Coho Relative Value ESG

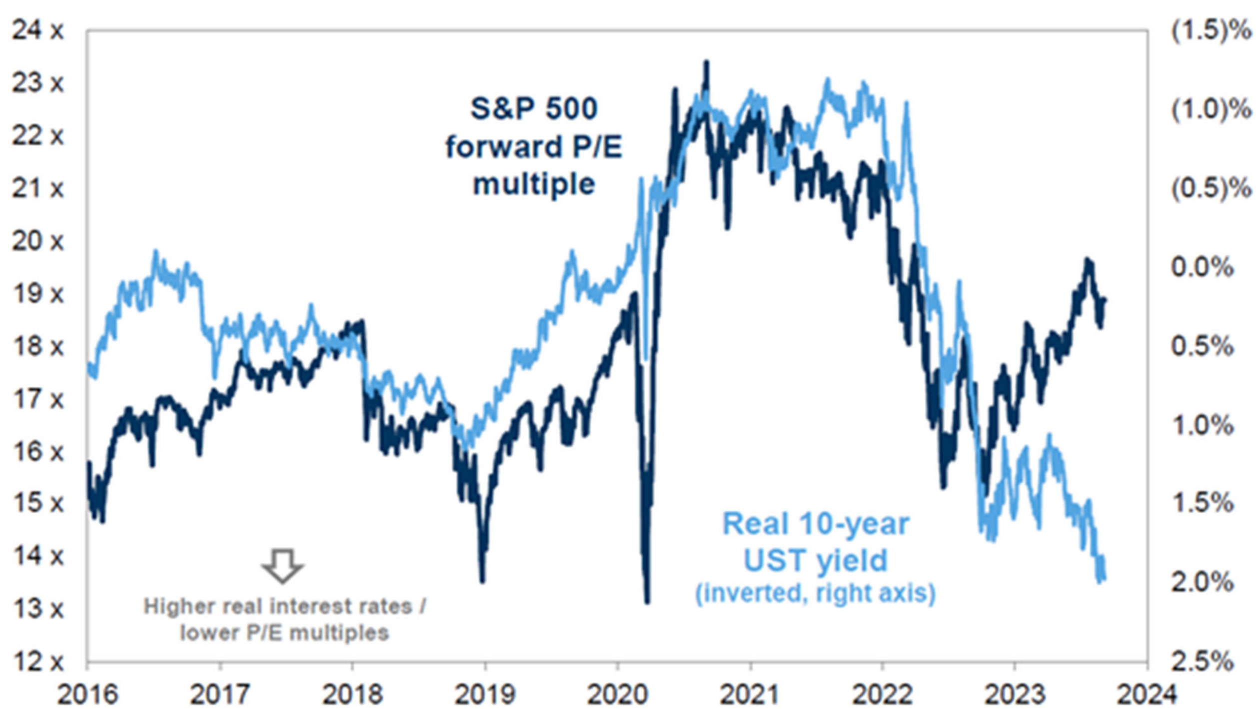
Monthly Portfolio Commentary

December 31, 2023

Following strong relative performance in 2022 for the Coho Relative Value ESG portfolio, 2023 was a disappointment. The year prior, the portfolio again demonstrated its ability to provide meaningful downside protection amidst difficult market environments. This year, however, it was unable to provide the level of upside participation we typically expect. Through the 2022 downturn and the 2023 rebound the S&P 500 Index returned 1.7%, the Russell 1000 Value Index rose 1.5%, and the Coho Relative Value ESG portfolio was slightly negative at -0.9%.

Early in the year, the Information Technology sector began leading the market higher as euphoria surrounding the potential for AI took off following the release of ChatGPT. This sparked the beginning of an impressive but narrowly led market rally despite interest rates continuing to push higher. Optimism about the future AI could bring caused investors to brush aside the typical inverse correlation between rates and P/E multiples (Chart 1).

