first-time-since-2006.html*
2 *http://www.cnbc.com/2015/10/30/feds-lacker-heres-why-i-dissented-at-last-fomc-vote.html*
3 *FactSet*
4 *http://www.bloomberg.com/news/articles/2015-12-17/yellen-voices-economic-optimism-as-fed-begins-gradual-tightening*

**Chart 3. Dividend Growth stocks have outperformed in periods of rising rates**




*Source: Ned Davis Research, CCM*

## Introducing the Copeland International Small Cap Dividend Growth Strategy

By all accounts 2015 was a volatile year for International equities with many of the major indices experiencing negative returns. At Copeland, however, our International and Global strategies had a very strong year both in absolute terms and relative to their respective benchmarks. By focusing solely on companies that have demonstrated consistent Dividend Growth, we believe our International strategies are best positioned to navigate market volatility. One product of which we are particularly proud is our International Small Cap Dividend Growth Strategy. After getting off to a great start in its first year of performance, we recently launched it in a mutual fund format in order to make it available to a wider audience of investors. Many investors incorrectly assume that dividend growth is a domestic, large cap opportunity. As much success as Copeland has had over the last few years in our Domestic strategies (Large Cap, Mid Cap and Small Cap), and then in our International All Cap strategies (both traditional and tactical), we believe that there is an even greater opportunity to provide a differentiated solution to the marketplace with our International Small Cap Dividend Growth Strategy.

Most investors believe that, in order to secure higher returns over time, they must take on increased risk. We have detailed in prior versions of The Copeland Review how, by investing in only companies that have demonstrated a commitment to Dividend Growth, we believe investors can secure returns typically associated with higher-risk segments of the markets, without necessarily enduring the increased volatility associated with those segments. As demonstrated in the charts below, International Small Cap Dividend Growers have historically outperformed all other types of stocks as broken down by dividend policy (Chart A), even while taking on considerably less risk (Chart B). If you would like to learn more about this, please contact Chuck Barrett, Director of Sales, at **cbarrett@copelandcapital.com**.

**Chart A. Performance by Dividend Policy Over Time**

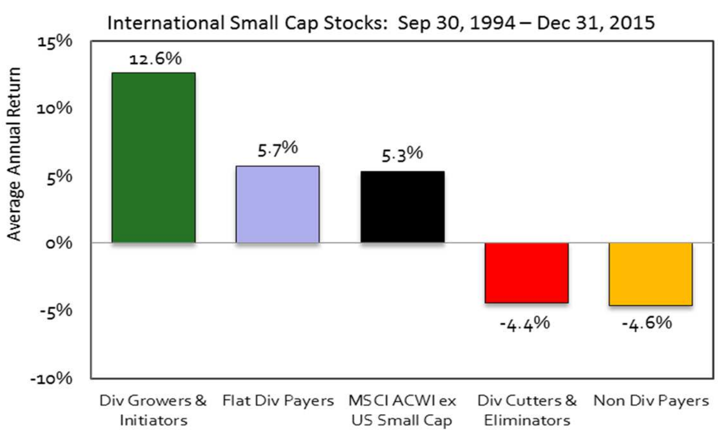
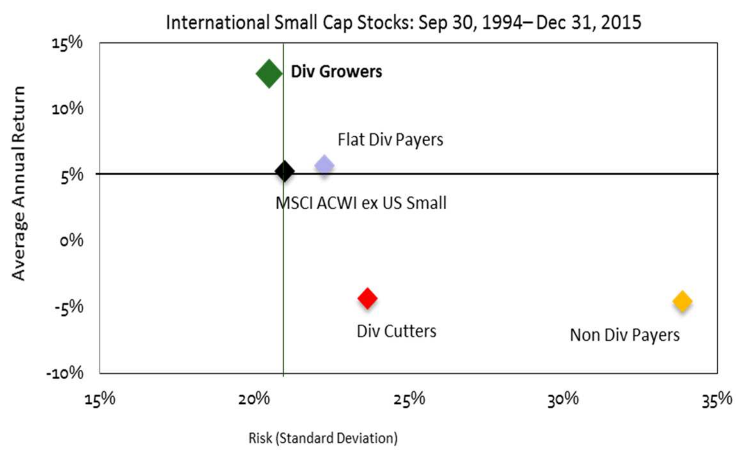



**Chart B. Risk/Reward by Dividend Policy**

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### *Disclosures:*

***Ned Davis Research Additional Disclosures –*** *Ned Davis Research adjusted its calculation method, as of December 31, 2014, to capture only those names that meet a certain liquidity threshold in order to better represent the investable universe. As a result, historical performance information may differ from previously disseminated performance information for stocks according to their dividend policy. This is not the performance of the firm and there is no guarantee that investors will experience the same type of performance.*

