Fourth Quarter 2021

The Copeland Review

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

Reality Bites

Troy Dyer: "Hello, you've reached the winter of our discontent."

Reality Bites, MCA Universal, 1993

In these pages over the past year, from *(Let's Not) Party Like It's 1999* to Running Hot to *Can't Stop the Feeling*, we highlighted mounting evidence of speculative investment behavior that coincided with unprecedented levels of fiscal and monetary support. Driven by the COVID-19 pandemic, these government programs also fueled a surge in consumer spending and a rapid GDP recovery. But, like the late 1990s tech boom or the Nifty Fifty era of the 1970s, the importance of valuation was minimized or totally ignored. Evermore "easy money" poured into risky assets, creating pockets of elevated valuations in the market and headwinds for fundamental investment approaches, including Copeland's Dividend Growth strategy.

Nevertheless – though we didn't know when – we felt confident that eventually this mindset would change. Ultimately, burgeoning inflation and the expectation of higher borrowing costs crashed the party. Now, as widely reported, broadly higher prices across numerous categories of goods and services have brought inflation to its fastest pace in forty years,[1] a hangover effect of too much stimulus combined with COVID-19 pandemic induced logistics and labor challenges. The situation is front page news and top of mind in boardrooms, households, and – increasingly – at retailers, where many store shelves are running empty. Welcome to "the winter of our discontent."

Still, US equity markets continued to reach to new highs into December, with the S&P 500 Index finishing 2021 up almost +29% on a total return basis after +18% in 2020 and +31% in 2019.[2] This, plus rising home values, creates a strong wealth effect for consumers, which drive 70% of the US economy. Further, sentiment is supported by record low unemployment, plentiful job openings, and rising wages, as well as strong corporate balance sheets and investment plans. Bulls can even plausibly surmise that as the latest COVID-19 variant recedes, labor and logistics challenges should begin to ease.

In this *Review*, we highlight the following realities:

1. Widespread and persistent inflation is pushing the Federal Reserve to reverse course and project tighter monetary actions.
2. Support for speculative assets is dwindling.
3. The outlook for high quality, profitable, reasonably priced investments remains bright.

Inflation Reality Bites Across Economy

Spiraling gasoline, heating, and electricity bills. Shipping rates up fivefold and apartment rental rates up double digits in many markets, not to mention empty shelves at grocery stores. Explanations for the environment include rebounding consumer demand post-pandemic – aided dramatically by government support – combined with a supply chain negatively impacted by episodic and, in numerous cases, sustained labor shortages.

First, COVID-19 illness and quarantines kept people from working, creating disruptions. At the same time, many people simply left certain parts of the workforce, some for retirement, others to cover childcare needs, and still others to pursue entirely new career paths. Together, these factors created a shortage of available workers in certain industries. Meanwhile, prolonged, substantial government transfer payments arguably altered natural labor market incentives and weighed on labor force participation. The net result is that significant wage increases are required to attract employees to many businesses, with those costs often passed directly on to consumers. US average hourly earnings are currently increasing at almost a 5% year over year pace,[3] and even faster in some "essential" industries such as trucking and food production.

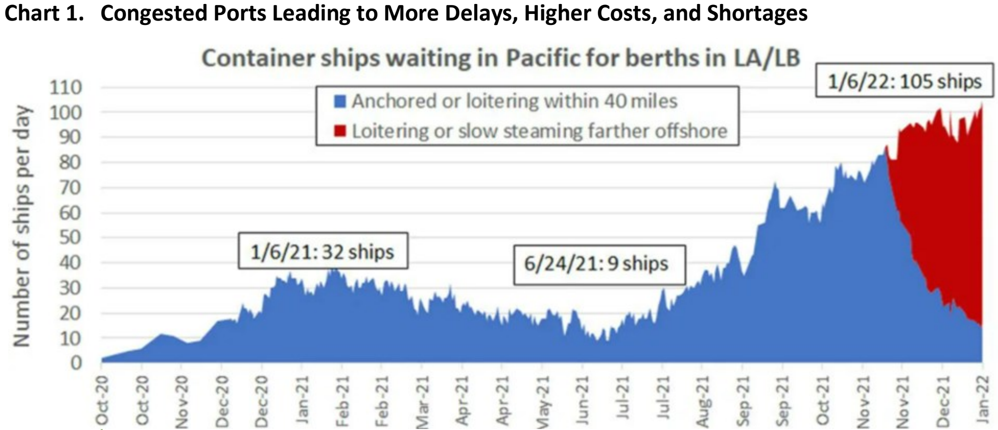
Meanwhile supply shortages are widespread thanks to transportation bottlenecks created by rebounding demand amidst COVID-19 work absences. The widely reported containership backup off the coast of Southern California is getting worse, with a record 105 ships waiting to berth as of early January 2022 (Chart 1).[4] Costco Corporation said in December that its Pacific Coast import containers "are late by an average of 51 days!"[5] No wonder many grocery store shelves are empty.

