NELSON ROBERTS QUARTERLY COMMENTARY

2015 | FIRST QUARTER

ECONOMIC OVERVIEW

Is Volatility the New Normal?

What a difference a day makes! Had the first quarter of 2015 ended one day earlier, stock market returns would have been twice as high. During the first quarter, especially in January and March, the stock market gyrated daily, with numerous moves of over 1%. Up one day and down the next, this directionless intraday volatility produced a quarter with net returns of less than 1% for large-cap domestic stocks.

The securities market is often an answer looking for a question. News editors must keep the volume of articles up to justify the online and print ad revenue. But when we see business section headline articles in the New York Times that start with “on a recent Friday,” we conclude that this is a filler article in print only because there is nothing better to publish. Sports sections this quarter had big articles on Rodeo and Cricket, evidencing the ennui pervasive in the media. This “news vacuum” tends to heighten skittishness among investors, which leads to bursts of volatility.

Volatility has been a persistent “pattern” for months. Last fall, the fear that Ebola was spreading caused a sharp selloff in the market. Then in late November, with the price of oil down 20% from the Ebola selloff, the news wires confirmed that OPEC would not reduce its oil production target, and the oil market decline became a rout. Lower energy costs stimulate the economy as a whole, but of course are harmful to most of the energy sector. In late December and January, the focus shifted from losses and cutbacks in the oil patch to the reports that for every $0.01 decline in the price of gasoline, US consumers collectively have another $1 billion in their pockets. Things quieted down briefly in February, but big swings resumed in March over speculation about when the Federal Reserve would begin increasing interest rates.

During the first quarter, international and small-cap US stocks were the stars, with returns of 5.04% and 4.3%, respectively. The bond market had total returns of about 1.5% and the S&P 500 returned just under 1%. The US Dollar Index continued to be the big winner. (Please see chart on page 2.) It was up over 10% in the second half of 2014 and another 10% in the first quarter. This means that in local currency, the Euro-based markets were up 15-23%.

So far, the bonus that consumers have received from lower energy costs has not been spent in stores. We think that consumers have used their gasoline savings to repair the damage that was done to their balance sheets during the 2008-2009 financial crisis. Gas prices have bounced up in the last month, especially in California, reinforcing consumers’ beliefs that they should not be spending these short-term savings.

INDEX PERFORMANCE	Q1’15	YTD
Dow Jones Industrials	0.33	0.33
Standard & Poor’s 500	0.95	0.95
EAFE (international stocks)	5.04	5.04
Russell 2000 (small stocks)	4.32	4.32
Barclays Interm. Gov/Credit	1.45	1.45
Barclays Municipal	1.01	1.01

INSIDE THIS ISSUE

TOP FIFTEEN HOLDINGS:

- WHITEWAVE FOODS CO.
- SCHLUMBERGER LTD.
- AKAMAI TECHNOLOGIES INC.
- AMAZON.COM INC.
- COSTCO WHOLESALE CORP.
- WALT DISNEY CO.
- T. ROWE PRICE GROUP INC.
- UNITED PARCEL SERVICE
- INVESCO LTD.
- TJX COMPANIES INC.
- WW GRAINGER INC.
- QUALCOMM INC.
- UTILITIES SELECT SECTOR SPDR
- HEALTH CARE SELECT SECTOR SPDR
- VARIAN MEDICAL SYSTEMS

ECONOMIC OVERVIEW

Is Volatility the New Normal? (cont'd)

What a difference a word makes! The big news in the Federal Reserve's March 18th press release was the absence of the word "patient." With "patient" gone from the statement, the markets are now expecting that the Fed will act to increase rates sometime later this year. How much it will choose to increase is anyone's guess, but because we are starting with money fund rates at 0.01%, any increase would be significant.

