NELSON ROBERTS QUARTERLY COMMENTARY

2014 | SECOND QUARTER

ECONOMIC OVERVIEW

Climbing a Wall of Worry

The markets are stuck in a state of emotionless malaise. Since the January drop, the stock market has ground steadily higher. News, whether positive or negative, seems to have little impact. There are no signs of euphoria, but rather an increasing level of concern that the inexorable rise in asset prices, especially stocks, portends a coming bubble.

This investor concern and the concomitant rise in prices bear out the old adage that "the market is climbing a wall of worry." Paradoxically, as long as the worry remains, the general trend toward higher stock prices is likely to continue. There are legitimate things to be worried about. The market no longer appears to be undervalued. At 18 times earnings, prices are well above the March 2009 lows of 11 times.

Volatility has waned. The VIX index, a measure of volatility, has been dropping for five years, with the exception of notable spikes in the spring of 2010 during the "PIIGS crisis" and the summer of 2011 when the US Government was technically in default and suffered a credit downgrade (see chart on page 2). The VIX has reached the historically low levels that have coincided with previous market tops. Market news has been minimal and does not seem to affect volatility. Mergers and acquisitions are picking up, but bank lending is soft even though interest rates have been falling. The yield on the benchmark 10-year US Treasury note has declined from 3% at the beginning of the year to 2.5%.

Inflation, as measured by the Consumer Price Index or the Personal Consumption Expenditures data, continues to be quite low. Economic growth remains sluggish. The latest revision to the first quarter report showed a 2.9% decline from the fourth quarter of 2013. The economic growth that is occurring is mainly concentrated on the coasts. Asset gains are largely benefitting the wealthy and the middle class is having a harder and harder time garnering real income gains. Meanwhile, the tax increases enacted at the end of 2012 are bringing in higher revenues for the US and a number of states, including California.

The global economy is in much the same state. Europe has had a weak economic recovery, inflation is very low and banks are sitting on reserves that are begging to be lent. To stimulate lending, the European Central Bank (ECB) recently declared that it had set interest rates below 0%. While at first this conceptually makes no sense, what the ECB said was that instead of paying banks a low rate of

INDEX PERFORMANCE	Q2'14	YTD
Dow Jones Industrials	2.83	2.67
Standard & Poor's 500	5.22	7.12
EAFE (international stocks)	4.31	5.22
Russell 2000 (small stocks)	2.04	3.18
Barclays Interm. Gov/Credit	1.23	2.25
Barclays Municipal	2.60	6.00

INSIDE THIS ISSUE

TOP FIFTEEN HOLDINGS:

- iSHARES MSCI EMERGING MARKETS
- iSHARES S&P SMALLCAP 600
- INVESCO LTD.
- DIAGEO PLC ADR
- UNITED PARCEL SERVICE
- AMAZON.COM INC.
- QUALCOMM INC.
- TJX COS INC.
- AKAMAI TECHNOLOGIES
- WW GRAINGER INC.
- CHEVRON CORP.
- COSTCO WHOLESALE CORP.
- ORACLE CORP.
- PAYCHEX INC.
- SCHLUMBERGER LTD.

ECONOMIC OVERVIEW

Climbing a Wall of Worry (cont'd)

interest on the excess funds that they deposit with the ECB, it was now going to charge a fee for any capital that banks keep on deposit. Banks love to charge fees, but hate to pay them, so the idea is that this will stimulate lending. We are skeptical.

Do you remember the talk of Financial Armageddon in the European Union in the spring of 2010? There was much concern over the Euro splitting up and the "Grexit," with many observers expecting that Greece would go off the Euro. Today, Portugal, Italy, Ireland, Greece and Spain are no longer the "PIIGS." The yield on a Spanish 10-year bond, which was 8% above US Treasury yields, has now dropped below the 2.6% yield on 10-year US Treasuries. This is a major change in outlook.

