NELSON ROBERTS QUARTERLY COMMENTARY

2013 | THIRD QUARTER

ECONOMIC OVERVIEW

Lessons Learned (Or Not) from the Financial Crisis

Five years ago this month the Financial Crisis of 2008 was marked by the bankruptcy filing of Lehman Brothers. What have we learned? What has changed? Many recent articles have highlighted lessons that individual investors have (hopefully) learned. (See our article on page 6.) Unfortunately, we do not think that either the "markets" or government leaders have learned much at all and very little has changed. Princeton economics professor Alan Blinder addressed this in a Wall Street Journal article published on September 10. The article was titled "Five Years Later, Financial Lessons Not Learned."

"Consider the stark historical contrast between the 1930s and this decade: Years of financial shenanigans in the 1920s, some illegal, many just immoral, conspired with a variety of other villains to bring on the Great Depression. Congress and President Roosevelt reacted strongly, virtually remaking the dysfunctional US financial system.

Years of disgraceful financial shenanigans in the 2000s, some illegal, many just immoral, brought on the Great Recession with virtually no help from any co-conspirators. Congress and President Obama reacted comparatively weakly."

Dr. Blinder pointed out that the Dodd-Frank rules to reign in risky mortgage lending remain unwritten, let alone implemented, 1,110 days after the law's passage. Derivatives like credit default swaps (CDS's) and collateralized debt obligations (CDO's) are largely not standardized and rarely trade on regulated exchanges. And the rating agencies such as Standard and Poor's and Moody's are still being hired and paid by the companies whose securities they rate. As the French would say, "plus ça change, plus c'est la même chose." The more things change, the more they stay the same.

The roots of the crisis long predated the Lehman filing, which was simply the big, dramatic, headline-grabbing culmination of years of problems. The subprime mortgage phenomenon began early in the last decade. It peaked when mortgages packaged, securitized and leveraged by CDS's, CDO's and other weapons of wealth destruction grew to tsunami-like proportions. Fortunately, today we have nowhere near the same volume of this garbage; however, we do not have the rules to prevent a repeat from occurring, either. Indeed, the spring 2012 "London Whale" trading in which JP Morgan suffered $6.8 billion in losses from trading CDS's demonstrates that the system is still at risk. Financial trading and instruments are so complex that even the likes of Jamie Dimon, JP Morgan's CEO, cannot keep track of it all.

INDEX PERFORMANCE	Q3'13	YTD
Dow Jones Industrials	2.12	17.63
Standard & Poor's 500	5.25	19.79
EAFE (international stocks)	11.71	16.78
Russell 2000 (small stocks)	10.21	27.68
Barclays Interm. Gov/Credit	0.62	-0.85
Barclays Municipal	-0.19	-2.87

INSIDE THIS ISSUE

TOP FIFTEEN HOLDINGS:

iSHARES MSCI EMERGING MARKETS
DIAGEO
ISHARES S&P SMALLCAP 600
AMAZON.COM
INVESCO
COSTCO WHOLESALE
CHEVRON
QUALCOMM
INGREDION
VERIZON COMMUNICATIONS
ADOBE SYSTEMS
AKAMAI TECHNOLOGIES
PAYCHEX
ORACLE CORP
UTILITIES SECTOR SPDR

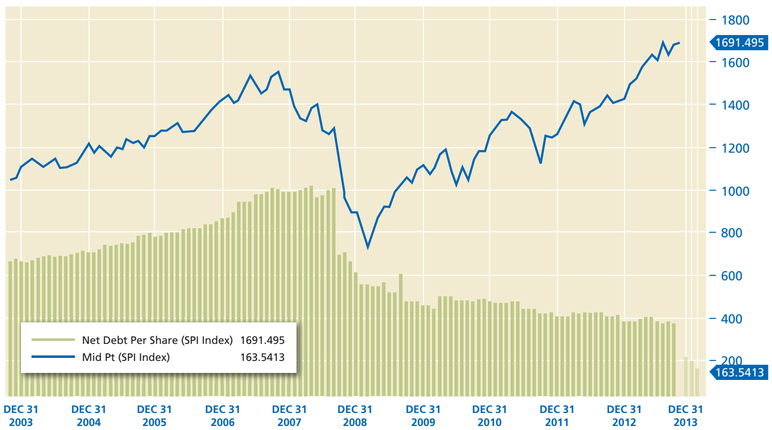
Please contact us for a complete list of holdings.

