NELSON ROBERTS QUARTERLY COMMENTARY

2014 | FIRST QUARTER

ECONOMIC OVERVIEW

The Battle Between Skepticism and Optimism

Uncertainty and lethargy have dominated the market over the last several months. In January, US stocks declined about 5%. The selling was driven by fears that the less-than-robust economic recovery in the US might slow even further due to the deceleration in China's growth rate and the already sluggish emerging markets elsewhere. Stock markets rallied back in February and moved sideways in March, ending the quarter about where they began.

The markets seem to be bouncing between skepticism that the US economy can get out of low gear and optimism that economic acceleration is just around the corner. The big issues worrying the markets continue to be: retirement and healthcare costs, complex, burdensome taxation and regulation, and economic lethargy and financial messes outside the US. Investor optimism has been fed by continued monetary stimulus by the Federal Reserve, improvement in the housing market, burgeoning Initial Public Offerings (IPOs), and hope for a return to growth with our European and Asian trading partners.

China's economy has been growing over 7% annually for many years, and emerging countries, especially in Asia, have been feeding on that growth. Last year China's growth slowed amid rumors of banking system problems and governmental tightening. A lack of transparency and concern over the reliability of published financial data exacerbate these worries. After a tumultuous 2010, 2011 and 2012, the European Union has been quiet, with little news of immediate economic consequence.

We have harped repeatedly on the major demographic shift that is already here and will only become more dramatic in future years. Life expectancies continue to rise. The Society of Actuaries recently updated its mortality tables for the first time since 2000. The average 65 year-old man is now expected to live to 86.6, up from 82.6, and the average 65 year-old woman is expected to make it to almost 89, up from 85.2. While this is good news for individuals (presuming they remain reasonably healthy) it is bad news for state and municipal budgets. According to the Employment Benefit Research Institute (EBRI), as of 2011 (the most recently available data), only 14% of private sector workers are covered by defined benefit plans. This is down from 38% in 1979. Contrast this number with the 84% of public sector workers who get pension benefits. The cost of public retiree health care and retirement benefits is crowding out all other items in governmental budgets.

And then there is the tax code. We desperately need simplification. News of a bipartisan effort led by Republican Paul Ryan and Democrat Patty Murray has largely faded. There does not seem to be any sense of urgency about this issue. This will likely change as we head into the mid-term fall elections, but we think there will be a lot more talking than doing in the arena of tax reform.

INDEX PERFORMANCE	Q1'14	YTD
Dow Jones Industrials	-0.16	-0.16
Standard & Poor's 500	1.80	1.80
EAFE (international stocks)	0.83	0.83
Russell 2000 (small stocks)	1.12	1.12
Barclays Interm. Gov/Credit	1.00	1.00
Barclays Municipal	3.32	3.32

INSIDE THIS ISSUE

TOP FIFTEEN HOLDINGS:

- iSHARES S&P SMALLCAP 600
- iSHARES MSCI EMERGING MARKETS
- INVESCO LTD.
- AMAZON.COM INC.
- DIAGEO PLC ADR
- QUALCOMM INC.
- UNITED PARCEL SERVICE
- AKAMAI TECHNOLOGIES
- ORACLE CORP.
- PAYCHEX INC.
- COSTCO WHOLESALE CORP.
- CHEVRON CORP.
- INGREDION INC.
- WALT DISNEY CO.
- VARIAN MEDICAL SYSTEMS

ECONOMIC OVERVIEW

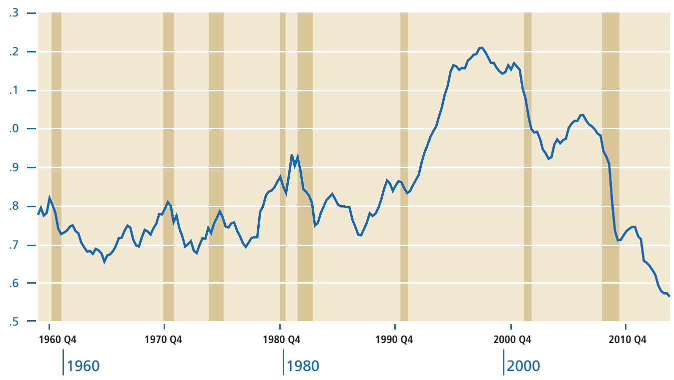
The Battle Between Skepticism and Optimism (cont'd)

The "Taper" started 12/18/13 when the now ex-Fed Chairman, Ben Bernanke, announced the initial reduction of the Federal Reserve's bond buying program, known as Quantitative Easing or QE, from $85 billion to $75 billion per month. In the midst of the Financial Crisis of 2008 the Fed lowered short-term rates effectively to 0%, thereby exhausting its traditional monetary stimulus tool. Bernanke had instituted QE in late 2008 to further stimulate economic growth. Buying longer-term mortgage-backed and US Treasury securities injected cash into the economy and reduced long-term interest rates. As a result, the Fed has accumulated over $4 trillion worth of bond holdings over the last five years.

