COHO PARTNERS, LTD.

October 5, 2013

Dear Friends of Coho Partners:

Returns for the third quarter were nicely positive and similar to those of the broader averages, as solid monthly returns in July and September were more than enough to offset a weak August. For the first nine months of this year, the benchmarks have risen by about 20% and performance for your portfolio has been right in line. Usually, when the market advances as much and as quickly as this one has, we would tend to modestly lag because our investment style is defensive and conservative. However, the sector return differential has been somewhat atypically narrow and our stock selection this year has been able to offset the relatively modest sector headwinds.

Specifically, during this quarter all of the traditionally “defensive” sectors, with the exception of Healthcare, underperformed the S&P 500, and all of the more “economically sensitive” sectors, with the exception of Financials outperformed the benchmark. Our portfolio structure remains overweighted to the defensive sectors, particularly Consumer Staples and Healthcare and underweighted in the more economically sensitive sectors, notably in Financials and Technology.

A similar pattern existed for the year to date period as well, with Healthcare the only defensive sector outperforming the benchmark and Materials and Technology being the only economically sensitive sectors to lag the benchmark. Utilities and Telecom, two traditionally defensive but low growth sectors where we have no exposure, have massively lagged the indices this year with the increase in interest rates, which along with our overweighting in Healthcare and relatively good stock selection has kept us very competitive so far this year.

So what’s driving the strong quarterly and year to date returns? We believe the advance is mostly attributable to an expansion in the P/E multiple. Table 1 shows the changes in the S&P 500 and its underlying operating earnings from the end of 2011. Over the past year and three quarters (12/31/11 through 9/30/13), the S&P 500 has appreciated by 33.7% (excluding dividends) while the operating earnings have risen by a much more modest 5.9%. This has led to an expansion of the P/E multiple for the S&P 500 from 13.0x at the end of 2011 to its current multiple of 16.5x.

TABLE 1

DATE	**S&P 500**	**TRAILING 12 MONTH OPERATING EARNINGS**	**S&P 500 P/E**
12/31/11	1257.60	$96.44	13.0x
12/31/12	1426.19	$96.82	14.7x
6/30/13	1606.28	$99.28	16.2x
9/30/13	1681.55	$102.10 *	16.5x
12/31/13(e)		$107.17 *	
12/31/14(e)		$118.03 *	

- Mid-point of the bottom up and top down estimates as published by S&P

What has driven the increase in this multiple that investors are willing to pay for earnings? Certainly the Fed's policies of Zero Interest Rates and Quantitative Easing (QE) have played a role in boosting the relative attractiveness of equities and risky assets in general. Investor memories are also short (perhaps blessedly so) and equities being one of the best performing asset classes since the bottom four years ago has attracted significant investor attention and flows. Lastly, there is some justifiable optimism that the global economy is finally repaired enough that it may at long last be ready to break out of its funk, potentially leading to a reacceleration in earnings.

While we are sympathetic to the above positions, we do worry that expectations for future operating earnings may now be too enthusiastic, and if so, then the odds of a correction have increased. Looking back to Table 1, you can see that in 2012, there was essentially no growth in S&P 500's operating earnings. However, the forecast for 2013 calls for eps growth of 10%+, which appears overly optimistic in that eps growth through June was a tepid 2.9%. This implies 7.9% growth in the second half (15%+ annualized) and clearly this would be a major uptick from recent trends. Given this, we like our defensive positioning.

Another concern for investors is the direction of interest rates. Essentially all fixed income investments, with the exception of Treasury Bills have produced a negative return year to date. Once again, interest rates continued to rise this quarter, as shown on Chart 1. The benchmark 10 year Treasury, whose yield bottomed in early May at 1.63% began this quarter at 2.49%. With rumors that the Federal Reserve was contemplating "tapering" its monthly bond buying, the yield nearly touched 3% in early September. However, following the surprising announcement later this month that the Fed would hold pat on the bond buying, the 10 year recovered in price and its yield fell to end the quarter at 2.61%.

