January 5, 2013

Dear Friends of Coho Partners:

Year-end letters give us an opportunity to reflect back on the preceding twelve months and prognosticate on what lies ahead from our perspective. This past year seemed destined to be a year dominated by major obstacles looming both here and abroad. Yet despite all these uncertainties the S&P 500 and the Russell 1000 Value posted solid double digit returns. We modestly lagged these benchmarks but still had a very competitive year. Although we never like to underperform, we believe our performance for 2012 was consistent with our investment philosophy of protecting principal during challenging times while staying competitive during the rising periods. Looking over longer cycles, our composite returns continue to compare favorably against the benchmarks.

Annualized Returns for the Periods Ending 12/31/12

	1 Yr.	3 Yrs.	5 Yrs.	10 Yrs.
Coho Partners **	**13.5%**	**13.4%**	**7.5%**	**9.8%**
Russell 1000 Value	**17.5%**	**10.9%**	**0.6%**	**7.4%**
S&P 500	**16.0%**	**10.9%**	**1.7%**	**7.1%**

** Coho Relative Value Equity Composite Gross of Fees

As is typical, sectors that may have benefited you one year can hurt you the next and this was true this year. The best performing sector in 2012 was Financials (up 28.7%) while in 2011, they were the worst (down 17.1%). The combination of being underweighted to Financials and not owning the large money center banks hurt our overall portfolio returns by more than 2% this year. We do own two niche Financials, Cullen Frost and Marsh & McLennan. Both are wonderful companies and their stock price movements tend to be uncorrelated to those of large money center banks. For instance, during the financial crisis of 2009, Cullen Frost's earnings contracted from a peak of about $3.50 to a low of about $2.90, but unlike so many other financials, the dividend was never reduced and in fact, Cullen Frost increased its dividend in 2009. Marsh & McLennan had positive earnings growth in 2009 and they maintained, but did not increase its dividend that year.

We feel the earnings and dividend patterns for these two companies are much more stable than those of the money center banks, which during the 2009 period saw their earnings go negative, their solvencies threatened and their dividends greatly reduced. We fully understood that there would be a time when the money center banks would regain investor favor and produce strong price appreciation, but the volatility and unpredictability of their underlying businesses makes them incompatible with our low risk investment strategy. We are happy to make this trade-off over the longer term.

Annual Total Shareholder Return

	2008	2009	2010	2011	2012	Cumulative
Cullen Frost	**5.0%**	**3.4%**	**26.2%**	**10.3%**	**4.6%**	**58.1%**
Marsh & McLennan	**-9.6%**	**-5.3%**	**26.7%**	**18.1%**	**10.2%**	**41.2%**
Bank of America	**-59.8%**	**8.4%**	**-12.2%**	**-59.6%**	**102.6%**	**-68.7%**
Citibank	**-76.4%**	**-51.8%**	**40.1%**	**-44.9%**	**46.0%**	**-87.2%**
JP Morgan	**-21.6%**	**35.5%**	**2.0%**	**-20.8%**	**32.5%**	**13.5%**

Source: www.NASDAQ.com

Fourth quarter corporate results will become clearer over the next few weeks, and we remain confident that our holdings performed well both operationally and financially in the final quarter and throughout 2012. Of our 27 holdings, 24 should have higher earnings, all of our holdings increased their dividend, and 24 used their surplus cash flow to reduce their outstanding share count. These achievements are typical for the types of companies in which we invest. Since we do not know with certainty the final earnings and share count figures for 2012, we can only truly report on the dividends for 2012, which are summarized in Table 1.

TABLE 1

	DIVIDEND 2011	2012	Change	Est. Payout to 2012 EPS
Abbott Labs	**$1.88**	**$2.01**	**6.9%**	**40%**
ADP	**$1.44**	**$1.58**	**9.7%**	**54%**
Air Products	**$2.23**	**$2.50**	**12.1%**	**46%**
Amgen **	**$1.12**	**$1.44**	**28.6%**	**22%**
Becton Dickinson	**$1.64**	**$1.80**	**9.8%**	**29%**
Chevron	**$3.09**	**$3.51**	**13.6%**	**28%**
Colgate	**$2.29**	**$2.44**	**6.6%**	**45%**
Conoco Phillips	**$2.53**	**$2.64**	**4.3%**	**45%**
Cullen Frost	**$1.83**	**$1.90**	**3.8%**	**51%**
CVS	**$0.50**	**$0.65**	**30.0%**	**19%**
Illinois Tool Works	**$1.38**	**$1.46**	**5.8%**	**36%**
IBM	**$2.90**	**$3.30**	**13.8%**	**22%**
Int'l Flav. & Frag	**$1.16**	**$1.27**	**9.5%**	**31%**
Johnson & Johnson	**$2.25**	**$2.40**	**6.7%**	**48%**
Lorillard	**$5.20**	**$6.20**	**19.2%**	**71%**
Lowes	**$0.50**	**$0.60**	**20.0%**	**35%**
Marsh & McLennan	**$0.86**	**$0.91**	**5.8%**	**42%**
Microchip Tech.	**$1.38**	**$1.40**	**1.4%**	**67%**
3 M	**$2.20**	**$2.32**	**5.5%**	**37%**
Nike	**$0.62**	**$0.72**	**16.1%**	**28%**

