The Copeland Review

First Quarter 2021

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

I've been running hot
You got me ticking gonna blow my top
If you start me up
If you start me up I'll never stop
Never stop, never stop, never stop

- *"Start Me Up," The Rolling Stones, 1981*

Running Hot

In our last Review, "(Let's Not) Party Like It's 1999," we commented on the unprecedented fiscal and monetary support injected into the economy, in effect, serving as a literal money tree with significant multiplier effects. We further expressed concern over widespread speculative behavior, at least partly enabled by government funds, engendering a more challenging period for Dividend Growth investing. We cited aggressive retail investor activity, our opinion that many stocks had "gone nuts," and extended valuation levels for numerous stocks, particularly lower quality, non-dividend paying stocks. Historical experience suggests that these situations tend to end badly for those exposed to excessive risk.

Knowing how and when exactly the music will stop is impossible, yet – as it turns out – the tune skipped a beat in the first quarter and speculative fervor waned somewhat, leading to improved relative performance for Copeland's Dividend Growth Strategies. In this Review, we highlight:

1. More evidence of speculative behavior that brings heightened risk and, sometimes, collateral damage, as seen with the recent implosion of highly levered Archegos Capital.
2. The supercharged US economy begets potential for both higher inflation and interest rates.
3. Dividend growth stocks, which continue to trade at historically inexpensive valuations, are well positioned should inflation and interest rates trend higher.

Investors can choose between higher risk strategies with unfavorable risk/reward dynamics or follow a time proven investment path via Dividend Growth.

Easy Money Spurs More Speculation

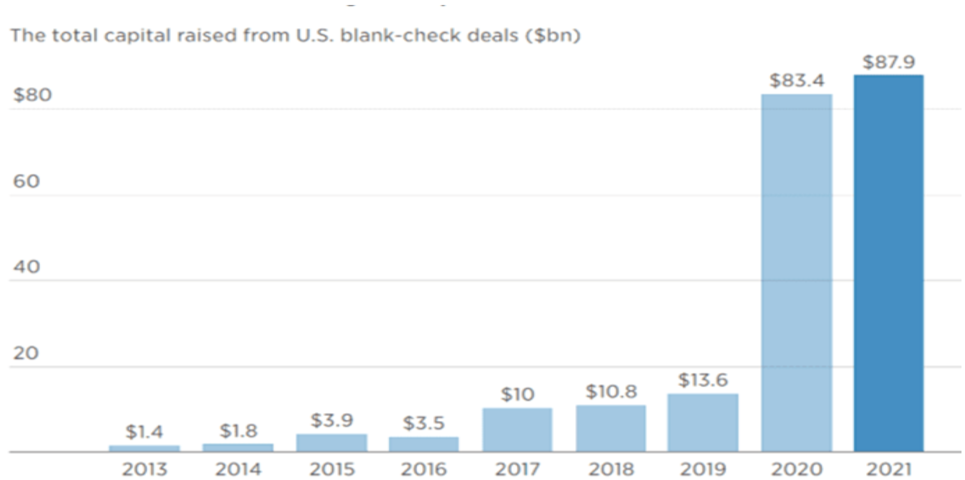
As 2021 started, the equity environment was largely a continuation of what occurred in 2020. The mood was euphoric and favored theme-oriented companies with no earnings, "hot" funds, and special purpose acquisition companies (SPACs). To that list, please add a newly popular creation called nonfungible tokens (NFTs), which represent unique, non-interchangeable "digital files such as digital art, audio, videos, items in video games and other forms of creative work."[1]

Examples of recent froth:

