NELSON ROBERTS QUARTERLY COMMENTARY

2014 | THIRD QUARTER

ECONOMIC OVERVIEW

Maturing in Optimism

Some say the stock market is getting long in the tooth. Valuations are high, especially in sectors like social media and biotech. A recent Wall Street Journal article reported that several prominent forecasters, who have long been predicting a coming bear market, have recently capitulated. This bull market has steadily marched higher (albeit with the occasional short decline) for more than five years.

Our title is not offering life advice that one should age cheerfully, but rather refers to the third part of the Sir John Templeton quote that we have referenced several times over the last five years. He said that "bull markets are born in pessimism, develop in skepticism, mature in optimism, and die in euphoria." From the bottom in March 2009 through 2011, investors were pessimistic. Recall the "Grexit," when the world thought Greece would default then exit the Euro or the US technical default in the summer of 2011 which resulted in the first credit rating downgrade from AAA since the advent of the modern system of credit ratings.

In 2012 and 2013, markets became skeptical. Unemployment stayed well above 6%, deflationary fears were rampant and yet stocks rose. This skepticism was still in evidence through mid-2013 when we experienced the "taper tantrum" and longer-term interest rates began to rise. In May of last year, the Federal Reserve first indicated that it would begin reducing Quantitative Easing (QE) and 10-year US Treasury note yields subsequently nearly doubled from 1.6% to 3.0% at year-end. Meanwhile, the stock market traded sideways for 90 days, then resumed its climb to a new high.

This year, skepticism has been waning as investors have turned more optimistic. Economic growth has been robust, with the most recent quarterly reports showing a 4.6% gain. Housing starts and home prices have been rising in most markets, especially the Bay Area. While the data on new jobs has been decidedly mixed, the stock market has moved steadily upwards, except for brief declines in January and July.

QE, the bond-buying program which the Fed has used to stimulate the economy, will end completely in October. Janet Yellen, Federal Reserve Chair, has said that the Fed will keep short term interest rates at current levels for a prolonged period of time. The yield on the 10-year note has declined from 3.0% at the end of 2013 to 2.35% by August, 2014. Since then, it has risen, as bond buyers anticipate the end of QE and look to riskier instruments in a search for yield. These higher rates and the robust economic reports have incentivized foreign investors to move funds to the US. As a consequence, the dollar has been rising.

INDEX PERFORMANCE	Q3'14	YTD
Dow Jones Industrials	1.87	4.58
Standard & Poor's 500	1.13	8.33
EAFE (international stocks)	-5.73	4.80
Russell 2000 (small stocks)	-7.35	-4.40
Barclays Interm. Gov/Credit	-0.02	2.22
Barclays Municipal	1.49	7.58

INSIDE THIS ISSUE

TOP FIFTEEN HOLDINGS:

SCHLUMBERGER LTD.
iSHARES MSCI EMERGING MARKET ETF
WHITEWAVE FOODS CO.
INVESCO LTD.
iSHARES S&P SMALLCAP 600 INDEX
TJX COMPANIES INC.
AMAZON.COM INC.
COSTCO WHOLESALE CORP.
UNITED PARCEL SERVICE
DIAGEO PLC ADR
QUALCOMM INC.
THE WALT DISNEY COMPANY
W.W. GRAINGER, INC.
AKAMAI TECHNOLOGIES
PAYCHEX INC.

ECONOMIC OVERVIEW

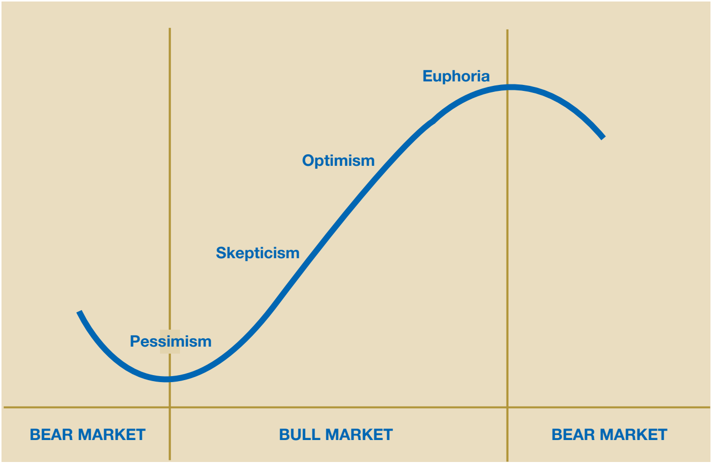
Maturing in Optimism (cont'd)

This fall, we will see the results of the mid-term elections. Right now, the odds look to be in favor of the Republicans winning majorities in both the House and the Senate. If this occurs, we expect little will get done in Washington over the next two years. Political cooperation, already an elusive approach, will likely hit new lows. Meanwhile, the "wealth gap" continues to widen. In the US, a small minority has benefited from the rise in asset prices. The rest of the population will need wage gains to catch up. With unemployment hovering at 6%, this is unlikely to happen soon.

