COHO PARTNERS, LTD.

Q3 2015 Quarterly Commentary

Is that all there is, is that all there is
If that's all there is my friends, then let's keep dancing
Let's break out the booze and have a ball
If that's all there is

Peggy Lee

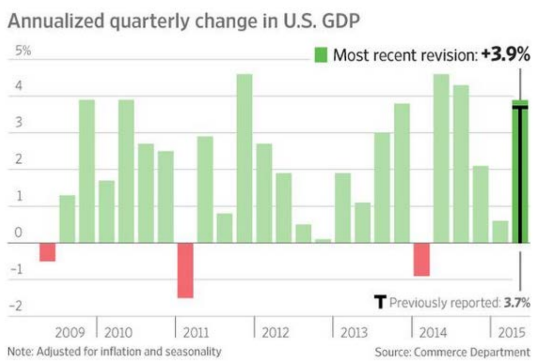
A myriad of global events have been proferred as a possible cause for the U.S. equity markets moving towards the long anticipated correction. Emerging market debt concerns exacerbated by an over 50% decline in oil and other commodities were closely followed by a marked slowdown in China's economy and huge decline in their Shanghai Composite index. Europe and Japan continue in an unresolved economic malaise and as such the International Monetary Fund (IMF) recently lowered 2015 global GDP to 3.1%, the lowest since the Great Recession. Through all of this, back home we ponder the future course of interest rates and how this might impact our sluggish economic recovery while adding to global debt concerns. Perhaps recent market volatility is as simple as the waning of confidence in the ability of global central banks to engender growth and support asset prices.

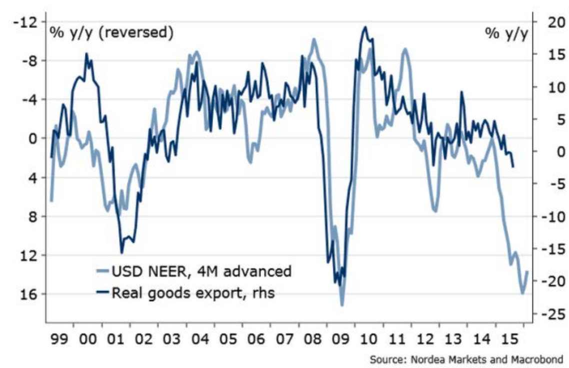
Recent revisions by the Commerce Department depict a U.S. recovery, already viewed as the weakest in post World War II history, that was even weaker than previously assumed. Inflation-adjusted GDP advanced from 2Q 2009 through 2Q 2015 at an annualized rate (a/r) of only 2.1%. We noted that the U.S. could not remain an "oasis of prosperity" completely immuned from the concerns of a slowing global economy. However,we felt that an economic system 90% driven by domestic demand and not dependent on exports would continue on a cyclical upswing.

It has been our baseline view over the last 6 quarters that tightening labor markets and lower levels of inflation would awaken the long slumbering U.S. consumer and engender a cyclical upswing in consumer spending. Indeed, as consumer spending accelerated to an annualized rate of 3.8% in the second half of 2014 re-energized at a 3.6% pace in the recently released 2Q GDP report, and looks set for a similar 3Q advance, we were optimistic in our above consensus view for a 2.5% growth rate for 2015. The recent deceleration in job growth and hours worked along with the continued lack of wage growth in the recently released September payroll report now give us pause.

UNITED STATES:

Real GDP has now been revised twice for the 2Q 2015 period and stands at 3.9% a/r mostly due to the increase in consumer spending noted above. Nominal GDP clocked in at 6.1% annualized rate and is now up 3.7% y/y. Our thesis on increased consumer spending, which represents 70% of the GDP calculation, appears to be materializing, but manufacturing and trade has continued to be a large drag on growth. Indeed, the most recent report on trade for August shows exports are now declining on a year-over-year basis and the forces leading to this weakness (a strong dollar and slowing global economies-chart below right) are not likely to reverse course soon. For these reasons, we now believe GDP for the third quarter will drop back towards 2.0% and forecast full year growth closer to 2.25%.

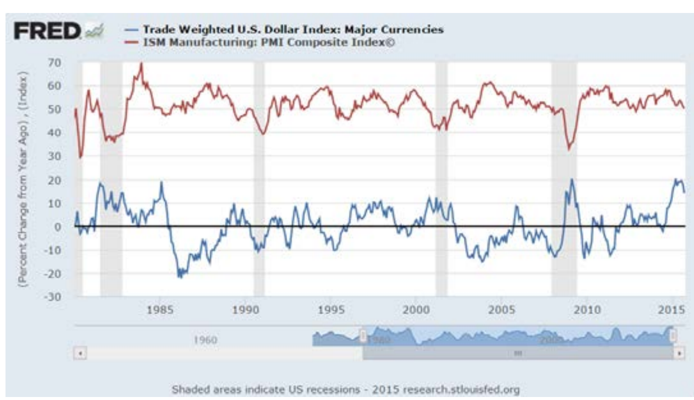




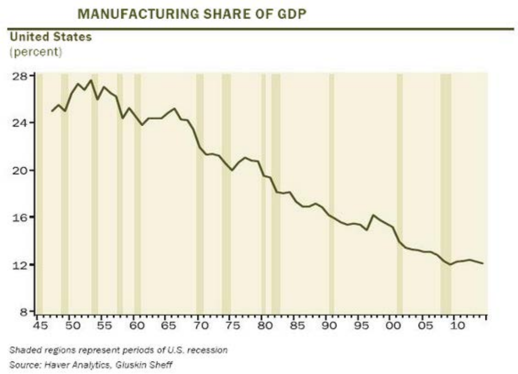
In our most recent commentary we had noted the major reason for our view that the Federal Reserve would remain on hold through at least 2015. We maintain that view and repeat that passage below.

