NELSON ROBERTS QUARTERLY COMMENTARY

2015 | THIRD QUARTER

ECONOMIC OVERVIEW

An Answer in Search of a Question

Market volatility returned with a vengeance in the third quarter. On Monday, August 24, the Dow Jones Industrial Average fell over 1,000 points in the first few minutes of trading. Why? Phil Nelson used to say that the market is an answer looking for a question. The media feels obligated to supply us with the question at all times and it would not make for dramatic headlines if the story line read “Markets Fall. Nobody Knows Why.” The drop in stock prices has been ascribed to economic weakness in China. We find this absurd. China’s economy has been weakening for more than 18 months. The cover article of the January 25, 2014 edition of *The Economist* reminded us of this fact with the title, “China Loses Its Allure.” The article observed that China saw 7.7% GDP growth in 2013, but points out the simultaneous disappointing manufacturing numbers and other signs of economic deterioration.

China has transitioned from an emerging economy to the world’s second largest economy after the US. Today, China’s GDP (if we can believe the data) shows total annual production of $10.4 trillion. China’s economy has grown between 7 and 14% annually for 20 years. As China becomes a bigger share of the world’s total economy, its growth will have to begin approaching that of the entire globe, which today is growing at about 2.5% annually. Slowing growth in China is not so much disastrous as inevitable.

Bespoke Advisors reported that the S&P 500 Index drop in late August caused a four standard deviation move from its 50-day moving average. They pointed out that the last time this occurred was on May 15, 1940. Few are alive today who recall that this was the Wednesday following the May 10th advance by German Panzer divisions through the Ardennes forest into France, which was regarded as the start of real combat in World War II. Do we really think that China’s economy slowing will be as devastating as the human catastrophe and economic dislocation caused by the Second World War? We do not.

So what is causing such volatility? Declining profit from trading, significantly increased regulation, and the conversion of nearly all of the large brokerage firms into banks during the 2008 financial crisis have resulted in a capital market that is not structured to handle large trading imbalances. Prior to the May Day deregulation on May 1, 1975, all brokerage commissions were fixed by regulators. As a percent of the value of each trade, brokers earned commissions of around 1%. Since then, discount brokers and computerized trading efficiencies have reduced this trading cost to a small fraction of a percent. Before 2008, the major brokerage firms such as Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers and Bear Stearns, to name

INDEX PERFORMANCE	Q3’15	YTD
Dow Jones Industrials	-6.98	-7.58
Standard & Poor’s 500	-6.44	-5.71
EAFE (international stocks)	-10.16	-4.83
Russell 2000 (small stocks)	-11.92	-7.73
Barclays Interm. Gov/Credit	-0.95	1.77
Barclays Municipal	0.84	1.77

INSIDE THIS ISSUE

TOP FIFTEEN HOLDINGS

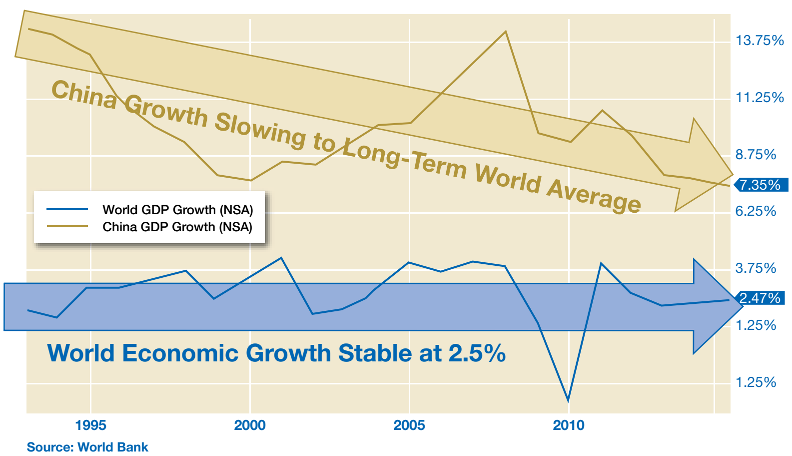
iSHARES CORE S&P SMALL CAP	SCHLUMBERGER LTD.
AMAZON.COM INC.	T ROWE PRICE GROUP INC.
AKAMAI TECHNOLOGIES INC.	UTILITIES SELECT SECTOR SPDR
WALT DISNEY COMPANY	WHOLE FOODS MARKET INC.
COSTCO WHOLESALE CORP.	INVESCO LTD.
UNITED PARCEL SERVICE	NOVARTIS AG
TJX COMPANIES INC.	UNITED HEALTH GROUP INC.
iSHARES CORE MSCI EMERGING	

ECONOMIC OVERVIEW

An Answer in Search of a Question (cont'd)

a few, had large staffs dedicated to institutional trading. In addition, many of these firms also had separate departments with billions of dollars devoted to taking large positions for their firms' accounts, called "proprietary trading desks." If the institutional traders could not move the large stock blocks without driving prices up or down, often the firm would step in and take the other side of the trade, buying or selling the position at or near the current market price.

