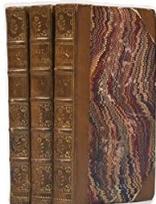


"We believe that stocks with sustainable dividend growth consistently outperform the market with less risk."



Great Expectations

"Take nothing on its looks; take everything on evidence. There is no better rule."

- Mr. Jaggers in *Great Expectations* by Charles Dickens, 1861

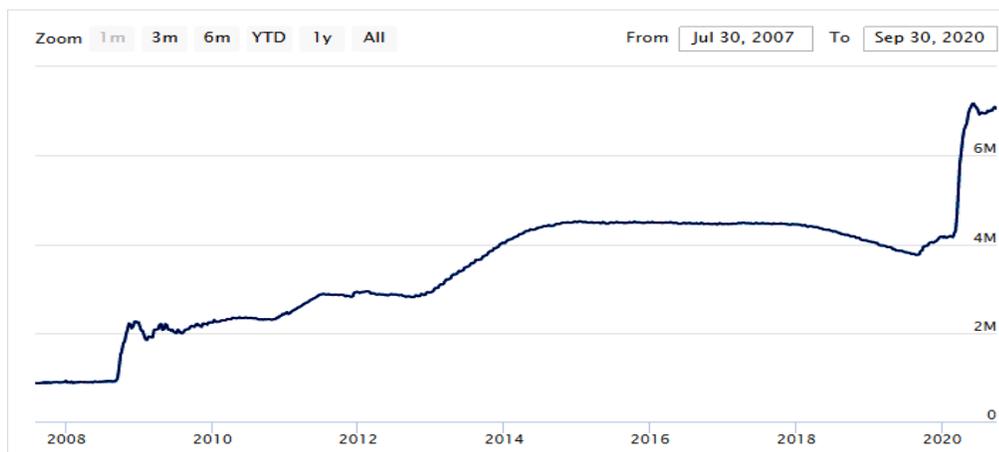
Although we commonly start our quarterly missives with a quote to draw the audience in, it's less common that we must go back more than 150 years to find it. We're often hesitant to do so, fearing that a certain portion of our readership – perhaps remembering high school English class with dread – might be put off before even leaving the starting blocks. There is, however, a reason that the great works are so characterized, and occasionally they afford a quote or title so apropos to the market environment that we simply cannot resist using it. Today, Dickens provides both.

In prior Reviews, we have devoted considerable space to highlighting the virtues of Dividend Growth investing. Like many investors, we believe long-term performance of stocks follows cash flow and earnings growth. Yet, whereas others consider dividend actions largely incidental, Copeland assigns significant value to the signal those dividend actions send and the guardrail they provide against poor decision making by management. We believe the latter factor accounts for much of the out-performance that dividend growth stocks have enjoyed relative to the pertinent benchmarks over time, regardless of market cap range ([Meet the 20s - Q419](#)), geography ([Ten Years Gone - Q318](#)), tax ([Taxman - Q112](#)), or interest rate environment ([So You're Telling Me There's a Chance - Q117](#)).

Despite this impressive track-record, there can be periodic, temporary dislocations during which dividend growth stocks lag. In particular, "beta rallies" – led by lower quality stocks and often following substantial downdrafts in the market – have proven especially challenging periods.

Since the pandemic-induced low in March, this year has been just such a period. Market leadership has come from lower profitability, higher leverage, and/or more "pandemic-impaired" companies. Take, as just one example, restaurants and hotels. Earnings estimates among these names remain depressed, consumer psychology about indoor dining and entertain-

Chart 1. The Federal Reserve's balance sheet has expanded aggressively



Source: Federal Reserve (https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm)

ment is mixed at best, and dividends – once robust – have been slashed. Yet against that backdrop, the S&P 600 Small Cap Hotels Restaurants & Leisure Index returned more than 80% for the six-month period ending September 30th.¹ While some recovery makes sense – as companies reopen following government-mandated lockdowns and industry solvency questions – the move is striking.