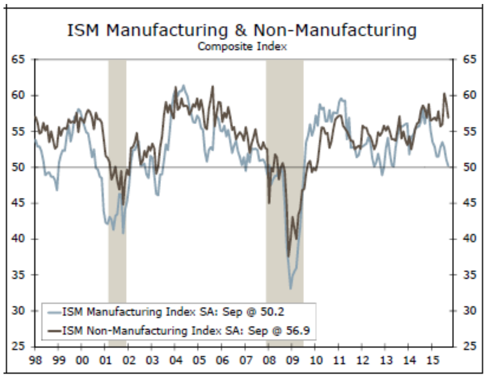
"If the dollar were to continue to rise, we can expect U.S. economic activity to soften and inflation to moderate further and the Fed to actually become more dovish. Dollar strength may reflect our relative economic strength but at a point it does not just act as a brake on growth but rather a major headwind.

Below is a graph depicting in blue the year over year change in the value of the trade-weighted U.S. dollar. It is up over 20% (now a still strong 17%), a level only broached three other times in the 35 year period reflected and two of those occurred during recessions. In red on the chart is the ISM Manufacturing index that we had noted is in steep decline from prior strong levels. As this is a diffusion index of the state of manufacturing, it stands to reason that this index will continue to weaken with a lag from the impact of this currency move. We find it difficult to envision Yellen raising rates at a point in time when manufacturing is actually contracting (as we expect to see in the ISM reading shortly) and inflation is running near 0%."



The ISM declined from 57.9 in October of 2014 to the most recent reading of 50.1. As a result, the view for the goods producing side of the U.S. economy (which is most exposed to the impacts of a strong U.S. dollar and weakening foreign demand) continues to deteriorate. However, the data on the services side of the domestic economy remains positive. According to the Bureau of Economic Analysis (BEA), manufacturing has declined from almost 30% of our economy during the post- World War II period to only 12% of total output currently (chart below left). Therefore, the services side of our economy, represented by the ISM Nonmanufacturing index more closely correlates to U.S. GDP growth. On this front we continue to be more optimistic and the services reading remained strong in September at 56.9-just off the recent cycle high of 59.0 achieved in August.



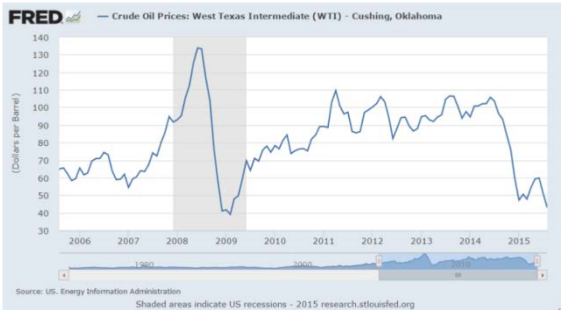


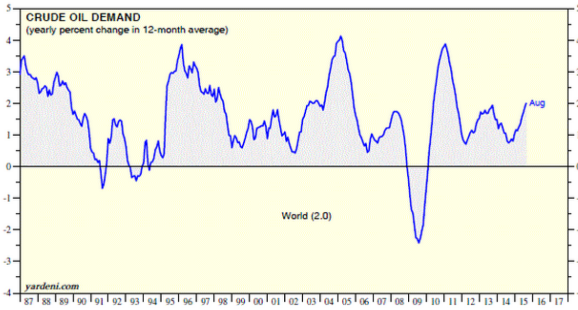
U.S. exports are on track to decline this year for the first time since the financial crisis, undermining a national push to boost shipments abroad. Through July, exports of goods and services were down 3.5% compared with the same period last year. Recent data released by the Commerce Department showed that exports of U.S. goods sank a seasonally adjusted 3.2% in August to their lowest level in years.
The weak trade performance is restraining overall economic growth, a sign of how troubles in China and other major economies are impacting the U.S. economy.

OIL & INFLATION:

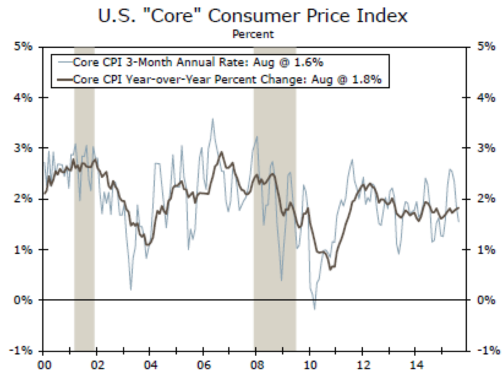
Though we have no idea at what level oil prices will bottom, it should never be forgotten that all economic prices are determined at the margin by supply and demand. Non-US supply is higher and, though declining now, US supply is far greater than it has been in the past. Moreover, it is clearer now than ever that technology has massively altered the energy landscape. Though this has clearly impacted job growth in the United States (over 100K jobs have been lost in this area in 2015), we continue to maintain that on balance this remains more positive for the U.S. consumer.

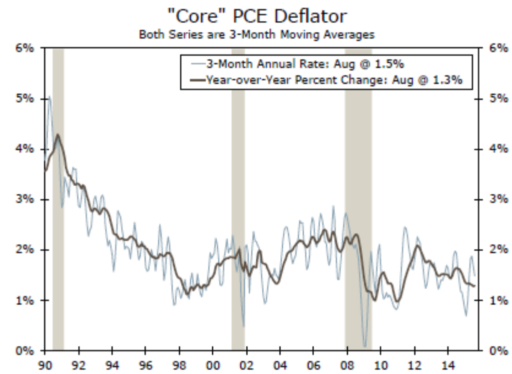
While a lot of focus is on the excess global supply of the commodity, it must be noted that demand has increased strongly commensurate with lower pump prices, U.S. consumer demand is now at the highest rate in five years. According to the Department of Transportation, through July of this year we have driven a record 1.82 trillion miles. According to data from Oil Market Intelligence, world oil demand increased 2.0% y/y to a new record high in August the best growth rate in four years.