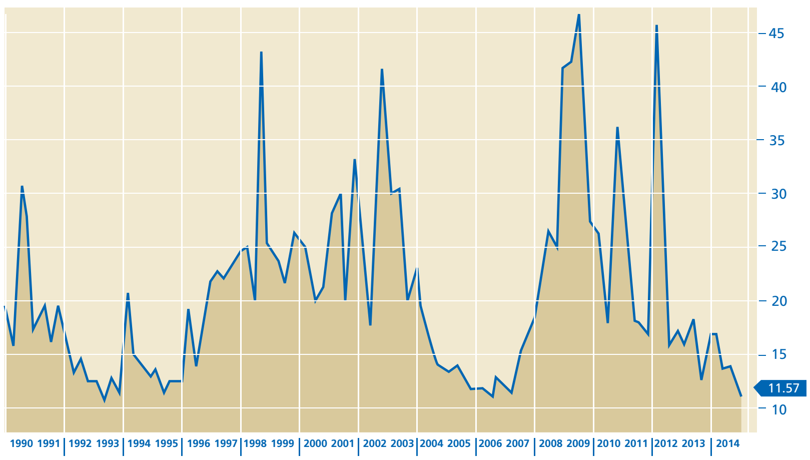
The global search for yield has investors buying up any bonds that pay above average interest, regardless of the risk of default. The "spread" (or difference) between the highest-rated bonds such as AAA-rated US Treasuries, and junkier debt, has narrowed significantly.

Emerging market economies are suffering. Brazil, Russia, India and China (the BRICs) are all weak for various reasons. Brazil is suffering from labor unrest while China's economy is slowing and government tinkering is not having much of an effect. Russia is embroiled in a mess of its own making in Ukraine, but it is still a mess.

With no meaningful catalysts on the horizon that might cause a downturn in the economy, the US Federal Reserve has indicated that it plans to steadily reduce stimulus. The markets are assuming that the Yellen-led Fed will cut Quantitative Easing (QE) by $10 billion every time the group meets. If this occurs, QE will be a thing of the past by year-end.

Barring an unforeseen exogenous event, we expect the stock market to continue to drift slowly higher and bonds to offer little in the way of real return as rates stay historically low. We will continue to be broadly diversified in our stock selection, focusing on strong companies with wide moats (unique advantages compared to competitors). Stocks selected for our portfolios must also be able to produce real earnings growth, as further gains in stock prices are not likely to come from higher valuations.

VIX 1990-PRESENT



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ASSET MANAGEMENT

A Busy Quarter

We had an unusually active quarter on the trading desk of Nelson Roberts Investment Advisors. The rise in the market created opportunities for employing some interesting strategies in our portfolios.

We continuously monitor both the progress of the companies held in our portfolios as well as their values relative to their closest competitors. We identified a gap in relative value between Fastenal and its main competitor, WW Grainger, that was large enough to warrant a swap in the two positions, so we exited a profitable investment in Fastenal for a position of similar size in Grainger. We believe that Grainger, with its lower valuation metrics, provides a greater upside for investors.

We initiated a new position in White Wave Foods. (See Featured Equity article on page 5.) It was already clear to us back in 2006 that organic or sustainably-produced food was a coming trend. We observed then that Horizon organic milk was popping up in traditional grocery stores. Our research showed that Horizon was owned by a much larger food company, Dean Foods. In 2012, Dean Foods spun out White Wave and we concluded that this now pure play in plant-based foods and premium organic dairy products was a good investment opportunity.

We swapped Lindsay, a provider of irrigation equipment and transportation barriers for Masco, a company with exposure to the home remodel and renovation market. Masco manufactures, distributes and installs home improvement and building products, including faucets, cabinets, architectural coatings and windows. Its brands include Delta, Brizo and Hansgrohe faucets, Behr paint and primers and Milgard windows. We think the housing recovery is far enough along for this change to be a good one.

A concerning earnings announcement from Dick's Sporting Goods drove our sale of this position. Approximately 30% of Dick's revenues are generated from their golf and hunting divisions. Golf in particular is suffering from what is likely to be a long, and perhaps permanent, downward trend as fewer young people take up the game. We used the proceeds to add to our position in TJ Maxx. TJ Maxx has been a very successful long-term holding for us, and we think that their Home Goods outlets and international expansion will continue to drive healthy growth.

Our final sale of the quarter was Ingredion. After languishing in a trading range for a year, the stock price broke out above $75/share. We took advantage of the move as we believed that their prospects were dimming in the face of the decline in soft drink consumption.

Lastly, we initiated a position in Celgene. Celgene is a biopharmaceutical company focused on developing, acquiring and marketing drugs for treatment of cancer and immune/inflammatory disease. The company's growth to date has been driven by its multiple myeloma drug, Revlimid. This market is expected to double to $15 billion by 2017. Celgene has leveraged its success with Revlimid and expanded its portfolio of drugs to include new treatments for psoriatic arthritis and pancreatic cancer, among others.

