The first half of 2023 has reminded us that we work in a very humbling industry. Thus far, 2023 has been one of the most challenging periods in Coho Partners’ history. The factors driving the market have been a meaningful headwind as has the market’s concentration of returns within a handful of stocks. However, we also acknowledge that a few of our holdings have uncharacteristically experienced execution issues. We will touch on each of these contributors to our year-to-date relative performance, and while the entire Coho team is keenly aware of this short-term underperformance, we remain resolute in our conviction and confidence that our disciplines and processes will continue to produce better-than-market returns with less risk over time.

Through the first six months of 2023, the portfolio had a fractional loss, which compared poorly against the S&P 500 Index’s return of just under 17% and the Russell 1000 Value Index’s return of just over 5%. The factor headwinds we have highlighted in several commentaries this year have only gotten stronger as the year progressed. Chart 1 highlights the extreme divergence in returns between factors with growth, economically sensitive and high beta stocks delivering far superior returns relative to their counterparts.

### Chart 1

<table>
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<tr>
<th>2023 YTD Returns by Style Russell 1000</th>
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<tbody>
<tr>
<td>R1000 Growth</td>
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<tr>
<td>R1000 Value</td>
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<table>
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<th>2023 YTD Returns by Factors S&amp;P 500</th>
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<tr>
<td>Economically Sensitive</td>
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<tr>
<td>Demand Defensive</td>
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<td>High Beta</td>
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<td>Low Beta</td>
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Past performance is not indicative of future results.

Since our founding, the Coho Relative Value Equity portfolio has been purposefully tilted away from the factors currently driving the market. We have consistently maintained a “value” bias with an
emphasis on lower beta, higher quality holdings with a tilt toward demand defensive businesses that can provide consistent earnings, revenue, and cash flow growth regardless of the macroeconomic environment. We try to be very transparent in acknowledging that our philosophy will not always be in style, and it certainly has not been thus far in 2023. However, throughout the 23-year history of the firm, this approach has provided an asymmetric pattern of returns by delivering strong downside protection and good upside participation, and nothing has shaken our confidence that it will continue to do so.

Another major challenge this year has been the narrowness of the returns for both the S&P 500 Index and the Russell 1000 Value Index. Charts 2 and 3 show the returns for the two benchmarks of the top 10 contributors compared to all other stocks in the indices. The left chart below shows that the top 10 stocks year-to-date for the S&P 500 Index accounted for 80% of the total return for the index. The right chart indicates performance for the Russell 1000 Value Index was only slightly broader with the top 10 contributing roughly 73% of the total return. Chart 4 puts this in perspective, showing that at the end of May, breadth reached record levels of narrowness. It has improved only slightly in June.
Much of the concentration in returns can be attributed to the excitement surrounding generative artificial intelligence (AI) and its transformational potential. Investors have flocked to those companies with immediate exposure to the technology, and they populate the contribution charts above. Nvidia is a prime example, up 190% year-to-date and surpassing a $1 trillion market capitalization. We too are enamored by AI and are excited about its potential; however, with those top 10 contributors to the S&P 500 Index’s performance trading at an average of nearly 36x forward 12-month earnings, we struggle to find attractive risk/returns.

The obvious winners are understandably enjoying the limelight right now, but almost by definition, for those companies to deliver on the lofty earnings expectations, the benefits of AI will need to inure to every other industry. We envision advances in drug development and improved customer targeting as just two of many examples that could benefit our preferred demand defensive sectors of Health Care and Consumer Staples. We have been doing this a long time, and we remember the ‘dot.com’ era well. After the initial euphoria wore off, the benefits of the technology broadened widely and ushered in a nearly decade-long period of “value” outperformance. History may not repeat itself, but we do believe that over time, AI will drive revenue and margin gains far beyond just a handful of Information Technology companies.

The headwinds noted above have certainly pressured our returns in 2023; however, we must also admit that some of our holdings have uncharacteristically mis-executed against their longer-term operating strategies, so let us opine on what has happened and what we believe management will do to get back on track. We will focus on CVS, Dollar General and U.S. Bancorp, which are down year-to-date by 25%, 31%, and 22%, respectively.

In December of 2017, CVS Health Corporation (CVS) agreed to buy Aetna, which broadened its offering by entering the managed care business. CVS has been moving its portfolio to a more value-based outcome model, and Aetna was a major move in that direction. We were willing to accept the leverage that came with the deal because CVS has a very cash generative model, and we anticipated the free cash flow would enable the company to de-lever fairly quickly.

By mid-2022, CVS was in a position to use the free cash flow that had been going to debt repayment to do bolt-on deals to further prepare for the value-based outcome model and/or return more cash to shareholders in the form of higher dividends or share repurchases. However, CVS lost a “star” in its largest Medicare plan in late 2022 and this will adversely impact earnings in 2024. This was a surprise and disappointment to us, but management should be able to regain the “star” in the back half of 2023, which will then give the company a nice tailwind in 2025.

Earlier this year, CVS agreed to buy two other health-care providers, Oak Street and Signify Health, which are consistent with its strategy and should give them access to more home health and prescription care. These deals will add debt to the balance sheet but both deals should be accretive reasonably quickly.