Omnicom	**$0.95**	**$1.15**	**21.1%**	**32%**
Philip Morris Int'l	**$2.69**	**$3.16**	**17.5%**	**60%**
Procter & Gamble	**$2.06**	**$2.21**	**7.3%**	**53%**
Royal Dutch	**$3.36**	**$3.44**	**2.4%**	**41%**
Smucker (JM)	**$1.84**	**$1.96**	**6.5%**	**38%**
Sysco	**$1.04**	**$1.08**	**3.8%**	**49%**
United Health	**$0.61**	**$0.80**	**31.1%**	**15%**

**** Amgen initiated its first dividend in 2011 so dividend is annualized for calculation purposes.**

A couple important observations: first, the increases were fairly generous and second, some of the larger increases came from those holdings with lower overall payout ratios. We expect increases from these companies to remain elevated for some time because they are consciously trying to increase their dividend payout. If we are correct, these increases will provide strong cash flow and be a nice hedge to inflation.

As a quick aside, effective on January 1, 2013, Abbott Labs split into two independent companies so you will see a new position, AbbVie (ticker is ABBV) on your January statement. AbbVie will be the ethical drug portion of the old Abbott and the new Abbott will have the diversified medical products businesses, which includes the branded generics, nutritionals, diagnostics, and devices.

As we turn to a new year, having barely averted the January fiscal cliff in such fine fashion, our country will once again be confronting the debt ceiling in a few months, which currently stands at $16.4 trillion. Without political partisanship, it is worth understanding the magnitude of this debt. The $16.4 trillion figure equates to nearly $50,000 of debt for every man, woman and child in America. If you calculated the per capita debt load for every full or part time worker in America, the figure jumps to $115,000 per person. These absolute levels and the projected growth in this debt are truly not sustainable if we wish to remain a global economic power. To correct the situation will require wholesale and dramatic changes in the attitude and philosophy of governing by both parties and our President. We are not terribly hopeful in the near term that this will occur.

So what do we expect in 2013? Modestly positive economic fundamentals offset by increasing tax rates, continued bad political theater, stubbornly high unemployment, and fragile consumer and corporate confidence will likely keep economic growth positive, but subdued. In such an environment, corporate profits may struggle to show much gain as we believe cost cuts and productivity have been pushed just about as much as possible, leaving better top line growth needed to push the bottom line. On the plus side, however, we would note that there is a lot of "dry tinder" should some of the obstacles be removed, as the corporate balance sheets are very strong. Moreover, with the exception of the excessive government debt, even if the higher taxes or some other negative outcome should slow the economy further from here, other economic excesses are not nearly what they were in 2000 or 2007 when we last toppled into recession, so the fall would not be as steep. Unfortunately, the more we are forced to be preoccupied with political and debt shenanigans both here and abroad, the more unlikely it is that some spark can ignite that tinder and instead, we may stay mired in a mediocre economy. So, given all that, we think a conservative and defensive investment posture is warranted and should benefit our investment approach. If returns are modest, then the dividend contribution will play an even more important role in achieving one's expected return.

In closing, we want to thank you for once again giving us the opportunity to oversee your assets. We are pleased to report that Coho Partners finished the year with record assets under management of about $950 million. This growth has allowed us to deepen our investment and client service teams by hiring Chris Leonard, a seasoned equity analyst, who is working with Brian and me and Michelle Benner, who is focusing on client service and marketing with Glenn. We encourage you to meet them both if you have not done so already.

Please do not hesitate to call us with questions or concerns about our outlook or your portfolio. Best wishes for a happy, healthy, prosperous and peaceful New Year.

Sincerely,

Peter A. Thompson　　　　Brian L. Kramp, CFA

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