On 1/29/14, the Bernanke Fed announced another QE cut, this time from $75 billion to $65 billion. Janet Yellen was sworn in as the next Chair of the Federal Reserve on 2/3/14. The Yellen Fed announced a further taper on 3/20/14, reducing monthly purchases from $65 billion to $55 billion. James Bullard, the President of the St. Louis Fed, said (in a notable understatement) that there is "ambiguity" about when the QE program will end: maybe October, possibly December, or even January, but clearly "the end is in sight." However, there has been no action taken to change interest rates.

Given this massive amount of monetary stimulus, the question is why the economy remains so lethargic. We think the lethargy is caused by the declining velocity of money. The best way to think about velocity of money is to imagine the US economy as a store that has an inventory of money. Sales ramp up when store inventory is "turned over" more frequently. The Fed has been successfully adding to inventory, but does not know how to increase the turnover or "sales" of that inventory. Nor does anyone else. So while the Fed is reducing QE, it is still keeping the interest rate pedal to the metal and short-term interest rates look to remain near 0% for the foreseeable future.

VELOCITY OF MONEY (Federal Reserve Economic Data – Federal Reserve Bank of St. Louis)



The statistics for the housing market indicate continued improvement. Yes, some homeowners are still underwater seven years after the housing bubble burst. But pricing continues to improve, with the Case-Schiller S&P Housing Index up over 13% in the last year. We think there will be continued improvement in 2014.

Lastly, we are seeing the beginnings of an IPO frenzy. There were 261 IPOs in 2013 that raised $70.5 billion, surpassing the high seen in 2007; we are on pace for a repeat in 2014. Certainly there will be some company stars that come out of this process, but we worry that there will be too many inexperienced management teams bringing out businesses that are "one-trick ponies" due to pressure from greedy investors. This results in a situation where a gullible public is being taken advantage of. That said, we are still a long way from a "dot.com" bubble.

Near term, as the markets continue to waft between skepticism and optimism, we will experience more trendless volatility. Longer term, we think that the march to prosperity will continue and optimism will rise while skepticism fades. This will be accompanied by an increase in the velocity of money, which in turn will drive a stronger economy and higher stock prices.

> "The markets seem to be bouncing between skepticism that the US economy can get out of low gear and optimism that economic acceleration is just around the corner."

IN THE NEWS

What is Bitcoin?

Bitcoin has been much in the news. But what is it and why has there been so much buzz? Bitcoin is a virtual currency that has left individuals, corporations and government regulators all scrambling to understand it and determine how to deal with it. At its core, Bitcoin (and other virtual currencies) are a form of electronic payment system. While other electronic payment systems exist, there are some key characteristics of virtual currencies that make them different:

Privacy: Clients can conduct transactions in a digital currency without divulging their identities. In this way, it is similar to cash. When someone uses a digital currency to purchase goods or services, there is no personal identifier attached to that payment. Other electronic payment systems, for example, credit cards, have names and addresses associated with them. Another system, Paypal, is linked to a bank account.

Open System: Anyone, anywhere, with access to the Internet, can conduct a transaction in a virtual currency. This eliminates the need for credit or an associated bank account. Someone can transfer money across international borders without requiring currency translation.

Decentralization: Virtual currencies are maintained by an Internet community and are not associated with traditional banks. This makes it extremely difficult to charge back or reverse a transaction once it has been initiated.

Detractors of virtual currencies have pointed out that these characteristics make it easy to use them for illegal activities. In the fall of 2013, the FBI shut down an online black market called "Silk Road" and seized Bitcoins valued at $28.5 million.

Bitcoin is the most recognized virtual currency. It is a "crypto-currency" which means that it uses cryptography to securely control the transfer and creation of money. Like most virtual currencies, Bitcoin has to keep fraud out of the system so that participants can be assured that value is being transferred. To do this, Bitcoin network participants electronically generate a public ledger that verifies and records historical transactions. The incentive to validate this historical ledger for "data miners" is the creation of newly minted Bitcoins as compensation. "Mining" aims to legitimize the ownership of each Bitcoin.

Bitcoin can be exchanged from or into traditional currencies, such as US dollars or Euros, using exchange services. Mt. Gox was a Bitcoin exchange service located in Japan that once handled 70% of all Bitcoin transactions. It announced in February that 850,000 Bitcoins (since reduced to 650,000) belonging to clients had been stolen. This highlights the greatest risk of electronic payment systems: value can be electronically "stolen" by hackers.