As long-term investors, we remain confident in the company’s operating and financial strategies. Coho has maintained a position in CVS for more than 20 years and over this span, different management
teams have faced challenges and each and every time, they have overcome them. We believe management has the talent to do so again, but it is not lost on us that despite these recent setbacks, earnings continue to rise, and the Board approved a 10% dividend increase in each of the last two years. CVS currently trades at less than 8x trailing and forward earnings, and it yields 3.5%. We believe the earnings power in 2025 is well over $10, and we see an excellent risk/reward for the shares.

Dollar General (DG) has experienced an unusual period of execution issues exacerbated by external pressures on its core consumer. It began as a problem of riches as the success in meeting the needs of existing and new customers throughout the pandemic started to catch up with the company toward the end of 2022. At that point, supply chain wobbles suggested the distribution infrastructure couldn’t keep up with the growth. Given DG’s ability to quickly course correct, we believed these issues would be resolved within a few quarters. What we failed to appreciate was the cascade effect the distribution center bottlenecks would have on the company’s expansive store base. Inefficiencies in the distribution centers led to labor inefficiencies in the stores and out-of-stocks on the shelves. This, in turn, resulted in decreased customer satisfaction, declining traffic trends, and the need to invest in price to win customers back. This all took place in the context of a core customer base that was being impacted by the roll off of government stimulus, lower tax receipts, and a cut to SNAP (supplemental nutritional assistance program) benefits.

We established our initial DG position in 2015 when the stock was being hit by an uncannily similar confluence of events. Back then the company’s customer base was facing some of the same macro pressures. There were operational miscues that raised concerns about management competence, and there were fears of a competitive price war. We used that as an opportunity to initiate a position in what we believed was a low-risk, high-return business model that had a meaningful growth trajectory while exhibiting compelling demand defensive characteristics. From that time up until the guidance cut in F3Q22, DG was one of the largest contributors to overall portfolio performance. We acknowledge that it will take time to start up new distribution centers and stabilize traffic trends, but at current prices we see an opportunity for future returns similar to what we saw back in 2015. As such, we added to our DG position in June.

U.S. Bancorp (USB) has a well-deserved reputation of being a high quality, conservative lender and historically the company has performed well versus peers during challenging times. We believe the near-term pressure on USB’s share price stems from the collapse of Silicon Valley Bank, Signature Bank, and First Republic. USB has been caught up in the regional bank issues, but we believe it has a bright future. Since our initial purchase during the pandemic, USB has performed in line or ahead of our expectation. We were also very positive on the company’s decision to acquire Union Bank, which operated primarily in California, a market in which USB had limited exposure. Union Bank’s customers were primarily small businesses, where USB saw potential to leverage its cash management and payment offerings to gain meaningful revenue growth with above average margins. The conversion of Union Bank to USB programs went without a glitch.

We believe USB is well capitalized but with the Union Bank deal, USB will be subject to additional capital requirements, which will prevent buybacks in the near term. However, we do anticipate a
modest dividend increase this December but, in the meantime, USB trades at less than 8x trailing earnings with a 5.8% dividend yield.

Coho seeks to identify stable, predictable business models, so we do not take issues like those described in the three examples above lightly. Even the best companies will stub their toe from time-to-time, but at the portfolio level these missteps should be manageable. To that point, we think it is worth looking at the fundamental drivers of year-to-date returns compared to those that are out of our control.

Chart 5 shows sales and earnings revisions so far this year for the portfolio and the S&P 500 Index and Russell 1000 Value Index. It also highlights the changes in the forward 12-month P/E multiple for the portfolio and the indices. As shown, even with some of the uncharacteristic operational performance of some of our portfolio holdings, the change in EPS expectations for the portfolio is consistent with the revisions for the broader indices. That is not the case when looking at the multiple. The P/E multiple for the S&P 500 Index has expanded nearly 15% so far this year while the Russell 1000 Value Index is 4% higher. That compares to a contraction for the Coho Relative Value Equity portfolio approaching -5%. With similar fundamentals on the top- and bottom-line, the meaningful divergence in the P/E multiple explains virtually all of our relative performance lag to both benchmarks.

It has been a frustrating start to the year, but we feel good about the positioning of the portfolio and its ability to close the performance gap should the market continue to move higher. We also remain cognizant of the many risks to the market including higher-for-longer interest rates, a historically steep inverted yield curve, the potential for tightening credit and rising delinquencies, and geopolitical concerns to name a few. Should the market correct, the factors that have been a headwind to performance will likely turn to tailwinds.

Regardless of what transpires, we like the characteristics of the portfolio as shown in Chart 6. Compared to the S&P 500 Index, the portfolio carries superior dividend growth and yield, competitive EPS growth rates, and meaningfully discounted P/E. Versus the Russell 1000 Value Index the dividend and valuation metrics are similar but the portfolio’s earnings growth is greater.
There has only been one other time in Coho’s 23-year history when we trailed both benchmarks over a six-month period at a similar level to what we have experienced in the first half of 2023. That was the middle of 2009 during the rebound coming out of the Great Financial Crisis. We were rewarded then by sticking to our philosophy and process, and we believe we will be again this time.

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 year progresses.

Sincerely,

Coho Partners’ Research Team