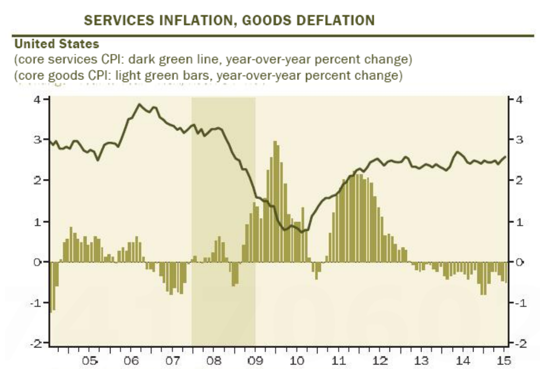


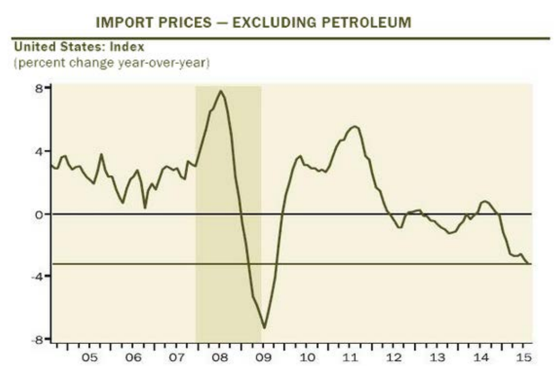
The recent release of inflation data (charts below) from August continues to exhibit little sign of core inflation concerns with the core CPI reading now 1.8% y/y and the 3-month a/r even softer at 1.6%. The personal consumption expenditure price index (favored by the Federal Reserve) continues to show little inflationary pressures at an increase of 1.3% y/y.





On a year-over-year basis, shelter inflation is running at 3.11%, core services ex shelter at 1.91%, and core goods at -0.51%. This is in the context of an overall inflation rate of 1.80% for core CPI. In addition, core goods inflation will likely continue to be restrained by import prices, which have softened over the last year in part due to U.S. dollar strength. A strong currency has two major impacts on a domestic economy. As noted, it makes export prices relatively expensive versus international goods thus impacting export growth. However, it also has the benefit of making imported goods from abroad cheaper which benefits input costs and the consumer. With the trade-weighted U.S. dollar up almost 17% year over year, we are experiencing import price deflation of -11.4% y/y in August, the lowest level since September 2009. Even removing oil from the equation, we have still seen import prices down for nine consecutive months including -3.2% y/y in August



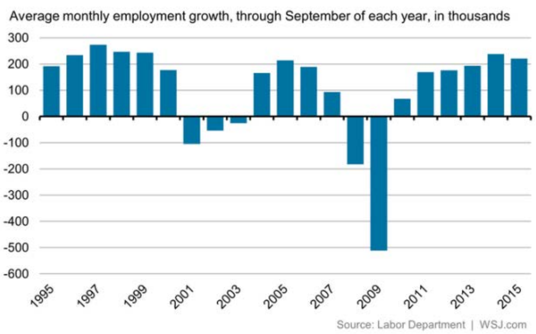


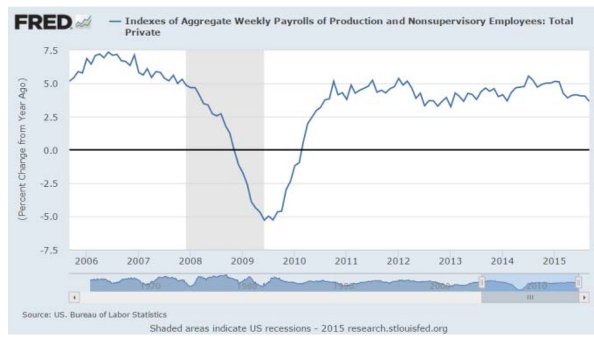
We should not ignore, however, that these trends will move through the calculations of inflation which is computed from an existing base, usually year-over-year. As the effects of the dollar and energy increases fade, inflation may rise. For example, the US dollar is up about 17% year over year but is basically flat over the last 6 months. Oil is down 50% from the end of 3Q 2014 but is only down about 5% over the last 9 months. Unless these two trends re-accelerate, within two quarters the impact will have faded from the inflation calculations and we may see the figures rise.

EMPLOYMENT & WAGES:

It is simply the nature of business cycles that later in an economic expansion, hiring will inevitably slow. The next few jobs reports should provide clues on the degree to which private-sector employers maintain optimism on hiring. Will the deteriorating health of the manufacturing sector and global financial market turmoil make employers more cautious? If labor momentum appears to be fading, the Fed's confidence in consumers' ability to propel growth could diminish. This may already be occurring and will most certainly impact the timing of any rate increases. Our prior call for no rate increase in 2015 appears accurate.

After a very disappointing September jobs report, the 3-month average of job creation has moved to the slowest pace since February of 2014 at 167K versus the average in the first half of 213K. Since the Spring of 2014, employers were adding jobs at an average of more than 200,000 per month. Though job creation has slowed, 2015 is still on pace for the second highest level of employment growth in the past decade. However, our anticipation of higher wage growth due to this tightening labor force remains elusive. Aggregate weekly payrolls is the product of aggregate weekly hours and average earnings and is a great proxy for overall wage growth. It has slowed from around 5.2% at the beginning of the year to the latest reading of 3.6% a/r. Absent further productivity growth (up only 0.4% a/r over the most recent 5-year period), this may keep us in a range bound economy.

