NELSON ROBERTS QUARTERLY COMMENTARY

2013 | FOURTH QUARTER

ECONOMIC OVERVIEW

The Good, The Bad and The Ugly

Wow! What a year. Think back for a moment to where we were this time last year. At the end of the last trading day of 2012, Congress had failed to pass legislation to avert the Fiscal Cliff. This term was coined by Fed Chairman Ben Bernanke to describe the tax increases and spending cuts that previous laws had set for implementation on New Year's Day, 2013. Chairman Bernanke predicted that the combination of cuts and taxes would derail the nascent recovery of the US economy. Financial Armageddon seemed imminent. Then at the 11th hour on New Year's Eve, the Senate passed a bill that increased taxes on the wealthiest 2%. The House convened later that evening and also passed the bill. As a result, on the first trading day of 2013, the Dow Industrials posted a 300-point rise and we were off to the races. The Index has risen more than 3,000 points since then, with a better than 20% return for stocks this year.

The stock market produced gains every month in 2013 except for June (-1.4%) and August (-4.1%). The June swoon was the result of the "tapering tantrum," fear that the projected reduction in the Federal Reserve's pace of bond buying would stall the economic recovery. In August, the market decline was driven by concern that the US government would be unable to pay its bills once it hit the $16.699 trillion debt ceiling. Political brinksmanship has become the norm as both parties' platforms have evolved to reflect the extremes of each, with most of the Democratic Blue Dogs retired or voted out of office and the Tea Party driving much of the Republican agenda.

However, the markets treated blustering politicians like the Boy Who Cried Wolf. Even as the US government shut down in early October and came closer to hitting the debt ceiling in the weeks that followed, the market plodded along, inching ever higher as investors realized that the brinksmanship was an empty threat. It appears that some of our elected representatives have taken the failures of this political tactic to heart with the recent compromise spending bill engineered by Democratic Senator Patty Murray and Republican Congressman Paul Ryan. We hope for further progress in this mold.

Two years ago we quoted Sir John Templeton, who once said, "Bull markets are born in pessimism, develop in skepticism, mature in optimism and die in euphoria." At that time, it was our view that we

INDEX PERFORMANCE	Q4'13	YTD
Dow Jones Industrials	10.20	29.63
Standard & Poor's 500	10.49	32.36
EAFE (international stocks)	5.78	23.57
Russell 2000 (small stocks)	8.72	38.81
Barclays Interm. Gov/Credit	-0.02	-0.86
Barclays Municipal	0.32	-2.55

INSIDE THIS ISSUE

TOP FIFTEEN HOLDINGS:

- AMAZON.COM INC.
- iSHARES S&P SMALLCAP 600
- iSHARES MSCI EMERGING MARKETS
- DIAGEO PLC ADR
- INVESCO LTD.
- PAYCHEX INC.
- COSTCO WHOLESALE CORP.
- ADOBE SYSTEMS INC.
- QUALCOMM INC.
- CHEVRON CORP.
- VERIZON COMMUNICATIONS
- INGREDION INC.
- ORACLE CORP.
- TJX COS INC.
- AKAMAI TECHNOLOGIES

ECONOMIC OVERVIEW

The Good, The Bad and The Ugly (cont'd)

were crossing from pessimism into skepticism. Today we think that we are in the process of moving into optimism and hence the market has further room to rise. The growth in stock prices over the last five years has been nothing short of spectacular, with the Dow up 16% and the S&P 500 up 17%, compounded per year. Our optimism is rooted in the belief that equity markets are valued at a reasonable price. Since 2009, earnings multiples for the S&P 500 have been solidly in the mid-teens, meaning that most of the of the price gains have been driven by earnings growth. We will worry about euphoria when we see price-to-earnings multiples expanding and hear cocktail chatter about how much money people are making from day trading. We still think this is a ways down the road.