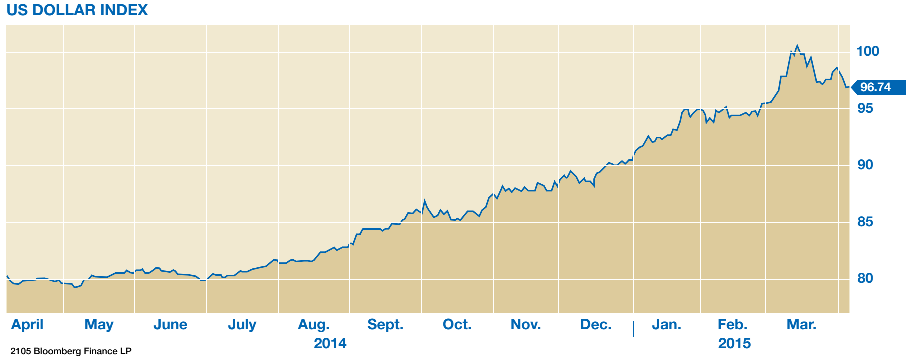
Conversely, on March 9th, the European Central Bank (ECB) began buying bonds as the beginning of a Euro Quantitative Easing. This economic stimulus had been anticipated since late fall, as the Euro area economy has been very weak and flirting with deflation. The ECB's January 22nd announcement was not a surprise, and the Euro area bourses continued their rise. German and Swiss 5-year bonds now yield negative returns and, according to a February 27 Bloomberg article, 88 of the 346 bonds in the Eurozone Sovereign Bond Index have negative yields. In other words, investors in these bonds are presumably willing to agree to take small losses in order to avoid larger ones.

Meanwhile, politics in the US continues as usual, which is to say that a state of disunion persists. A complete unwillingness to cooperate, as well as a continued focus on polarizing social issues, trumps any progress on economic or tax legislation.

Whither goes oil? If we had to venture a guess, the price of the West Texas Intermediate benchmark will be lower by summer before heading back up to the high 40s at year-end. It takes time to drill oil wells, and once started, they must be taken to completion in order to prevent ground water contamination. Capital raised cannot be returned and cannot just sit, so even with a 60% drop in price over the last six months, production cannot stop on a dime. For traditional wells, depletion is about 10% in the first year and declines from there. For a fracked well, first year depletion can range from 40-70%. Thus when drilling slows, production volume will not fall until about 6-18 months later.

We anticipate that the US will continue to lead the world economy and that the Fed will begin to increase rates this summer, pushing the dollar even higher. The Fed rate increases will be very modest until there are stronger signs of wage inflation. Commodity prices will likely remain weak, which will negatively affect emerging economies. Our research focus will be on companies with a higher percentage of domestic revenues and our bond selections will be in short to intermediate maturities.

US DOLLAR INDEX



US DOLLAR INDEX CHART HERE

> “Never let the tax consequences rule the investment decision.”
>
> — Phil Nelson

ASSET MANAGEMENT

Portfolio Turnover and Focus

Last year was a particularly active trading year for Nelson Roberts Investment Advisors (NRIA). The metric commonly used to quantify the amount of trading that occurs in a fund is called “portfolio turnover.” Turnover is calculated by taking the dollar value of securities sold divided by the total market value of the portfolio at the beginning of the year. Expressed as a percentage, this tells us how much of the portfolio was sold over the course of a year.

A low turnover percentage equates to a longer portfolio holding period, and vice versa. For example, 20% turnover would roughly equate to an average holding period of five years, whereas a 100% turnover rate would equate to an average holding period of one year. Higher turnover of securities in a portfolio creates additional costs, such as transaction and commission costs, and may also create taxable gains for taxable portfolios.

A portion of our turnover last year was due to tax-loss selling, which helps clients avoid capital gains tax liability. In general, we try to keep turnover ratio on the low end, although we sometimes need to make larger shifts in the portfolio towards investments that we think will perform better. Phil Nelson, founder of Nelson Capital Management, often advised his staff, “never let the tax consequences rule the investment decision.” On average, NRIA’s portfolios have a turnover ratio of about 19%, compared to last year’s ratio of 32.5%. This compares to an average turnover ratio of over 90% for actively managed mutual funds.

During the first quarter, we aligned our portfolio to match both our macroeconomic and sector-specific themes. In the macroeconomic arena, the price of oil has fallen in half and the US dollar has strengthened significantly versus most major foreign currencies. The wealth gap continues to widen as wage gains remain elusive, especially for those lower on the economic ladder. These are trends that we believe will persist; therefore, we looked for companies that would benefit in this type of environment. Michael Kors (tkr: KORS) is a luxury retail company that caters mostly to the higher-end market. Furthermore, with 80% of revenues coming from North America and a very low valuation, we think it is well-positioned for growth. We sold Methanex (tkr: MEOH), a Canadian company whose revenues are tied to the price of oil. With US fracking continuing to build supply, OPEC maintaining its high output and China showing signs of a slowing economy, we concluded that Methanex was unlikely to perform well over the next few years.