Chart 1
10-Year UST (inverted) vs. S&P 500 P/E



Sources: FactSet, Goldman Sachs Global Investment Research. As of September 5, 2023

The enthusiasm that drove returns of greater than 40% for the Information Technology, Communication Services, and Consumer Discretionary sectors in 2023 was not evenly spread. While market breadth began to expand a bit in the fourth quarter, performance for the full year remained concentrated in a handful of stocks, and bigger was better. The five largest stocks in each of the Information Technology, Communication Services, and Consumer Discretionary sectors contributed 74%, 97%, and 79% of the sector return, respectively (Chart 2). Reducing those 15 stocks to just the Magnificent 7 (Apple, Microsoft, Nvidia, Google, Amazon, Meta, and Tesla) doesn't change the numbers meaningfully as those seven companies dominated performance the past year. The primary focus of our philosophy is on downside protection, so while we marvel alongside everyone else at the dominance of the Magnificent 7 in 2023, we remain mindful that those same seven stocks dominated performance to the downside in 2022 (Chart 3).

Chart 2
Top 5 and Magnificent 7 Contribution to 2023 Total Sector Return

2023 Performance Sector (Mag 7 consituents)	Sector Total Return	Top 5 Largest Stocks Contribution to Total Sector Return	Magnificent 7 Constituent Contribution to Total Sector Return
Information Technology Mag 7 (AAPL, MSFT, NVDA)	61%	74%	66%
Communication Services Mag 7 (GOOGL, META)	56%	97%	86%
Consumer Discretionary Mag 7 (AMZN, TSLA)	43%	79%	75%

Sources: Coho Partners, FactSet

Chart 3
Top 5 and Magnificent 7 Contribution to 2022 Total Sector Return

2022 Performance Sector (Mag 7 consituents)	Sector Total Return	Top 5 Largest Stocks Contribution to Total Sector Return	Magnificent 7 Constituent Contribution to Total Sector Return
Information Technology Mag 7 (AAPL, MSFT, NVDA)	-30%	63%	60%
Communication Services Mag 7 (GOOGL, META)	-42%	86%	71%
Consumer Discretionary Mag 7 (AMZN, TSLA)	-38%	84%	78%

Sources: Coho Partners, FactSet

The extent to which the largest stocks in the S&P 500 Index contributed to returns in 2023 is relatively unprecedented. Over the past 30 years, when the market has finished the year with a positive return, there have been only five instances in which the top 10 weightings at the end of the year contributed more than 35% of the total index performance. One of those was 2023, and its concentration of returns exceeded that of every other occurrence. Of the 26% total return for the S&P 500 Index this year, the ten largest stocks contributed two-thirds of the performance with those stocks up a whopping 93% on average.

History suggests that when market returns are heavily skewed toward a narrow list of companies in one year, performance the following year can be difficult (Chart 4). In the four instances outside of this one where ten stocks drove more than one-third of annual returns, the market was positive the next year only once – when 2020 led into the pandemic rebound in 2021 thanks in large part to massive government stimulus. The remaining times were 1999 – just before the dot-com bubble burst, 2007 – just before the Great Financial Crisis, and 2021 – just before the rate hiking cycle that precipitated an 18% decline in the S&P 500 Index in 2022. The past is not always a predictor of the future, but it is worth considering as we head into 2024.

Chart 4
Contribution to S&P 500 Total Return by the Top 10 Largest Weights

Year	Top 10 Ending Index Weight	Top 10 Contribution to Total Return	S&P 500 Total Return	S&P 500 Total Return Following Year
2023	32%	67%	26%	???
2020	29%	63%	18%	29%
1999	25%	51%	21%	-9%
2007	20%	47%	5%	-37%
2021	31%	37%	29%	-18%

Sources: Coho Partners, FactSet

Why it bears watching is that valuations can play a significant role in future returns. Among the frustrations with our performance this year was the widening gap between the multiples the market was willing to pay for certain stocks versus what it was willing to pay for companies within our portfolio. We firmly believe that fundamentals ultimately drive stock prices, yet multiple expansion drove a preponderance of the returns for the market this year while the multiple for our portfolio actually contracted. Yes, we had some stocks that disappointed, and we discuss them below, but at the aggregate portfolio level, our earnings and dividend growth were in line with the averages we have experienced over the 24 years of our history.