Lehman Brothers declared bankruptcy on September 15, 2008, Bear Stearns was bought and buried in JP Morgan, Merrill Lynch is now a division of Bank of America and both Goldman Sachs and Morgan Stanley have adopted bank charters. The Dodd-Frank Act forced all of these firms out of the proprietary trading business. (See "Understanding Market Liquidity" for more discussion of how these banks make markets.)



High-frequency trading and electronic markets have exacerbated the problem further, such that when there is a trade imbalance, market prices move very significantly until a balance between buy and sell orders is achieved.

While we do not subscribe to the "China argument," neither are we sanguine about the state of the economy. The rise in real estate and stock prices since the 2009 lows has been driven by the near-negative real interest rates that the Federal Reserve has maintained for the last seven years. Instead of raising rates at the September meeting as the market had expected, the Fed ultimately got cold feet and left rates unchanged, expressing concern that "recent global economic and financial developments" (a.k.a. China) might put pressure on inflation. As Albert Einstein once said, "the definition of insanity is doing the same thing over and over and expecting a different result." So why does the Fed persist in keeping rates so low? The short answer is that if the world does not build up a significant inflationary force, then sovereign default will occur and there will be hell to pay. That hell is called deflation.

Although service price inflation is up, commodity price inflation is flat to down. The latter has kept the consumer price index (CPI) and personal consumption expenditure (PCE) below targets. Global governmental spending to support commodity production (grain in the US, cement in China, lumber in Canada, etc.) causes excess production. This keeps prices down while boosting employment, which should ultimately lead to economic growth. But government spending also causes sovereign debt to continue to rise.

What happens if the sovereign debt issued does not boost a country's GDP enough for it to be paid back? The country has two options: default on the debt or devalue the country's currency. (Please let us know if you would like us to resend you the May 25, 2010 article on this topic.) This is the larger structural issue that we believe could pose a greater threat to global economic growth.

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SPECIAL TOPICS

Understanding Market Liquidity

An investor who wishes to buy a stock will typically not spend time and energy searching out a counterparty who wishes to sell the same stock in the same quantity; instead, he will simply go to a broker, who then goes to a "market maker," to execute the trade. A market maker's job is to facilitate the buying and selling of stocks, or "make a market" in a particular stock.

For a frequently traded stock, for example, General Electric (tkr: GE), a market maker will have a high degree of confidence that after buying 100 shares of GE from one investor, he could quickly and easily sell those 100 shares to another investor. But the market maker would still like to be paid for his service. He will do this by buying 100 shares of GE at a slightly lower price (the bid) from Investor A and selling 100 shares of GE at a slightly higher price (the ask) to Investor B. After the trade is executed, Investor B owns the 100 shares she wanted, Investor A was able to sell the 100 shares he was looking to unload, and the market maker gets to keep the spread between the bid price and the ask price. Because the market maker's job in this case was relatively easy, the bid and ask prices were probably very close together, and his "take-home" bid-ask spread was fairly small.

However, what happens if Investor A wants to sell 1,000 shares and Investor B only wants to buy 100? In this case, the market maker might have a harder time matching buyers with sellers while taking on the risk that GE's stock price could move up or down in the meantime. For this more difficult, riskier job, the market maker will demand a higher bid-ask spread. Similarly, a market maker will demand a higher spread for an infrequently traded stock or during a volatile period in the market, since both scenarios carry greater risks.

