# The Copeland Review

Second Quarter 2024

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

## Ant-Man and the Hulk

*Scott Lang (Ant-Man): Hi! Uh, is anyone home? This is Scott Lang.*
*We met a few years ago? I got really big.*

*Avengers: Endgame,* Disney, 2019

Fans of Marvel movies will recall that *Avengers: Endgame* began with the surviving Avengers living out their days in a despondent state, struggling with the loss of half the global population, including many of their friends. Shortly thereafter though, Paul Rudd's character – Scott Lang, or Ant-Man – shows up and explains how the surviving characters may be able to reverse the tragedy. Spoiler alert! With the help of everyone from the microscopic Ant-Man to the ginormous Incredible Hulk, the Avengers stop the bad guys and save the planet.

Today's market has been dominated by mega-cap stocks.[1] Yet, a portfolio concentrated too heavily in these names is like a movie focused exclusively on the Hulk. Sure, it may be entertaining, but the Hulk can also be volatile. Instead, we suggest investors construct their portfolios like the more successful Avengers' movies, driven by ensemble casts with each character bringing attractive attributes.

In this Review we draw attention to:

1) The top-heavy nature of today's market relative to history, and the abnormal risks investors assume by focusing exclusively on seven Incredible Hulks, even when passively investing in an S&P 500 Index fund.
2) The attractive valuation and profit recovery opportunities beyond the Magnificent Seven.[2]
3) The benefits of employing a dividend growth approach to create more diversified, lower risk portfolios.

**Chart 1. Share of S&P 500's market cap and earnings for the index's top 10 companies**

*Source: https://www.wsj.com/finance/stocks/earnings-season-to-test-investors-faith-in-big-tech-stocks-a16dc89e*

**Follow the Leader… or not**

Even seasoned investors sometimes confuse the S&P 500 Index and other commonly quoted indices – the levels and directions of which are dominated by a small number of very large companies – with the "stock market" which includes hundreds of companies with distinct size, growth, and industry characteristics. Massive automatic money flows into passive vehicles add to this confusion, but raise the risk of serious pitfalls, too. Remember, even in 2008 – when the S&P 500 Index fell -37% – many healthcare and consumer staples stocks still managed to post positive returns for the year.[3,4]

Admittedly, the extraordinary returns of the Magnificent Seven over the last few years have been well documented and with good reason.[5] The latest group to capture the public's fascination is seemingly populated with high margin, competitively advantaged companies in markets with strong secular growth. Indeed, some of these names are dividend growers held in Copeland's portfolios because of those exact attributes.

Still, even in that context, for both the communication services and technology sectors to have rallied more than 95% in only 18 months (through June 30th), is absolutely striking. This performance has pushed the weight of the ten largest names in the S&P 500 Index to 37% at the end of the most recent quarter.[6] This is the highest level in more than three decades, and far exceeds the 25% concentration experienced at the peak of the dotcom bubble, before things came crashing down. Meanwhile, the earnings contribution of the ten largest names in the Index sits a full 13 points lower at roughly 24%, only marginally above levels seen in the mid-2000s.[7] Hence, despite recent fundamental success for these mega-cap companies, their stocks have run far ahead of their profits (Chart 1).

Against this backdrop, investors might do well to remember that similar positive sentiments prevailed about the largest companies in earlier eras, too – namely, that scale, access to capital, and switching costs would allow them to sustain their superiority "forever."

In Table 1 (below), we see some companies – such as Microsoft – that have proven successful for extended periods, which likely only bolster investor confidence. Of course, for every Microsoft though, there's a GE or IBM that has fallen by the wayside. Investors who purchased those names when they were riding high, directly or via a large cap index fund, would have been deeply disappointed with their subsequent results.

Alas, human psychology and biases can be stubborn. After a long period of success, identifying the hazards that might derail such a story can be difficult. Below, we attempt to identify some key risks.

**Risk #1: "If you build it, they will come."**

Unfortunately, unlike in the 1989 film, *Field of Dreams*, in the stock market, building "it" doesn't guarantee that earnings or returns "will come." Instead, numerous companies have latched on to an exciting idea and investors have followed, only to learn the road ahead was bumpier than expected. Versions of this phenomenon include the dotcom bubble, the housing bubble, and – more recently – the consumer inventory build that arose in response to COVID-19. Today's artificial intelligence (AI) arms race may just be the latest.[7]

**Table 1. The Top Ten US Traded Stocks By Market Cap Over Time**

| | 1989 | 2009 | 2023 |
|---|---|---|---|
| 1 | AT&T | ExxonMobil | Apple |
| 2 | ExxonMobil | Microsoft | Microsoft |
| 3 | General Electric | Walmart | Alphabet |
| 4 | International Business Machines | Alphabet | Amazon |
| 5 | Student Loan Marketing Association | Apple | Nvidia |
| 6 | Altria | Johnson & Johnson | Meta Platforms |
| 7 | Merck | Proctor & Gamble | Tesla |
| 8 | Bristol-Myers Squibb | International Business Machines | Berkshire Hathaway |
| 9 | DuPont Nemours | AT&T | Eli Lilly |
| 10 | Amoco | JP Morgan | Visa |