Chart 1

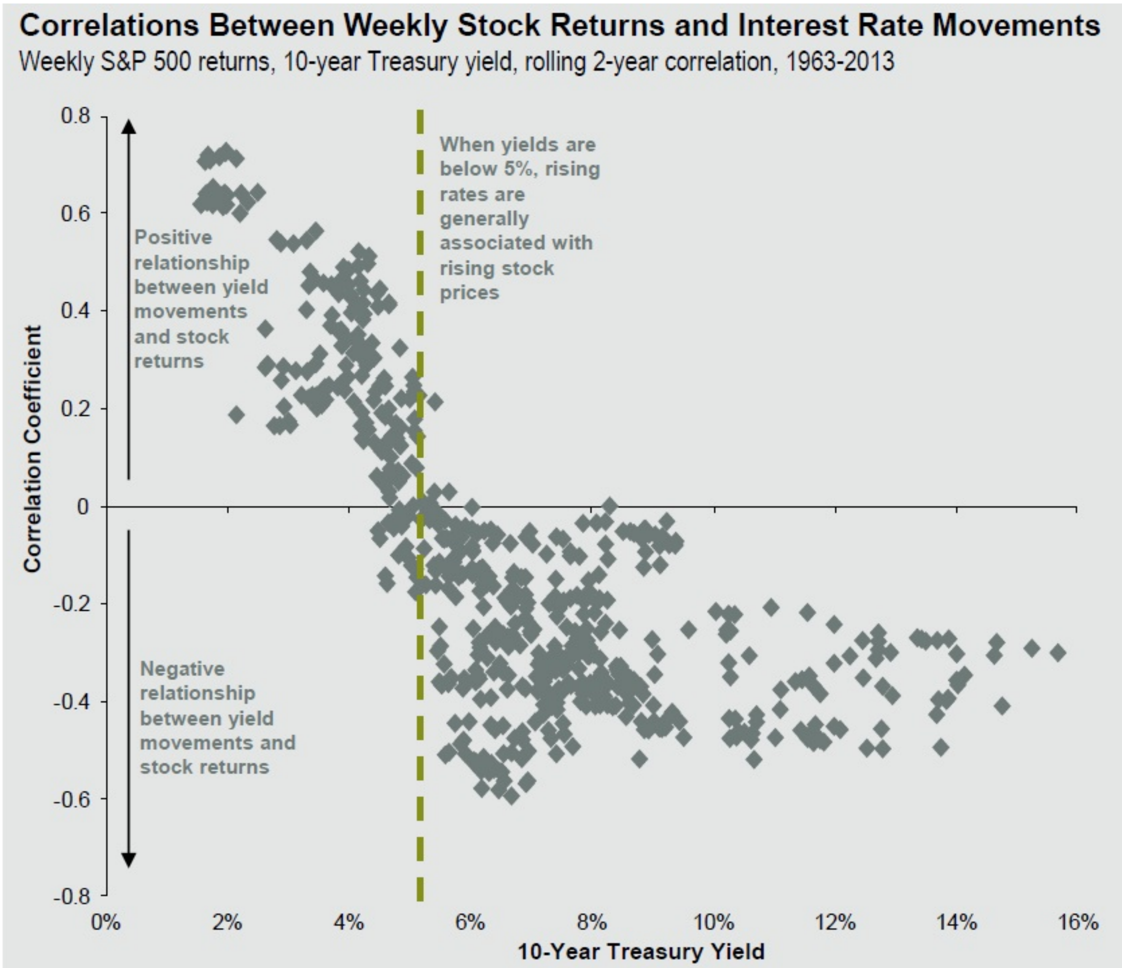
10 Year Treasury Yield

Source: Thomson One/Baseline

Upward pressure on rates tends to worry equity investors because bond yields become more competitive with equities. As Chart 2 shows, when the yield on the 10 year Treasury is rising, but still below 5%, it generally coincided with positive returns for equities. We will continue to monitor the yield on the 10 year, but at the present time, it remains a long way away from 5%, when historically the yield would pose a more challenging alternative to stocks.

Chart 2

Correlation between Equity Returns and Changes in the 10 Year Treasury Yield



Source: Standard & Poor's, US Treasury, FactSet, J.P. Morgan Asset Management.

During the quarter, we eliminated Nike from the portfolio purely on valuation and we added a new position in State Street**.** State Street is well positioned to benefit from the rising interest rate environment, a shift to riskier assets by their clients which in turn is more profitable for the company and the secular development of global retirement plans. Moreover, the business model has high recurring revenues, is not overly capital intensive and generates a tremendous amount of free cash flow, which State Street is returning to shareholders via dividends and share repurchases. We also repositioned a number of existing holdings, which on balance made the portfolio slightly more defensive and somewhat less economically sensitive. The goal, as always, is to focus on preserving principal during any downturn, while still participating as meaningfully as possible during the advancing periods.

As we begin the final quarter of the year, all of our holdings, with the exception of Abbott Labs have increased their dividends this year. Abbott has historically increased its dividend in April, but this year, the company separated into two separately run public companies on January 2. Abbvie, which was the spin company, did modestly increase its dividend earlier this year, but the “new” Abbott has not. We are still holding out hope that it will still announce an increase before year end, but we have little doubt that it will surely increase the dividend in 2014.

Finally in closing, we would be remiss if we did not mention two noteworthy events that occurred this quarter. First, we welcomed Joanne Powell to our family at Coho Partners. She will bolster our operations and client reporting capabilities. And secondly, we officially launched the Coho Relative Value Equity mutual fund (COHOX) on August 15th and it is off to a great start. You can learn more about it at www.cohofunds.com.

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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