In total, we reduced our equity cash position by 1.5%. We continue to believe that there are companies with strong, consistent earnings that are using the lower interest rate environment to grow their businesses and those are the ones we want in our portfolios.

vision *[vizh' en] n. the ability to perceive or foresee through mental acuteness*

WHAT IS MONEY?

At its simplest, it remains a form of barter, an exchange of energy for goods. At its most complex, it's a symbol of mastery, a measure of power. At its center are people with vision, talent, skill, families, children, hope and dreams.

UNDERSTANDING INVESTING

What is a Stock Split Worth?

The mathematical answer is "zero." A stock split is a non-economic event that typically increases the number of shares in a public company and lowers the stock price by the same factor. After a split, the company's market capitalization, or the value of the equity in the company, remains the same. It is just like exchanging a $100 bill for five $20 bills. At the end of the day, you still have $100.

Market observers often claim that stock splits lead to higher stock prices. Although splits do not increase shareholder value, they can and often do create a psychological shift. If a stock is trading at $200/share, people think it is expensive. If the company institutes a 4:1 split and the stock now trades at $50/share, people think it is "cheaper." This effect can cause greater demand from retail investors which then drives the stock price higher. In contrast, institutional investors typically are not price-sensitive and do not care whether the stock price is $200 or $50/share. Their main concern is valuation, not price.

Also, increasing the number of shares outstanding can result in greater liquidity for the stock. This in turn makes trading easier and may narrow the bid-ask spread. (The bid-ask spread is the difference between the highest price a buyer will pay and the lowest price at which a seller will sell.) An investor can accumulate a large block of shares over time if companies split again and again. Here is a real-world example: if an investor had bought 100 shares of Wal-Mart when it first went public in 1970, then held on for the next 30 years, that individual would then own over 200,000 shares. Why? Because the stock split 2 for 1 eleven times during that period.

Recently, two of the biggest companies in the S&P 500, Google and Apple, announced stock splits, but for different reasons.

In June, Apple announced a 7 for 1 split. This was Apple's first split since 2005. As a result of the split, the price per share was adjusted from $650 to $92. Apple described its rationale for the split by stating that it wanted its stock to be more accessible to a larger number of investors. This follows the theory that more investors would be willing to buy shares of Apple at a lower price. And, in fact, the stock price jumped after the split announcement.

Google completed a 2 for 1 stock split in April. At the time, the stock was trading at over $1,000/share, but the company did not split the shares to make them more affordable for investors. Instead, management issued a new class of stock to existing shareholders in order to retain control and voting rights over the company. The new class of shares has no voting rights. In other words, the reason for the stock split was to solidify the founders' control of the company by diminishing future shareholders' voting power. What used to trade as GOOG is now GOOGL and the new non-voting shares trade under the old ticker of GOOG.

Warren Buffett has avoided splitting shares of Berkshire Hathaway. The Class A shares now trade at over $190,000/share. Mr. Buffett's logic has been that trying to game the market by doing stock splits attracts the wrong type of investor. By keeping the stock price high, he believes that long-term investors will buy while traders and speculators will not.

FIRM UPDATES

Nelson Roberts was delighted to be the first-ever presenting sponsor of the "Are you IN Run for Education" on June 1, 2014. This long-standing fundraiser, dating back eighteen years, attracted 1,500 registered runners to a 5K course that wound through Menlo Park. There was also a Family Fun Run. We are pleased to report that the event raised over $100,000 for our local school district. The Nelson Roberts family was well-represented at the race, with twelve runners. Evan Nelson and Tyler Brown finished in the top six for the entire field.