Despite setbacks like Mt. Gox's bankruptcy filing and the IRS ruling that Bitcoins will be treated as an asset, the attractive features of virtual currencies continue to garner investments from venture capitalists. The VCs believe that virtual currencies are in the very early stages of a dramatic change in how payments will be made in the future.

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.

ASSET MANAGEMENT

First Quarter Portfolio Changes

Last year's impressive stock market rally came to a halt in January, as the markets were down 5% that month, but then renewed its vigor in February before hitting news highs in March. Toward the end of the quarter, the markets seemed to be taking a breather. For the quarter, the S&P 500 returned 1.8%. Within the S&P 500, the strongest performing sectors were utilities and healthcare, up 10.1% and 5.8%, respectively. The strong performance from healthcare was a surprise, as we believe pharmaceutical and health insurance companies' operating margins will get squeezed by the new health care laws. (Please see article on page 6.) The worst-performing sectors were consumer discretionary and telecom, down 2.80% and up 0.5%, respectively.

For our Nelson Roberts portfolios, the best-performing names came from the technology sector. Akamai Technologies (tkr: AKAM), a company that optimizes Internet traffic, and Cavium (tkr: CAVM), a semiconductor developer, were both up more than 20%. The names that performed most poorly in our portfolios were Rackspace (tkr: RAX) and Amazon (tkr: AMZN), both down about 15%. We bought Rackspace because we believed that the company's high service, hybrid approach to cloud hosting would differentiate it in the marketplace. However, the marketplace appears to be more interested in cloud hosting at the lowest price, at least for now. Amazon seemed to suffer mainly from the speculation that it would raise its annual fee for Prime membership (which it did, from $79 to $99) and should recover.

In February, we trimmed our Verizon Communications (tkr: VZ) position due to concern that high dividend stocks will underperform as bond yields rise. At the beginning of March, we sold our holdings of Adobe Systems (tkr: ADBE), which we had owned since April 2008. Adobe has been a great stock for us, but with the stock trading at 80 times earnings, we felt that its valuation had reached a higher level than we were comfortable with.

At the end of March, we sold our position in Expeditors International (tkr: EXPD) as ocean shipping rates continued to slide. Price declines hurt EXPD's profitability and pricing is unlikely to recover in the face the muted global outlook, especially in Asia.

We used the proceeds to add to our United Parcel Service (tkr: UPS) position. UPS stumbled over the Christmas holidays, as orders placed 1-3 days before Christmas significantly exceeded management's expectations, resulting in late packages and customer disappointment. The delivery debacle cost the company $20 million in refunds and overtime expenses. We think UPS is generally a very well-managed company and therefore its leadership will learn from this experience. There has already been some discussion about both logistics and pricing changes to better manage future holiday seasons.

Our exposure to emerging and international markets was a drag on performance, as those geographies continue to underperform US markets. We ended the quarter with 7% cash, which is higher than our target. We have identified several companies that we would like to own, but are being patient and waiting for lower price points.

Despite the market rally, investors have long memories and remain torn between skepticism and optimism: skepticism because 2008 is still fresh in their minds, optimism because most indicators are turning for the better. We believe that the record level of cash on corporate balance sheets and the increasing level of merger and acquisition activity this year will prove positive for the markets in 2014.

FIRM UPDATES

Nelson Roberts Investment Advisors is pleased to welcome two new staff members. Evan Nelson began work as a relationship manager's assistant in March. He most recently was an outside sales manager in the commercial industrial construction industry and brings a strong background in sales and marketing. Evan is a graduate of USC, and enjoys running, hiking, basketball and cooking in his free time.

Darcy Nelson joined Nelson Roberts in April as a research analyst. She has gained extensive experience in equity analysis and securities trading through her work first for Bloomberg LP in New York City, and more recently in her position as an equity sales trader at Susquehanna International Group in San Francisco. She serves on the board of the San Francisco Security Traders Association. Darcy participates regularly in Bay area triathlons and is a graduate of Swarthmore College.

FEATURED EQUITY

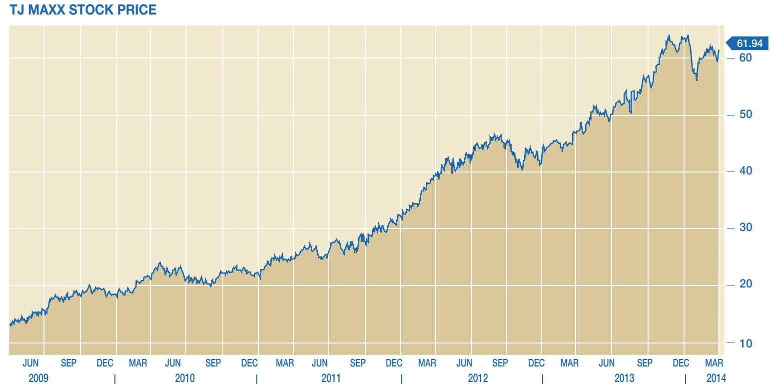
T. J. Maxx

T. J. Maxx (tkr: TJX) is the leading off-price retailer of clothing and home décor in the US and worldwide. The company is ranked #115 in the most recent Fortune 500 listings. In 2013, TJX reported revenues of over $27 billion and earnings per share grew 15%.

