Coho Relative Value Equity

Monthly Portfolio Commentary

December 31, 2018

As we entered the 4th quarter of 2018, Coho Partners was roughly 300 basis points behind the S&P 500 Index, which had gained more than 10.0% over the first nine months, and we had a reasonable advantage over the S&P 500 Value Index, which had only risen 3.5%. This quarter was horrible for domestic equities with the S&P 500 Index declining 13.5% and the S&P 500 Value Index falling 12.0%. Our focus on downside protection was tested and Coho's 10.1% decline was not as good as we would have liked, but this allowed us to finish the year slightly ahead of the S&P 500 Index and increase our margin against the S&P 500 Value Index. Coho finished the year with a total return of -3.3% versus -4.4% and -9.0% for the S&P 500 Index and S&P 500 Value Index, respectively. The 4th quarter of 2018 was the worst quarter since the third quarter of 2011, when the market fell nearly 14%. We noted in our October and November letters that it was possible that the advantage that "growth" has had over "value" might be turning, and we continue to believe this is the case. At its peak this year the S&P 500 Growth Index had a nearly 1,400 basis point performance advantage over the S&P 500 Value Index, but during this recent sell off, "value" outperformed "growth" and the gap narrowed to approximately 900 basis points.

December was a particularly challenging month with the major indices falling roughly 9%. Coho also declined 9% which on the surface appears quite disappointing, but the selloff was indiscriminate across ten of the eleven sectors. Utilities only fell 4% but all of the other sectors fell between 7% and 13%, with some of the more "defensive sectors", such as Consumer Staples and Health Care each down roughly 9%. According to Credit Suisse[1], if one adjusted earnings for tax reform impacts this year, earnings for the Consumer Staples sector would have declined by 2.5%. Over the past 25 years, Consumer Staples earnings have only declined three other times and never for two consecutive years. Over the 20 years of Coho's existence, we have relied on Consumer Staples to provide strong downside protection during market corrections. This was not the case in the quarter or for the full year, and we exacerbated the problem with poor stock selection. Four holdings within this sector (Altria, ConAgra, Philip Morris International and J.M. Smucker) reduced the annual return by roughly 450 basis points. We remain confident in each of these companies' long-term outlooks and believe they will provide strong recoveries in 2019.

So, what triggered this selloff? The two most common hypotheses are that earnings in 2019 will be slower than they were in 2018. The other is that interest rates are rising, and the yield curve is signaling a recession. From our perspective, neither of these concerns should have a materially negative impact on the companies in the portfolio. We agree that earnings growth in 2019 will be slower than it was in 2018, but 2018's earnings got a huge one-time benefit of the corporate tax rollback which clearly won't recur this year. However, earnings should continue to move higher and given this quick correction, valuations on forward earnings appear quite reasonable. The consensus estimate for S&P 500 Index earnings per share in 2019 is about $171, which is up about 7.5% from the 2018 estimate. We admit that the $171 estimate has been trending lower, but this is not unusual for analysts to start with "best case" estimates and then slowly lower them as reality sets in. As for interest rates, we have consistently posited that rates can rise from this low level for quite some time before bonds truly pose a competitive threat to equities, and we believe the domestic economy is strong and consumer confidence remains high. We believe the 4th quarter decline and December in particular was more a function of

[1]Credit Suisse: "Equity Strategy Navigator", 2 January 2019

algorithmic trading and investors panicking out of passive funds or ETFs. Coho Partners' returns do not typically correlate closely to movements in the indices because we manage a focused, high conviction portfolio with a long-term orientation. Additionally, we have very high active share. Of the top ten holdings in the S&P 500 Index, which represent 21% of the index's market capitalization, we own only one of them, Johnson & Johnson.

So, what do we see for 2019? We first and foremost focus on the long-term operating and financial strategies of our companies, and we would expect all of them to improve their competitive positions in 2019. We do have a few investments which are consolidating acquired companies and, in these situations, we are paying close attention to the smooth integration of the management teams and a rapid repayment of their borrowings. For those companies, dividend progress in 2019 will likely be tempered but we still expect the aggregate dividend growth to be consistent with historical growth, which is very close to 10%. We are not driven by macro prognostications, but we do monitor four major levers that can impact valuations and they are the marginal changes in fiscal policy, monetary policy, trade policy and regulatory policy.

On fiscal policy, the heavy lifting occurred in 2018, so we would be pleased if overall corporate and individual rates stayed near current levels.

Regarding monetary policy, the Federal Reserve seems committed to at least two quarter-point hikes in 2019. At year end, Fed Funds were under 2.2% and the U.S. ten-year Treasury was yielding 2.7%. We believe our economy can withstand those increases without negatively impacting the U.S. equity markets.

Trade policy is likely the largest wild card. The saber rattling between the U.S. and China over tariffs does worry us, but we are optimistic that cooler heads will prevail, and global trade will improve during 2019. If this were to happen, this should be a major benefit to overall global valuations.

Finally, on regulatory policy, we have seen progress in eliminating some onerous policies that slowed earnings growth and arguably raised the cost on products to consumers as companies passed along the burden of unnecessary regulation. More could be done here, but it is harder to measure progress on this front and there may be little with a divided congress.

Bottom line, we see valuations for our holdings as being attractive and as such we expect higher portfolio valuations in 2019 driven by further earnings growth and commensurate dividend growth. The S&P 500 Index finished the year at 2,507, which equates to a very reasonable P/E (price/earnings) multiple of less than 15x on forward earnings. The portfolio that we supervise on your behalf trades at an even more compelling 13.9x on a forward one-year basis and yields 2.8%. Moreover, half of the portfolio trades at less than 12x forward earnings and yields 3.6%. We believe we are well positioned to participate in any advance while also providing downside protection should the market weaken further.

We hope you enjoyed the holiday season, and we wish you all the best in the New Year. If you have questions or concerns about our outlook or the portfolio's positioning, please do not hesitate to call us.

Sincerely,

Coho Partners' Research Team

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