NELSON ROBERTS QUARTERLY COMMENTARY

2014 | FOURTH QUARTER

ECONOMIC OVERVIEW

Markets Near Record Despite Volatility

Volatility has returned, but again markets closed the quarter near a high. At the end of September we concluded that “stocks have further to go; however, they will not rise in a straight line.” This has proven to be a good summary of what happened during the fourth quarter of 2014. Just as the quarter began, the markets reacted negatively to the news that Ebola had been contracted by two Dallas-area healthcare workers. Concurrently, the markets also started to focus on the very weak economic conditions in both the Eurozone and China. This combination of news started an 11-day, 1,000-point drop in the Dow Jones Industrial Index punctuated by only two positive days: Friday, October 3rd, when a strong jobs report gave the markets a lift, and Wednesday, October 8th, when stocks rallied as Fed concerns over a global slowdown spurred bets that interest rates would remain low.

From mid-October to December 8th, the Dow rose 2,000 points, then over the course of seven trading days, gave half of that gain back, only to recapture all of this loss in four days before coasting into a year-end close near an all-time high. The December decline was a reaction to the rapidly accelerating slide in the price of oil, and the subsequent snap-back was due to the realization that lower oil and gasoline prices are highly stimulative to the US economy.

The price of oil has fallen nearly in half since August, as Saudi Arabia pushed prices down dramatically by manipulating supply. In the past five years, US oil production has risen over 60%, from about 160 million barrels per month to nearly 260 million barrels, as fracking of shale has been highly productive. Global demand for oil is highly inelastic; we still fill our gas tanks and heat our homes regardless of price. OPEC found this rising supply very threatening and decided not to cut output at its November 27 meeting. Saudi Arabia (the de facto OPEC leader) pressured other OPEC members into maintaining production levels despite lower oil prices. The Saudis can withstand a prolonged drop in oil prices because they have much larger cash reserves than fellow OPEC members. The Saudis will maintain output in order to keep market share, having learned their lesson in the 1980’s. By keeping prices low, Saudi Arabia is making higher-cost exploration projects in the US economically unviable. Why spend $60/barrel to find and pump out oil that can only be sold for $52/barrel? Recently, many exploration and production companies have announced capital budget cuts and mothballed projects. This has hurt the stock performance of the entire energy sector, which is down over 12% since September 30, 2014. More significantly, the decline in the price of oil may actually be more effective than any embargo in combating terrorism, by depressing the revenue streams of ISIS, Russia, Venezuela and Iran.

INDEX PERFORMANCE	Q4’14	YTD
Dow Jones Industrials	5.20	10.04
Standard & Poor’s 500	4.93	13.68
EAFE (international stocks)	-3.45	-4.20
Russell 2000 (small stocks)	9.73	4.90
Barclays Interm. Gov/Credit	0.88	3.13
Barclays Municipal	1.37	9.05

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TOP FIFTEEN HOLDINGS:

- TJX COMPANIES
- iSHARES S&P SMALL-CAP
- WHITEWAVE FOODS
- SCHLUMBERGER LTD.
- UNITED PARCEL SERVICE
- COSTCO WHOLESALE CORP.
- T ROWE PRICE GROUP
- AKAMAI TECHNOLOGIES
- WALT DISNEY CO.
- INVESCO LTD.
- AMAZON.COM INC.
- PAYCHEX INC.
- WW GRAINGER INC.
- QUALCOMM INC.
- UTILITIES SELECT SECTOR SPDR

ECONOMIC OVERVIEW

Markets Near Record Despite Volatility (cont'd)

In the US, the drop in oil prices serves to boost consumer spending. While estimates vary, the general rule of thumb is that a $0.01 drop in the per gallon price of gasoline leads to about $1 billion in added yearly consumer spending. Gasoline prices have dropped from $3.70 per gallon (average) at the peak this summer to $2.30 per gallon. The price drop has added an extra $450 million in consumer spending each day, or $165 billion per year. This is a big number and will be more effective than any tax cut made since the financial crisis.

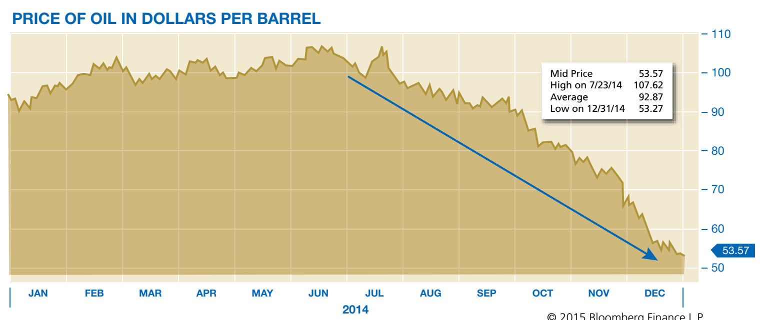
While the stock markets gyrate, economic growth has steadily marched on. Early third quarter economic growth was reported at 3.5%. The first revision was to 3.9% and the final revision came in at 5.0%. With the spending boost from lower energy costs, we could easily see another big jump when fourth quarter results are announced in late January. Revisions upward in February and March, continuing the trend of last quarter, would not be surprising. Jobs data have also been encouraging. Nonfarm payrolls for November were 91,000 higher than the 230,000 expected, and unemployment has now fallen below 6%. Wage growth is still subdued at under 0.5% month-over-month, which helps moderate inflation pressures as the economy grows.