TJX operates more than 3,000 stores in six countries (soon to be seven) and employs about 180,000 people. The company has four divisions: The Marmaxx Group (T.J. Maxx and Marshalls) and HomeGoods in the US; TJX Canada (Winners, HomeSense and Marshalls); TJX Europe (T. K. Maxx and HomeSense); and Sierra Trading Post, an off-price Internet retailer.

The company's mission is "to deliver a rapidly changing assortment of fashionable, quality, brand name and designer merchandise at prices generally 20-60% below department and specialty store regular prices, every day." Management and staff characterize the experience of shopping at a T.J. Maxx store as a "treasure hunt" because customers never know exactly what they might find. TJX sources merchandise from over 16,000 vendors in more than 60 countries. The company has a proprietary inventory management system that allows it to track and turn inventory much more rapidly than a typical retail store.

TJX MAXX STOCK PRICE



TJX was founded in 1919, when Max and Morris Feldberg started the New England Trading Company in Boston, MA. The company grew over the next 40 years and by the 1950s, had metamorphosed into the Zayre's discount department chain. In the 1970s, the company became T. J. Maxx, a new-concept, off-price chain.

TJX has delivered steady sales and earnings growth in the 36 years since then, with only one year of comparable stores sales decline. The company is remarkably flexible for one of its size and has been successful through many business cycles. One of the interesting features of the stores is that they have no walls. This allows individual store management to expand and contract inventory to respond to the market and customers' changing tastes.

The company is currently headed by CEO Carol Meyrowitz, a savvy and articulate leader with good experience in the business. During the February, 2014, earnings conference call, she said "We begin our new fiscal year in an excellent position to pursue our near- and long-term opportunities. ….we continue to see tremendous global growth potential for TJX."

INVESTMENT TEAM

Steve Philpott, CFP®, MBA

Brian Roberts, CFA, MBA

Ann Oglesby, MD, MBA

Brooks Nelson, CFA

INVESTMENT THEMES

Why We Are Not Piling into Healthcare Stocks

Health care as a sector has outperformed the market during the last year. In 2013, the sector grew 39%, driven by increased health care spending, new drug launches and a pick-up in the pace of merger and acquisition activity. Earnings have also been strong, with 86% of companies reporting above-consensus numbers.

A recent estimate by the Centers for Medicare and Medicaid Services (CMS) projects that aggregate health care spending in the US will grow at an average annual rate of 5.8% for 2012-2022, or 1% faster than the projected growth for GDP (which would put GDP growth at 4.8%, a remarkably optimistic number…). By 2022, health care is expected to be 19.9% of the GDP, versus its current level of 17.9%.

On the other hand, 2013 growth in health care spending came in at about 4%, significantly under projections, because of slower growth in Medicare/Medicaid spending, substantial increases in cost-sharing requirements for privately insured consumers and the “sluggish” economic recovery.

The Affordable Care Act (ACA) requires that everyone in the US be covered by health insurance or pay a penalty, although this requirement has been a moving target. The popular thesis has been that this will drive millions of additional people into the health care system who previously did not have access to care, thereby substantially increasing health dollars spent. The other force driving overall health care spending is, of course, the aging population.

Our view is that the anticipated growth in overall health spending is unsustainable. Health care simply cannot continue to consume a greater and greater percentage of GDP without consequences. We are already seeing indicators that support this: the newly-insured have been enrolled in plans with very narrow provider networks and limited drug formularies. Health insurers are steadily ratcheting down the amount of money they pay providers. Pharmacy benefits managers are striking tougher deals with pharmaceutical companies. There are regular outcries about the annual cost of new drugs (sometimes $80-100,000/year). And for-profit radiation therapy centers are going out of business. To us, this means that it is going to be harder and harder for companies in the health care sector to grow at the rate the market expects. Health care insurers themselves face uncertainty because the ACA allows only the bare minimum of underwriting (age and gender). This will make it hard for them to price their products appropriately and profitably. There are already rumblings about substantial premium increases next year as more older, sicker patients have signed up for insurance compared to the number of younger, healthier new enrollees.

We will continue to look carefully at individual health care stocks and buy in the sector selectively. But we still think that we are early, not wrong, about the overall direction of the sector.

NELSON ROBERTS
INVESTMENT ADVISORS

1950 University Avenue, Suite 202
East Palo Alto, CA 94303
tel 650-322-4000
web www.nelsonroberts.com
email invest@nelsonroberts.com