On a related note, TD Synnex Corporation, a large information technology distribution company, recently said that supply constraints would last through 2022 and impair near-term revenue by approximately 5% because of an inability to meet demand.[6] Likewise, production at major auto manufacturers around the world remains highly constrained due to component and labor shortages, with the Detroit Big Three inventory levels at less than one-half of pre-pandemic levels.

All the while, ocean shipping costs keep climbing, with the Shanghai Containerized Freight Index (SCFI) now at approximately $5,000, up 11% over the last three months and up fivefold from one year ago.[7] Domestic shipping rates also keep moving higher, with Cass Freight Index inferred freight rates up approximately 40% year over year across shipping modes.[8]

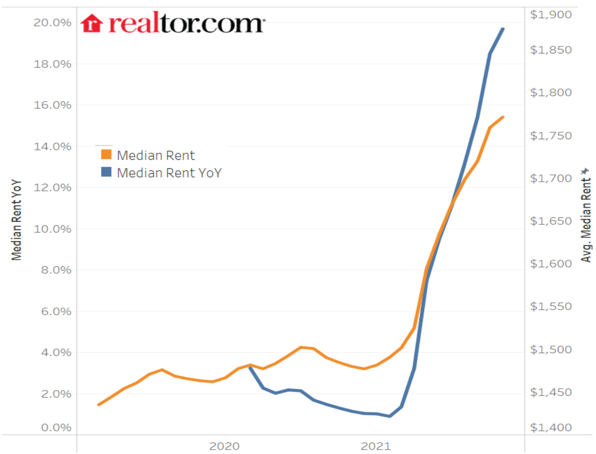
In response to these increased input costs, virtually all companies are trying to "take price" either in the form of "sticker price" increases or reduced discounting. As an example, auto industry incentives are at the lowest level in many years.[9] Thus, per Bureau of Labor Statistics (BLS) data, pricing for the limited number of new vehicles available is running up 12% year over year. However, that increase pales in comparison to used car pricing – up a whopping 37% year over

Chart 1. Congested Ports Leading to More Delays, Higher Costs, and Shortages



Source: https://www.freightwaves.com/news/new-year-brings-new-all-time-high-for-shippings-epic-traffic-jam