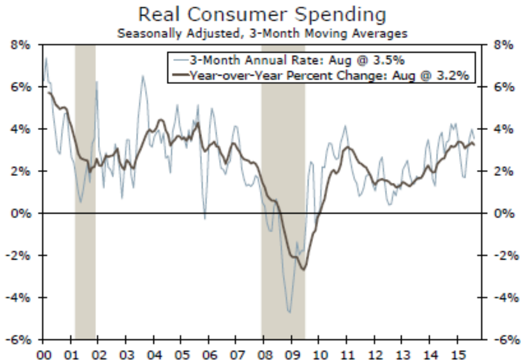




The unusually rapid decline in the unemployment rate over the past few years has been the result of solid job growth and unusually weak labor force growth. The labor force was up only 0.55% y/y in the latest September reading and 0.5% a/r over the last three years. The most recent reading for the labor force participation rate fell to a cycle low of 62.4% (chart below left). This pace of labor force growth is less than half that during comparable periods of prior expansions. The weakness in labor supply partly reflects anticipated demographic trends including an aging population, the continued gradual longer term downtrend in participation rates (as the level of women in the labor force plateau), and the longer-lasting cyclical effects of the decline in participation rates in the aftermath of the recession. The early view of a potential cyclical rebound in this rate has long since faded, and the problem may now be more of a skills mismatch between available jobs and applicants that reflect this. Indeed, more small business owners now cite this as the primary concern in the National Federation of Independent Businesses (NFIB) survey (chart below right).

CONSUMER:

Despite the slower than expected increases in most nominal wage data, we had noted in our previous commentary that with lower inflation (chart below right), real incomes were growing. Following a second half of 2014 that exhibited consumer spending growth of 3.8%, the 1Q collapse (a rate of 2.1% a/r) tested our thesis of a strengthening consumer. Real consumption is now up 3.2% y/y (chart below left) and may approach 3.7% in 3Q. Over the last decade, the average growth rate in spending has only been 1.7% compared to 3.1% over the last four decades. However, data over the last few quarters represent solid spending numbers as the low prices that the U.S. economy has been importing due to the strong dollar has inured to the benefit of the U.S. consumer.



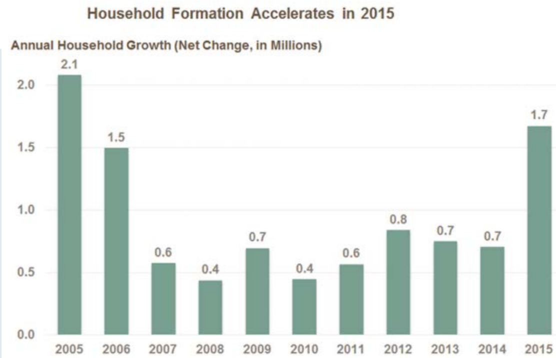
Though spending patterns have moved more towards purely discretionary services (restaurants and bars exhibit the highest levels of growth), large durable purchases of housing and autos have also been a meaningful contributor to overall growth.

HOUSING & AUTOS:

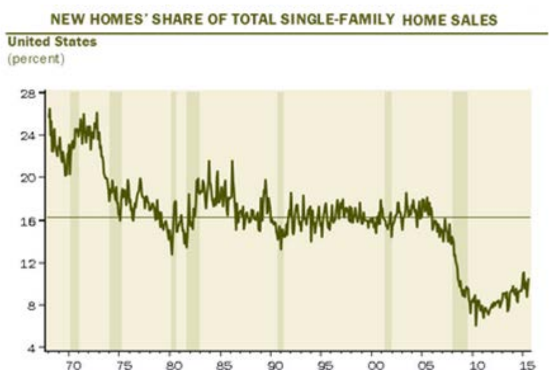
Over time, the rate of household formation is affected by certain drivers, most often demographics. In the period following World War II, the onset of the baby boom led to high household growth, averaging more than 2% per year between the mid-1960s and the early 1980s according to data from CoreLogic. During this period, baby boomers reached prime household formation ages. Smaller birth cohorts conceived in the 1970s led to household formation rates almost half of the prior levels between 1990 and the mid-2000s.

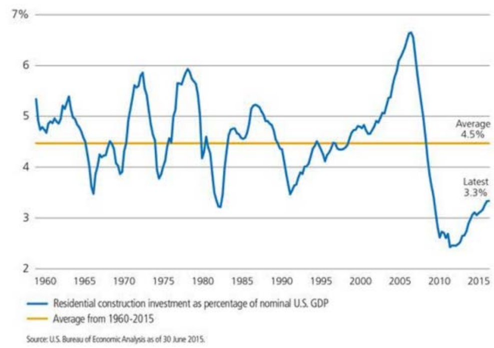
However, it is not just demographics at work. The economy may also have an important though more temporary influence on household formation. While an economic expansion would have the likely consequence of creating more, solid-paying employment opportunities that allow young people to strike out on their own, an economic recession might have the opposite impact. As economic opportunities become scarce, young adults may choose to remain with family longer or share housing with roommates rather than get their own home. And job layoffs could force some who had already formed their own household to move back in with relatives. This effect was particularly pronounced during the Great Recession, the longest and deepest recession since the 1930 as household formation rates fell to the lowest levels recorded since the end of World War II.