Over the last 20 years, bid-ask spreads on stocks have decreased significantly. In 2001, the SEC ordered all stock markets to convert to decimals from fractions, making each stock price increment smaller. This led to dramatically tighter bid-ask spreads. Many people point to smaller bid-ask spreads as an indication of higher liquidity. On the surface, this seems to make sense; more liquid stocks typically have smaller bid-ask spreads than less liquid stocks. But this conclusion leaves out a key piece of the story: the quantity. In addition to bid and ask *prices*, market makers often show a corresponding bid or ask *size* on which they are willing to commit. For example, a market maker might quote a bid-ask spread of (bid price) $25.00 to $25.03 (ask price) for a lot of 100 shares of GE. This indicates that the market maker is willing to buy 100 shares of GE at $25.00 and is willing to sell 100 shares of GE at $25.03 (a 3-cent bid-ask spread). For 10,000 shares, the bid-ask spread might be 20 cents. Most people tend to forget about the lot size when they see tighter bid-ask spreads. Investors might assume they can buy their entire share quantity from the market maker at the ask price displayed, but in reality those prices are good for just 100 shares. The market maker is only "committed" on what he is showing, so in our example, he must sell 100 shares at the ask price.

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.

SPECIAL TOPICS

Understanding Market Liquidity (cont'd)

As bid-ask spreads have decreased over the last 20 years, so has the share quantity available at those prices. Ironically, this results in less liquidity, especially for larger market orders, and more turmoil in times of market panic. Since we only know the bid-ask spread displayed for a small quantity, no one has any idea where a larger quantity of shares could trade.

When market sentiment tilts one direction or the other, we end up with an imbalance of buyers and sellers that makes the market maker's job even more difficult and risky. This is exactly what happened on Monday, August 24 when the Down Jones Industrial Average briefly dropped by over 1,000 points in the first six minutes of trading. As market sentiment tilted negative and more sellers emerged, there were more parties going to market makers looking to sell their shares. In this volatile environment, market makers scrambled to try to execute large orders without exposing themselves to huge risks while more sellers poured in, leading to the sharp price decline.

In reality, a rational human investor who sees the stock's price drop 20% over a few minutes with no meaningful news would detect an overreaction. In fact, if the entire market were made up of rational investors, the stock would probably not even make such a move in the first place. But, of course, the market is not made up exclusively of rational investors.

Stop-Loss Orders

One popular mechanism among retail investors is a "stop-loss order." This type of sell order is triggered when a stock drops below a specified threshold. The idea is that an investor can limit her loss on a position. For instance, if an investor has a stop-loss order set 10% below her cost, when the stock drops below that level, it will be sold automatically. However, this does not mean that the investor's loss is limited to 10%. Imagine an investor had a cost basis of $27 and wanted to implement a stop-loss order if GE were to drop more than 10% to $24.30. GE closed the previous Friday, August 21 at $25, so the stop-loss order would not have been triggered on Friday. On Monday August 24, GE opened at $22.84, and the stop-loss order would have immediately become a market order. Sometime in the next panic-filled six minutes, the order would have been executed somewhere between $22.84 and $19.37. This would mean the investor would face losses of up to 26%! Had she never implemented the stop-loss order, the investor would still own her GE position which currently stands around $25, where it was before the panic. With the stop-loss order, the investor would have sold out of her position at the absolute bottom, only to see the stock recover most of those losses as the rational investors realized that the drop was an over-reaction. In fact, many argue that the popularity of stop-loss orders among retail investors is what led to the panicked declines in the first place.

Because the orders are automatically triggered by a machine, there is no human sanity check done prior to the execution. As the stop-loss orders are executed one after the other, the stock is allowed to free fall until opportunistic investors step in to buy, bringing balance to the order flow.

FIRM UPDATES

Nelson Roberts is pleased to congratulate Darcy Nelson on her recent marriage to Cliff Smoot. Darcy and Cliff were married in San Francisco on September 12, 2015. They are planning a honeymoon trip to Paris in October.

ASSET MANAGEMENT

Tax-Loss Harvesting

This quarter's market downturn presented an opportunity to reduce our clients' tax burden using "tax-loss harvesting" and add a name to our portfolios at relatively low cost. Earlier in the quarter we also pared several of our largest positions and sold out of two others.

Tax-loss harvesting means that we sold several stocks that fell in value from their cost bases. Realizing those losses makes them tax-deductible, which can be particularly beneficial in a year like this one, because despite the recent market decline, clients are still likely to have taxable net gains for the year. After a 30-day waiting period required by the IRS to claim the loss, we are then able to buy those stocks back, ideally for a net benefit, including tax savings and trading fees. Ultimately, we intend to recreate most positions that clients held before selling.