ECONOMIC OVERVIEW

Lessons Learned (Or Not) from the Financial Crisis (cont'd)

Corporate leverage (see graph below) is much lower today and the US banking system has managed to write off most of the Crisis losses, but there is still no system in place to prevent a repeat of the banking issues, either.

S&P 500 vs. Net Debt



Another problem looms over the horizon. Corporations have gradually weaned their workforces away from relying on fixed-benefit pensions for retirement and instead offer defined contribution plans like 401(k)s. This approach transfers the investment risk from the employer to the employee. In contrast, government employees generally still have rich defined benefit pension plans. The financial crisis and its associated very low interest rates have left many municipalities with pervasive and serious problems meeting their pension funding obligations. (Please see our article expanding on this topic on page 5.)

Despite all of these issues, the S&P 500 and the Dow Industrial averages both hit new highs in September. However, both indices have since backed off as investors' focus turned toward the continuing sub-par economic recovery and the impact of what we have been calling "financial politics." Two years ago US borrowing hit the debt ceiling and political conflict between the parties impeded the vote to increase the ceiling. In the fourth quarter, we will suffer "déjà vu all over again" (to quote the eminent philosopher Yogi Berra) as non-essential government services will be shut down while (we hope) some reasonable compromise is struck to increase the debt ceiling. The political system is still not serving the economic system well and we think we will have many more opportunities to comment on this topic. We hope that the selection and approval of a new Federal Reserve Chairman will be straightforward, but the political environment may also make this process contentious. Janet Yellen appears to be the current frontrunner and while she is likely to continue current policies, the change will make the markets anxious.

The economy continues to muddle along. Monetary stimulus of near 0% interest rates and Quantitative Easing have not been strong enough to change this. With the recovery of the value of their portfolios, investors have become complacent. The market has changed from one driven by macroeconomic forces to one driven by the performance of individual companies. We worry about the complacency, but continue to find attractive and undervalued stocks to buy.

> “What have we learned? What has changed (since the Financial Crisis of 2008)? Unfortunately, we do not think either the ‘markets’ or government leaders have learned much at all and very little has changed.”

ASSET MANAGEMENT

Sector Leadership Changes Propel Markets Upward

Market participants brushed aside concerns and pushed the S&P 500 to positive territory for the third consecutive quarter. It returned a strong 5.3% in Q3. More significantly, sector performance leadership shifted dramatically in the last three months. The first half of 2013, the Health Care, Financials, Consumer Discretionary and Consumer Staples sectors led the way. The most recent quarter saw Materials (+10.3%) and Industrials (+8.9%) become the standard bearers of the continuing market recovery. Another welcome development was the recovery of emerging market stocks. While the emerging market index remains negative for the first three quarters overall, returns exceeded those for domestic equities in the most recent quarter.

We believe this shift in sector leadership reflects two changes in investors' thinking: fears about a dramatic negative change in economic growth continue to subside and the focus is turning to growth opportunities in the stock market. Three potential catalysts for continued market appreciation are fund flows into stocks, cash on corporate balance sheets and initial public offerings or merger and acquisition activity. According to Morningstar, fund flows into the equity markets were $27.7 billion for the year through August. This is in marked contrast to negative fund flows in both 2012 and 2011. There is still plenty of cash on the sidelines ($2.4 trillion parked in money market funds) that could still be invested to keep the momentum going.

We, like many market participants, have grown weary waiting for corporate managers to loosen the purse strings on their cash balances. We have detailed in previous commentaries how the recovery of the last five years has strengthened corporate balance sheets leading to higher profit margins and substantial debt reduction. In aggregate, corporate cash flow measures are more than triple the levels experienced during the market peaks of 2007 and 2000. Corporate managers have been content to watch their coffers expand. Non-financial corporations currently have $1.8 trillion in cash on their balance sheets. We think that the more stable economic outlook will encourage the deployment of these balances in the form of hiring and capital investment.