Chart 2. Median Apartment Rents up 20% Y/Y

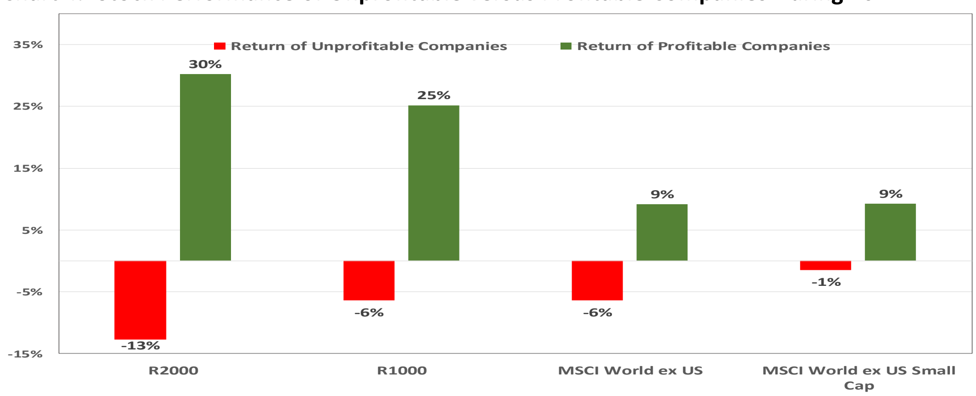


Source: Realtor.com https://www.realtor.com/research/november-2021-rent/

Chart 3. Skyrocketing Costs Wiping Out Strong Wage Gains

Source: The Washington Post, https://www.washingtonpost.com/business/2022/01/22/wages-inflation/

Chart 4. Stock Performance of Unprofitable versus Profitable Companies During 2021



Source: FactSet, CCM. The return data shown is total return including dividends. Profitable/Unprofitable companies are defined as companies with positive/negative earnings per share in their current fiscal year. All stocks in each group are equal weighted.

year, as desperate consumers search for any vehicle they can find. Other areas of constrained supply include housing, where the S&P/Case-Shiller US National Home Price Index is up 27% since March 2020, and the median national apartment rent increased by 20% year over year in November (Chart 2).[10,11] Though homebuilders and auto companies are running at full capacity, these shortages will likely take considerable time to unwind.

While strong wages benefit many consumers, for most Americans they are not enough to offset skyrocketing costs, as shown in Chart 3. The result is a loss of purchasing power, creating a potential headwind to spending, particularly as government support fades.

Where the Rubber Meets the Fundamental Road

Upon hearing these anecdotes, readers of a certain age or students of economic history may be forgiven for conjuring up visions of the late 1970s and early 1980s, when inflation peaked at 15%. At that time, the Federal Reserve acted aggressively to curb rampant inflation and the Federal Funds rate topped out at 20%![12] The difference then versus now was that unemployment was quite high and real (excluding inflation) GDP growth was decelerating or even negative.[13]

Currently, for 2022, real GDP and earnings growth are poised to decelerate but remain positive, a more benign set of circumstances. However, unlike each prior bout of "taper tantrums" since the Financial Crisis of 2008, when market volatility was consistently met with dovish policy reversals, we suspect the inflationary environment described above may prevent such a safety net from being deployed. As sure as the sun rises, the Federal Reserve is coming with higher rates to slow inflation and soon.[14]

As we discussed in *Running Hot* three quarters ago, the likelihood of higher inflation started to bring about a harsh reality for the most speculative areas of the market. Since that time, the fantasyland where valuation and fundamentals did not matter has faced a comeuppance as many speculative "investments" have fallen sharply out of favor. Yes, profits, cash flow, and dividends matter, and underpin the fundamental value of any business. Period.

In our view, "easy money" government policies contributed mightily to increased speculative behavior in recent years, including the extraordinary outperformance of non-dividend paying stocks – which are frequently unprofitable and more speculative – relative to profitable dividend growth stocks in 2020. We specifically covered this topic one year ago in *(Let's Not) Party Like It's 1999*, noting that, historically, such outperformance is rare and was unlikely to continue. But, when the music would stop was uncertain.

Since then, the music skipped a beat and possibly stopped altogether. Several data points suggest a more realistic tone to the market:

- At year-end, a *Wall Street Journal* article noted that shares of "more than 300" unprofitable growth companies fell more than 50% from recent highs during 2021.[15] In fact, the return of unprofitable companies lagged profitable companies across Small Cap, Large Cap and international markets by a significant margin (Chart 4).
- Another *WSJ* article counted a total of almost 400 "traditional IPOs" plus another 600 special purpose acquisition corporation (SPAC) launches in 2021 amidst a flurry of new issuance activity.[16] Yet, by year-end, approximately two-thirds of those were trading below their initial trading prices.
- The ARK Next Generation Internet ETF (ARKK) is down more than 50% from its early 2021 high and Bitcoin is down nearly 50% from its recent peak.[17]

We believe equity market investors will continue to be more discerning going forward, especially if capital is more costly. Further, we suspect more pain may lie ahead for investments in high risk, unprofitable business models or assets of indeterminable, esoteric value.

