October 6, 2015

Dear Friends of Coho Partners,

September was another challenging month, with the broader averages falling about 2.5%. We declined in lock step, which was disappointing. The problem for us was our overweight in Health Care, which has been beneficial over the longer term but was weak this month. We will have more to say on this later in the letter.

We have to go all the way back to 2011 to find a worse quarter of market performance than 3Q's 6.5% decline. All of the S&P 500 sectors, with the exception of Utilities, had a negative return. Energy, Materials and Healthcare were all down more than 10%. Point-to-point for the quarter, we did not distinguish ourselves, but under the surface, the portfolio behaved somewhat better. The quarter started out strong, with the S&P 500 rising by 3.2% in the first 20 days. It is always difficult for us to keep up in an advance with that kind of slope (a 70% annualized rate!), and we fell behind the index by almost 180bps in just those 3 weeks. However, from that peak on July 20th, the market declined by 9.4%, and we outperformed that period by over 150bps. Linking these periods together, we performed essentially in line with the market for the full quarter.

It is worth noting that the divergence is widening between the S&P 500 and the Russell 1000 Value Index. The Russell 1000 Value is being hurt by larger weights in both Energy and Financials, while the S&P 500 is benefitting from its heavier exposure to technology related names such as Amazon and Google, which both delivered high-teens returns this quarter. The divergence can also be observed when comparing the Russell 1000 Value index's third quarter decline of 8.4%, to the more modest 5.3% fall for the Russell 1000 Growth index. On a year-to-date basis, the performance gap is even more stark: the Growth index is only down 1.5% while the Value index is down 9.0%.

The third quarter's earnings reports will be forthcoming shortly and this will be a very important period. Estimates for the S&P 500 continue to come down which has put a cloud over the market. The best way for our companies to differentiate themselves from "the market" is to demonstrate that they are executing well against their operating and financial strategies. It is quite possible that we are moving into a period when stock performance within sectors becomes more variable. Under these conditions stock selection will take on an ever greater role and this should favor us. We believe the selling pressure on many of our holdings is unwarranted given their outlooks and current valuations. Strong earnings reports, coupled with encouraging outlooks, would go a long way in restoring valuations, and this is what we expect in October.

We have discussed our Energy holdings in prior letters so we will not repeat ourselves here, but suffice it to say, we like our companies, and we are confident that there will be no reductions to their dividends. We have current yields that range from 4.5% for Occidental to 7.9% for Royal Dutch.

Healthcare is a sector where we have maintained a significant overweight position for quite some time. Much of our overweight was built during and in the immediate aftermath of the healthcare reform debate that took place between 2009 -2011. At that time, healthcare stocks were indiscriminately punished vs. the market due to the surrounding uncertainty. Now, after having materially outperformed the market each full year since 2011 and through the first half of 2015, the S&P Healthcare sector uncharacteristically underperformed a down market, lagging the broader S&P 500 by 420 bps and ending the third quarter down 10.7%. We believe the sector sell off was driven by three primary factors: 1) profit taking heading into its fifth year of outperformance, 2) concentrated selling in biotechnology, and 3) election year rhetoric. Let's briefly examine all three.

First, the healthcare sector has indeed been a stellar outperformer over the 4 ½ years since its relative bottom in the first quarter of 2011. Essentially all of the valuation discount vs. the market during the 2009-2011 weakness had been erased by the second quarter of 2015 and sentiment toward the group has also vastly improved, making it more ripe for some kind of pullback. But despite the big up move, the group is only back to its long term median valuation vs. the market; it is not expensive vs. history, only average. We maintain that the aging populations in the developed markets and the long term opportunities for greater healthcare spend per capita in the developing markets will drive a long term runway of better than market growth for the sector. Perhaps more importantly to Coho, this growth is also recession resistant as healthcare spending is less subject to cyclical factors than the market as a whole. Therefore, as long as we can find stocks with strong fundamental outlooks and reasonable valuations in the group, we will be happy to own them. Currently our portfolio of healthcare stocks carries a trailing p/e of 15.6x and a yield of 2.0% vs. the S&P healthcare sector p/e and yield of 16.7x and 1.7% respectively.

Second, some of the most severe selling was concentrated in the pricey and highly volatile Biotechnology industry. This sub-segment of healthcare has performed extremely well over the past five years, and many investors have been gaining exposure through ETFs (exchanged traded funds). One of the problems with ETFs is that when investors buy and sell them, they by definition buy and sell all the companies within that ETF indiscriminately. In periods of stress such as that experienced in the past month, solid companies are sold right along with weaker ones. The proverbial baby-out-with-the-bathwater syndrome.

Coho Partners owns two biotech companies, Amgen and Gilead Sciences. Each of these companies comprises over 8% of the iShares Nasdaq Biotechnology ETF (ticker: IBB), which is the largest biotech ETF as measured by total assets. From the market peak on July 20th to the end of the third quarter, the IBB has declined nearly 30%, and our holdings within this ETF have been caught in this selloff despite having strong operating and financial outlooks and attractive valuations. Amgen is selling at 12.8x the consensus 2016 EPS estimate with low double-digit eps growth expected over the next five years. The stock yields 2.3%, and this is before its expected dividend increase in December, which we believe will be more than 20%. Gilead is selling at 8.4x the consensus 2016 EPS estimate, and its meaningful cash flow generation gives it tremendous balance sheet flexibility to enhance shareholder value. Earlier this year, the company signaled its confidence in the sustainability of this cash flow by both initiating a dividend and authorizing a five year, $15 billion share repurchase program.

Finally, it is likely that we will experience further relative volatility in the healthcare sector in the lead up to the 2016 election. Given its size and emotional impact, healthcare is a popular political target from both sides of the aisle. Currently, one side is calling for the dismantling of the ACA while the other side is calling for the dismantling of drug pricing. While the rhetoric may lead to continued volatility, we do not expect any of the more extreme positions to become law. And similar to the healthcare reform debates several years ago, we will look for opportunity in the resultant volatility. We believe the healthcare companies in the Coho portfolio are executing well and are attractively priced, and we are confident they will reward us over time.

As we enter the final quarter of the year, we are pleased to report that all but three, of our portfolio companies have increased their dividend in 2015. The exceptions are Chevron, Omnicom and Royal Dutch. We are still forecasting dividend income growth this year around 9%, which is consistent with prior years.

We look forward to sharing our results and thoughts on the market with you as the year progresses. If you have questions or concerns about our outlook, please do not hesitate to call us.

We wish you all the best.

Peter A. Thompson

Brian L. Kramp, CFA