- Margin leverage is rising at a rapid clip – the Financial Industry Regulatory Authority (FINRA) announced that, through February, customer borrowings against their investment portfolios increased 49% year over year, which according to the WSJ, "is the fastest annual increase since 2007, during the frothy period before the 2008 financial crisis. Before that, the last time investor borrowings had grown so rapidly was during the dot-com bubble in 1999."[2]
- SPAC IPO proceeds year-to-date already exceed the total raised for all of 2020 – according to ICR, 298 new SPAC IPOs raised almost $88 billion during the first quarter, exceeding the 248 SPAC IPOs that raised more than $83 billion in all of 2020 (Chart 1).[3] These hundreds of new "blank check" companies are all actively competing to find and purchase viable operating businesses.
- Nonfungible tokens are generating millions of dollars for items having seemingly little tangible value – Jack Dorsey of Twitter and Square sold his first tweet ever as an NFT for "over $2.9 million."[4] A digital artist known as Beeple sold an NFT of his work for $69 million.[5] Other kinds of "crypto" collectables have been sold for tens of millions of dollars, which seems especially bizarre since a quick Internet search allows anyone to find, see, and copy the NFT digital material that may have just cost a fortune.[6]
- A publicly traded unprofitable New Jersey deli was recently valued at $113 million despite sales of less than $14,000 in 2020 – In his quarterly letter, value investor David Einhorn flagged extreme risk taking and noted the incredible valuation for Hometown International (HWIN), which owns only "a single deli in rural New Jersey."[7] Even with very limited revenue, no paid employees, and consistent annual operating losses since at least 2017, shares of Hometown increased 715% last year![8]

Easy money sloshing around tends to lead to high-risk profit seeking behavior that, in our view, does not pass the smell test.

Chart 1. SPAC Issuance YTD Already Exceeds All of 2020



Source: SPAC Research
https://www.cnbc.com/2021/03/19/spacs-break-2020-record-in-just-3-months.html

The Underlying Engine is Clearly Running Hot

Recall that approximately one year ago, at the height of the initial COVID shutdowns and uncertainty, policymakers quickly embraced fiscal and monetary policy tools to stabilize the economy. First, in March 2020, Congress passed the Coronavirus Response Act (or CARES Act) providing $3.5 trillion in support. Next, the Federal Reserve consistently added liquidity to the monetary system by purchasing treasury and mortgage securities, ultimately increasing its balance sheet by a staggering $3.2 trillion, or 76%, to reach nearly $7.4 trillion in total assets by year-end.[9]

By last fall, it was clear that these actions – combined with reopening market forces – jumpstarted business activity and drove a remarkably rapid recovery in the stock market. After a stunning 30% decline for US real gross domestic product (GDP) during the June quarter, a second half surge resulted in GDP finishing off only 3.5% for the full year.[10] Speedy COVID therapeutic and vaccine development has also helped consumer confidence and behavior.

The strength continues year-to-date with major US macroeconomic indicators showing further improvement and, in some cases, achieving levels not seen in decades:

- Business Confidence, as measured by the ISM Manufacturing PMI surprised to the upside in March to reach the highest level since December 1983. New orders hit their highest level since January 2004.[11]
- The unemployment rate declined to 6.0% in March 2021 from 6.7% at year-end 2020 and versus a peak of 14.8% in April 2020. Some economists are forecasting further improvement to 4.0% by year-end 2021, approaching the multi-decade trough of 3.5% last seen just before COVID.[12]
- Consumer Confidence, as measured by the University of Michigan's consumer sentiment survey, not only reached a one-year high in March 2021, but posted the largest one-month increase since May 2013. On a related note, retail sales – which dropped precipitously during the initial few months of the COVID pandemic in 2020 – logged almost 10% year-over-year growth in January and 6% in February, continuing a streak of positive performance that started last June.[13]

The bevy of favorable economic data into mid-March brought the Federal Open Market Committee (FOMC) to increase its median forecast for 2021 US real GDP growth to 6.5% from its prior projection of 4.2%.[14]

The Trend is Your Friend… Until it is Not

At the same time, the FOMC also increased its median forecast for core personal consumption expenditures (PCE) inflation to 2.2% from 1.8%. This level is low versus history but is a touch above the Federal Reserve's target inflation level of 2.0%. Further, the action comes as a broad range of companies are reporting higher input, production, and logistics costs. Labor is particularly tight in some sectors. Higher costs are expected to persist over the near-term and, per a CEO we spoke with recently, "everyone is taking price." Strong demand, coupled with supply chain constraints – COVID-related and otherwise –are the key drivers of inflation.

The likelihood of higher inflation spooked equity and credit investors during the quarter. The yield on the 10-year US Treasury almost doubled to 1.75% from 0.92% at year-end. Mortgage rates also jumped, including a 0.51% increase in the average rate for a 30-year fixed rate mortgage to 3.18%.[15]

Higher borrowing costs triggered intra-quarter corrections in many of the most speculative areas of the market. For example, the widely ballyhooed ARK Next Generation Internet ETF (ARKK) gave back a 26% gain into February to end the quarter down 4%. Numerous other thematic ETFs suffered similar fates as highly valued, no profit "growth" stocks came under pressure.

