Coho Relative Value Equity

Monthly Portfolio Commentary

June 30, 2020

The divergence between "growth" and "value" continues to widen as shown in the table below. Our valuation discipline has made it difficult to keep pace with the technology-driven S&P 500 Index but we are pleased with our relative performance versus the Russell 1000 Value Index.

	June 2020	2Q 2020	YTD
S&P 500	2.0%	20.5%	-3.1%
Russell 1000 Growth	4.4%	27.8%	9.8%
Russell 1000 Value	-0.7%	14.3%	-16.3%

Source: FactSet

Following a harrowing first quarter, when the S&P 500 Index and Russell 1000 Value Index each declined more than 30% at the lows, the second quarter results continued the late March rally to help erase some of the first quarter's pain. To us, this recovery, which again favored growth over value, has been quite remarkable and surprising. The COVID-19 concerns that negatively impacted first quarter's results are still here, but investors appear to fully believe that the economic recovery will be faster and steeper than originally thought. Surely this is possible, but valuations would suggest a more defensive posture is prudent until more evidence of sustainable earnings with commensurate dividend growth is seen.

The S&P 500 Index posted an advance in June of 2.0%, while the Russell 1000 Value Index fell 0.7%. Technology was the strongest sector this month, while Financial Services lagged, furthering the growth versus value divergence. This was the primary differentiator this month between the two benchmarks. Coho had a small decline of 0.2%, putting us ahead of the Russell 1000 Value Index but behind the S&P 500 Index.

For the quarter, the S&P 500 Index rose 20.5%. Consumer Discretionary, Technology and Energy were the best performing sectors, each appreciating more than 30%. All sectors posted a positive return, but Consumer Staples was the laggard rising only 8.1%. Coho's advance of 15.5% fell between the S&P 500 Index and the Russell 1000 Value Index return of 14.3%.

The second quarter had a strong bias towards economically sensitive sectors, along with lower quality and higher beta companies. These all represented headwinds to Coho Partners' performance as we purposefully tilt toward demand defensive sectors and as such our process and philosophy result in a higher quality, lower beta portfolio. Economically sensitive companies now represent nearly 75% of the S&P 500 Index, while the Coho portfolio has about 45% exposure. Economically sensitive companies returned 24.2% this quarter versus demand defensive companies showing gains of 11.2%. High-quality companies (those with S&P 500 ratings of A- or higher) returned 15.3%, while the low-quality companies posted returns of 23.0%. Finally, the two lowest quintiles for beta advanced 14.2% while the highest three quintiles for beta rose 24.8%.

Year-to-date, the S&P 500 Index and Russell 1000 Value Index have declined 3.1% and 16.3% respectively, while Coho is down 5.6%. A disproportionate amount of the S&P 500 Index's return has come from the five largest market capitalization companies within the index. Those five companies represented more than 19% of the S&P 500 Index and accounted for 5.1% of the year-to-date return. Said another way, without those five companies, the S&P 500 Index's return would be down more than 8%. If one looked at the equal-weighted return for the S&P 500 Index over this same period, the return would be -10.8%, significantly less than the reported return.