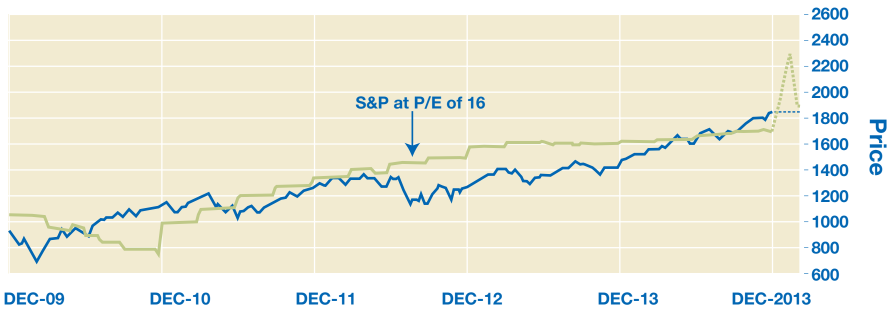
The fixed income markets are a different story. After producing consistent 5+% returns in 2009, 2010 and 2011, the Barclays Aggregate Index was up less than 4% in 2012 and closed down in 2013. In our view, the prognosis for improvement is bleak. After the decline in 2013, bonds are not as overpriced as they were in the fall of 2012, but with a real (net of inflation) return of about 1% on the 10-year US Treasury, they are still not attractive. The "average investor" clearly understands this. For the five years prior to 2013, money had been moving from stock mutual funds into bond funds, for total stock fund redemptions of $535.7 billion and bond fund additions of $1.07 trillion. Through October 1 of this year, this trend reversed, with $38.7 billion in bond fund redemptions and $134.4 billion in stock fund additions.

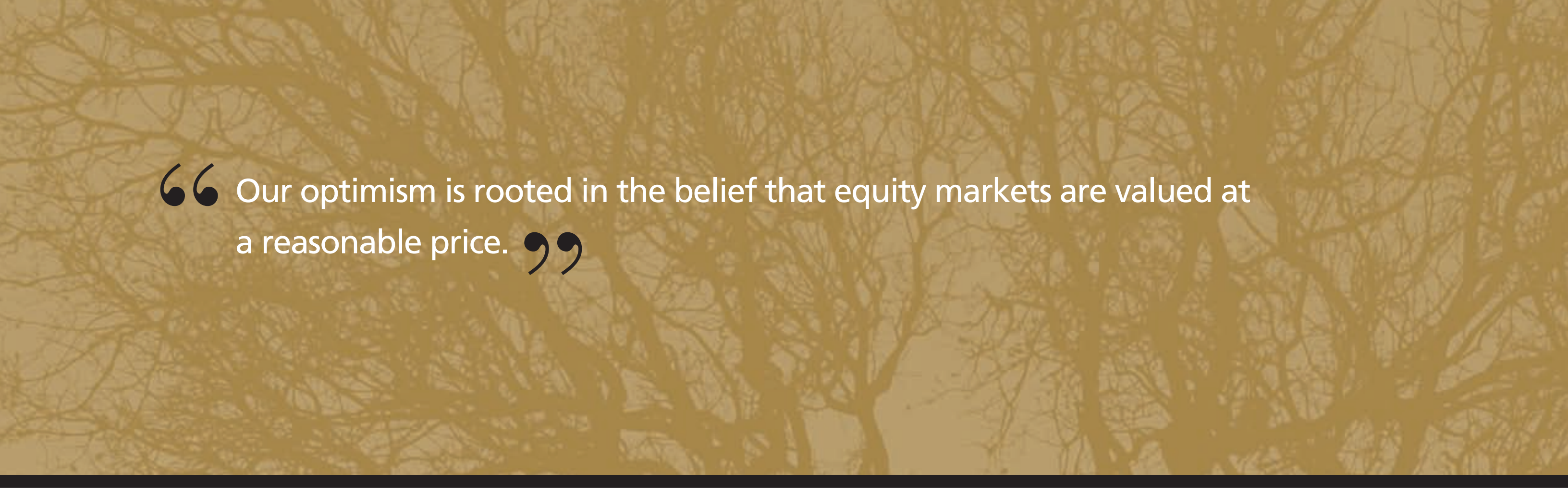
As for the rest of the world: after an ugly first half, the developed country stock markets roared back while emerging market equities will end the year with a significant loss. China's economy is cooling, depressing emerging market exports. Meanwhile, the European Union continues to struggle to dig out of the hole caused by the 2008 crisis.