As more speculative, non-dividend paying stocks corrected, companies with real earnings and dividend growth began to outperform. "Value" and/or cyclical stocks also fared well. There is constant, tireless debate over how "to play" the next move – e.g., buy "value" versus "growth" – but we submit that choice is difficult and not necessary. An investor can garner both growth and value via Copeland's strategies.

Dividend Growth is Time Tested Across Different Environments, including Higher Inflation and Rates

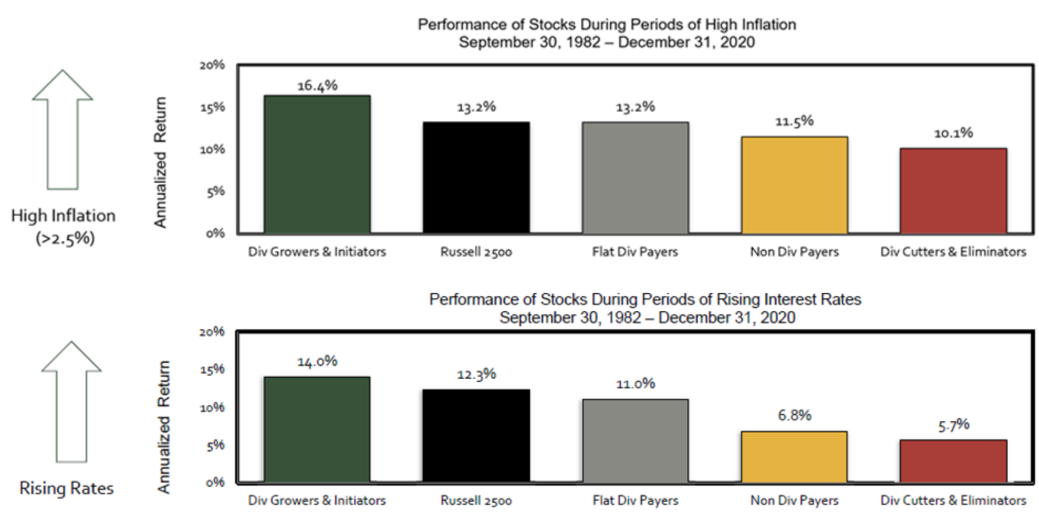
Impressively, dividend growth stocks consistently outperform their respective benchmarks over rolling periods of time (Chart 2), as well as during periods of rising inflation and interest rates. We believe the outperformance through various types of market cycles occurs because dividend growers have more consistent, growth-oriented business models that produce more sustainable excess cash flow, support rising dividends, and minimize surprises that lead to stock "blow ups."

Chart 2. Consistency of Dividend Growth – Smid Cap

Data as of 12/31/2020	Initiation Date	Benchmark (total return)	One Year Rolling	Three Year Rolling	Five Year Rolling	Ten Year Rolling
Smid Cap Dividend Growers	9/30/1982	Russell 2500® Index	64%	76%	81%	93%
Smid Cap Flat Dividend Payers	9/30/1982	Russell 2500® Index	41%	32%	28%	32%
Smid Cap Non-Dividend Payers	9/30/1982	Russell 2500® Index	35%	21%	21%	10%
Smid Cap Dividend Cutters	9/30/1982	Russell 2500® Index	29%	15%	16%	14%

Source: NDR

Chart 3. Smid Cap Performance during Periods of High Inflation and Rising Rates, 1982–2020



Source: NDR

Given the appropriate concern of higher inflation on the horizon, we specifically evaluated the performance of dividend growth stocks under different inflation scenarios alongside our prior research on performance across varying interest rate environments. Here, we continue with our Smid focus. “Inflationary periods” were determined using monthly core PCE deflator data annualized and sourced via the Bureau of Economic Analysis (BEA), while stock performance data came from Ned Davis Research dating back to 9/30/82. We defined “high inflation” periods as any months where the number was >2.5%, while all remaining periods were considered “low inflation.”