*Source: CCM, FactSet*

Research shared by Sequoia Capital in late March estimated that AI companies are generating approximately $3 billion in revenue, up from zero just one year prior.[8] Impressively, that pace of growth is nearly ten times faster than software-as-a-service (SaaS) companies experienced at a similar developmental stage. Yet, here's the crux: to drive that revenue, Sequoia noted that companies invested a whopping $50B in Nvidia GPUs in 2023, along with billions more on power, facility, and other costs. As a business, those numbers simply aren't good enough.[9]

Should AI evolve along a jagged path – akin to the early days of the World Wide Web – the technology may prove revolutionary, and yet future investment returns may prove both less exciting and more volatile than recent experience.

**Risk #2: Great Companies, Terrible Timing**

Consider the Technology Selector Sector SPDR Fund (Ticker: XLK), an ETF designed to replicate the performance of the tech stocks in the S&P 500 Index. In March 2000, XLK peaked at nearly $65, commanding a forward P/E of 47 times. Following the dotcom bust, the ETF didn't reach that price level again until December 2017, even though the earnings of the underlying companies had nearly tripled.

Today, at nearly 30 times forward earnings expectations, the average valuation of the seven largest US-traded names is back to levels rarely seen since the dotcom bubble imploded, commanding a ten-point premium to the remainder of the large cap universe (Chart 2). The lesson is that even continued successful growth may be offset by valuation contraction.

**Risk #3: Creative Destruction/Competition**

Part of what has allowed the Magnificent Seven stocks to achieve their eye-popping market caps is the perception that they have unassailable competitive advantages that will only grow with time, bolstered by large scale, wide margins, and strong cash flows.

These economics, though, are exactly what's attracting a flurry of competition to their respective spaces. Tesla was one of the earliest to feel this pressure, first from electric vehicle (EV) upstarts, then from the large global automakers.[9] Next came Google, which, after years without a new challenger in search, must now contend with AI-driven alternatives, including subscription-based Perplexity and ChatGPT. Even Nvidia – with its apparent death grip on the AI chip market today – must be considering the possibility that Intel, AMD, or even nascent challengers from the proverbial garages of Silicon Valley, will become formidable competitors.

As competitors fight for a slice of the Magnificent Seven earnings pie, these stocks' ascents could be derailed.

**Risk # 4: Regulation?**

Finally, future regulation of large technology companies remains a wildcard. Yes, the Magnificent Seven companies have been subject to extensive on-going anti-trust and privacy regulation and have nonetheless been extremely successful.[10,11]

Nascent AI considerations are especially significant though, both because they create the potential for new precedents and because, at its extreme, a "rogue" AI could pose a serious societal danger. While the latter risk is viewed by some as unlikely, knowing who will regulate the AI landscape – or how extensively – remains an open debate.

**Beyond the Magnificent Seven**

Investors can point to a simple explanation for why the Magnificent Seven have left other stocks in the dust: stock prices reflect expectations for future earnings, and the group has seen strong projected growth, while other companies have not (Chart 3).

This observation is fair. If estimates for the Magnificent Seven continue upward while those of other companies slip further, recent performance trends may continue. That said, many companies outside the Magnificent Seven were beset by myriad challenges over the last three years. Obstacles ranged from elevated inflation and rising interest rates to a massive inventory correction that is still being unwound today.

Some reprieve seems forthcoming. The US Core consumer price index (CPI) declined to almost 3% at the end of the quarter, approximately half the late 2022 peak of near 7%.[12] As addressed in prior Reviews – "It Just Doesn't Matter" and "Double Vision" – continued progress along this path will eventually lead the Fed to cut interest rates, which market participants now widely expect to begin in September.[13] A pending change in monetary policy to accommodative from restrictive could usher in a new era of market leadership as two key concerns weighing on non-Magnificent Seven stocks begin to lift.

Meanwhile, the same benefits of lower inflation and rates may not accrue to the Magnificent Seven given their lack of net debt. Through the recent rising rate environment, these companies experienced little to no interest expense drag but, in some cases, saw earnings boosted by smartly higher interest income. Now, the implicit effects would be the opposite.