But over the past year the creation of new households has accelerated as has our optimism for continued increased contributions from housing towards economic growth. Over the first six months of 2015, compared with the same period a year earlier, the number of new households has grown by 1.7 million, the largest annual growth in a decade (chart below right). As the job market has improved for the 25-34 year cohort (chart below left), many now have the financial wherewithal to form their own household. The Joint Center for Housing Studies at Harvard University now projects an increase of 11 to 13 million households over the next decade which is consistent with this level of continued demand.



Consistent with the improved demand backdrop, new home sales accelerated to an annual rate of 552K in August the highest since February of 2008 while housing starts have now topped 1M for five straight months. The sales increases have been outpacing the increase in supply of available new homes for sale which is very supportive of a continued increase in housing starts. New homes have historically averaged over 16% of total single family home sales and the current rate of about 10% remains way below this level (chart below left). Supply will have to ramp up and after 8 years acting as a drag on overall economic growth, housing should increasingly add to GDP growth. With a 50 year average of contributing 4.5% to the economy, residential construction is currently at a 3.3% level (chart below right) indicating a long though bumpy runway may still be in front of us.





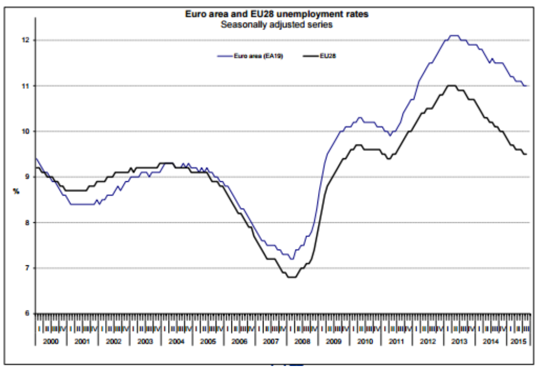
Though it contributes less to total GDP than does the housing industry, the aggressive rebound in U.S. auto sales from the depths of the recession is impressive and a powerful indicator of improving growth. During the recession, auto sales posted a 9.0MM a/r. According to Autodata, September vehicle sales are in excess of 18.17MM a/r, the strongest pace since July of 2005. With employment continuing to grow and auto credit availability continuing very strong, we see no reason why this segment of the U.S. economic recovery would not continue to contribute to growth. Adjusting the sales levels to historical norms of a larger U.S. population would translate to an annualized rate in excess of 18.6MM, a realistic target.

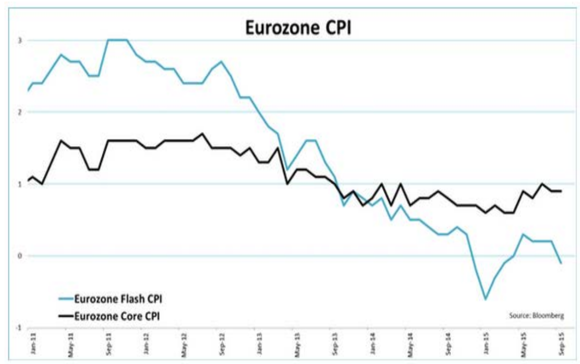
INTERNATIONAL:

EUROPE:

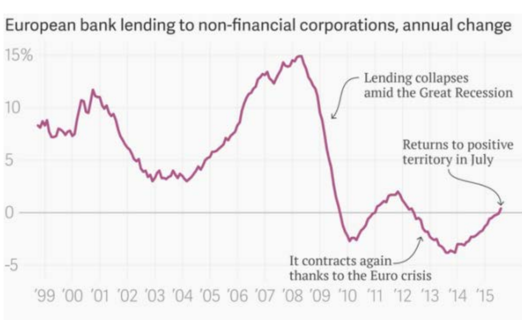
Although still scarred by the global recession in 2008 and rolling sovereign debt crises, the Euro Area has continued to meet our prior expectations for above-trend growth in 2015 led by improving private sector demand. The major issue is that “trend” growth is below historic levels and reflects secular concerns.

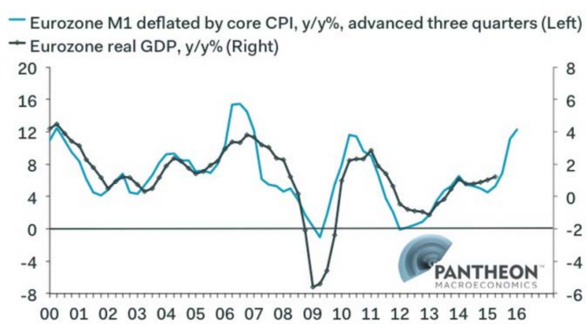
Though they have declined from the greater than 12.1% reading recorded in 2013, unemployment rates for the Euro Area are still depressingly high (chart below left) with the most recent August reading at 11.0%. The most recent CPI readings (chart below right) in the Eurozone show a contraction in headline inflation to -0.1% y/y with energy down 9%. We expect this level to rise over the next year as the precipitous decline in energy prices falls out of the calculation. The core inflation reading (ex-energy) remains at +0.9% y/y way below the ECB target of 2% but fears of persistent deflation have subsided and we see continue to see signs of cyclical improvement.



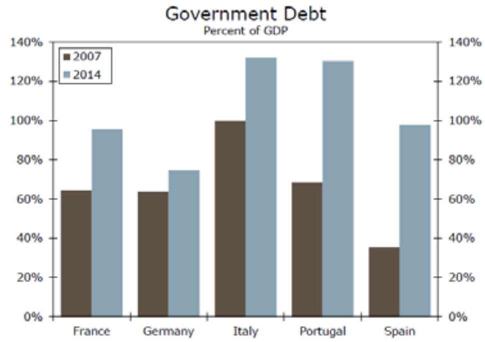


Mario Draghi’s July 2012 pronouncement to do “whatever it takes” has helped to turn the perception and fostered a large decline in bond yields in the more vulnerable peripheral European countries. This aggressive monetary policy of pushing deposit rates below zero and along with the launch of the ECB’s version of quantitative easing (the ECB has targeted buying €60 billion of assets each month at least until September 2016.) has so far managed to engender increasing levels of private sector loan growth (chart below left). Real GDP (chart below right) rose an annualized 1.8% in the first six months of the year (1.5% y/y) which represents the best performance since the first quarter of 2011. Leading indicators point to further good news in coming quarters and has solidified our confidence in our earlier estimate of full year growth of over 1.5%.