Gains of this magnitude have surely been bolstered by aggressive monetary and fiscal policy actions globally since the start of the pandemic. Consider the US specifically. At the beginning of 2020, interest rates appeared to be trending higher, while the Federal Reserve Bank's (the "Fed") balance sheet was relatively stable. Since the onset of COVID-19 however, the Fed's balance sheet has ballooned as the central bank has unleashed nearly \$3T of liquidity into the economy - nearly tripling its efforts from the height of the financial crisis in September 2008 (Chart 1). Moreover, whereas the Fed's prior efforts to drive down rates and boost economic activity primarily concentrated on purchasing US Treasuries, in an alarming move, this round of quantitative easing included unprecedented buying of mortgage-backed securities and corporate bonds, including high-yield debt.²

At the same time, Congress passed the Coronavirus Aid, Relief, and Economic Security Act or CARES Act, a massive stimulus bill, with wide-ranging support for consumers and pandemic-impacted businesses alike.

While much has been written about large cap stocks – and technology names in particular – benefiting from this government support as well as the pandemic environment, we find the divergent fortunes of smaller cap stocks equally notable, but less well-covered.

Whereas aggressive government stimulus seems to have aided the economic recovery, it has also fostered substantial risk-taking among investors. Consequently, unprofitable and non-dividend paying stock returns have far exceeded those of more stable, well-capitalized dividend growers over the past two quarters, particularly among smaller capitalization stocks (See Table 1 on page 2).

To put this period in perspective, since September 30th, 1982 there have been 151 six-month performance periods. SMID cap Dividend Growers (a group which combines both small and mid cap companies) have underperformed non-dividend paying SMID cap stocks by a wider margin than the current period only

Table 1. Riskier SMID cap stocks have outperformed significantly since March 31, 2020

Within the Russell 2500 Index:	Unprofitable Companies	Highest Debt to Market Cap Quintile	Non-Dividend Paying Stocks	Russell 2500 Index	Dividend Growers
Return between 3/31/20 - 9/30/20	48.9%	53.0%	51.7%	34.0%	16.5%

Source: FactSet, NDR, Russell

two other times – in the final two quarters of the dotcom bubble and in the first two quarters of recovery following the Great Financial Crisis. While these periods may appear to be direct opposites of one another, the key similarity is a huge investor appetite for risk, just as we have experienced in recent months.

“Take Everything on Evidence”

Of course, when everyone seems to be making money hand over fist, it’s sometimes difficult for investors to perceive the true risk of their investments until they’ve suffered significant losses. However, we believe that investors who read the tea leaves carefully can prepare for and avoid the eventual consequences of such a perilous environment. Below we highlight some of the unusual signals we’re observing, which – in our view – suggest that our Dividend Growth approach could prove particularly timely moving forward.

Exhibit 1:

The number of unprofitable companies in the Russell 2000 has exploded

After the implosion of the dotcom and housing bubbles, the percentage of unprofitable companies in both the large cap S&P 500 and small cap Russell 2000 Indices spiked sharply, which probably comes as no surprise. After all, both periods were marked by steep recessions, huge job losses, and major corporate restructuring efforts.

Now, here’s something completely shocking: even before most Americans had ever heard of COVID-19, the percentage of unprofitable names in the Russell 2000 Index was again nearing peak levels. This is even more striking when considered in contrast to a near-record low percentage of unprofitable firms in the S&P 500 Index (Chart 2).

At first blush this seven-year (and counting) expansion of money-losing enterprises seemed to fly in the face of the consistent growth of corporate profits experienced in the US since the Great Financial Crisis.³ Upon further review, however, we believe that

the two go hand-in-hand. Specifically, moving later into the economic cycle, a combination of short memories and easy money has fostered an IPO boom, not to help profitable enterprises take the next step in their growth trajectory, but rather to act as cash registers for founders and venture capitalists. As a result, “profit” is practically a four-letter word, with investors sold on the idea that the more money firms lose today, the greater their haul will be in three, four, or five years... if they can survive that long.