To paraphrase the spaghetti western title, if the news on stocks is the "Good" and the outlook for bonds is the "Bad," then the "Ugly" has to be the failures of polarized politics and regulatory rulemaking. Brinksmanship is getting us nowhere, and immensely complex legislation such as the Dodd-Frank Financial Regulation Act (more than 3,200 pages of regulations) and the Affordable Care Act (ACA, also known as ObamaCare, weighing in at now more than 11,000 pages of regulations), are not serving their intent. Dodd-Frank has allowed the return of nearly all of the activities that precipitated the 2008 financial crisis, just not yet to the same degree. The implementation of the ACA has thus far been one stumble after another, and does nothing to solve the most pressing problem in health care: steadily rising costs.

Until these political issues are appropriately addressed, we expect they will comprise a significant part of the Wall of Worry over which we think stock prices will still continue to climb.

S&P 500 AND PRICE/EARNINGS BAND METRIC





ASSET MANAGEMENT

The Year in Review

The market ended the year at a new high, surpassing the returns expected by even the most optimistic prognosticators. For the year, the S&P 500 was up 32%, with the index ending the year at 1,848. The Dow Jones also ended the year in record-breaking territory, finishing the year up 29% at 16,576. In less than five years, both the S&P 500 and the Dow Jones have rocketed off the lows established in March of 2009, returning over 150% since the depth of the financial crisis. Even when compared with the highs of 2007, the markets have posted respectable gains of 6.7% (for the Dow) and 6.2% (for the S&P 500) annually.

The robust markets of 2013 had sector leadership from some unlikely sources. Following is a review of the ten business sectors that comprise the S&P 500.

THE LEADERS

1. **Consumer Discretionary:** This sector enjoyed the highest return. Its 43% gain for 2013 contrasted sharply with the 45% loss suffered from 2007-2009. This is logical, considering that the sector consists of businesses that sell nonessential goods and services. Companies include retailers, media, automobile, and consumer service providers. The nonessential nature of the products causes this sector to be sensitive to economic conditions. Leading the way was Netflix, which continues to transform the way consumers use media, and two retailers, Best Buy (electronics) and GameStop (video games). Holdings in our portfolios also contributed positively, with Amazon, TJ Maxx and Disney all enjoying returns above the sector average in 2013.

2. **Health Care:** We were surprised by how well health care did this year. As we entered 2013, we had concerns about how stocks in this sector would react to the uncertainty surrounding the implementation of the Affordable Care Act. As a general rule, the market abhors uncertainty, so we chose to be cautious with our investments. In fact, health care was the second highest performing sector, returning 41% for the year. We added one of the sector's best performers, Gilead Sciences, in the first quarter, but were underweighted in the sector as a whole, especially big pharma and managed care/health insurers. We continue to feel strongly that these companies face major challenges in the coming two years as the ACA is implemented.

3. **Industrials:** The recovery in the airline industry drove performance, with airlines Delta and Southwest, and aircraft manufacturer Boeing all responding to the economic recovery with stock gains of 40%. UPS led our portfolio in this sector, up 37% in the calendar year. We are optimistic that the macroeconomic environment will continue to improve and industrials should therefore be a source of above average return.

4. **Financials:** The gain for this sector was 35.6%. The markets' recovery has increased investors' appetite for financial assets and that has benefited many types of companies. Brokerage firms and asset managers led the sector, with E*Trade being the star performer. Traditional banks, such as Wells Fargo and Bank of America, had average returns for the sector, while real estate investment trusts (REITs) lagged after a strong performance in 2012. Invesco proved to be a solid holding for us, returning over 40% this year.

THE LAGGARDS

1. **Telecommunications:** This sector gets the prize for worst performance of the year. There are only six companies in this group. The two largest, Verizon and AT&T, comprise 86% of the market capitalization for the sector. That is, the sector performance is almost entirely predicated on how well, or poorly, AT&T and Verizon do. We own Verizon, which was up 18%, outperforming the 16.3% average return for the sector.

value *[val'yoo]*
n. a quality having instrinsic worth

HOW DO WE MEASURE VALUE?

By producing it — in the growth of assets, in how our clients view us, in how we create partnership.

ASSET MANAGEMENT

The Year in Review (cont'd)

2. **Utilities:** This year utilities were up 13.3% overall. We own an ETF that is diversified in line with the S&P weightings within the sector.