The most recent US inflation report showed prices rising at 1.3% per year. Inflation in Europe has been lower, at 0.5%, and monetary authorities there fear that it might tip into deflation. As a consequence, interest rates in London and on the continent have trended lower. With sluggish growth in the UK, Germany, France and the rest of the EU plus weak reports from Asia, the US dollar has surged higher.

The US Dollar Index (measured against a basket of major currencies) is up over 10% since the summer. Corporations with significant foreign sales will be facing currency headwinds going forward as the goods and services they sell are now at least 10% more expensive in local currency terms. Conversely, foreign producers have effectively "cut" their prices by the same amount, due simply to the rise of the dollar.

In the report of their last meeting on December 17th, the Federal Reserve governors changed their stated outlook for interest rates from leaving them "unchanged for a considerable time" to more equivocal wording. Essentially, they said that if growth and inflation pick up, then they will act to "remove accommodation." In quintessential Fed style, they left the interpretation of this statement to the reader.

As we move into 2015, we think that higher volatility and rising stock prices will continue. Economic growth will expand payroll employment. This, in turn, will bring about a tipping point when wage growth resumes. Bond market investors universally expect that this will push the Fed to action sooner rather than later. We think the bond market will be disappointed by the meekness of the Fed's response and that their actions will be a combination of slightly higher short-term interest rates (to perhaps a 0.25% target), along with the end of reinvesting principal payments from agency debt.



> The oil price drop has added an extra $450 million in consumer spending each day, or *$165 billion per year*. This is a big number...

ASSET MANAGEMENT

Anticipating Continued Growth in Equity Markets

Now that the ball has dropped on 2014, we can look back on a good year for the US equity markets. Both the S&P 500 and the Dow Jones Industrial Average established new highs in December. The S&P 500 outpaced the Dow, rising 13% in 2014 vs. a 10% rise in the DJIA. This strong performance was not shared by all asset classes, however. Small stocks struggled to repeat the success of 2013, rising only 4.89% in 2014. Even more challenged were international investments. A very strong US dollar resulted in declines of -4.2% in developed international markets and -3.92% in emerging markets.

The dramatic discrepancy in returns was also notable among the S&P 500 sectors. The Utility Sector was surprisingly the strongest performer of 2014, rising 34.2%. Historically known for being a defensive sector, utility stocks were safe havens for investors searching for income within the equity markets. The Healthcare sector posted another strong year, finishing up 27.0%. This sector is now on a four-year streak of greater than 10% annual returns.

On the other side of the spectrum were the Energy and Telecommunications sectors. The sharp drop in the price of oil resulted in a dramatic decline of stocks within the Energy sector, which were down 12% overall in the fourth quarter. For the year, Energy stocks fell -6.5%, the only S&P sector to have a negative return for the year. Telecommunications stocks struggled as pricing wars were waged between mobile carriers, while many cable providers are facing uncertainty about how consumers will access mobile content in the future.

Nelson Roberts Investment Advisors was active in the markets in the fourth quarter as we positioned our portfolios for what we expect to be another strong year for stocks in 2015. In mid-October, we initiated a position in Google. Google's search engine market leadership will enable it to continue to monetize the explosion in spending for online advertising. We expect the company to face challenges as it expands geographically and broadens its platform of products, but we are confident that its dominant market position will lead to a solid long-term holding. In November, we bought stock in Whole Foods Market. Whole Foods has done an impressive job in defining and growing the natural food industry. We believe strong consumer spending trends and a company-wide refocus on articulating their value proposition will result in a revitalized growth story. Finally, we swapped positions in two of our asset managers, trimming a large position in Invesco and adding to T. Rowe Price. Both of these companies will benefit from the rise in equity markets, but T. Rowe provides a more compelling valuation story, having lagged Invesco the last few years.

We exited two positions entirely in the fourth quarter. We are concerned that the Asia Pacific region will have a tough time regaining its momentum in the near term, especially with the continued strength in the US dollar relative to other world currencies. To reduce our exposure, we sold our position in the Emerging Asia Pacific ETF. We also sold a profitable position in Sun Hydraulics after holding it for five years. Sun Hydraulics had provided a solid return for our portfolios but had reached the higher end of its valuation range, leading to our decision to sell it.

