October 5, 2012

Dear Friends of Coho Partners:

Domestic equities enjoyed a wonderful third quarter, with the S&P 500 and Russell 1000 Value both up over 6%. We captured the majority of this advance as well, but we did not get the entire move. All of our quarterly underperformance occurred in September and specifically after the recent Federal Reserve announcement of their third round of quantitative easing (QE3). In the two prior rounds of quantitative easing (QE1 and QE2), the cyclical industries outperformed the defensive industries over the subsequent few months. This same pattern is playing out this time as well. We tend to be under weighted the more cyclical industries, which explains our relative weakness in September.

On a year to date basis, the S&P 500 and the Russell 1000 Value benchmarks are up approximately 16% and we have captured about 80% of this advance. Our philosophy stresses downside protection and upside participation, which biases us towards some of the more defensive sectors such as Consumer Staples, Healthcare and Integrated Energy. All of these sectors have underperformed the benchmark return over this period, while Information Technology, Financials and Consumer Discretionary have posted better than benchmark returns. Of note, Apple alone accounted for over 2% of the 16.4% return for the S&P 500; in other words, Apple stock alone was responsible for just over 13% of the entire return.

This upcoming third quarter earnings season may have heightened importance given the year to date returns. There have already been some notable preannounced earnings warnings from such bell weathers as Caterpillar, Federal Express and Intel, yet the broader market continues to move higher. We are cautious of the growing disconnect between risk and return in the market. The risks that we have cited in prior letters are still before us and they include:

- high unemployment both here and abroad;
- persistently sluggish global economic activity;
- record high profit margins (nowhere to go but down?);
- low consumer confidence around the world;
- elevated tensions in many geographies;
- potential consequences from our own “fiscal cliff”; and
- our own national election.

Investing clearly involves taking risk and successful investing requires properly assessing the potential risks with the possible returns. We do not get all of our investment ideas correct, but we do endeavor to minimize mistakes. Looking holistically at the portfolio, our dividend discount models continue to suggest that the expected annualized rate of return of the collective stocks that we hold in the portfolio remains above 10%, which we believe should be an excellent risk adjusted return over the foreseeable future. We also know that investing can be very humbling and that annualized returns can be the byproduct of very volatile annual returns that swing widely from year to year. Nevertheless, we have confidence in our models and disciplines so that we are comfortable with our holdings and our portfolio construction. We have never relied on market timing and although the concerns mentioned above are quite real, we believe we have properly discounted them in our models. There are of course no guarantees in our business, but we like our holdings and their outlooks. Beginning very shortly with the onset of the third quarter's earnings reporting season, we will see how they are performing relative to our expectations both operationally and financially. Our sense is that the investment environment will have a wider range of "winners" and "losers" over the next few quarters and the more successful managers will be those with above average stock selection.

As we enter the final quarter of this year, we are happy to report that all of our holdings increased their dividend this year and that the weighted average of the increase was more than 10%. As generous as this may sound, this is consistent with prior year increases. This type of income growth should provide a solid inflation hedge to rising prices over time and as you may know, if you were to grow an income stream at 10% per year, the income essentially doubles every 7 years. Unfortunately, there are fewer and fewer such opportunities available to prudent investors in this environment.

Finally, all of us at Coho Partners are very pleased and excited to welcome Michelle Benner and Chris Leonard to our team. Michelle has over 23 years of experience in the financial services industry and she will be responsible for advancing and deepening our client service efforts and some business development. Chris is a seasoned investment professional with over 15 years in the investment field and he has earned his Chartered Financial Analyst designation (CFA). He will be focused on augmenting our research effort and helping with portfolio management. Coho is continuing our reinvestment into the two most important aspects of our business; the integrity and efficacy of our investment process and how well we serve our clients. We hope to provide excellent returns on both of these hires in our continual quest to improve our firm.

Please do not hesitate to call should you have questions about our commentary or the portfolio.

Sincerely,

Peter A. Thompson

Brian L. Kramp, CFA

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