October 7, 2016

Dear Friends of Coho Partners,

Coho Partners did not distinguish ourselves in September or the third quarter. We lagged by more than 1% in September and by more than 3% for the quarter. For the year-to-date period, we are now even with the S&P 500, which is up 7.8% but still behind the Russell 1000 Value Index, which has risen 10.0%. As much as we would like to outperform each month and quarter, that aspiration is not entirely realistic. Fortunately, you have to go all the way back to the second and third quarters of 2005 to have experienced a similar period of poor relative performance. Over that six month period, we posted a -1.0% return vs a gain of 5.0% for the S&P 500 and 5.6% for the Russell 1000 Value.

During the quarter, we modestly tilted the portfolio to be more “demand defensive” by adding to our existing holdings in both CVS and Kroger. We reduced our exposure to two of our “economically sensitive” holdings, Illinois Tool Works and Microchip. These trims were entirely due to valuation. Both of them have been in the portfolio for years and consistently done well but current valuations are less attractive than seen in prior periods.

Looking back at what drove performance for the quarter, there was a strong predilection for cyclicality by investors as Technology and Financial outperformed by a wide margin, while Health Care, Consumer Staples, Utilities and Telecommunications were material underperformers. We intentionally overweight the less cyclical (demand defensive) sectors all the time, so this was a major headwind. Our under-representation in Technology alone, which advanced nearly 13% in the quarter, cost us 1% in relative return. Our largest demand defensive sectors, Consumer Staples and Health Care both lagged the benchmark, with Consumer Staples down for the quarter and Health Care up only 1%. This combined overweight cost us another almost 1%. Additionally, there was a bias toward higher beta and lower quality stocks across the sectors. While we don’t specifically target the lower beta/higher quality stocks, they are a definite residual of our process, so this also impacted our performance in the rest of the sectors.

The remaining 1% performance drag came from our position in Dollar General. The second quarter earnings were disappointing, but we have subsequently met with management in their offices and believe that their business model remains quite durable and that management is capable of restoring all of this temporarily lost shareholder value.

A question that keeps arising is whether our orientation to Consumer Staples and Health Care is going to be pressured both up and down by the growing popularity of low volatility strategies. It is undeniable that these two sectors are good candidates for low volatility strategies but the research process that we employ is highly differentiated from the current low volatility (and mostly passive) products. While these strategies tend to focus predominantly on price beta for inclusion in their products, Coho Partners endeavors to analyze what we believe are the *underlying* causes of price beta, such as earnings volatility, cyclicality, balance sheet strength, consistency of cash flow generation, management execution and the like. In addition, Coho devotes a large part of its process to analyzing forward growth prospects. We are not just interested in defense, but also expect our companies to grow their earnings, cash flows and dividends in line to slightly better than the market over time. Finally, our value discipline plays a critical role in our stock selection and portfolio pattern of returns over time. This focus on valuation adds another layer of downside protection while allowing for the potential for better upside. We believe our holdings in both Consumer Staples and Health Care offer above average growth in earnings and dividends relative to their peer group and that valuations remain attractive as well against the peer groups.

Relative to the S&P 500 Consumer Staples universe, our Staples holdings trade at a discount to the group, they have a higher dividend yield, their earnings per share growth both historically and prospectively is faster than the peer group and the dividend payout ratio is lower than the group, which gives our companies incremental financial flexibility. So we remain comfortable with these holdings and most importantly, we believe their outlooks appear quite bright.

Our Health Care holdings vs the S&P 500 Health Care universe shows a more mixed picture. Our holdings have and are projected to have lower P/E ratios than the peer group and our holdings have a higher dividend yield. However, the projected eps growth rate for our companies is less than the peer group. The reason for this is that Gilead's earnings rose six-fold between 2013 and 2015 on the back of the unprecedented ramp in sales of its hepatitis C drugs. As pent up demand recedes and hepatitis C sales slow to a more sustainable level, this depresses the company's earnings growth in the near term. With the stock trading at 7x current earnings, we feel that the market has more than discounted this slowdown. If we removed Gilead from our Health Care holdings, our prospective eps growth rate would be in line with the S&P Health Care universe.

So bringing this all together, we are disappointed with the recent month and quarterly results, but even with this we are essentially in line with the nearly 8% year-to-date advance for the S&P 500, and we look to recover some of our recent relative loss over the remaining three months of the year.

Third quarter earnings season will be critical to this goal, but we look forward to reporting on our progress. Volatility will remain high as investors navigate the election, the actions of the Federal Reserve and all of the daily issues that arise unexpectedly. We will endeavor to get through these uncertainties by focusing on the long term operating and financial strategies of our companies. If we get that correct, we will experience rising earnings and this will allow for consistent dividend growth. So far this year, all but two of our holdings have increased their dividend, with Royal Dutch and Chevron being the two remaining holdouts. Royal Dutch will not, but we still believe Chevron will give shareholders a token increase to extend their historical record.

If you have questions or concerns about our outlook or the portfolio's positioning, please do not hesitate to call us.

Sincerely,

Brian Kramp, CFA   Christopher Leonard, CFA   Ruairi O'Neill, CFA   Peter Thompson