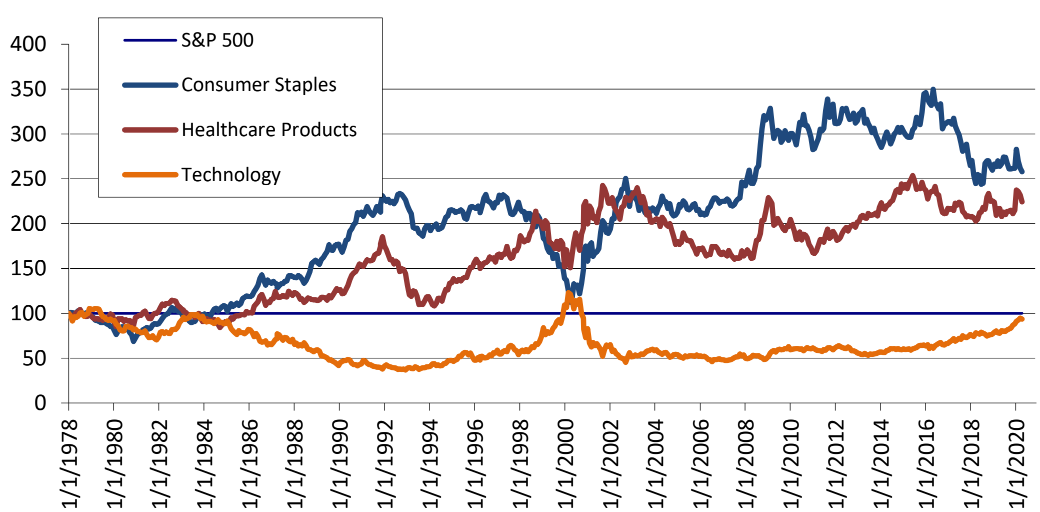
Table 1
Contribution of the Top 5 Weights to the S&P 500 Index

	S&P 500 Weight	YTD Return	YTD Contribution
Microsoft	5.33%	29.9%	1.63%
Apple	5.07%	24.9%	1.19%
Amazon	3.67%	49.3%	1.78%
Facebook	1.96%	10.6%	0.29%
Alphabet A	1.63%	5.9%	0.10%
Alphabet C	1.63%	5.7%	0.09%
Total	**19.3%**		**5.1%**

Source: FactSet

It seems that many of our recent commentaries have lamented the fact that Coho's recent underperformance to the S&P 500 Index is due to our over indexing to the more defensive sectors, such as Consumer Staples and Health Care and our under indexing to the more economically sensitive sectors, such as Technology. By design, we want to have extra exposure to demand defensive sectors because during down or challenging times, those sectors tend to generate strong relative results. Chart 1 shows a long-term history of sector performance.

Chart 1
Performance by Sectors



Source: Bernstein

What some may find surprising is that over the last 40 years, the Technology sector has dramatically underperformed both Consumer Staples and Health Care. Technology certainly goes through periods when it massively outperforms, but even with these impressive stretches, the sector has failed to consistently deliver outperformance relative to the S&P 500 Index over time.

Optically, the last time that Technology led the market's advance at the expense of both Consumer Staples and Health Care was the period prior to the "dot com" bear market. We are not predicting a similar outcome, but we do not anticipate the divergence in sector performances to persist forever.

Table 2 compares some common valuation metrics against the same sector ETFs and against the S&P 500 Index as of June 30, 2020.

Table 2
Valuation Characteristics of Select ETFs

	Price	2019 EPS	2020 EPS (e)	2021 EPS (e)	2020 P/E	2021 P/E	Yield
Consumer Staples (XLP)	$58.64	$2.95	$2.94	$3.17	19.9x	18.5x	2.8%
Healthcare (XLV)	$100.07	$5.89	$5.69	$6.56	17.6x	15.2x	1.6%
Technology (XLK)	$104.49	$3.91	$3.92	$4.52	26.6x	23.1x	1.1%
S&P 500	$3100.29	$163.02	$126.86	$163.34	24.4x	19.0x	1.8%

Source: FactSet

The current pandemic had no effect on 2019 results, but it will negatively impact 2020 EPS and analysts expect a recovery to the 2021 EPS. Based on these consensus estimates, analysts believe the S&P 500 Index's 2021 earnings will essentially return to where it was in 2019. Meanwhile, Consumer Staples are expected to grow 7.5% over this period, Health Care by 11.4% and Technology by 15.6%. However, we believe the better risk/return valuations are in Health Care and Consumer Staples, where P/Es are lower and dividend yields are higher. Our holdings within Consumer Staples and Health Care are "serial earnings compounders" and as such these companies have both offensive and defensive characteristics which provide protection when needed in downturns but still participate relatively fully during market advances. The average P/E for our Consumer Staples holdings on expected 2021 earnings is 15.9x with a current dividend yield of 3.9% and for our Health Care holdings their P/E averages 13.0x with a current yield of 2.4%. All these metrics compare favorably to the P/Es of the sector ETFs shown in the table above.