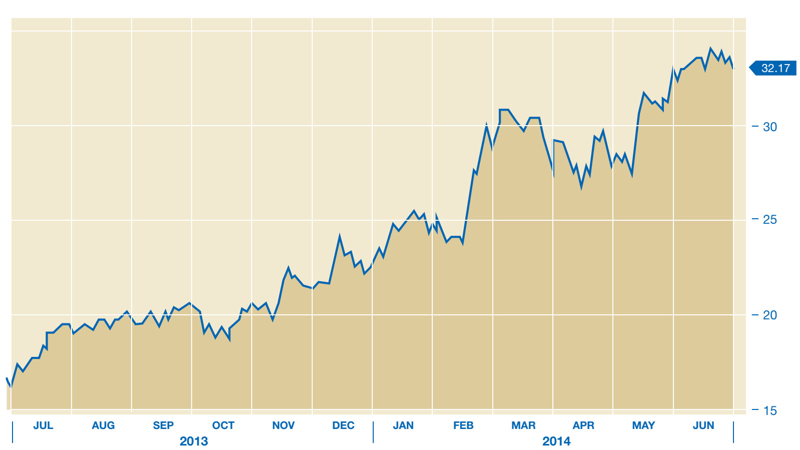
FEATURED EQUITY

White Wave Foods

White Wave Foods' mission is "to create a food and beverage company that combines the entrepreneurship, spirit, principles, and practices of small food companies with the professionalism, resources, and scale of large food companies." The company, based in Denver, CO, employs almost 4,000 people and was spun off from Dean Foods in the fall of 2012. White Wave Foods (tkr: WWAV) focuses now on the manufacture, marketing and sales of plant-based foods, beverages and dairy products. Brands include plant-based milk substitutes Silk and International Delight, Land o'Lakes, Horizon organic dairy products and European brand Alpro. In January of 2014, WWAV bought Earthbound Farms for $600M, launching itself into the prepackaged organic market for salad, fruits and vegetables. WWAV is also in the coffee creamer business and believes that this is another growth area, as more people are drinking their coffee with flavored creams.

The growth of the organic food sector is substantially outpacing the growth of the overall food and beverage industry. Consumers are looking for healthier choices and White Wave is in a great position to provide those products. WWAV sells to grocery stores, mass merchandisers, club stores, convenience stores and health food stores, as well as restaurants and food service outlets. Approximately 17% of revenues come from Europe and the company recently announced that it has formed a joint venture with China's Mengdiu Dairy Company to manufacture and distribute products in China beginning later in 2014.

WWAV 6/26/13 -6/26/14



WWAV is pursuing a dual growth strategy: aggressively expanding its present product lines and adding new ones through acquisition, such as Earthbound Farms. The company believes, and we agree, that Americans and Europeans are in the process of permanently changing their eating habits, both in terms of what they consume (less fat and cholesterol) and the source of the food (organic instead of traditional). We like WWAV because it fits the old adage of "doing well by doing good."

INVESTMENT TEAM

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IN THE NEWS

High-Frequency Trading

Ever since Michael Lewis appeared on “60 Minutes” and declared that stock markets are “rigged,” hardly a day has gone by without a new headline on high-frequency trading (HFT). Lewis’ new book, *Flash Boys*, alleges that HFT firms “rip off” buyside investors. Many commentators have countered that HFT lowers overall transaction costs by providing liquidity to the market. In our opinion, both of these views are correct.

Transaction costs paid to brokers are made up of two main components: commissions and the bid-ask spread. The bid-ask spread is the difference between the ask price (price offered by a seller) and the bid price (price a buyer is willing to pay).

HFT firms are a relatively new phenomenon, born out of technological advances in electronic trading. In a nutshell, these “flash traders” use complex algorithms to trade between the bid-ask spread just slightly ahead of other investors, skimming off a tiny percentage from each trade in the process. A typical HFT firm will establish real estate in or near the exchange data centers, shortening the actual distance the data has to travel, thereby shaving additional microseconds off of the time it takes the HFT firm to receive market data. This all takes place within a fraction of an eye blink, and is repeated hundreds of thousands of time per day.

The problem thus far has been a complete lack of transparency in the “dark pools,” private trading forums where HFT firms operate. An investigation by the SEC is underway to determine whether these HFT strategies qualify as “front-running”, an illegal practice that entails trading ahead on advance knowledge of customer orders.

Regardless of what the SEC decides, we at NRIA do not see HFT as cause for alarm. Although we believe that predatory HFT should be considered front-running, we acknowledge that these trades contribute to overall liquidity, which in turn lowers bid-ask spreads. Furthermore, it is unlikely that our orders are impacted by HFT, given the relative size of Nelson Roberts trades compared to overall trade volume. Finally, the total transaction cost today is about one-twentieth of what it was thirty years ago, indicating that markets are more investor-friendly than ever. In any case, we will continue to stay in front of these issues and strive to ensure best execution for our clients’ trades.

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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