Both of these sectors are made up of companies that pay nice dividends. Many investors were attracted to them when the market was at its lowest, but the focus has now shifted to companies that are more economically sensitive and have greater growth potential.

THE 20-PERCENTERS

It is a testament to how good the year was when four sectors that generated returns in excess of 20% are not highlighted as particularly impressive.

1. **Technology**: After a weak start, technology posted a very strong second half to finish the year up 28.4%. A contributor to that surge was Apple, which was down 14% through July, but rebounded to finish the year in positive territory. Our portfolios were led by Adobe, which is in the process of a very successful transition to a subscription-based model, and was up 59%. Paychex, a company specializing in payroll processing technology, saw a jump of 49%, indicating that the market for small to medium sized businesses is improving. Our three-company foray into the "cloud" has had mixed results so far. Amazon (though characterized as a consumer discretionary stock) was a solid performer, while hardware vendors Rackspace and F5 have not yet generated the returns we expected.

2. **Consumer Staples:** This sector was up 26.1%. Our portfolios received an early bump when Berkshire Hathaway and 3G Capital announced their acquisition of Heinz in February. Costco and Diageo continued to be solid performers for us.

3. **Energy:** Traditional oil companies, like Chevron and Royal Dutch, which we hold, faced falling oil prices, but exploration continued for new reserves, which drove Schlumberger's return of 32%. After a challenging 2012, our holding in Hess Corp rewarded us with a return of over 58%.

4. **Materials**: Economic recovery also benefited materials. The sector rose 25.6% overall. Two of our holdings, Praxair and Nucor, performed in line with the sector while Hexcel, with its exposure to the airline industry, jumped 62%.

FOLLOW THE LEADERS?

Despite the fantastic year for market returns and the market closing the year at all-time highs, we are confident that 2014 will be another good year for US stocks. The economy has stabilized and is now demonstrating signs that more economic growth is ahead. Corporate earnings grew in the low double digits in 2013 and should match that pace in the coming year. As both investors and managers gain confidence, there is a good chance that earnings will surprise on the upside, leading the markets even higher.

SECTOR PERFORMANCE FOR 2013

The Leaders	The Laggards	The Twenty-Percenters
Consumer Discretionary	Telecommunications	Technology
Health Care	Utilities	Consumer Staples
Industrials		Energy
Financials		Materials

FIRM UPDATES

In Memoriam

Dennistoun Karl Brown April 9, 1957 — October 26, 2013

Nelson Roberts mourns the passing of Dennistoun (Denny) Brown, who died peacefully while hiking near his home in Boulder, Colorado. Denny was a valued member of the Nelson Roberts Investment Advisors equity research team for the last six years. His previous experience in healthcare brought valuable knowledge and insights to decision-making. In past years, he was known as a happy-go-lucky little boy, an enthusiastic undergraduate sleep researcher at Stanford, a gifted, compassionate surgeon, and a meticulous luthier (builder of guitars). He was a devoted husband, father, son, brother and friend who will be deeply missed.

FEATURED EQUITY

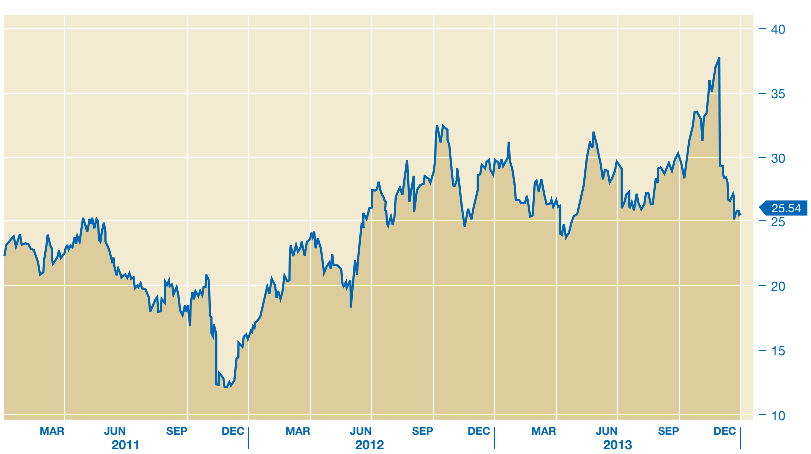
Bio-Reference Laboratories, Inc. (BRLI)

Bio-Reference Laboratories, Inc. (BRLI) is a clinical laboratory company offering testing, information and related services to physician offices, clinics, hospitals, employers and government. The company is based in New Jersey and employs 3,560 people. Pathologist Marc Grodman, MD, who has been its only CEO, founded BRLI twenty years ago. BRLI is the fourth-largest full-service lab in the US, behind Quest, LabCorp of America and Australia-based Sonic Health Care Ltd.