And, you might already have received a tweet about this from @twitter, but the San Francisco-based media company, Twitter, is expected to raise approximately $1.5 billion from their initial public offering (IPO) according to their recent filing with the Securities and Exchange Commission. The number of IPOs in the first three quarters of 2013 has already exceeded the number for calendar 2012, raising over $30 billion. More importantly, the support for these companies after their IPOs has been significant, with post-IPO performance of these stocks showing a nearly 30% gain overall. A healthy IPO market not only provides capital for growing companies to spend, creating economic activity, but also often results in more mergers and acquisitions, further bidding up prices.

Because we had positioned our portfolio for a growth-oriented market in the first half of 2013, we are encouraged by the shift in sector leadership. After a challenging first half, we feel that our patience is being rewarded. Our portfolio activity has been very light this quarter, as we have stayed the course. Our one addition is Bio Reference Labs (tkr: BRLI), a clinical lab offering both standardized and esoteric laboratory testing to physician offices, clinics, hospitals, employers and government entities. BRLI should benefit from both an increase in volume from the Affordable Care Act and the more specialized testing needed to customize treatment.

integrity *[in teg'r te]*

n. honesty, sincerity, completeness

WHERE DO YOU FIND INTEGRITY?

It emanates from tradition, endures market cycles, and sustains long-term partnerships. Trust lies at the heart of what we do, how we serve and who we employ.

FEATURED EQUITY

Gilead Sciences, Inc.

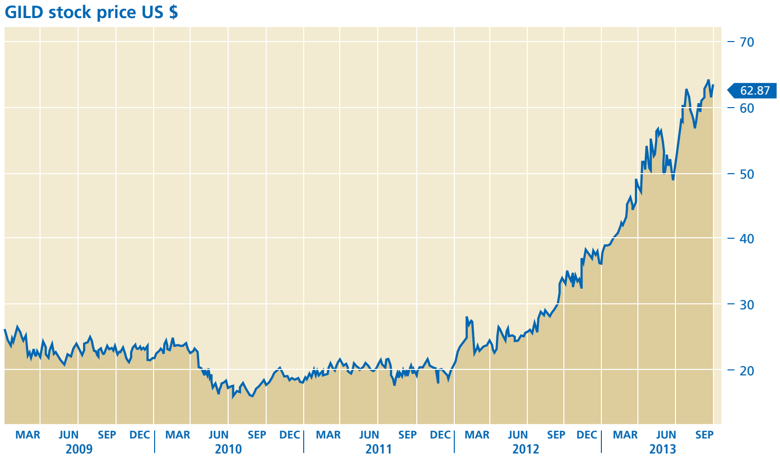
For those of you who have been clients for more than three years, you may recall that we owned Gilead Sciences, Inc. (tkr: GILD) several years ago. Then, as now, we liked Gilead's focus on viral infectious diseases, particularly HIV. The company created the first oral triple-drug combination drug for people infected with HIV. We sold GILD because we felt that the company was getting a bit far afield with its acquisitions and were concerned that its expertise in the very subspecialized area of viral disease would be diluted.

We decided to revisit the company when our healthcare analyst saw that Gilead had purchased a company working on a drug for hepatitis C. Hepatitis C is a viral disease that infects the cells of the liver. Experts estimate that 4 million people in the US have the disease, only a quarter of whom have been diagnosed. Worldwide, up to 170 million individuals may suffer from hepatitis C. Its severity varies, but over time it generally causes "scarring" of the liver leading eventually to cirrhosis and liver failure. Treatment has been difficult to tolerate and leads to a cure in only 50% of cases. Gilead bought Pharmasset in spring of 2012 in order to acquire a promising new drug for hepatitis C. Like HIV, there is no vaccine for hepatitis C.