Chart 5. Strong Dividend Growth for Copeland's US and Int'l Strategies as of 12/31/2021

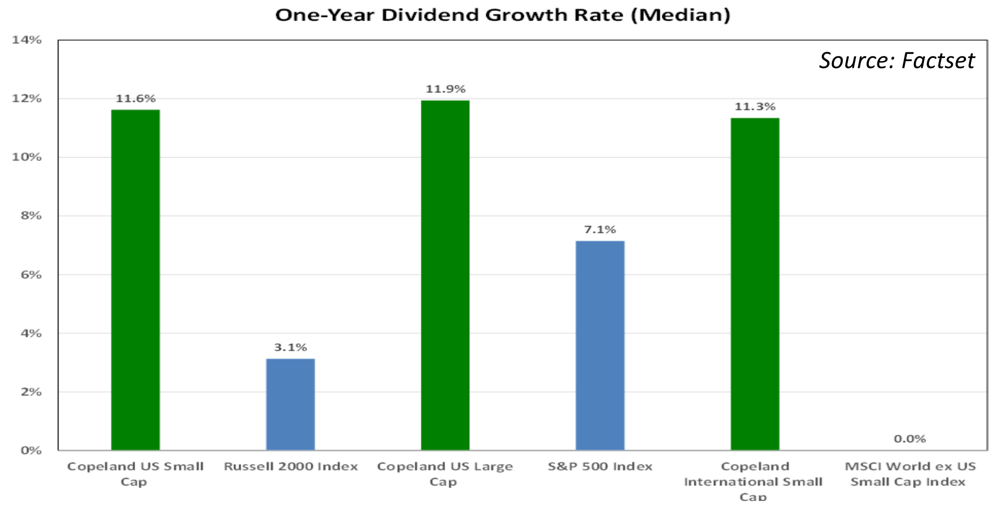
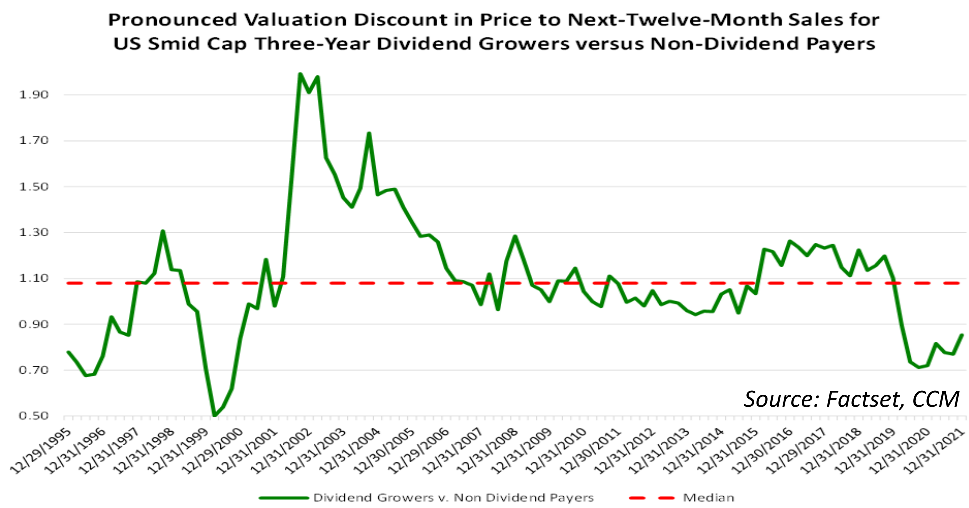


Chart 6. Dividend Growth Valuation Remains Compelling



Dividend Growth is Back in Town

As speculative areas retrenched, 2021 saw a reversal of fortune. The environment for dividend growth stocks became much more fruitful. Notably, we believe the change in mindset will, and should, continue.