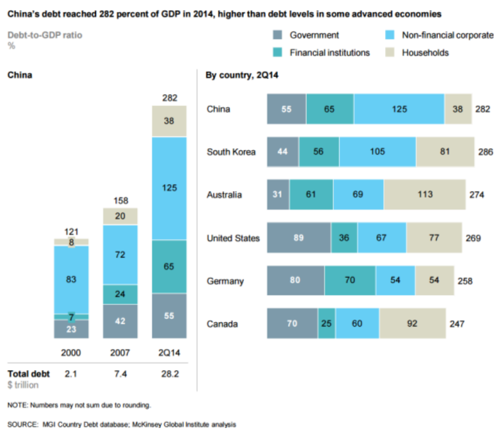


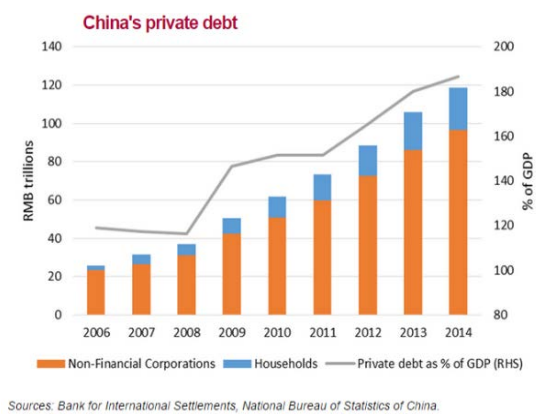
Our largest secular concerns for Europe remain debt and demographics. Both public and private debt levels have continued to rise as nominal GDP growth has remained below the level of debt payments (the main reason that increased inflation is the desired target). This, combined with an aging demography, that reduces the potential growth rate as the labor force growth declines, suggests longer term headwinds remain. This is precisely the rationale for Germany allowing as many as 800,000 refugees and migrants into the country by the end of 2015.



CHINA:

We have highlighted for much of the last year that China represented our single largest global concern. Much of the growth in China since the Great Recession has been debt-fueled. The country's debt-to-GDP ratio nearly tripled in the last 15 years from 121% to 282% (charts below) and private debt in China is now 6X larger than in 2007. The recent slowdown in growth in China is acting as a headwind to the government's objective of paying off much of this debt.





As Beijing has kept the yuan tied to a very strong dollar, other countries exports have gained an edge over China over the past year. In the last 3 years, the yuan has risen over 30% versus the euro (China's largest trading partner) and 40% versus the yen. This further crimps exports and August exhibited a year-over-year decline of -5.5%.. This had moved us previously to lower growth expectations in 2015and to anticipate the People's Bank of China (PBOC) moving to defend its markets via additional rate cuts and even allowing the yuan to decline. While those expectations were realized, we feel the growth rate for China has probably slowed to closer to 5% versus the officially released measures which depict an economy growing close to 7%.

China has been slowing for a few years which should be expected given that it now represents the second largest economy ($10T) in the world and has doubled in size over the last eight years. Now representing about 16% of global GDP, China has accounted for about 25% of global growth over the last eight years. The goal of China is to eventually be on par with the United States as a world superpower. Much as the U.S. did over a century ago, it will need to move more from an industrial society to one that is more balanced towards consumption.

China is looking to move away from its reliance on the government as a driver of growth. Language from government officials indicates a desire to move towards an economy driven by private consumption and investment. However, the Chinese economy has a long way to go before the Chinese consumer will be a significant driver of economic growth on par with major developed countries. For example, the Chinese enjoy a very high savings rate, currently estimated to be as much as 40%-50% on income. China's consumer represents just 36% of GDP, compared to an average 60% for the G-7 and 70% in the U.S.

With all the gloom surrounding the decline of manufacturing in China (factory activity is now at a 6 ½ year low), it is apparent that the long transition towards consumption is being ignored. Demand for services has risen (the non-manufacturing PMI for September posted a strong expansionary reading of 53.4) and China services are now occupying an increasing share of the Chinese economy. Recently, we noted that retail sales in China are actually up over 10.5% on a y/y basis and recent government stimulus aimed at housing and car sales should further benefit this area. China may have slowed but it is certainly not collapsing.

China by itself may not be an obvious threat to the U.S. economy. While it does have a large influence on U.S. consumer prices and wages (keeping inflation contained) as it accounts for 21% of the total of U.S. goods and services, it accounts for only 7% of U.S. exports. As the U.S. is not an export-driven economy, the impact from a slowdown of sales to China is bound to have a small impact on the gross domestic product calculation.

However, broader spillovers from China's slowdown could pose challenges for U.S. companies and the economy as it is not just the direct effect on US exports that matters. There are many other emerging and developed economies with significant Chinese exposure as China is the world's largest exporter and consumer of oil. It may be the indirect impact of a slowdown in China that matters most.