To echo the message from our October presentation to clients, we continue to think that the market is maturing in optimism. The stimulus of lower gas prices will energize the consumer, while higher tax receipts will buoy state and local government spending. These tailwinds will drive equity markets to new highs in 2015.

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

HOW DO WE MEASURE VALUE?

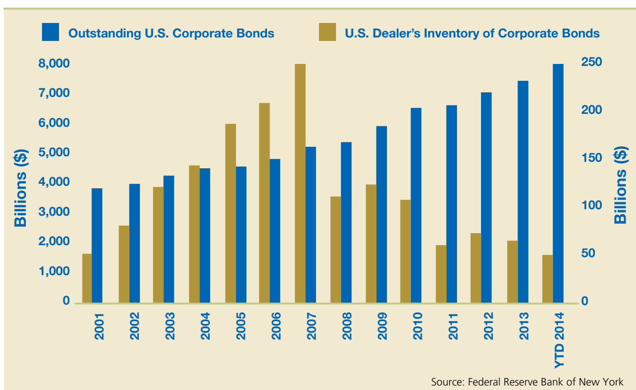
By producing it — in the growth of assets, in how our clients view us, in how we create partnership.

FIXED INCOME

The Law of Unintended Consequences and the Bond Market

Debt issuance by corporations has grown rapidly in recent years, as low interest rates have made borrowing attractive and investors' demand for yield has resulted in billions of dollars flowing into bond funds. At the same time, inventories held by bond brokers have fallen to the lowest levels in recent history. New regulations, enacted after the financial crisis in 2008, require banks and brokerage firms to hold more capital against bonds they own. This has had the unintended consequence of decreasing liquidity in the bond markets. The concern is that if the Fed decides to increase interest rates and investors rush to exit bonds, the lack of liquidity could cause significant disruptions and big price declines in the bond market.

OUTSTANDING CORPORATE BONDS VS. US DEALER'S INVENTORY OF CORPORATE BONDS



Source: Federal Reserve Bank of New York

What is liquidity? There are several ways to measure liquidity, but in general, liquidity is the ability to buy or sell a security quickly at a given price. Less liquidity can lead to sharper moves in prices.

Liquidity in the primary markets, where companies like Apple and Microsoft can sell billions of dollars of debt in a single day, has covered up the real problem in the secondary market. The secondary market is where bonds change hands between investors. In contrast to the stock market, the bond market does not have an exchange (e.g., the NYSE) where bonds are bought and sold and prices are clearly visible. If investors want to sell bonds, they need to contact a broker who searches for potential buyers. If a buyer can't be found, the broker's trading desk can step in, buy the bonds, and hold them as part of broker inventory. This helps provide liquidity for the market and minimizes wide price swings.

The changes in banking regulations provide a disincentive for financial firms to hold a large bond inventory because of the increase in capital required on their balance sheets. The good news is that this increase in capital has made banks and brokerage firms more solvent and better prepared to withstand the next economic crisis. The downside is that this requirement has forced many firms to shrink their bond inventories because it is not worth the risk or the cost of holding bonds. Thus this has reduced an important intermediary in the secondary market.

We recommend holding some cash or cash equivalents like short-term US Treasury Notes as one way to protect portfolios from the current lack of liquidity. Treasuries are generally one of the most liquid securities in the bond market. While buying Treasuries today may hurt performance in the short term (due to very low yields), it will provide a safe haven in times of economic stress.

FIRM UPDATES

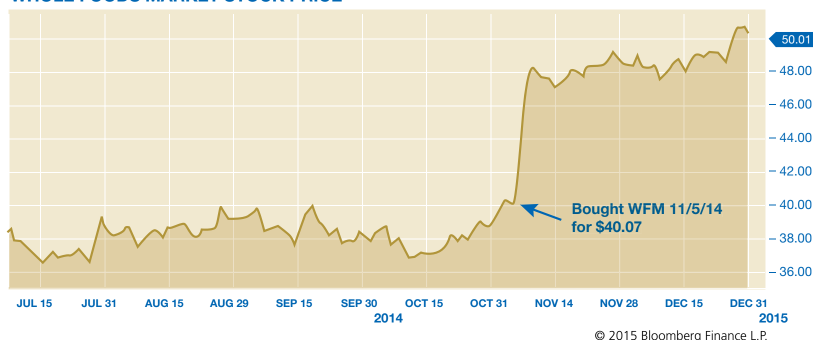
Nelson Roberts Investment Advisors is pleased to announce that Tyler Brown has joined the firm as a research analyst. He has worked for NRIA as an intern during the last two summers. Tyler graduated from Stanford University with a Bachelor of Arts degree in Science, Technology and Society, which is the study of the relationship between social and technological systems. He grew up in Montana and Colorado, where he developed a love for the outdoors. In his free time, he enjoys hiking and swimming.