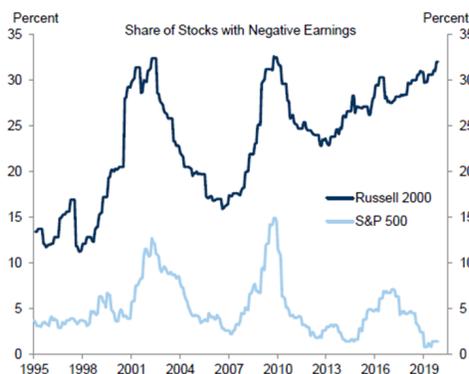
Today, these issues have only been compounded by the pandemic, with the number of unprofitable companies in the Russell 2000 Index pushing to an all-time high of 35%.

Exhibit 2:

Most unprofitable companies in the Russell 2000 Index aren’t expected to be profitable any time soon

Within the Russell 2000 Index, 703 companies are unprofitable based on current fiscal year earnings estimates. Among those, more than 70% are not expected to be profitable in either of their next two fiscal years and more the 50% are not expected to be profitable for at least their next three fiscal years. Alternatively, only 12 companies are expected to make the leap

Chart 2. The Share of Unprofitable, Small Companies was Near Prior Recession Peaks Even Before COVID



Source: Goldman Sachs Research Division as of 1/6/20; Past performance isn’t indicative of future results. *Midwestern Hedge* <https://twitter.com/MidwestHedge>

to profitability in the current fiscal year.¹

Exhibit 3: IPOs (and SPACs) are booming

Given the lull of activity that accompanied the height of the pandemic and the fact that many investment bankers continue to work remotely, the number of companies that have gone public this year and the valuations they’ve achieved, are truly remarkable. Through September 30th, there were 265 IPOs, while another 38 companies have come public as of this writing. This level is nearly 1.5x greater than the activity we saw in all of 2019 (only 211 IPOs). Further, 2020’s IPOs have been far larger than last year’s with nearly \$400B of capital raised versus a mere \$62B last year.^{4,5}

Let those statistics were not sufficiently eye-popping, let’s compare the year-to-date 2020 activity to 1999, which some readers may recall marked the frenzied end of the dotcom era. Incredibly, while the total number of new public companies brought to market that year (546) dwarfs the current period, a mere \$69.2B was raised in the process.⁶ By today’s standards, that number seems downright quaint.

Earnings estimates are not available for many of the newly-minted companies, but for those where Wall Street analysts have published outlooks, the result is consistent with Exhibit 2 (above): nearly 60% of all newly-minted IPOs are not expected to report positive profits in the next three years.⁷

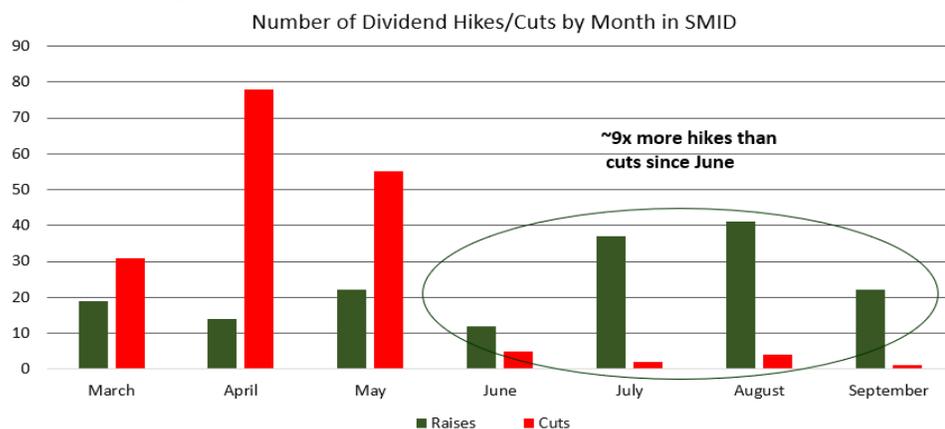
Even some recent darlings show little outward sign of a commitment to profitability. Take for example Snowflake (Ticker = SNOW). After being offered at \$120 per share, the stock spiked to \$319 on its first day of trading before settling in to the mid-\$200s recently. Expected 2023 earnings for Snowflake, you ask? A mere \$0.01 per share according to current analyst projections.¹

Irrational exuberance, anyone?

Great Expectations

While there is certainly evidence of risk in the market, as outlined above, we continue to have great expectations for dividend growers and the SMID Cap space, in particular.