JAPAN:

Japan's Prime Minister, Shinzo Abe, originally focused on three main areas in reigniting growth in Japan, a country with roughly the same size economy as existed in 1995: end decades of deflation, jump start current economic growth, and structurally increase long term growth potential. Over the past 2 years, the third largest economy in the world has had a recovery that to be kind may best be termed elusive with 2Q GDP revised to a -1.2% a/r. Core inflation readings were actually negative for the first time during this period, though in Japan this includes energy. The impact of the slowdown in China is most apparent with

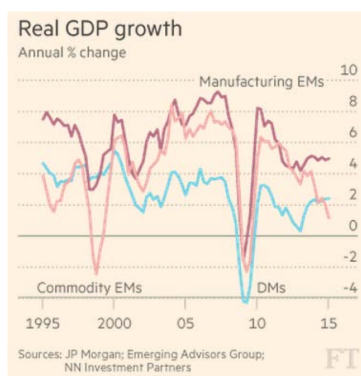
Japan as exports fell during 2Q by -16.5% on an annualized basis. Analysts are estimating the 3Q GDP figure to be over 2.5% so domestic consumption (over 50% of Japan's economy) will need to accelerate.

New efforts by Prime Minster Abe are now focused on supply-side growth in making demographic concerns part of his longer term strategy calling for a boost in the fertility rate. This includes efforts to increase and incent household formation growth and continuing to focus on the labor force growth of females. Additional reforms in corporate governance and increasing shareholder value have been more successful but corporate profits have benefitted from a weak yen and diversification of pension funds into equites from near zero yielding Bank of Japan bonds.

EMERGING MARKETS:

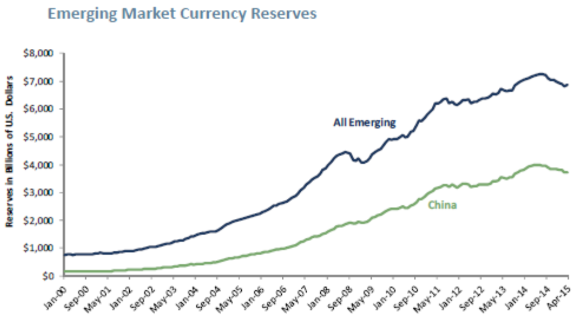
Though still sporting rates of economic growth that are the envy of the developed world, emerging economies will, nonetheless, close 2015 with the fifth consecutive your of decelerating growth. As a group emerging market GDP growth has slowed from 7.4% in 2010 to an estimate approaching 3.8% in 2015 and the haves and have nots are clearly separated by the dependence on commodity exports.

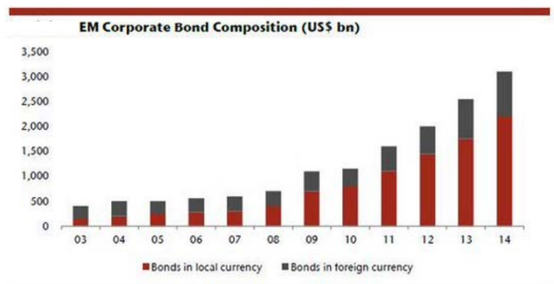
Analyzing the formerly fast growing nations known as BRIC (Brazil, Russia, India & China) highlights this divergence. While China and India have both slowed their growth rates, it has been from a level close to 10% to a still healthy 6% or so. Meanwhile, Russia and Brazil are heavily dependent upon the exporting of oil and have slowed from growth rates of 5%-7% to outright recessions that have caused growth to collapse to declines of -5% and -3% respectively.



For much of the last 15 years, emerging economies surprised to the upside and after the crisis of the late 90's, they registered strong growth and accumulated large financial reserves. Therefore, they were better positioned than developed economies following the financial crisis, and exhibited stronger growth rebounds. Large flows from developed economies (both for Foreign Direct Investments and to their capital markets) during the global recovery may have overwhelmed their markets and the net debt of many of the companies in the MSCI-EM index doubled from 2009-2014. These debts were often denominated in U.S. dollars. Now a rising dollar is quite toxic for these borrowers because their liabilities rise as the dollar rises while their domestic assets do not.

Flexible exchange rates and large foreign reserves (estimated by the IMF to be over $8.1T versus $659B in 1999) should allow emerging markets to avoid the full blown crises of 1998 but the ride will be bumpy. As growth has slowed, the budget surpluses seen previously have moderated and reduced the cushion that buffered against weakening growth. However, reserves are still at high levels (chart below left) and in recent years a greater percentage of total emerging market bond issuance has been denominated in local currencies mitigating some of this concern (chart below right).





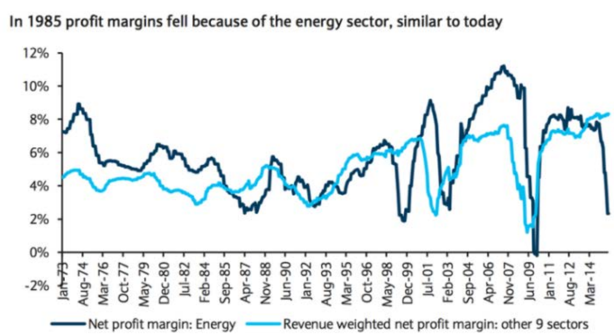
Source: IMF, Jefferies estimates

MARKETS:

For much of the last three years, we have pointed to historically high profit margins as being unsustainable in the long term and inflating earnings from historic trend growth. The impact of margins on understanding valuation can be dramatic and is best exhibited in the alchemy that has allowed a 1.8% revenue growth rate in the S&P 500 since January 2011 to generate 4.9% in earnings per share growth through the 2Q 2015 period according to data supplied by Thomson Reuters.