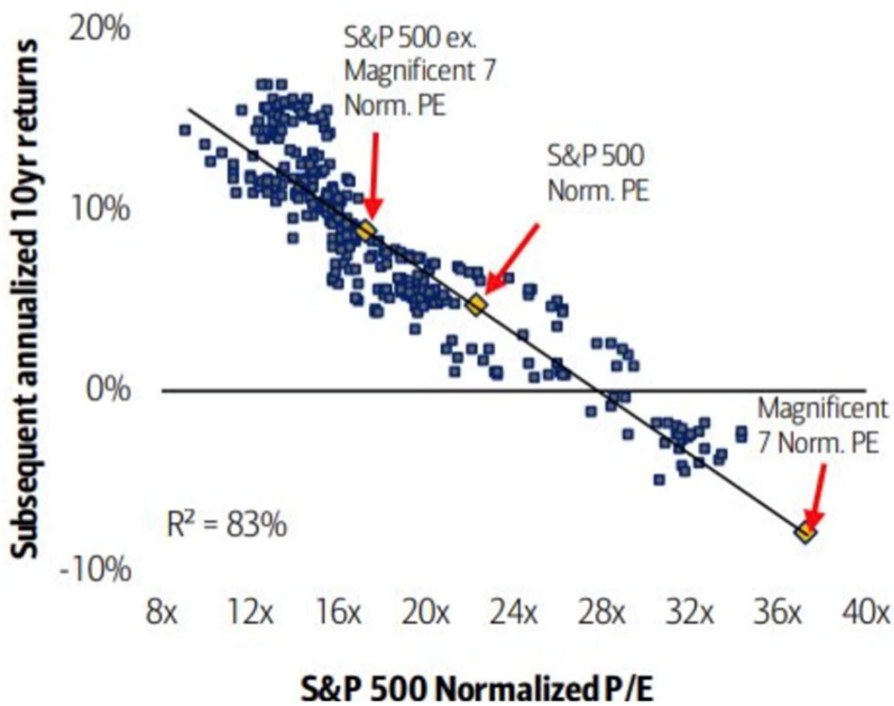
The first step of our investment process is to rigorously identify a universe of companies that we believe have the greatest opportunity to deliver consistent and predictable revenue, earnings, and cash flow growth. We call this universe the Coho 250. We do not apply a valuation restraint to this universe as this stage of our process is focused solely on identifying advantaged business models. However, at the portfolio level, we believe valuation discipline is critical. To deliver on the portfolio's commitment to provide downside protection, we cannot simply buy great companies, we must also buy them at attractive prices.

In years like 2023 when multiple expansion drives returns more so than earnings and dividends, our valuation discipline is an expected headwind. That headwind gets exacerbated when market breadth is narrow as it combines with lofty valuations to limit our opportunity set. Some may argue we already limit ourselves by only considering stocks within a narrowly defined universe and while that sounds valid given just 23% of stocks within the Coho 250 outperformed the S&P 500 Index this year, that is similar to the S&P 500 Index as a whole where only 26% of stocks outperformed the index return.

We would counter that selecting attractively priced stocks from an advantaged universe of companies that, over long histories, have demonstrated an ability to produce consistent growth and favorable shareholder returns is the best way to provide an asymmetric pattern of returns with a lower level of risk and lower return volatility. That requires us to acknowledge that we will underperform in periods where valuation is less relevant to investors. We would consider 2023 to be one of those years. For the stocks in the Coho 250 that outperformed the S&P 500 Index this year, the average P/E was 30x and the median was 28x, both well above historic levels. For the S&P 500 Index, the average P/E for stocks that outperformed the index was 32x and the median was 27x.