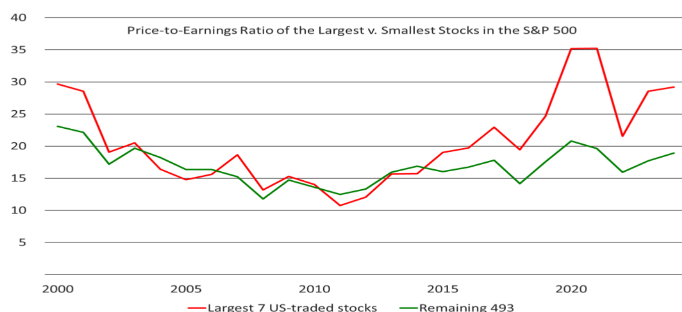
**The Benefits of Dividend Growth**

Going back to the end of 1988, there have been three major periods of outperformance for mega-caps relative to both other large caps and small caps, as represented by the Russell 2000 Index. The third period is currently on-going.[3]

Table 2 illustrates how the first two periods of mega-cap outperformance were followed by long periods during which market leadership broadened, the concentration of the S&P 500 Index declined, and both the S&P 500 Equal Weight and Russell 2000 Indices outpaced the S&P 500 Index by a wide margin.[3]

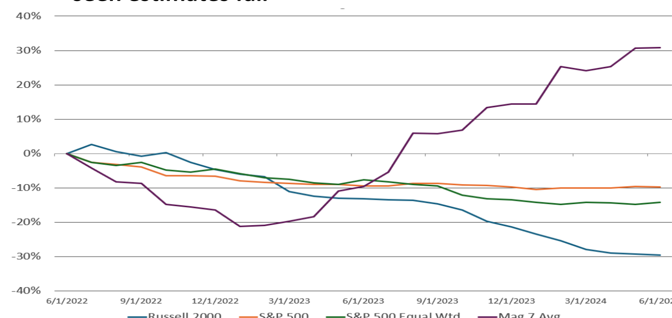
Knowing in advance exactly when or why market leadership will flip is impossible.

**Chart 2. Since the Dotcom Bubble, Mega-Caps Have Rarely Commanded a Larger Premium versus the Rest of the Large Cap Group**




*Source: CCM, Factset*

**Chart 3. 2024 Earnings estimates for the Magnificent Seven have significantly improved while most other companies have seen estimates fall**




*Source: CCM, Factset*

Instead, we submit that investors remain diversified across the capitalization spectrum throughout the economic cycle and strongly resist the urge to put all their eggs into one basket (e.g. Magnificent Seven). Further, with the current run of mega-cap success now stretching to approximately ten years, the argument for removing some eggs from the colloquial mega-cap basket becomes especially compelling.

Fortunately, dividend growth investors do not need to time any such rotation so perfectly. In fact, on average in the prior two cycles, even if a dividend growth investor shifted to an all-cap approach ***one year before the peak in relative performance for mega-caps***, she would still have bested the top-heavy S&P 500 Index by 5.3% per year through the next cycle.

Moreover, had an investor opted to shift to small cap dividend growers ***one year before the peak in relative performance for the mega-caps***, he would have fared even better: outpacing the Russell 2000 benchmark by 4.2% per year and the S&P 500 Index by 6.7% per year through the end of the next cycle.[14]

How might that performance be explained? Fundamental to Copeland's approach is the view that stocks with sustainable dividend growth consistently outperform the market with less risk. Notably, the pace of dividend growth within Copeland's portfolios continues to comfortably outstrip that of the respective benchmarks (Chart 4).

### An All-Cap Approach to Dividend Growth, Like an Ensemble Cast of Super Heroes, may be a Winning Recipe

For the last few years, the Hulks of the market – i.e., mega-cap stocks – have run far ahead of Ant-Man and friends – i.e., small cap stocks. However, even if the giants continue to smash their way to success, it seems increasingly likely that the smaller stocks will have their day in the sun as well. For every Incredible Hulk, there are super-heroes of smaller stature but of no less importance to the ultimate mission, including Ant-Man, Rocket, and Black Widow.

At Copeland, we manage dividend growth portfolios across capitalization ranges and geographies, allowing investors to gain the exposures they prefer. Importantly, our approach leverages the synergistic knowledge that our portfolio management team captures by following companies of all sizes.

Should the market leadership transition from mega-caps down to the rest of the market, we believe a balanced dividend growth approach will be the best possible way to capture those returns, given the strong competitive advantages, high profitability, and prodigious cash flow generation characteristics consistently found within the dividend growth universe over time.

Even if bad guys from another planet show up, we believe dividend growth is a "super" approach investors can count on in all scenarios.