There are very sound arguments as to why current high margins should not regress towards historical means including reduced tax rates and lower interest rates. An increasing portion of the profits of larger companies has come from overseas where taxes are generally lower and multi-national companies in the S&P 500 have seen margins widen. Many view this as a structural rather than cyclical change in margins. We agree with some of this but caution on the level of these margins. Historically profit margins compress in the more mature phase of the economic cycle as labor markets tighten and we may be in the early stages of a rolling over of these margins in aggregate.

Profit margins for the S&P 500 reached an all-time high in 2014 of over 9% and have since receded to a level of 8.5%. Barclays notes that declines of this magnitude are rare outside of a recession with only one occurrence in the prior 40 years. They go on to further note, however, that the other large margin drop was in 1985 where there was also a 60% plunge in oil prices, a sector where margins have plunged from over 8% to 2%. Other sectors outside of energy have enjoyed the benefit of lower input costs from the associated oil price drop and margins in those sectors have actually trended higher.



Source: Thomson Reuters, Barclays Research

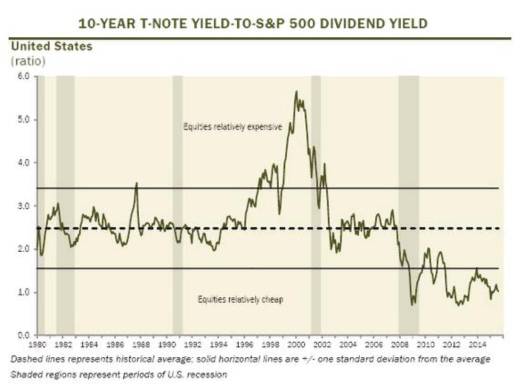
Consensus estimates for 2015 S&P earnings were $131 per share entering the calendar year. They are now around $112 and we are now reducing our full year target to a below consensus level around $107. As we enter reporting season for the 3Q of 2015 analysts are looking for a y/y decline of -5.1% according to data provided by Factset. On the heels of a -0.7% decline in 2Q earnings, this would represent the first back-to-back earnings decline (or earnings recession) since the depths of 2009. It must be noted however that these totals are clearly distorted by the energy sector. If the earnings decline from the energy sector were excluded, the -5.1% decline in earnings would turn into a 2.3% increase.

In addition to the impact of lower oil prices, the meteoric rise in the U.S. dollar over the last year has placed a stranglehold on corporate revenues for multinational companies. According to Factset, the 3Q expected revenue decline of -3.3% will be the third consecutive quarterly decline with an average over that period of -3.2%. Perhaps more important for longer term investors, aggregate dividend payments continue to be strong rising over 11.3% for the full year ending June 30. Though these are expected to slow along with earnings, we should still enjoy an average increase of over 7.6% over the next twelve months according to data supplied by Standard & Poors.

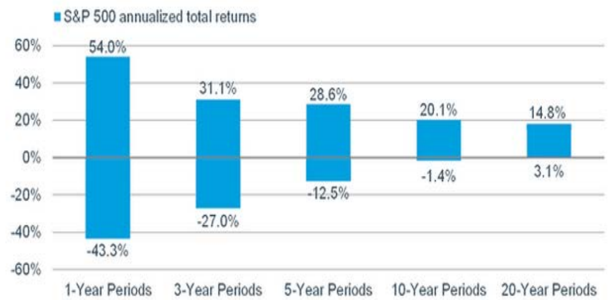
Despite declining earnings and revenues, the major indices were still down less than 2% from the late May highs until the Chinese devaluation in mid-August. Over only three trading days from Aug. 21 to Aug. 25, all the major indices declined about 8%. From the record high of the S&P 500 achieved on May 21, the total decline was 12% — the first big correction in four years.

The S&P 500 index finished the quarter down -6.9%, leaving it with a -6.7% loss so far in 2015. The small cap Russell 2000 index suffered through a decline of -11.92% during 3Q bringing the full year to a loss of -7.73%. The MSCI EAFE index of developed economies declined -10.28% for the quarter and -5.28% for the year while the MSCI Emerging Market index plunged -17.9% in 3Q and is now off -15.48% in 2015. Though clearly facing concerns discussed above, emerging market valuations are now among the lowest levels of the last 15 years, and we believe represent an attractive opportunity for longer term investors.

Though still elevated by historical standards, valuations in domestic markets have improved both in absolute terms and relative to the risk free rate of the 10-year U.S. Treasury bond.



Years of low volatility and rising markets often create complacency and shorten memories. Constant exposure to a sensationalizing media has altered the ultimate objective of investing from long term creation of a stream of future cash flow towards short-term speculation on whether prices rise or fall. Look at the chart below left to see how the average holding period for a stock has changed over the years. Then compare that to the chart on the right depicting the outcome of returns of the S&P 500 over various time periods. When one's time horizon lengthens, the likelihood of investment success naturally increases. Over short periods, it is more speculation.



When volatility and corrections occur in the stock market, there are often two very important considerations that are forgotten by individual investors. Firstly, lower current prices create *higher* expected future returns along with *higher* current yields. Secondly (and this is critical in a world of low to negative real interest rates), preserving the nominal amount of dollars currently held will not fund a long term retirement. The primary emphasis needs to be on preserving *purchasing power* in the face of rising inflation. For this reason, one may actually be assuming *more* risk by not maintaining equity exposure to a degree consistent with one's goals and tolerance.

We have noted in the past that the economic recovery is still highly correlated to the markets (as is the Fed) and, though stronger, still vulnerable to more volatility. We are currently seeing what a normal market correction of 10%+ does to a better, yet still fragile, recovery and investor psychology. This is precisely why we at Coho Partners always strive to construct a differentiated portfolio populated with high quality companies with resilient earnings streams, growing dividends, strong balance sheets and reasonable levels of expectations and valuations.

Sincerely,

Rick Wayne

Rick S. Wayne, CFA