The reason we place such emphasis on valuation is first, to enhance our ability to protect on the downside and second, because we believe it impacts future returns. Chart 5 highlights a tight correlation of P/E multiples to forward returns (Bank of America shows data beginning in 1987). The R^2 of 83% implies that more than 80% of annualized returns over the following decade are explained by what you are paying for the index at the start of that decade. With this in mind, we feel good about the opportunity for the Coho Relative Value ESG portfolio to more fully participate in the coming years given its attractive valuation relative to the benchmark.

Chart 5
S&P 500 Normalized P/E vs. Forward 10-year Annualized Returns



Sources: Bank of America, FactSet, since 1987; projection as of November 17, 2023

When valuations get stretched and momentum is driving returns, it typically results in Economically Sensitive (ES) sectors outperforming the Demand Defensive (DD) sectors we tend to overweight. That was the case in 2023; however, the magnitude of the return variance was extreme. The performance spread between ES and DD sectors was a massive 3,500 basis points. That is more than twice the next largest dispersion we have observed over Coho's entire history. It was driven by a convergence of the excitement surrounding AI propelling those sectors we tend to underweight (Information Technology and Communication Services), and concerns over the impact GLP-1 obesity drugs might have on the sectors we tend to overweight (Health Care and Consumer Staples). A perfect storm of thematic headwinds like that fortunately doesn't occur often. The last time it did was 24 years ago in 1999 at the height of the dot-com craze. That was also the last time the spread between ES and DD performance reached levels commensurate with 2023. Of course, that reversed in 2000 when the bubble burst (Chart 6).

Chart 6

Performance Spread of Demand Defensive Versus Economically Sensitive Sectors

1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
7.5%	-9.7%	4.7%	1.8%	-36.8%	38.6%	3.8%	10.2%	-14.6%	-4.5%

2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
2.7%	-2.8%	5.2%	15.2%	-15.1%	-10.5%	16.7%	-4.1%	-0.4%	11.6%

2015	2016	2017	2018	2019	2020	2021	2022	2023
11.6%	5.6%	-13.4%	-5.7%	-5.7%	8.0%	-10.4%	21.3%	-35.2%

Sources: Coho Partners, FactSet

The two themes noted above account for a significant portion of our underperformance this year. For 2023, the S&P 500 Index returned 26.3%, the Russell 1000 Value Index was up 11.5%, and the Coho Relative Value ESG Portfolio was up 2.9%. More than 40% of our underperformance relative to the S&P 500 Index is attributable to the Magnificent 7 stocks. That impact carried over to the value index as well since Facebook and Google were both included in the Russell 1000 Value benchmark for the first six months of the year and explains more than 20% of our underperformance relative to that index.

Compelling obesity and cardiovascular protection data for the GLP-1 drug class weighed heavily on the Health Care and Consumer Staples sectors this year. Investors theorized that widespread use of the drugs would decrease demand for everything from hip and knee replacement to diabetes care to food consumption. These concerns led returns for both sectors to show up near the bottom of the list for 2023 and contributed to the widespread between the Economically Sensitive and Demand Defensive sectors described previously.

Cumulatively, the result of our overweight positions in these Demand Defensive sectors had a more meaningful impact on our relative performance than did our selection within those sectors. The pressure from our sector allocations to Health Care and Consumer Staples combined with the headwind of not owning the Magnificent 7 accounts for greater than 70% of our 2023 underperformance versus either benchmark.

While identifying headwinds, we do not want to shy away from challenges with our stock selection. Our packaged food holdings were pressured by the GLP-1 concerns, and we have written multiple times this year about CVS Health Corporation as well, but by far the largest detractor at the stock level was Dollar General.