At the sector level, we brought our healthcare allocation to market weight with the additions of United Health Care (tkr: UNH) and the Health Care Select Sector SPDR exchange-traded fund (tkr: XLV). While we believe that the current astronomical level of healthcare spending will eventually need to moderate, given the glacial pace at which the government moves, we think that contraction is at least five years away. We sold Bio-Reference Labs (tkr: BRLI), which is facing high legal costs and pricing pressure. We will watch healthcare closely as the practical implications of the Affordable Care Act become clearer.

In our financial sector, we sold Brown and Brown (tkr: BRO) in favor of a basket of smaller banks: First Republic Bank (tkr: FRC), Silicon Valley Financial Group (tkr: SIVB) and New York Community Bancorp (tkr: NYCB), which should benefit from lower levels of regulation compared to larger banks. (Please see Featured Equity article on page 5.)

integrity *[in teg'r te]*
n. honesty, sincerity, completeness

WHERE DO YOU FIND INTEGRITY?

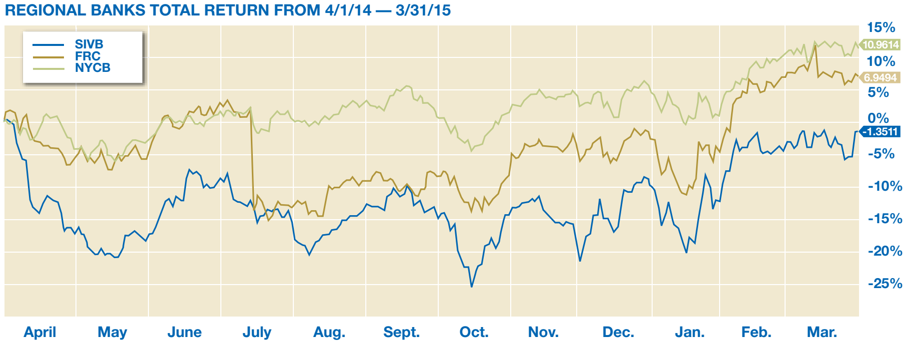
It emanates from tradition, endures market cycles, and sustains long-term partnerships. Trust lies at the heart of what we do, how we serve and who we employ.

FEATURED EQUITY

Basket of Small Banks

Sprawling organizations and post-financial crisis compliance costs and legal settlements are making it difficult for the largest banks to generate pre-2008 returns. To diversify the portfolio away from that regulatory overhang, we selected three regional banks that are not subject to as many or as strict rules on how to run their businesses and manage their capital. We also think that the Federal Reserve might increase a key regulatory threshold that these banks expect to cross in the next several years, prolonging one of their competitive advantages.

REGIONAL BANKS TOTAL RETURN FROM 4/1/14 — 3/31/15



2105 Bloomberg Finance LP

Each of the banks operates a lean business, originates high quality assets, and is heavily exposed to domestic growth markets. These banks are specialists in their geographic areas, and work to fund their loans with deposits, which cost them less over time than capital markets alternatives. Because these banks are at least five times smaller by assets than the smallest "global systemically important bank" and their portfolios are so narrowly focused, we diversified our investment by buying three banks, each with a different combination of assets and deposit bases, exposure to geographic markets, and strategies for the unpredictable regulatory market.

First Republic Bank (tkr: FRC) is a relatively young institution, with branches predominantly in the affluent urban coastal markets near San Francisco Bay and in New England. The majority of its loans and deposits are in California, with most of the remainder in New York City. The bank's lending focus is large, high down payment mortgages and home equity lines of credit in the San Francisco area. First Republic services about a quarter of the number of accounts relative to peers with similar assets, which allows them to provide high-touch client service while keeping headcount lower.

Silicon Valley Financial Group (tkr: SIVB), the parent company of Silicon Valley Bank, is entrenched in the domestic innovation economy, with a strong foothold in lending to and taking deposits from early-stage businesses and the venture capital firms that fund them. The bank also invests in and manages venture capital funds and funds of funds. Its investment portfolio consists primarily of warrants and post-IPO equity investments, which exceeds the value of its loan portfolio.

New York Community Bancorp (tkr: NYCB) is an expert in lending to the owners of multifamily housing in New York City, a market where rent regulation confers unusually stable returns and low default levels. It is one of the most efficient banks in the country, and its recent acquisition deals have diversified the bank's deposit base and increased its fee income. NYCB also stands out with its 12-month dividend yield of over 6%.

(The preceding information regarding the featured equity should not be construed as a recommendation to purchase the security. It should not be assumed that future returns will be profitable or will equal the historical performance. Please contact us for a complete list of holdings.)

FIRM UPDATES

Nelson Roberts Investment Advisors is pleased to announce that we now have over $400 million of assets under management. We would like to thank our valued clients for their ongoing support and referrals.