Total revenue for lab testing in the US in 2012 was about $68 billion. Clinical lab testing is divided broadly into two types of services: blood tests and anatomic pathology (tissue examination under a microscope). Approximately 60% of testing is done by hospitals, 35% by independent commercial labs, like BRLI, and 5% in physician offices.

BRLI focuses on esoteric testing (very specialized tests done in only a handful of labs), molecular diagnostics, anatomic pathology, genetics, women's health and correctional health care. The lab processes about 7.8 million requisitions (orders) per year. BRLI also operates 116 patient service centers, primarily in the northeastern US. Routine testing generates 40% of revenues and esoteric testing about 60%.

BIO-REFERENCE LABORATORIES, INC.



Strategically, BRLI is focused on three priorities: growing its specialty lab business, which generally is reimbursed more generously by insurers, marketing its brand and expanding into new geographic regions. The company has recently bought facilities in Florida and California. BRLI believes it differentiates itself from its competitors by its high quality of personalized service and consultation for referring physicians, its specialty businesses (GenPath, GeneDx and Women's Health) and its large and knowledgeable marketing team.

Following a nice run-up in the stock after we bought it, the price is down significantly from its high. The company warned that fourth quarter revenues would be under original estimates due to significant changes in reimbursement, investment in infrastructure for the new labs in Florida and California and a delayed launch of the inherited cancer program. The new health care law is providing challenges to health care businesses nation-wide and BRLI is no exception. However, we believe the company still offers excellent growth potential and will successfully navigate the changes ahead.

INVESTMENT TEAM

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WEALTH MANAGEMENT

News You Can Use: eMoney

Nelson Roberts Investment Advisors introduced a new wealth management software tool at the beginning of 2013. It is called "eMoney" and is designed to help our clients organize their financial accounts and view their overall financial position daily, if they so wish. After a year of offering this new internet-based product, we are pleased to report that most of our clients have adopted eMoney and believe that it is helping them to effectively track their personal financial circumstances and make progress toward their financial goals.

Historically, we built balance sheets, tracked income and expenses and ran cash flow analyses for clients by compiling spreadsheets and updating the data on an annual basis. This was time intensive for both clients and us, necessitated a significant amount of data entry (which is prone to error) and required us to repeatedly bother clients in order to get copies of account statements that we did not have. eMoney solves all of these issues.

WHAT ARE THE BENEFITS OF USING EMONEY?

- Information can be gathered much more easily. Once accounts are linked to the site, the data will update daily. As your investment advisors, we can use this information to be proactive in helping you make more informed decisions regarding investing, insurance purchases, tax and estate planning.
- Historical tracking of net worth allows clients to view changes to their wealth over time.
- Cash flow analysis and Monte Carlo simulations built into the product help determine the probability of achieving financial independence and promote discussion of potential estate planning issues.
- A document vault within eMoney allows us to transmit account statements and other sensitive financial documents more securely than email or traditional mail.
- eMoney is free to clients of Nelson Roberts Investment Advisors.

SECURITY

Some clients have expressed concern about storing financial information on a website. We believe that eMoney has taken all the proper steps to ensure that your information is protected. The site employs multi-layer security technology similar to that being used by big banks and brokerage firms. In addition, the website is "non-transactional" which means that if the site were breached, information could be viewed, but money could not be moved. Actively monitoring your assets is the only certain way to ensure their safekeeping. eMoney makes this easier since there is only one login to see everything.

If you are not yet using eMoney, we encourage you to get signed up. Please contact us and we will be happy to give you a demonstration and answer any questions you may have.

NELSON ROBERTS
INVESTMENT ADVISORS

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

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