From the time of our original purchase in September 2015 to the end of 2022, Dollar General was one of the largest positive contributors to portfolio performance. That changed markedly in 2023 when the success the company enjoyed during the pandemic caught up with it in the form of supply chain bottlenecks due to outsized growth that were made worse by strategic and operating decisions of newly installed management. Throughout these challenges, we maintained conviction in the company's business model and its ability to work through its challenges and return to the steady growth and returns we had come to expect through the initial seven years of our ownership.

We were too early when we added to our position in June. In October, the company's Board of Directors reinstated Todd Vasos to the CEO role he had departed less than a year earlier. Discussions with Mr. Vasos and his team reaffirmed our view that much of the pain was self-inflicted and correctable within a reasonable timeframe. We added to the position again in October. Since then, we have continued actively engaging with Mr. Vasos and other senior managers inclusive of on-site visits to the company's headquarters and numerous stores. We are pleased to see meaningful positive change already visible, most importantly in on-time truck deliveries and customer traffic.

There is still a lot of recovery ahead, but we are encouraged by the performance of Dollar General shares since our most recent addition. After a miserable nine months, the stock was one of the top three performers in the portfolio against both the S&P 500 and Russell 1000 Value indices in the fourth quarter. The concentration of returns that dominated full year results for the market began to broaden somewhat in the final three months. This allowed the Coho Relative Value ESG portfolio to participate more fully during a very robust quarter of equity returns. For 4Q23, the S&P 500 Index advanced 11.7% with the Russell 1000 Value Index rising 9.5%. The Coho Relative Value ESG portfolio was up 10.8%, much more in line with the type of upside participation we expect to achieve.

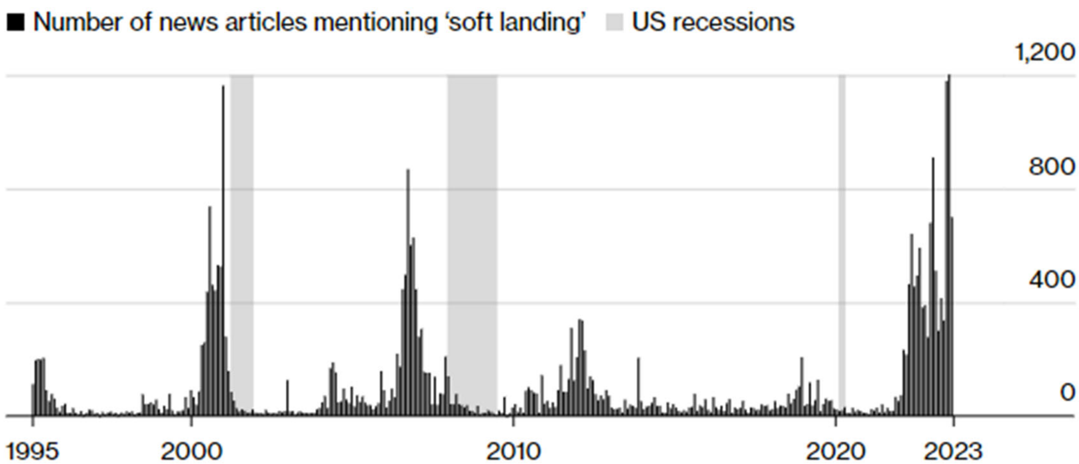
From a trading perspective, we were relatively quiet through the first three quarters of the year as we were happy to maintain positions in what we perceived as good value in high quality companies while investors chased a handful of stocks. As that trend persisted, we became more active in the fourth quarter as it afforded us the opportunity to further upgrade the risk/reward of the portfolio.