Outside the US, economic growth is tepid at best and is slowing in many places. Europe is teetering on the brink of deflation, with Germany and France both sluggish. Growth in China, if we can believe the official state statistical reports, is also slowing. Military conflicts in the Ukraine, Syria, Iraq, and Israel are human tragedies, but are not likely to expand further and should therefore not materially affect world markets.

Economic disruptions due to new technologies have been accelerating over the last twenty years. The advent of email in the 1990's changed communication. Ten years ago, search engines altered the way we find information. The advertising revenue model that Google pioneered has spread broadly into social media. As a result, the way we acquire many goods and services is now completely different. We think the future will bring even more changes. For example: electric cars? Hydrogen fuel cell cars? Magnetic levitation trains? Delivery by drones? Some or all of these will change the face of transportation. But these types of changes are part of the creative destruction process that makes capitalism in the US so dynamic, enabling us stay at the forefront of the world economy.

So whither go the markets? Bonds will be challenged by the absence of QE and the absolutely inevitable rise in interest rates. It is hard to make money investing in bonds when the difference between yields and inflation is near zero. We think stocks have further to go; however, they will not rise in a straight line. When the Yellen Fed first increases the Federal funds rate, we expect the stock market to fall sharply initially. After a 10 to 15% drop, the stock market will wake up to the fact that the reason for the rate increases is higher economic activity. This eventually brings higher earnings and stock prices. We think this Fed-driven reaction will precede the eventual euphoria-driven top, which may be years in the future. Accurately predicting when this will occur is impossible. In the meantime, we recommend all clients have enough ready cash to weather the volatility that is likely to ensue.



> "It is hard to make money investing in bonds when the difference between yields and inflation is near zero. We think stocks have further to go; however, they will not rise in a straight line."

ASSET MANAGEMENT

Being Picky

As the market continued its general trend upward over the third quarter, we were able to pick spots and find opportunities to add value.

Last quarter, we bought WhiteWave Foods, a maker of organic milk as well as plant-based milk alternatives. Although we kept uncovering new confirming data supporting our buy, the stock seemed stuck around the $30 level, stalled by an overall market pullback in July. We decided to take advantage of the stall and add to our WhiteWave position. We did this before WhiteWave's earnings announcement, which was a significant positive catalyst for the stock, as the company presented excellent quarterly results. Since then, the stock saw yet another boost when General Mills announced that it was buying organic food producer peer Annie's at a 37% premium.

Time Warner (see Featured Equity article on page 5) follows our theme of owning content providers, which we believe should benefit as content distribution methods proliferate. We originally considered buying Time Warner about July 10. We compared it to other content providers and noted that not only was Time Warner trading at a lower valuation but it also had a higher dividend yield. Before we could buy it, Fox announced a bid worth $80 billion, sending the stock up nearly 20%. We decided that rather than chase Time Warner at the new, higher valuation, we would remain patient and wait for a better entry point. That point came a month later when Fox dropped its bid and Time Warner came down to the price at which we had initially considered it.

We decided to sell Nucor, given the chronic challenges that the steel industry faces. Global steel production overcapacity and illegal dumping of foreign-made steel into US markets are affecting the entire steel industry. Even though Nucor is a very well-run company, it is not immune to these forces and we felt it unlikely that its stock could outperform. In place of Nucor, we purchased Methanex, the world's leading producer and marketer of methanol. Methanol is a liquid chemical produced from natural gas that is used in the manufacture of other chemicals, such as formaldehyde, or as a gasoline additive as part of the "fuel blending" process. The demand for methanol is strong and growing, the input (natural gas) is very cheap, and the company has established 10-year contracts to guarantee supply. Management and financials are both sound.

