January 5, 2015

Dear Friends of Coho Partners,

At the onset of this year, few would have predicted such a strong year for domestic equities, especially given the outsized returns from 2013. However, 2014 was a great year and we were able to participate fully in this year's advance. Unlike 2013's return, which was largely attributable to P/E multiple expansion, the gains this year came much more from true underlying EPS growth. Every quarter this year was a positive one, with the 4th quarter the strongest of them all, and somewhat surprisingly, we had our best relative performance during this final quarter. Our performance advantage this year was entirely due to stock selection, as we had positive contribution in every sector except Technology and Financials.

Utilities, where we had no exposure all year, were the best performing sector this year, which is somewhat counterintuitive since Utilities are typically viewed as one of the more "defensive" sectors and as such this sector does not typically lead a market advance. In this low interest rate environment, investors were attracted to sectors like Utilities that carry above average yields, but valuations should always be the critical determinant if you are truly a long term investor. According to Thomson Reuters Baseline, the XLU (Utility Spider Index) yields 4.0%, but its forward P/E is now 18.4x, which is higher than that of the S&P 500. Rarely do Utilities trade with trailing or forward P/Es higher than the market, so we see little value in this sector at this time and worry that if interest rates were to rise, this could lead to P/E multiple compression which would more than offset any benefits from the above average dividend yields.

The worst performing sector and the only sector to post a negative return in 2014 was Energy, yet we believe it is one of the more attractive sectors at the current time. We gravitate to the large integrated energy companies where the stability in cash flows comes from the interplay of their exploration activities (upstream) with their refining and marketing efforts (downstream). Rarely are both sides doing well simultaneously, but they tend to complement one another so that during times of high energy prices, the exploration side does particularly well and conversely, when energy prices weaken, the refining and marketing side tends to excel. At the moment, there is a clear excess supply of oil and this is depressing prices. But large commodity complexes such as oil tend to have inherent stabilizers built into their markets. The recent rapid decline in oil and natural gas prices has reduced the expected profitability on many projects that may have been predicated on higher energy prices. Given that, incremental supply should contract fairly quickly and materially, while on the demand side, falling energy prices should stimulate overall marginal global growth, which in turn should stimulate demand for the commodity itself. We are very early in the healing part of this cycle, but we do believe energy prices will gradually stabilize and then if global GDP accelerates, we should see demand and pricing improve. This will take some time, but the long term fundamentals for our integrated energy holdings remains bright. Our holdings have above average dividend yields and strong balance sheets which will enable them to reward shareholders with both future dividend increases and ongoing share repurchases. At the present time, we remain quite comfortable with our energy holdings and believe they will be good performers in 2015 and beyond.

With the exception of our elimination of IBM due to its violating our position paper, all transactions in 2014 were valuation driven when we saw candidates to add to, or new positions to establish, that offered better long term risk/return than the ones we were reducing. This subtle repositioning gives us confidence in our ability to provide downside protection when needed and still participate in any further market advance. Harkening back to our comment on Utilities, income is an important component of our strategy as well, but the more important aspect is the annual growth in the portfolio's income. In 2014, all of our holdings increased their dividend and the income growth was greater than 10%. We believe it is the combination of a competitive current dividend yield, coupled with above average annual dividend growth that plays a key role in helping protect principal during down periods.

As we look forward to 2015 and beyond, we need to be mindful that the S&P 500 has now advanced for six consecutive years and over this period there have only been two corrections of more than 10% and none since the third quarter of 2011. From our perspective, valuations are simply not as attractive as they were a few years ago, so we must be extra cautious in evaluating the risk vs. return potential of all new and existing holdings. Our overarching goal remains to preserve the gains that we have achieved over time, while still prudently participating in any further market advance. We will attempt to do this by focusing our research effort on the following factors, while maintaining our valuation disciplines:

- finding business models that exhibit a high degree of consistency in both earnings and revenue growth
- companies whose businesses are not overly economically sensitive
- companies that are highly profitable and where those margins can be maintained or even expanded
- companies with strong balance sheets and an ability to generate excess free cash flow
- companies that are not overly capital intensive
- managements that faithfully execute their business plans and adroitly redeploy the free cash flow via dividends, stock repurchases and niche/strategic deals

With every new year there is always a list of concerns. The list for 2015 would include the possibility that the Fed could start raising short term interest rates. For the record, we have erroneously predicted this over the past few years, but maybe we will be right in 2015. It is possible that parts of Western Europe are headed back into recession and clearly China's growth is slowing. Emerging markets in general may struggle with lower growth rates and more expensive dollar denominated debt. All of this could negatively impact global GDP growth, but this still seems manageable at this time. Geopolitical tensions are likely to remain elevated and with oil and commodity prices in decline, this could easily make matters worse. The strong dollar will likely pressure reported earnings, but this too seems manageable.

On the positive side, the US consumer is benefitting currently from a rare combination of strong job growth, falling energy prices, increasing real wages, cheaper imports and low borrowing costs. All else being equal, this should finally propel the US economy to some of the best growth rates in this recovery. While this would likely make the Fed pull back on their extraordinary easing, historically the first increases in interest rates have not been hard on the market or the economy until the yield curve really starts to flatten.

So, as we begin a new year, we start with a portfolio that holds 26 core positions and two positions that were spun out from core positions late in 2014. These holdings are all financially strong with above average dividend yields and trailing and prospective P/E multiples that compare well against the broader averages. The portfolio's beta remains well below that of the market. These types of characteristics have been consistently present since our founding and we remain convinced that they will dampen downside volatility, while still participating in market advances. We look forward to updating you as the year progresses.

In closing, we once again wish to thank all of our clients and partners for the trust you give us to oversee these assets. It is our desire to constantly improve our team and our processes and to that end, we added two highly experienced people to our team this past year. Wayne LeSage joined us in February from Scotia Institutional Investments, where he oversaw the firm's institutional client service effort. He is our Client Relations Director. In November, we were fortunate to attract Ruairi O'Neill to our firm. He was a Senior Vice President at PNC running their Dividend Focus strategy. He has joined the research team as a Portfolio Manager/Investment Analyst. Both are terrific individuals and both make our firm stronger. We remain 100% employee owned and we are pleased to have both Lisa Moneymaker and Chris Leonard as new shareholders. They too have added tremendously to the firm.

Wishing you all the best in 2015.

Peter A. Thompson

Brian L. Kramp, CFA