July 2010

Dear Friends of Coho Partners,

The downturn that began in May continued into June with domestic equities falling another -5.2%. All of the gains from the first quarter have now been eliminated and the broader averages are now down for the year.

Although we lagged slightly during the advance in the first quarter, we have more than made it up on a relative basis during the correction experienced in the second quarter. This is typical of our investment approach, which strives to preserve principal during down periods, while posting competitive returns during the advancing markets. Over the past two months, the selling pressure was broad based and reasonably indiscriminate. As such, our downside protection was not as great as we would have liked.

Clearly, there are serious domestic and global concerns confronting investors, which are now depressing valuations. The most commonly cited problems would be:

- the stubborn lack of job creation in the US
- the prospect for higher taxes and the uncertainty surrounding increased regulation
- sovereign debt problems in Europe; municipal and federal debt levels domestically
- the tragedy in the Gulf and the long term consequences
- fading stimulus impact not being replaced by private sector activity
- the overall lack of improvement in consumer and business confidence
- increasing signs of a second down leg in housing

It feels as though we are at an inflection point. This is a time of unusual uncertainty, where the risk of a "double dip" recession is real. We entered the 2008 recession with an overleveraged, interdependent financial sector. When the housing bubble burst and the contagion followed, it nearly brought down the entire system. That disaster was averted (some might argue, postponed) in large part by essentially transferring the private sector's leverage onto the public sector's balance sheet. The risk now is if we have another serious downturn, with federal and local balance sheets already stretched and with little popular appetite for more debt, we may be extremely limited in our ability to respond.

Conversely and not inconsequentially, there are also many positives. Corporate America has reacted quickly and effectively to the changing economic landscape over the past 18 months.

With the exception of the financial and auto sectors, the rest of the market has emerged without government bailouts and with their balance sheets in reasonably good shape. Corporations have taken a cautious view on this recovery, as evidenced by their keeping a tight rein on expenses and hiring. Hence, unemployment remains high, but profit margins for the non-financial sectors are approaching the old peaks experienced before the 2008 recession began. Even within the damaged financial and auto sectors, we are starting to see significant repair of their balance sheets and operating models. Should the economy even just muddle along from here, corporate profits could continue to propel the market.

Bottom line, we are not at all sure what the trajectory will be for the economy and/or the broader market, nor frankly, do we spend an inordinate amount of time thinking and acting on such predictions. What we *do* spend an inordinate amount of time on is analyzing and finding companies that have the ability to consistently grow earnings, dividends and cash flows in just about any environment. We take a long term perspective to investing at Coho Partners and as such believe these are the critical drivers of shareholder value and true wealth creation over time. Our philosophy holds that if we can populate the portfolio with those kinds of stocks at reasonable levels of valuation, we should be able to produce that valued pattern of returns where we provide protection in the difficult times and participation in good times. Ultimately, this should provide for better than market returns with less than market risk. Based on these criteria, we remain particularly encouraged by the outlooks for our holdings and the portfolio.

Tables 1 and 2 below compare the weighted earnings and dividends over various periods for the current holdings in the Coho portfolio and the same for the S&P 500. We use the holdings of the Coho portfolio as of June 30th, 2010 to illustrate how this current portfolio's value drivers would have fared over the difficult environment we experienced from 2007 through last year. We understand that there have been transactions over the past three and a half years that may have changed the composition of both portfolios slightly, but for purposes of illustration, we believe the conclusions would not change materially.

We used the peaks and troughs recorded by the index in our analysis as we feel these best represent the respective peaks and troughs of the recent economic cycle. On a trailing four quarter basis, the earnings of the S&P 500 peaked at $92.25 in the June quarter of 2007 (6/30/06 – 6/30/07) and it troughed in September of 2008 when the trailing four quarter earnings were $59.37. That is a 36% decline in earnings over that period. Over this same period, the earnings from the Coho portfolio declined only 6%.

TABLE 1

	Peak EPS Yr. Ending 6/30/2007	Trough EPS Yr. Ending 9/30/2009	Difference	Forward 4 Quarter P/E
S&P 500	$92.25	$59.37	-36%	13.0x
Coho Portfolio (weighted)	$3.64	$3.41	-6%	11.7x

Source: Coho Partners, Baseline

Looking at dividends (which lag the impact of earnings), the trailing one year dividend rate on the S&P 500 reached its peak in September of 2008 at $28.76 and it bottomed in March of this year at $21.91. This was a 24% decline. Again, over this same period, the dividend rate for the holdings in our portfolio actually rose by 12%. We consider this to be a huge vote of confidence by management on the prospects for our companies during one of the most turbulent economic times in modern history.

TABLE 2

	Peak Annual Dividend 9/30/2008	Trough Annual Dividend 3/31/2010	Difference	Current Dividend Yield
S&P 500	$28.76	$21.91	-24%	2.1%
Coho Portfolio (weighted)	$1.25	$1.40	12%	3.1%

Source: Coho Partners, Baseline

We estimate that the sustainable eps growth rate for the portfolio is close to 10% and the current yield on the portfolio is over 3%, which now exceeds the yield on the 10 year Treasury. The forward four quarter P/E is only 11.7x. Those metrics, coupled with healthy balance sheets and strong competitive positions gives us confidence that current valuations appear particularly attractive. At the mid-point of this year, we believe all of our holdings will have higher earnings in 2010 vs. what they produced in 2009. Moreover, about 75% of our current holdings have already increased their dividend rate for 2010. We expect increases from many of the companies who have not yet done so to do so by year end.

History is certainly no guarantee of future performance and it (almost) never repeats, but given recent experience and current uncertainty, we like the hand we hold. We look forward to updating you on our progress as the year progresses, but please do not hesitate to call us if you have questions.

Sincerely,

Peter A. Thompson
Partner

Brian L. Kramp
Partner

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