First, we are only one year into the dividend growth recovery. Our analysis in *(Let's Not) Party Like It's 1999* noted that non-dividend payers outpaced dividend growers by 40% or more in only 3% of all rolling twelve-month periods since September 1982.[18] But, in every case, dividend growers thereafter went on to outpace non-dividend payers by a significant margin over the subsequent three years. Thus, history suggests that the turn in tide is only the beginning.

Second, the annual dividend hikes provided by dividend growth companies bring a tangible, rising income stream in the face of mounting inflation, which is quickly eroding real asset values and creates a higher nominal total return hurdle for all types of investments. Fortunately, our dividend growth investments tend to have durable business models with pricing power to offset inflationary headwinds and drive higher earnings as well as dividends. Importantly, the one-year median pace of dividend growth across Copeland's strategies continues to handily outpace that of the relevant benchmark (Chart 5).

Finally, the valuation of dividend growth stocks remains very compelling. To share one glaring example, Chart 6 highlights a still pronounced valuation discount for US Smid Cap dividend growers versus non-dividend payers.

Embracing Reality

Admittedly, prognosticating inflation, interest rates, GDP growth, or other variables is not our strong suit. We prefer to spend our time uncovering the best dividend growth stocks around the globe. Yet, we believe inflation trends and higher rates bring potential for negative earnings surprises which, in turn, elevate the risk of forthcoming equity market "taper tantrums" as investors adjust to a new reality.

We further think that business model quality and fundamental metrics will retain newly rediscovered significance. As in *Reality Bites*, a movie about recent college graduates adapting to life in the "real" world, adaptation to a new investment backdrop can be painful for those investors who aren't adequately prepared.

While the reality around us has changed, our reality has not. Copeland's focus remains squarely on researching, understanding, and owning companies that can drive sustainable dividend growth across market cycles. Further, our investable universe of domestic and international dividend growth stocks continues to expand from COVID-19 pandemic lows, providing a sizable opportunity set from which we build diversified portfolios. By maintaining our disciplined approach, we embrace the new reality without reservation.

January 25, 2022

1 *Bureau of Labor Statistics https://www.bls.gov/news.release/cpi.nr0.htm*
2 *S&P Dow Jones Indices https://www.spglobal.com/spdji/en/indices/equity/sp-500/#overview*
3 *Trading Economics https://tradingeconomics.com/united-states/average-hourly-earnings-yoy*
4 *Freightwaves.com https://www.freightwaves.com/news/new-year-brings-new-all-time-high-for-shippings-epic-traffic-jam*
5 *Costco Corporation F1Q22 conference call on 12/9/2021*
6 *TD Synnex Corporation F4Q21 conference call on 1/12/2022*
7 *Shanghai Shipping Exchange https://en.sse.net.cn/indices/scfinew.jsp*
8 *Cass Freight Index https://www.cassinfo.com/freight-audit-payment/cass-transportation-indexes/november-2021*
9 *Morgan Stanley Research, "Global Auto Databook," 11/30/2021*
10 *FRED Economic Data https://fred.stlouisfed.org/series/CSUSHPINSA*
11 *NYTs https://www.nytimes.com/2021/11/12/magazine/real-estate-pandemic.html*
12 *Trading Economics https://tradingeconomics.com/united-states/interest-rate*
13 *Statista https://www.statista.com/statistics/996758/rea-gdp-growth-united-states-1930-2019/*
14 *Federal Reserve https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20211215.pdf*
15 *WSJ https://www.wsj.com/articles/five-big-tech-stocks-are-driving-markets-that-worries-some-investors-11640060038?st=m1d6q4ejzwdsiaj&reflink=desktopwebshare_permalink*
16 *WSJ https://www.wsj.com/articles/ipos-had-a-record-2021-now-they-are-selling-off-like-crazy-11640773806?st=3zm2tdl1z1ky39l&reflink=desktopwebshare_permalink*
17 *Factset*
18 *Ned Davis Research, CCM*

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Currency - Unless otherwise specified or disclosed, the currency used for data in the report is US Dollar (USD).

Charts 4, 5, 6: © 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.**

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Definitions

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

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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