October 14, 2010

Dear Friends of Coho Partners,

The third quarter began nicely and ended nicely, and had it not been for a down August, performance for the quarter would have been even more robust. We participated meaningfully in both the very strong month of September and the overall performance of the quarter.

The strong returns in the markets this quarter were driven by continued optimism in the ultimate economic recovery. A combination of weaker economic data and concerns about a possible European contagion kept the stock market on edge this summer, but recent psychology seems to have improved on both of those fronts. While some of that optimism has to do with modestly better data that came in September, some appears to be faith that if the economy falters, the Fed is poised with new monetary activities to do whatever it takes to forestall a return to a recession with potentially deflationary consequences. We are not so sanguine that we have a reasonable understanding of the potential scope of collateral damage from these actions, particularly quantitative easing. Meanwhile, earnings continue to forge higher as corporate America seems to have adjusted well to the "new normal" lower level of demand.

The Coho portfolio managed to stay very competitive with the advance this quarter despite some sector headwinds as several of our holdings posted 20%+ returns over the period. Favored sectors of ours such as Consumer Staples (+10.6%) and Healthcare (+8.8%) modestly lagged this rally (+11.8%), while sectors where we have little to no exposure such as Telecom (+19.1), Basic Materials (+17.8%) and Utilities (+12.3%) did particularly well. Countering the negative sector exposures, were standout stocks such as Walgreen's (+26%), UnitedHealth Group (+24%), and Philip Morris International (+23.6%). Year to date, we have outperformed because the portfolio has done relatively well during the corrective periods and stayed close during the rising months.

Investors are justifiably nervous about the future. The specter of higher taxes, persistently high unemployment and a fragile US economy are all weighing on market valuations. Income oriented investors are particularly frustrated, as yields on money markets are virtually nil and fixed income yields are quite low. Conversely, we are particularly excited about the current yield and prospects for income growth in the Coho portfolio. We do not choose stocks primarily for their dividend yield, however, dividend yield and consistent dividend growth is a natural and expected outgrowth of the specific kinds of business models that we invest in. We especially value companies with predictable, stable and growing cash flows because these characteristics tend to be highly prized during downturns. We seek companies that generate substantial cash flow but have low capital investment requirements. These types of companies have extra financial flexibility to enhance shareholder returns. We strongly favor companies that we feel consider their balance sheets to be a sacred part of their enterprise, such that they possess the wherewithal to withstand a recession or even a company specific disaster without endangering its solvency. These preferences all enhance the security of the dividend and allow for consistent dividend growth in almost any economic environment.

Shortly after we founded Coho Partners in June of 1999, we established a model portfolio, which we have maintained ever since. Investment decisions uniformly made for our discretionary clients are replicated in our model portfolio. Table 1 compares our model portfolio to the S&P 500 assuming each began with $1.0 million on January 1, 2000. You will note that our model portfolio generated significantly more income and the portfolio value appreciated at a much higher rate than the S&P 500 over the same period.

Table 1

COHO PARTNERS MODEL PORTFOLIO
DIVIDEND GROWTH 1/1/2000 - 9/30/2010

	COHO PORTFOLIO	COHO DIVS	DIV YIELD	S&P 500 PORTFOLIO	S&P 500 DIVS	DIV YIELD
1/1/00	$1,000,000			$1,000,000		
12/31/00	$1,117,000	$15,638	1.4%	$922,000	$11,064	1.2%
12/31/01	$1,138,223	$15,935	1.4%	$812,282	$11,372	1.4%
12/31/02	$987,978	$15,808	1.6%	$631,955	$11,375	1.8%
12/31/03	$1,224,104	$18,362	1.5%	$812,695	$13,003	1.6%
12/31/04	$1,412,616	$22,602	1.6%	$901,278	$14,420	1.6%
12/31/05	$1,419,679	$22,715	1.6%	$945,441	$17,018	1.8%
12/31/06	$1,663,864	$64,891	3.9%	$1,094,821	$19,707	1.8%
12/31/07	$1,752,049	$35,041	2.0%	$1,155,036	$21,946	1.9%
12/31/08	$1,454,201	$42,172	2.9%	$727,673	$22,558	3.1%
12/31/09	$1,721,774	$43,044	2.5%	$920,506	$18,410	2.0%
9/30/10	$1,845,741	$35,992*	2.6%**	$956,406	$14,346*	2.0%**
Cumulative Income		$332,199			$175,219	
% of Initial Value		33.2%			17.5%	

* Actual income received first 9 months of 2010
** 9/30/10 dividend yield is annualized

Coho Model Portfolio holdings for each period are available upon request.

Throughout this entire period, our portfolio has had a current dividend yield close to or higher than the yield on the S&P 500. However, the absolute level of income and its growth in our portfolio has been dramatically better over this period. The surge in income for Coho in several of the years is explained by the fact that our portfolio has benefited from three special, one time dividends (Microsoft in 2004, Alberto Culver in 2006 and JM Smucker in 2009). These had a more positive impact for us since their weight in our portfolio was greater than their weighting in the S&P 500.

Over this period of ten and three quarter years, our portfolio generated cumulative income of $332,199, which was nearly twice the income generation of a similarly sized portfolio of the S&P 500.

If we measure the growth in dividend income from the respective starting positions in 2000 through the last full year ending 12/31/2009, the annual income generated from the Coho portfolio has grown at an 11.9% compounded annual growth rate vs. 5.8% for the S&P 500 portfolio. We attribute the magnitude of this difference to the fact that the Coho portfolio's dividend kept up with the market in good times, but still showed growth even during down periods. We all remember the reductions and eliminations in dividends that swept the market in 2009 and we have noted in previous letters that we had no dividend cuts or omissions in our portfolio that year. This divergence explains the current above average dividend yield on our portfolio vs. that of the market, and importantly, explains why we expect to maintain our yield advantage for quite some time.

The current yield on our portfolio is just under 3%, which is greater than the yield on the ten year treasury, which finished the quarter with a yield of 2.51%. Given our current dividend yield and the outlook for further annual dividend increases, we believe the income stream should be compelling vs. most fixed income alternatives. In a deflationary environment, a growing income stream should be highly prized, which is one of the primary reasons we are confident about the prospects for our portfolio.

A final observation is that the Coho Relative Value portfolio had annualized appreciation of 6.3% over the ten year period ending September 30, 2010, which is in marked contrast to the annualized decline of -0.5% for the S&P 500 and the annualized 2.6% gain for the Russell 1000 Value Index. The cumulative dollar gain of $845,741 over the life of the model portfolio consisted of dividend income of $332,199, or 39% of the total, and realized and unrealized gains of $513,542, or 61% of the total.

As we begin the final quarter of this year, we look to build on our advantage over the passive benchmarks. We believe the portfolio is well positioned for the long term. Beyond the income characteristics that we have discussed, the P/E for the portfolio is 12.6x on a forward four quarter basis, which is a discount to the market. The combination of an attractive current dividend yield with good growth prospects, coupled with reasonable P/E multiples and strong business fundamentals gives us confidence in the long term potential of the portfolio.

We look forward to updating you on our progress. In the meantime, please do not hesitate to call us if you have questions.

Sincerely,

Peter A. Thompson
Partner

Brian L. Kramp
Partner