July 5, 2013

Dear Friends of Coho Partners,

Volatility dominated this month, as the averages see-sawed back and forth, but ultimately June closed down, which was the first down month for the year. Although we too were down this month, we declined far less than the benchmarks. For the second quarter, the benchmarks posted low single digit returns and we were slightly better than that. Year-to-date, we gained 15.2%, ahead of the S&P 500's return of 13.8%, but slightly behind the Russell 1000 Value's return of 15.9%. It is not uncommon for us to lag during periods such as this when the overall returns have been so large, but we are nonetheless encouraged by these returns.

You may recall that the first quarter's strong performance emanated from the more "defensive" sectors, such as Consumer Staples, Healthcare and Utilities, which was unusual since defensive sectors tend not to lead major advances. This quarter's performance was led by more of the "economically" sensitive sectors, with Healthcare being the only defensive sector to outperform the benchmark. The performance this quarter came from good stock selection, particularly within our Industrials, Healthcare, Materials and Consumer Staples. The only sector where our stock selection lagged was within Technology.

We eliminated two holdings this quarter, Colgate and Abbvie and we added one new holding, Occidental Petroleum. We first bought Colgate in late 2004 and since that time, the stock has appreciated nicely as the company delivered consistent earnings and dividend growth. However, early this quarter, the valuation rose to a level where the risk/return was no longer attractive to us, so we eliminated the position. Abbvie was the ethical pharmaceutical part of the spin off from Abbott Labs earlier this year. Since its spinoff, Abbvie shares performed nicely and also reached a price point that led us to eliminate the position based purely on valuation. Occidental Petroleum was in our "bull pen" for portfolio consideration, and when the Board extended CEO, Steve Chazen's term through 2014, we added it to the portfolio. We have met Mr. Chazen and believe he has an excellent strategy to develop the company's domestic resources, as well as build out its Al Hosn gas project by early 2015.

There were a number of noteworthy macro developments this quarter that deserve note for driving much of the recent volatility, such as the spike in interest rates, the continued weakness in emerging markets and the plunge in gold. In aggregate, these developments may be heralding some changes in the global economies and the markets, though, as always, we seek to construct a portfolio that can better withstand the unpredictable nature of these macro factors.

Taking each in turn, interest rates did increase meaningfully this quarter. The five year Treasury note began the quarter with a yield of 0.77% and finished the quarter with a yield of 1.40%. The ten year bond's yield moved from 1.85% to 2.49%. These are very large moves over a very short period of time and they were triggered by Fed Chairman Mr. Bernanke's comments that the Fed might begin to "taper" their bond buying if our economy continues to strengthen. The good news would be that the economy is finally being viewed as becoming strong enough to stand on its own, without the extraordinary quantitative easing measures from the Fed. The bad news would be that this might be the first step in moving toward a rising interest rate environment and ultimately not only a less accommodative Fed, but a more restrictive one. We may have seen the bottom in interest rates, but feel that we are still a long way from seeing the Fed tightening. On balance we view this as positive for the economy and the markets. In addition, while steadily rising rates tend to dampen P/E's and pressure debt laden balance sheets, our holdings have extremely strong balance sheets, and in many cases have NO net debt. Therefore, the low interest rate environment we have been experiencing has actually punished these companies' earnings because they have earned so little on their cash balances.

Emerging markets have run into a challenging economic period emanating from weak export demand to developed markets, lower commodity prices and the overall slowdown in China. Given the global footprint of many of our holdings, our portfolio has meaningful exposure to the emerging markets; however, our companies sell simple creature comforts, such as toothpaste, detergent and shampoo, as opposed to highly cyclical items such as airliners and earth moving equipment. We still like the theme of rising per capita incomes in these markets and the positive impact on demand for these types of goods. Moreover, if the US economy is getting better and if Europe is perhaps stabilizing, this would ultimately be a positive for the emerging markets that grow by exporting to these developed economies.

Gold is a different creature altogether from what we typically focus on as we avoid commodities because of their high volatility and lack of an income stream. As a result, our expertise is not in gold, but our sense is that the fall off in gold is related to both the prospect of less Fed easing and less commodity demand from the emerging markets. Thus we are seeing a break in the long term bullish trade that has been in place for quite some time. Altogether, we would view these underlying macro shifts as a positive vote towards steadier growth with low inflation risk on the horizon.

As we begin the second half of this year, our hope is that investors will again obsess less on the macro and return to focusing on the fundamentals of all companies, and if so, we believe we have a great portfolio of companies that are priced at attractive valuations, where we can hold them for long periods of time to build long term value. Our companies continue to perform well against our expectations, which we believe are the long term operating and financial stepping stones to their success.

We believe that a good way to build long term wealth is to identify companies that consistently grow their earnings and share that incremental earnings growth with an annual dividend increase. At the half way point in this year, roughly 75% of our holdings have increased their dividend and we expect the remainder will do so by the end of the year.

Valuations remain reasonable and we believe we are well positioned to preserve principle if the market were to correct and yet we still expect to participate meaningfully should the market continue to advance.

Please do not hesitate to call us with questions or concerns about our outlook or your portfolio.

Sincerely,

Peter A. Thompson   Brian L. Kramp, CFA

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