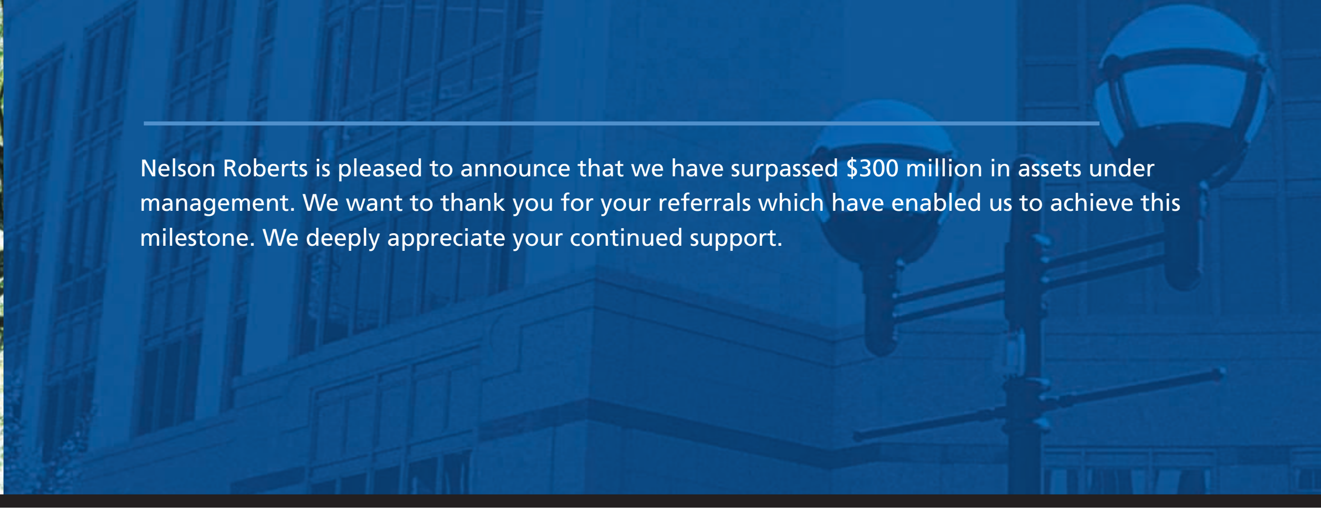
Clinical studies to date have borne out the effectiveness of the drug, named sofosbuvir. The FDA is undertaking a priority review of the drug in December of 2013, which means the drug could come to market as early as next year. One of the key features of the drug is that it can be taken by mouth, unlike other hepatitis C treatment regimens which require injections.

In the meantime, Gilead continues to be the leading provider of medications for HIV. Revenues have grown to over $10 billion a year. Of the 1.2 million cases of HIV in the US, 82% are being treated with Gilead's drugs. Although HIV is not in the spotlight as much as it used to be, there are still 50,000 new cases being diagnosed in the US each year. These numbers pale in comparison to the rest of the world, where 33 million people are estimated to be infected, with 23 million of those living in Africa. Although there is occasionally the much-ballyhooed news about a possible vaccine for HIV, or a patient who has been cured, there is as yet no successful approach to either a vaccine or a cure. However, patients with HIV who take their medicine daily are now living decades after the original diagnosis, a major medical achievement.

GILD stock price US $



The preceding information regarding the featured equity should not be construed as a recommendation to purchase the security. It should not be assumed that future returns will be profitable or will equal the historical performance. Please contact us for a complete list of holdings.



Nelson Roberts is pleased to announce that we have surpassed $300 million in assets under management. We want to thank you for your referrals which have enabled us to achieve this milestone. We deeply appreciate your continued support.

WEALTH MANAGEMENT

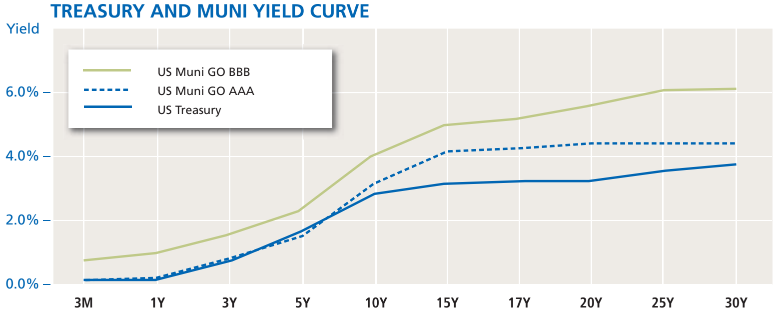
The Municipal Bond Market Becomes a Scary Place

The bond market has been weak this year (-0.9% year-to-date) amid rising interest rates, but municipal bonds have performed particularly poorly (-2.9% year-to-date). Detroit's record-setting bankruptcy filing and rumblings about Puerto Rico's financial health have led to a significant outflow of money from municipal bonds.

Bond prices began falling in May when the Federal Reserve floated the possibility of slowing its bond purchasing program. The Fed has been buying $85 billion per month of Treasury notes and mortgages to stimulate the economy by keeping interest rates low. After the Fed meeting, long-term bond yield began increasing, causing prices to fall.