WEALTH MANAGEMENT

Estate Tax Law Changes and Their Implications

The American Taxpayer Relief Act, passed by Congress in 2013, ended a decade of uncertainty over Federal estate tax law and ultimately eliminated estate tax concerns for 99% of American families. With a $5 million exemption level (indexed for inflation) and the ability to more easily use a spouse's unused exemption, there is reason to rethink your estate plan. These changes have caused families to shift their focus from how to avoid paying estate taxes towards how to minimize capital gains taxes for combined estates below $10 million. It might also mean that the common approach of using a bypass trust is no longer the best option.

Prior to 2013, the federal estate tax exemption level fluctuated wildly, from $675,000 in 2001, to an unlimited exemption in 2010, then to $5 million in 2011. In 2013, Congress permanently set the estate tax exemption level at $5 million per individual and raised the top tax rate to 40%. The exemption level for 2015 is $5.43 million, or nearly $11 million per couple (due to the inflation adjustment).

In addition to increasing the exemption level, Congress made a key provision called the "portability clause" permanent. "Portability" is the ability to transfer any unused exclusion amount between spouses. In years past, a credit shelter trust, also known as a bypass trust, was commonly used to preserve the deceased spouse's exemption. With the introduction of portability, the surviving spouse no longer needs to establish a bypass trust at the time of the first spouse's death to take advantage of the exemption. A tax filing can be done instead.

A bypass trust still has benefits in certain circumstances. If assets are left directly to a surviving spouse, the surviving spouse can change the trust terms. However, a bypass trust becomes irrevocable at death and is a useful way to ensure the decedent's wishes are carried out. This is particularly important in a second marriage, or where there is a concern that the surviving spouse may change the beneficiaries.

For those with relatively simple family situations, the benefits of foregoing a bypass trust are lower accounting fees, more flexibility and an additional step-up in basis. A step-up increases the owner's cost basis from what was originally paid to full market value at the time of death and essentially erases any unrealized capital gains. Assets transferred to a bypass trust at the first spouse's death receive a step-up in basis, but not again on the death of the surviving spouse. If assets are instead left to the surviving spouse using the portability clause, there is another step-up at the surviving spouse's death. If the surviving spouse lives well beyond the first spouse's death and his or her assets appreciate, the potential tax savings could be significant.

Estate plan documents should be reviewed at least every five years. Depending upon when a trust document was drafted and the provisions used, your beneficiaries could be at a disadvantage. We would be pleased to answer any questions you might have on this complex topic, and to work with your estate attorney to determine if your trust documents need updating.

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SPECIAL TOPICS

Robo-Advisors

“Algorithmic advisors,” “technology-driven investment managers,” or as the popular press has dubbed them, “robo-advisors,” are just a few of the terms used to describe companies that provide automated investing. These companies use basic inputs such as an investor’s age, financial position, goals and risk appetite into a company-specific proprietary algorithm to create a diversified basket of exchange-traded funds (ETFs) or other funds. The portfolio will generally include a mix of stock funds, bond funds, commodity funds and cash. Robo-advisors typically target smaller investors with uncomplicated portfolios, whose situations are more suited to this approach. Fees range from around 40-65 basis points, including fees charged by the funds in which they invest. While some robo-advisors offer features like automatic tax-loss harvesting, they cannot assist in setting up trusts or other more advanced estate tax planning undertakings. As the moniker suggests, most robo-advisors have little to no human interaction with an actual flesh-and-blood advisor, which is how they are able to charge such small fees.

Last year was one of explosive growth for the robo-advisors. At the end of 2014, these companies had combined assets under management of $19 billion, a 65% increase over eight months. Larger, traditional asset management firms such as Fidelity, Vanguard and Charles Schwab have all jumped into the space with their own robo-advisor platforms to compete with standalone companies such as Betterment and Wealthfront.

Attractive features of the robo-advisors include quick and easy account set-up, low cost structure and effective user interfaces and mobile apps to appeal to millennials, the generation that appears to be the target market. For example, Wealthfront boasts on its home page that “hundreds of employees of companies like Facebook, LinkedIn and Google are Wealthfront clients.”

The robo-advisors provide a simple and effective starting point for smaller investors who only need help with asset allocation. However, as investors’ net worth increases, they need both an unbiased sounding board and someone who is well-versed in all aspects of wealth management. Investors at this level typically need the broad expertise and experience that a wealth advisor can bring to balancing risk/return, income and estate tax management with the human concerns most important to each unique individual.

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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