We hedge market risk over that 30-day period by adding to some stock positions that have losses, selling the others, and doing the opposite a month later. We began the process by selling our entire position in W.W. Grainger (tkr: GWW) and doubling positions in Michael Kors (tkr: KORS) (see Featured Equity) and Whole Foods Market (tkr: WFM). After the 30-day waiting period, we will sell our long-term positions in Kors and Whole Foods. We might also elect to buy back Grainger pending our review of its business. By executing the initial transactions when we did, this strategy also avoids the risk of volatility due to earnings releases.

If potential tax-loss deductions are larger than the government's annual limit, clients can reduce their cumulative tax burden by carrying over "unused" net losses. This was a common practice after the financial crisis; it was several years before many clients had to pay substantial capital gains taxes again. (If you have questions about the mechanics of these transactions please give us a call at your convenience.)

Early in the quarter, we trimmed our investment in Amazon.com (tkr: AMZN) to 3.5% of the portfolio. It had grown to 4.8%, large enough that we thought it prudent to lock in some of the gains earned so far this year. Our conviction that oil prices will remain low long-term increased as OPEC continued to grow output above its target, leading us to sell our position in Hess (tkr: HES). Unlike our other oil producers ExxonMobil (tkr: XOM) and Chevron (tkr: CVX), Hess' cash flows are not hedged by refining operations, it pays only a small dividend that does little to compensate for sector volatility, and it has a relatively limited array of assets that it can sell to raise cash. We also sold TopBuild (tkr: BLD), a business spun out from Masco (tkr: MAS) during the quarter, to focus our exposure on Masco's businesses that derive most revenues from repairs and remodeling. We took advantage of the market dip to buy a 1.5% position in Illumina (tkr: ILMN). Illumina is the undisputed leader in genetic sequencing instruments, and we think its knack for developing winning technologies and its first-rate execution portend strong long-term growth.

OUR TEAM

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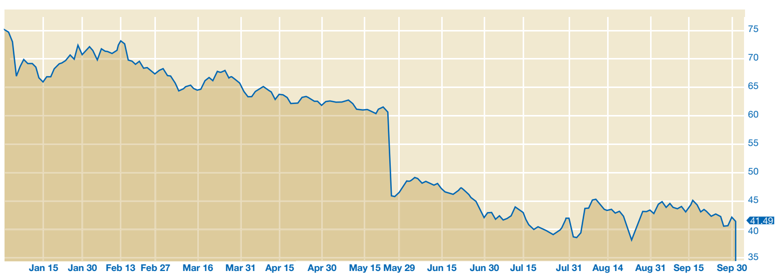
FEATURED EQUITY

Michael Kors

Michael Kors Holdings (tkr: KORS) is a designer, marketer, distributor and retailer of women's apparel and accessories and men's apparel. The company's primary focus has been on handbags, which still account for 80% of sales. In the last several years, Kors has expanded its offerings into clothing, watches, jewelry, and shoes for women. Men's clothing was added earlier this year. The company aims to create products with a luxury look and feel "for the masses." We bought Kors for two reasons: (1) the theme of a growing "wealth gap" in the US, Western Europe and Japan benefiting higher end goods and (2) low valuation despite solid growth.

Thus far, however, Kors has not performed as we had hoped. Recent earnings have not met analysts' expectations, nor have retail sales. Sales at existing stores have fallen, particularly in the US. The two big drivers for the decline have been lower spending by tourists due to the strength of the dollar and the company's weakening watch business (which management believes reflects a category shift to jewelry at 50% less per transaction). This was the first decline in same-store sales since Kors went public. Our longer-term concern is whether Kors can continue to attract and hold its consumer base, since it has aggressively attempted to grow its exposure through new stores (121 in the last year) and department store sales.



Source: Bloomberg LP

Kors now operates over 500 retail stores including concessions. When stores operated by licensing partners are included, the number is 728 worldwide. Operating margin has slipped despite management's comments that the company was being less "promotional" (i.e., fewer products on sale) than its competitors, due in part to bigger discounts at its retail stores.

Management has stated that this will be a year of "strategic investments." Plans to stimulate sales include: giving sales staff digital devices to help customers order items that are not in stock at the store, helping sales staff upsell customers, expanding the footwear business, expanding in both North America (30 stores) and internationally (45 stores), fully developing the men's business and investing in the company's digital strategy (the long-term goal is for 20% of sales to be online).

We are monitoring Kors's performance carefully and expect to see an impact from their strategies by spring, 2016. If this is not the case, then it will be time to move on.

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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