In June, Detroit announced that the city would stop payment on about $2.5 billion of unsecured debt. Two reasons were cited: the city's large, unbalanced budget and its $3.5 billion in unfunded pension obligations. On July 18th, Detroit filed for Chapter 9 bankruptcy, seeking to restructure $18 billion in debt. This gave the city the dubious honor of having the largest municipal bankruptcy on record. While the muni bond market was not surprised by the bankruptcy, it was spooked by the city manager's comment that he wanted to restructure Detroit's water and sewer debt by issuing new bonds. These new bonds would have different terms that could potentially free up millions of dollars and help the city pay off other debts. The courts will decide if this maneuver is legal, but if they give it their blessing, investors will start to think twice about buying essential service bonds (which are usually considered less risky). Investors would also demand more return for the added risk that the bond issuers could change the rules of the game at a later date.

TREASURY AND MUNI YIELD CURVE



The effect of Detroit's announcement carried over to Puerto Rico, as concern over the commonwealth's financial health and unfunded pension liabilities caused many investors to dump their bond holdings. Bonds have traded as low as 60 cents on the dollar as yields on 10-year paper jumped to over 10%. Puerto Rico's debt has been popular with US investors for its high yields and special tax benefits. The interest paid to bondholders is exempt from federal, state and local income taxes in any US state. As a result, Puerto Rico is one of the top issuers of bonds in the US, with $52 billion in outstanding debt. Puerto Rico's population is 3.6 million people. Compare this to California, which has 38 million people and debt of $96 billion.

In light of the troubles in the municipal bond markets and our belief that interest rates have to move higher, we think fixed income investors should lower their return expectations and invest defensively by buying short-duration and high credit quality bonds.

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INVESTMENT THEMES

Lessons Learned: Part II

While it does not look like legislators and regulators have learned much from the Financial Crisis of 2008 and the ensuing Great Recession, we hope that our clients have. We think that the most important lessons for individual investors are:

1. Don't Panic: One of the most difficult things to do when the market is dropping is to stay the course. Emotions run high, people become anxious and they just don't want to worry anymore. However, those that are able to tolerate the discomfort are usually rewarded. If you sold everything in a $100,000 portfolio of 60% stocks/40% bonds on March 9, 2009 (when the S&P 500 closed almost 60% below its peak) and put the money in cash, today you would have $100,000. If you had held on, you would now have $214,080.
2. Don't Invest in Things You Don't Understand: We operate on the principle that "if it sounds too good to be true, it probably is" and you should, too. Please bring your investment ideas to us, and we will be happy to research them and give you an honest opinion if you are looking to go outside the stocks and bonds that make up our portfolios.
3. The Price of Your House Won't Always Go Up (and sometimes it may even go down): Your house should be a place to live, not an investment you are counting on. Five years on, the real estate market in most of the country has recovered. However, 11% of mortgage holders are still "under water". This is an uncomfortable place to be and limits your options.
4. Liquidity Matters: In the 2008 Crisis only US Treasury Bonds, exchange-traded stocks and most money market funds were liquid (able to be sold at the market price with reasonable transaction costs). Before the crisis, nearly every traded security was liquid. Please keep us informed of potential changes in your planned expenses and be prepared to cut back on non-essentials if you need to in times of crisis.
5. Your Custodian Matters: A custodian is a financial institution that holds a customer's securities for safekeeping to minimize the risk of theft or loss. We do not take custody of our clients' assets. To avoid the kind of problems that Bernie Madoff's clients suffered, we recommend that investment management and custody be handled by separate providers. We will recommend who we think should be your custodian, especially in times of financial uncertainty.

DISCLOSURES

A complete list of all recommendations made by Nelson Roberts Investment Advisors will be furnished upon request. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of securities identified in either the Top 15 Holdings or securities identified in the Nelson Roberts Quarterly Commentary. Specifically, the security selected as our Featured Equity is just one holding of a larger portfolio. It should not be assumed that this security will be profitable or will equal its historical performance. There are risks involved in investing, including possible loss of principal.

For additional information on the services of Nelson Roberts Investment Advisors, to receive a complete list of recommendations or to receive our quarterly commentaries via e-mail or be removed from our mailing list, please contact us at 650-322-4000.

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