We eliminated our position in Baxter International and redeployed that capital into a new position in Abbott Labs which we view as having a superior management team, a more diversified business, and a favorable balance sheet. We also eliminated our position in J.M. Smucker due to its expensive and ill-timed acquisition of Hostess Brands. Along with trims of top performing names like Marsh & McLennan, this provided funding for adds to high conviction names where we believe the market underappreciates the long-term return potential. Additions in the quarter included Medtronic where pipeline progress is helping the company drive toward its organic revenue and margin targets, Nike where the China business is recovering and where further margin opportunity exists, ThermoFisher Scientific where transient headwinds are obfuscating long running secular tailwinds, Walt Disney which is on the cusp of streaming profitability, Microchip Technologies where execution remains strong and shareholder returns generous, and the aforementioned Dollar General.

With those portfolio changes we feel good about our positioning heading into 2024. What 2024 will bring is anyone's guess. Wall Street strategists are predicting the S&P 500 Index to finish anywhere from 4,200 to 5,200, or 12% lower to 9% higher. We view that as a fairly tight range given all the unknowns heading into the year. When will interest rates be cut and by how much? What will happen on the geopolitical front? Who will be the next U.S. President and to what side of the aisle will the Congressional balance fall? What will growth look like in China?

One thing we do know is that consensus entering 2023 was that the long-expected U.S. recession would finally occur. It did not. Consensus entering 2024 is that the Fed will successfully engineer a soft landing. Perhaps consensus will stick the landing this year. However, Chart 7 shows that optimism does not always equal reality. Chart 8 highlights that tightening cycles generally lead to a GDP recession or an EPS recession and typically both.

Chart 7
Soft Landing Discussion Precedes Recessions



Sources: Bloomberg tracked news sources

Chart 8
Tightening Cycles and Recession Outcomes

Start Of Tightening:	ISM Fell Below 50	EPS Recession	GDP Recession
1954	Yes	Yes	Yes
1958	Yes	Yes	Yes
1961	Yes	Yes	Yes
1967	Yes	Yes	No
1972	Yes	Yes	Yes
1977	Yes	Yes	Yes
1980	Yes	Yes	Yes
1983	Yes	Yes	No
1988	Yes	Yes	Yes
1994	Yes	No	No
1999	Yes	Yes	Yes
2004	Yes	Yes	Yes
2015	Yes	Yes	Yes
2022	**Yes**	?	?
Frequency	13/13	12/13	10/13

Source: Trahan Macro Research, LLC

Last year was disappointing from a returns' perspective, but for the most part, our portfolio companies continued to deliver the consistent revenue, earnings, cash flow, and dividend growth we expect from these proven, stable business models. Importantly, valuations remain quite attractive across the portfolio. We have learned from our long careers and the 24 years of Coho's existence that stock prices ultimately follow fundamentals, and that the biggest mistake an investor can make is to change or stray from their philosophy or process when performance lags. We firmly believe in our philosophy and process and look forward to it providing more robust participation in 2024 should markets continue moving higher and strong downside protection should they move lower.

On the ESG front, the 28th Conference of the Parties (COP 28) recently concluded. The conference reflected on the lack of significant advancement on climate goals since the 2015 Paris Agreement, underscoring the shortfall in emissions reduction targets. Pressing climate challenges resulted in the introduction of new pledges but financial commitments may stop short of achieving climate objectives. For example, commitments by 50 oil and gas companies included a pledge to achieve net-zero operations by 2050 but do not include Scope 3 emissions, which constitute a significant portion of the oil and gas value chain. Moreover, the failure to reach a consensus on global carbon trading at COP28, amid differences in standards between the EU and the US, highlights ongoing challenges in achieving a unified global approach to carbon reduction. In light of these concerns, Coho has proactively adopted a framework to evaluate and steer progress on carbon footprint reductions for our portfolio companies. Notably 61% of our portfolio companies aligned with Science-Based Targets as of September 30, 2023, underscoring our commitment to advancing sustainable practices and contributing to global climate mitigation efforts.

If you have questions or concerns about our outlook or the portfolio's positioning, please do not hesitate to call us. We look forward to updating you on the progress of the portfolio as the new year progresses.

Sincerely,

Coho Partners' Research Team

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