We are pleased to relay that, over the long-term, Smid cap dividend growth stocks outperformed both non-dividend stocks and the Russell 2500 Benchmark, regardless of the inflation backdrop. Further, as illustrated in illustrated in Chart 3, specifically during “high inflation” periods, dividend growth stocks also outperformed the benchmark by more than 3% annualized while also besting all other classes of stocks. Performance was also strong during periods of rising interest rates, with dividend growth stocks outperforming the benchmark by nearly 2% annualized and again beating all other classes of stocks.

From ‘Running Hot’ to ‘Gonna Blow My Top?’

Despite ongoing challenges presented by the devastating COVID pandemic, the economic recovery is well underway and the outlook is favorable. Indeed, the Fed and market pundits seem mostly sanguine that healthy economic growth can be sustained while keeping overheating risks at bay. Yet, to-date, the government's cumulative COVID-related monetary and fiscal support totals almost nine trillion dollars, representing over 40% of annual U.S. GDP.[16]

On top of this, the Biden Administration is proposing up to four trillion in various forms of “infrastructure” spending. This is an incredible amount of stimulus, which is normally reserved for the depths of tough times such as one year ago or back in the 2008-09 Global Financial Crisis. As The Rolling Stones sang in “Start Me Up,” the US government seems intent to “Spread out the oil, the gasoline… Kick on the starter give it all you got….”

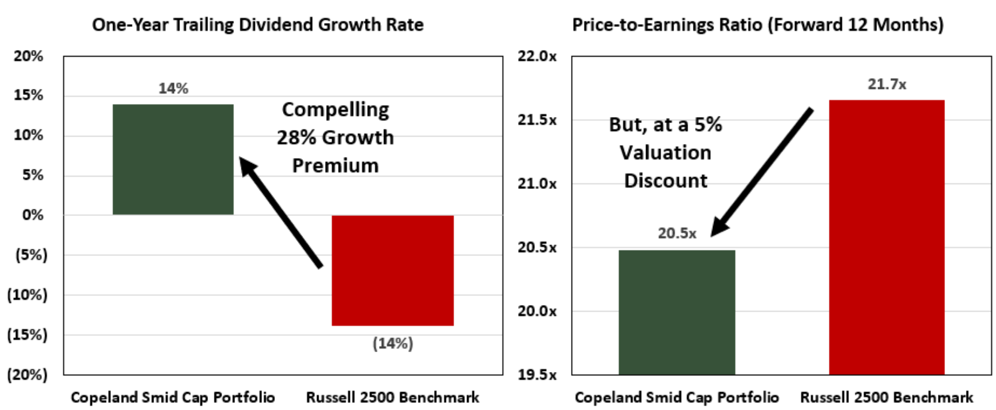
We believe the government is walking a fine line between managing animal spirits and dumping too much fuel on the fire. More stimulus is likely to further aid and abet speculative investment behavior. Investment banks are already rushing to line up and close as many SPAC deals as possible. Who will be left holding the bag? How many more overexposed Archegos are out there? We see evermore risk of mistakes and unexpected collateral damage.

Even with a modest sentiment shift toward companies that were left behind last year – including profitable dividend growth companies – our universe of companies continues to trade at historically low valuations, notwithstanding strong business models and market positions with above average growth (Chart 4).

We cannot say if the nascent psychology shift will continue in the near-term. But, based on historical experience, we are confident that over the long run, companies that consistently grow their dividends will encounter lower downside risk and be rewarded by the market.

April 16, 2021

Chart 4. Copeland Smid Cap Strategy: Compelling Growth Offered at a Discount



Source: Factset

[1] *Wikipedia, https://en.wikipedia.org/wiki/Non-fungible_token*
[2] *FINRA, https://www.finra.org/investors/learn-to-invest/advanced-investing/margin-statistics; and WSJ, https://www.wsj.com/articles/investors-big-and-small-are-driving-stock-gains-with-borrowed-money-11617799940*
[3] *ICR, https://www.businesswire.com/news/home/20210407005635/en/ICR-the-Leading-SPAC-Advisor-Publishes-Q1-2021-SPAC-Market-Update*
[4] *CNBC, https://www.cnbc.com/2021/03/22/jack-dorsey-sells-his-first-tweet-ever-as-an-nft-for-over-2point9-million.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

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

Gross Domestic Product (GDP) - A monetary measure of the market value of all the final goods and services produced in a specific time period.

IPO – Initial Public Offering.

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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