Long-time readers may notice that we did not include Integrated Energy in Chart 1 or in our discussion of demand defensive sectors. When Coho Partners was formed in 1999, we identified Integrated Energy companies as "demand defensive" because back then they had more balanced business models between the "upstream" exploration and production activities and the "downstream" refining and marketing activities. As such, they generated consistent cash flows and dividend growth. However, over time we have witnessed an increased emphasis on the upstream side of the businesses, driven by the upward trajectory of the underlying commodity prices. Chart 2 below shows the price history of Brent Crude since 1990. From 1990 to 2002, Brent traded in a reasonably defined channel but beginning in 2003, Brent had a long upward run from about $30 per barrel to nearly $140 in 2008. Over this period, the cash flows of Integrated Energy companies became skewed to the upstream side and the downstream operations were marginalized. Long-term capital projects began to be undertaken with an underlying assumption that oil prices would remain elevated for a very long time. At the extreme, we even saw previously “integrated companies” separate into two distinct businesses, such as Conoco Phillips, which spun off its Phillips 66 side as a pure downstream business while maintaining Conoco as a pure upstream business.

However, beginning in 2008 we began to see periods of rapid declines followed by periods of quick recovery, but the magnitudes of the declines outweighed the recoveries such that the trend for oil prices was down. These dramatic price changes, coupled with the reversal in oil prices, stressed projects that were already underway and made it more challenging for managements to plan future capital spending programs. The natural hedge between upstream and downstream operations slowly eroded, and exposure to the underlying commodity price increased. This decreases the stability of the business model and the security of the cash flow streams. As such, we feel it appropriate to move Integrated Energy from the “demand defensive” nomenclature to the “economically sensitive” designation. The reality is that this change has virtually no impact on how we invest as there are only two integrated energy companies within our Coho 250 investable universe, Chevron and Exxon.

Chart 2
Price History for Brent Crude

Source: Federal Reserve Bank of St. Louis

Some may wonder if Coho is now more reliant on Consumer Staples and Health Care for its downside protection. Although we very much believe Consumer Staples and Health Care remain reliable sectors for downside protection, we have lots of examples of holdings within sectors deemed “economically sensitive” that behave akin to “demand defensive” holdings. As a case in point, Dollar General or Ross Stores behave much differently than a JC Penney or Macy’s.

Another source of downside protection for the Coho portfolio is the security of its dividend income. Despite the earnings pressure from the coronavirus pandemic, we believe the dividend income generation of the portfolio in 2020 will be close to that of 2019. Of our thirty holdings, about half have already increased their dividend. To be fair, many of those increases came prior to the emergence of the pandemic, but we have seen several nice increases post the pandemic onset, such as Kroger, up 12.5% and UnitedHealth, up 15.7%.

The anticipated dividend for the S&P 500 Index this year is now down mid-single digits due to numerous cuts and suspensions. Year-to-date, there have been 21 dividend cuts and 41 dividend suspensions within the S&P 500 Index. Only one dividend cut was in a demand defensive company and only five of the dividend suspensions were related to demand defensive companies. Thus, the vast majority of the cuts and suspensions have occurred in the more economically sensitive companies and that is consistent with prior periods of economic stress. We readily admit that there is great pressure on Boards to be sensitive to rewarding shareholders with dividend increases when many of these companies are furloughing or reducing their workforces. However, this portfolio holds numerous companies with distinguished histories of annual dividend increases, and we believe these streaks will be extended though likely at a lower than usual growth rate.

As we embark on the second half of 2020, we are not pleased to be lagging the S&P 500 Index, but remain confident that if the managements of our companies continue to execute against their long-term operating and financial strategies, there is considerable upside to the portfolio.

If you have questions or concerns about our outlook or the portfolio's positioning, please do not hesitate to call us. We look forward to updating you on the progress of the portfolio as the year progresses.

Sincerely,

Coho Partners' Research Team