FEATURED EQUITY

Whole Foods Market (tkr: WFM)

Whole Foods Market (tkr: WFM) is the leading retailer of natural and organic foods in the US and the first national "Certified Organic" grocer. At the end of its fiscal year 2014, it operated 401 stores across the country. Its brand image as a purveyor of high quality, natural and organic products has allowed it to sell at premium prices and maintain a margin that is twice that of "conventional" grocery stores. Analysts estimate that current annual spending on natural products is only 15% of the $600 billion US consumers spend on food eaten at home, leaving a lot of room to grow. We think that WFM's growth plan to triple its number of stores will drive top-line revenues, its private label products and prepared foods will drive margins and its first-ever national marketing campaign "Values Matter" with the tagline "America's Healthy Grocery Store" will attract new customers and help modify the company's "whole paycheck" reputation. The company had revenues of over $14 billion in 2014, with average weekly sales per store of about $722,000. WFM is also known for being a strong community member, working with local groups to raise money for local causes.

WHOLE FOODS MARKET STOCK PRICE



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WFM pioneered the sale of fresh-cooked items in its stores and this portion of the business has doubled in the last seven years, to $2.7 Billion. More than 100 stores now have "restaurant venues," where customers can sit down to eat the food they have just purchased. The fresh-cooked items have a much higher margin, which is one way WFM has been able to drive its margins. The company is also growing it in-house brand, "365 Everyday Value," which allows it to compete on price for standard items with other grocery store chains.

For all practical purposes, WFM created the market for natural and organic foods following its 1980 founding in Austin, Texas. The company is led by co-CEOs Walter Robb and company founder, John Mackey. The rest of the senior management team has come up through the ranks, creating a consistent culture and a strongly mission-driven company. WFM employs 86,000 people and has been ranked for 17 consecutive years as one of the "100 Best Companies to Work For" in America by Fortune. We think that WFM's strategy for re-igniting growth will be successful and that it will also benefit from the lower price of oil as consumers will have more money to spend and thus be more likely to give WFM a try.

INVESTMENT TEAM

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Darcy Nelson

INVESTMENT THEMES

Cybersecurity

The goal of cybersecurity is to ensure confidentiality, integrity and availability of data, both in transit and at rest. The proliferation of data and application access points has made it even more difficult to ensure security. Furthermore, attacks have only become more sophisticated and frequent. Several recent examples have highlighted the crippling effects such attacks can have. In the past 12 months, customer data was stolen at JP Morgan, private photos were stolen from Apple's iCloud, and hundreds of millions of Target and Home Depot customers had their credit card numbers compromised. However, the most recent attack on Sony Pictures was perhaps the most devastating that any company has ever publicly suffered. Analysts estimate that 11 terabytes of data were stolen, revealing information about employee compensation, scripts and unreleased movies, and conversations between high-level executives. The hackers, who are believed to be from North Korea, threatened physical violence if Sony decided to release *The Interview*, a parody movie about an assassination plot on North Korea's "Supreme Leader," Kim Jong Un. Beyond the obvious financial losses, all of these companies suffered colossal reputational blows.

Bolstered by these recent headlines, cybersecurity has quickly become a hot investable theme. Even before the Sony hack, Bloomberg Intelligence projected a jump in cybersecurity spending of about 40% to $42 billion by 2017. There are several relatively new "pure-play" companies whose entire business centers on offering a cybersecurity software solution. A new cybersecurity ETF (ticker: HACK), which contains many of these new companies, has been in existence now for less than a month, and is already up significantly. However, we are wary of these cybersecurity companies' high valuations (at more than ~200x forward earnings) and volatile stock prices.

Instead, we choose to invest in cybersecurity through more established companies that have built a portfolio of security offerings to augment their core businesses. Volatility and valuation concerns aside, we think that this is a more efficient way to address the cybersecurity issue. One of our holdings, Cisco, acquired SourceFire for $2.2 billion as part of its security portfolio, allowing Cisco to establish security measures within its greater networking framework. We also own the content delivery company, Akamai, which acquired Prolexic last year to add to its homegrown "Kona" security offering. With Kona and Prolexic, Akamai aims to safeguard content and data while it is in transit. Another one of our holdings, F5 Networks, acquired Defense.Net, a company that provides cloud-based security services. As more data transitions to the cloud, security is becoming even more of a concern, so this acquisition by F5 positions them well to address those issues. We will continue to monitor this cybersecurity space and look for other investment opportunities in the future.

Past performance is not necessarily a guide to future performance. There are risks involved in investing, including possible loss of principal. This information is provided for informational purposes only and does not constitute a recommendation for any investment strategy, security or product described herein. Please contact us for a complete list of portfolio holdings.

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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