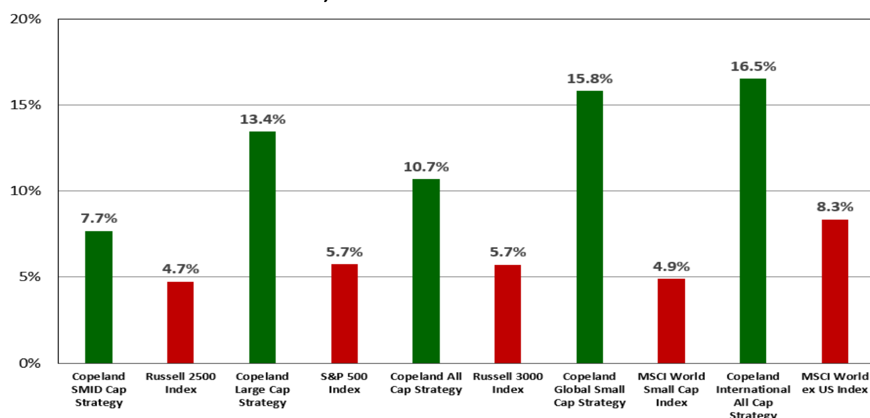
July 2024

**Table 2. Past periods of mega-cap outperformance have been followed by periods of severe underperformance**

| | | Beginning | End | S&P 500 Index | S&P Equal Weighted Index | Russell 2000 Index |
|---|---|---|---|---|---|---|
| Cycle 1 | Mega caps in favor | 2/28/90 | 10/31/90 | -6.3% | -17.0% | -23.5% |
| | Mega caps out of favor | 10/31/90 | 9/30/94 | 71.4% | 109.3% | 130.1% |
| Cycle 2 | Mega caps in favor | 9/30/94 | 3/31/00 | 259.1% | 149.7% | 127.4% |
| | Mega caps out of favor | 3/31/00 | 4/30/15 | 85.8% | 278.7% | 176.2% |
| Cycle 3 | Mega caps in favor | 4/30/15 | On-going | 210.0% | 141.6% | 90.0% |
| | Mega caps out of favor | ??? | ??? | | ??? | |

*Source: CCM, FactSet*

**Chart 4. One-Year Dividend Growth Rate for Copeland's US Strategies versus Respective Benchmarks as of June 30, 2024**




*Source: CCM, FactSet. Past Dividend Growth rates are not indicative of 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. The historical data is for illustrative purposes only and does not represent the performance of any strategy overseen by Copeland or any particular investment. 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.*

1. *Mega cap is a designation for the largest companies in the investment universe as measured by market capitalization. While the exact thresholds change with market conditions, mega cap generally refers to companies with a market capitalization above $200 billion. Many of the companies boast strong brand recognition and operate in major markets around the world, such as Apple (AAPL), Amazon (AMZN), and Meta (META), formerly Facebook.*
2. *The Magnificent Seven stocks are a group of the most influential companies in the U.S. stock market. This term has been popularized to describe a set of dominant companies, particularly in the technology sector. The group comprises Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla.*
3. *FactSet*
4. *https://money.usnews.com/money/blogs/new-money/2008/12/19/the-sps-10-best-and-worst-performers-of-2008-*
5. *https://www.cnn.com/cnn-underscored/money/magnificent-7-stocks#:~:text=%2C%E2%80%9D%20Hartnett%20explained.-,Performance%20analysis%20of%20Magnificent%207%20stocks,7%20generated%20a%2075.7%25%20return.*
6. *FactSet; WSJ https://www.wsj.com/finance/stocks/earnings-season-to-test-investors-faith-in-big-tech-stocks-a16dc89e*
7. *https://www.cnbc.com/2024/04/20/investing-in-the-ai-theme-for-the-long-haul-how-to-pick-the-winners.html*
8. *"The AI opportunity: Sequoia Capital's AI Ascent 2024 opening remarks," 3/26/24, Youtube, https://www.youtube.com/watch?v=TDPqt7ONUCY*
9. *Cox Automotive https://www.coxautoinc.com/market-insights/q2-2024-ev-sales/*
10. *https://www.reuters.com/technology/microsofts-decades-long-battle-with-eu-antitrust-regulators-2024-06-25/*
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13. *CNBC https://www.cnbc.com/2024/07/16/traders-see-the-odds-of-a-fed-rate-cut-by-september-at-100percent.html*
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**Currency** - Unless otherwise specified or disclosed, the currency used for data in the report is US Dollar (USD).

**Table 1, Table 2, Charts 2, Chart 3 and Chart 4:** © FactSet Data Systems Inc. All Rights Reserved. *FactSet is a company that offers financial industry analysis, financial data, analytics, and analytic software for investment professionals.* The information contained herein: (1) is proprietary to FactSet Research Systems Inc. and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither FactSet Research Systems Inc. nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results. **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.**

**Certain charts herein contain publicly available data, but the data has been formatted by Copeland to allow for ease of reading.**

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**Definitions**

**Consumer Price Index (CPI)** – A measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas.

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

**Forward P/E** – The forward P/E ratio (or forward price-to-earnings ratio) divides the current share price of a company by the estimated future ("forward") earnings per share (EPS) of that company. For valuation purposes, a forward P/E ratio is typically considered more relevant than a historical P/E ratio.

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