First, history is on the side of dividend growers following periods in which they’ve underperformed. In fact, over the last 38 years, when

Chart 3. Following pandemic-driven weakness, dividend growth has accelerated sharply

Source: CCM, FactSet.

dividend growers have underperformed non-dividend payers over a six-month period, they have subsequently gone on to outperform them by an average of 8.2% per year over the following three years.⁸

Second, as the severity of the pandemic became apparent in March, we saw announcements of dividend cuts and suspensions among SMID cap stocks accelerate sharply, with dividend hikes slowing to a trickle. This was accompanied by huge negative earnings revisions among SMID cap companies as illustrated by a 51% reduction in 2020 EPS estimates for the Russell 2500 Index between February 28th and May 31st.

On the other hand, results among large cap companies proved far more stable, with far fewer dividend cuts, and S&P 500 Index earnings estimates down only 27% over the same period. There are likely many reasons for this relative success, ranging from the strength of the “FAANG” stocks (Tickers: Facebook, Amazon, Apple, Netflix, and Google) as quarantine plays, to their larger international sales mix, to the relative ability of larger companies to access global supply chains for everything from merchandise to personal protective equipment.

But, since the beginning of June, the trends for SMID cap dividend actions have reversed sharply. From June 1st through September 30th, while there were only 12 incremental dividend cuts, there were 112 new dividend

hikes (Chart 3)!

We believe this shift is a strong harbinger of favorable fundamentals and returns in the SMID cap space in coming quarters. Companies do not typically raise dividends unless management teams and boards of directors have confidence that those dividends can be sustained at, or increased from, their new elevated levels.

Despite these bullish signals, large cap stocks continued to outperform SMID cap names between June and September and have also seen earlier evidence of an earnings recovery – with 2020 consensus estimates up 4% since the end of May for the S&P 500 Index, while the Russell 2500 Index’s estimates have hardly budged. Eventually though, as either the pandemic dissipates, or evidence of successfully managing through it mounts, we expect that SMID cap earnings will recover more aggressively and the stocks will be rewarded.

Between March and September, whereas only 16% of the companies in the SMID Cap Dividend Growth universe hiked their dividends, Copeland’s SMID Cap Dividend Growth portfolio saw an impressive 22 dividend hikes among its 66 names, or 33%. These positive actions increased the average pace of dividend growth across our portfolio to 14% year-over-year, while the median dividend increase in the Russell 2500 Index over the same period was a modest 3.9%. In our view, the superior dividend growth within our portfolio highlights

three key attributes:

1. Strong underlying growth potential, driven by exposure to secular growth industries and resilient business models, especially during times of macroeconomic duress
2. Well-protected competitive positions, insulated from competition through pricing power, network effects, and economies of scale
3. Balanced approaches to capital allocation, focused primarily on reinvesting in the business to support growth, but with the governor of a capital return policy that limits management’s likelihood of pursuing value destructive projects

As we move past this challenging economic backdrop, we submit that these factors will continue to support a substantial dividend growth advantage, especially in combination with our portfolio’s reasonable 37% average payout ratio.

In combination with the potential for a significant earnings recovery, and the historically steep valuation discount that SMID cap dividend growth stocks currently enjoy relative to the Russell 2500 Index, we believe that we, and our investors, are well-justified in holding great expectations for dividend growth stocks looking ahead.

October 18, 2020

¹ FactSet

² <https://www.bloomberg.com/news/articles/2020-09-01/fed-s-mortgage-buying-spree-at-1-trillion-with-no-end-in-sight>

³ <https://fred.stlouisfed.org/series/CP>

⁴ <https://stockanalysis.com/ipo/2020-list/>

⁵ <https://www.wsj.com/articles/2019-the-year-of-ipo-disappointment-11577615400>

⁶ https://money.cnn.com/1999/12/27/investing/century_ipo/

⁷ <https://stockanalysis.com/ipo/2020-list/>; FactSet

⁸ Ned Davis Research

About Copeland Capital Management — Copeland Capital Management is an employee owned, registered investment adviser with offices in Conshohocken PA and Wellesley MA. 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.

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