Oracle has been part of our portfolios for many years. We decided to trim our position in favor of Salesforce.com. In the ~$20 billion customer resource management (CRM) market, Salesforce has successfully taken market share from the bigger, more established players, Oracle and SAP. Salesforce has been able to do this through its Software-as-a-Service (SaaS) model, which offers a flexible, subscription-based model rather than the big upfront investment required by traditional on-premise solutions like Oracle's. However, we believe the next wave of Salesforce's success will depend on their expansion into the Platform-as-a-Service (PaaS) market. The company has already started this expansion, with the acquisition of Heroku as well as the development of their own Salesforce1 product.

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.

WEALTH MANAGEMENT

Tax Law Changes This Year? A Definite "Maybe"

It is unlikely that we will see any major tax reforms coming from Congress in the near future, given the current state of political gridlock and dysfunction. However, there are a few individual tax measures that could be voted on before year-end and a recent tax change made by the Treasury regarding corporate inversions that we are watching with interest.

1. **Qualified Charitable Distributions from an IRA** — this was a temporary tax provision created by the Pension Protection Act of 2006 that allows required minimum distributions (RMD's) to be taken tax-free as long as the money is paid directly to a qualified charity. If you are giving money to a charity anyway and are over the income limit for itemizing charitable deductions, this is a good way to do it. The provision applies to IRA owners or beneficiaries who are age 70 ½ or older at the time of the distribution and is capped at $100,000 per person per year. This provision expired after December 31, 2013, but is in line to be renewed. Earlier this year, the Senate failed to vote on a package of expired tax provisions that included this extension. In prior years, Congress has waited until December to reinstate this rule, also making it retroactive to the beginning of the year.

2. **Roth IRA** — two proposals in President Obama's 2015 budget, if approved, would change the rules for how Roth IRA distributions can be taken. Currently, the owner of a Roth IRA is NOT required to take distributions at age 70 ½ (unlike a traditional IRA), so the money can sit untouched and grow tax-free throughout the owner's lifetime. Roth IRA's can be passed to beneficiaries who are then required to take tax-free distributions. Those distributions can be stretched over the beneficiary's lifetime, making a Roth IRA a powerful estate planning savings tool. If passed, President Obama's proposal would require owners of Roth IRA's to take distributions at 70 ½ and non-spousal beneficiaries would be required to distribute the entire amount within five years of the owner's death. These changes could reduce the estate planning benefits of converting traditional IRA's to Roth IRA's.

3. **Tax Inversions** — the Treasury Department recently tightened tax rules to discourage US companies from moving their headquarters to other countries in order to lower their tax payments. A typical inversion deal involves a US company buying a smaller international company, then moving its headquarters to the country with a lower tax rate but keeping its offices and operations in the US. The new law should slow the number of inversion deals, but companies will most likely find ways to get around the rules in the future. Congress tried to slow inversions in 2004 by passing a law prohibiting companies from moving their headquarters to the Caribbean islands, but said moves to other countries were legal. Companies may challenge the Treasury's new rules based on this old tax law. We think the new rules will slow mergers and acquisitions in the short-term and reverse the inflow of cash into sectors like healthcare, which have seen a spike in recent deals. The increase in inversion deals highlights the issue with US corporate tax rates, which are too high and have too many loopholes. In order to truly correct the problem and keep US corporations competitive, comprehensive corporate tax reform is needed.

"Whenever Wall Street comes up with a hot new product, Main Street gets stuck with a bill. That happened with the dot com mania that inflated and then destroyed stock prices, and with the junk mortgages that inflated and then helped tank the economy. And it's starting to happen with Wall Street's newest favorite product: corporate inversions."