***Dividend Growers & Initiators*** *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 & Eliminators*** *included stocks that lowered their existing dividend or eliminated their dividend during the previous 12 months.*

***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 **S&P 500 EW Index** consists of 500 stocks. It is an equal weighted index which gives the same weight, or importance, to each stock in a portfolio or index fund. The smallest companies are given equal weight to the largest companies in an equal-weight index fund or portfolio.*

*Continued on next page.*

# Copeland Capital Management's Strategies

| Domestic Strategies | Universe | Benchmark | Vehicle |
|---|---|---|---|
| Large Cap | Above $5 billion in market cap with minimum of 3 years of Dividend Growth | S&P 500 | SMA, Model |
| Mid Cap | Between $1 billion and $25 billion in market cap with consistent Dividend Growth | Russell Mid Cap | SMA, Model |
| Smid Cap | Between $250 million and $15 billion in market cap with consistent Dividend Growth | Russell 2500 | SMA, Model |
| Small Cap | Between $250 million and $4 billion in market cap with consistent Dividend Growth | Russell 2000 | SMA, Model |
| Micro Cap | Between $100 million and $800 million in market cap with consistent Dividend Growth | Russell Micro Cap | SMA |
| All Cap | Above $250 million in market cap with 5 years of Dividend Growth | Russell 3000 | SMA, Model |
| Risk Managed | Above $250 million in market cap with 5 years of Dividend Growth | Russell 3000 | SMA, Mutual Fund |
| Risk Managed Long-Short | Long: Above $250 million in market cap with 5 years of Dividend Growth<br>Short: Any stock that pays little or no dividend | Credit Suisse Long-Short Index | Limited Partnership |

| Global Strategies | Universe | Benchmark | Vehicle |
|---|---|---|---|
| International All Cap | Above $1 billion with consistent Dividend Growth | MSCI ACWI Ex-US | SMA, Model |
| International Small Cap | Between $500 million and $5.5 billion in market cap with consistent Dividend Growth | MSCI World Ex-US Small Cap | SMA, Mutual Fund |
| International Risk Managed | Above $1 billion with consistent Dividend Growth | MSCI ACWI Ex-US | Mutual Fund |
| Global Equity | Above $1 billion with consistent Dividend Growth | HFRX Global | 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.

***Disclosures Continued** (from previous page):*

*The **Russell Mid Cap Index** is comprised of the 800 smallest companies in the Russell 1000 Index. The **Russell 1000 Index** measures the performance of the 1000 large cap U.S. companies based on total market capitalization, which represents approximately 92% of the investable U.S. equity market.*

*The **Russell 2000 Index** is comprised of the smallest 2000 companies in the Russell 3000 Index. The **Russell 2500 Index** is comprised of the smallest 2500 companies in the Russell 3000 Index. The **Russell 3000 Index** measures the performance of the 3000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.*

*The **Russell Microcap Index** measures the performance of the microcap segment of the U.S. equity market. It makes up less than 3% of the U.S. equity market. It includes 1,000 of the smallest securities in the Russell 2000 Index based on a combination of their market cap and current index membership and it includes the next 1,000 stocks.*

*The **Credit Suisse Long/Short Equity Hedge Fund Index** measures the aggregate performance of dedicated short bias funds.*

***MSCI All Country World Ex-US Index ("MSCI ACWI Ex-US") -** a market capitalization-weighted index designed to provide a broad measure of stock performance throughout the world, with the exception of U.S.-based companies. It includes both developed and emerging markets. Morgan Stanley Capital International is the owner of the trademark service marks and copyrights of the MSCI ACWI Ex-US.*

***MSCI World Ex-US Small Cap Index -** captures small cap securities exhibiting overall growth style characteristics across 22 of 23 Developed Markets countries (excluding the U.S.). With 2,437 constituents, the index covers approximately 14% of the free float-adjusted market capitalization in each country.*

***HGRX Global Hedge Fund Index (HFRXGL) -** a hedge fund index designed to provide returns that reflect the performance of the global hedge fund universe.*

***The material in this letter is for informational purposes only. It represents an assessment of the market environment at a specific point in time and is intended neither to be a guarantee of future events nor as a primary basis for investment decisions. It should also not be construed as advice meeting the particular needs of any investor. Neither the information presented nor any opinion expressed constitutes a solicitation for the purchase or sale of any security.***


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