— Allan Sloan, *Fortune* columnist

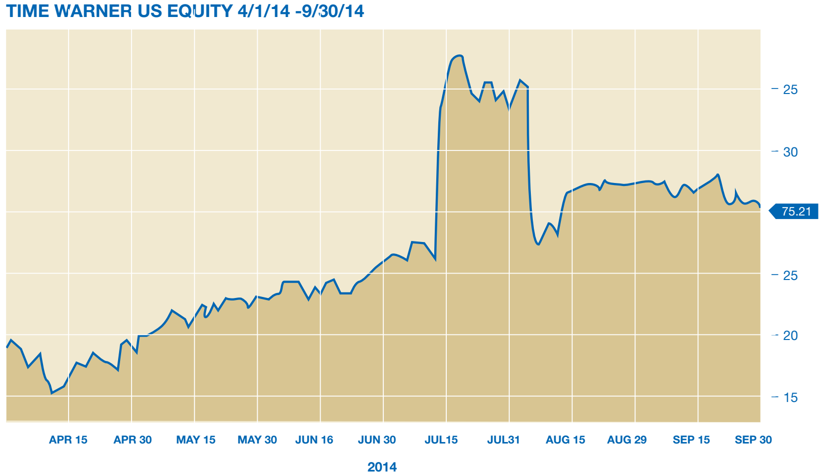
FEATURED EQUITY

Time Warner

Time Warner (tkr: TWX) wants to be "the world's leading storytelling company." It is well-positioned to continue to produce content which can be delivered through multiple devices in multiple locations to people all over the world. Following the June, 2014, spin-off of Time, Inc., TWX's print publishing division, the company now has three business segments:

1. **Turner:** cable networks and digital media properties (mainly websites). Turner generates revenue by providing programming to cable system operators, satellite service distributors, telephone companies and other distributors (affiliates). Turner's strong brands and focus on popular, high-quality programming in sports, original and syndicated series, news, movies and animation, are driving revenue growth.
2. **Home Box Office (HBO):** premium pay television services domestically and premium pay and basic tier television services internationally. HBO had 127 million worldwide subscribers at the end of 2013, 43 million of whom are domestic and 84 million international. In the last several years, HBO has become recognized for its award-winning and critically-acclaimed original dramatic and comedy series, as well as movies, boxing matches, family programming and documentaries.

TIME WARNER US EQUITY 4/1/14 -9/30/14



3. **Warner Bros.:** feature films produced under the Warner Bros. Pictures and New Line Cinema labels. The feature film strategy focuses on offering a mix of genres, talent and budgets that includes several "event" films and leveraging franchises. Warner Bros. has the rights to over 6,000 films in its film library. This division also licenses rights to various characters to publishers, retailers, theme park operators, etc.

The portfolio of cable networks (including HBO) generates more than 70% of cash flow. Warner Bros. brings in 20%.

TWX's main competition comes from Disney, Fox and Viacom. We believe that the demand for content is so strong and is increasing so fast that it makes sense to be invested in both Disney and TWX.

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INVESTMENT THEMES

The Age of Information

Alibaba set a new high water mark for an initial public offering with its $165 billion valuation in September when the company went public. After only two hours of trading the value of the company rocketed to $220 billion. Facebook went public in 2012 and is now valued at over $200 billion. Google has a market value of $390 billion, LinkedIn, $26 billion and Twitter, $31 billion.

Combined, these companies alone are worth nearly a trillion dollars. Most of us use the services of at least some of these companies: we follow a columnist on Twitter, we "Google" a topic to find more information, we access our Gmail accounts or keep up with family and friends on Facebook. And astoundingly, all of these services are free. The primary value of these companies is not derived from the services they provide but from the information they gather from their users. It is this information that commands a tremendous amount of value to the companies themselves and to the advertisers to whom they sell it.

Advertising is a huge industry. According to eMarketer, total media spending on advertisements worldwide will be almost $550 billion in 2014. This estimate includes the money that is being spent on traditional advertising outlets such as television and radio commercials, and print advertisements in magazines. Spending on digital advertising, however, is becoming an increasingly important piece of this market. The same eMarketer report estimates that digital ad spending will surpass 25% of the overall market for the first time this year.

One can argue that spending on digital advertising in much more effective because of the information that is being collected by companies like Google. A Google search can gather demographic information about the user, what the search was for, what geography was searched from, and how the searcher responded to the results. Contrast this with the data that has historically been used by rating agencies, such as Nielsen Media for example, to estimate how many viewers were watching a particular TV program. There was no demographic information available for a specific viewer (just the household), measurement was after the fact (not real-time) and there was very little data about how an individual user responded to information.

Today, key words in interactions over email accounts provided by Gmail or Yahoo, a search for a specific product type and even transactions for items such as airline tickets, are being collected and used by digital advertisers to create advertising customized for a specific user. The effectiveness of those ads can be measured and adjusted in real time.

Information is being collected on each of us every day as we go about our digital lives: what apps we use on our mobile phones, what content we stream through our Amazon Prime subscription and even our home thermostat settings. The high valuation of the companies positioned to collect this information is a reflection of the plethora of ways in which it can be used, many of which are yet to be invented.

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