NELSON ROBERTS QUARTERLY COMMENTARY

2017 | FIRST QUARTER

ECONOMIC OVERVIEW

Trump Trade

The Dow Jones Industrial Average continued its post-election ascent through February, hitting an all-time high of 21,115 on March 1. From the pre-election low to the March high, the market rose 18%. Since the election, investors bid up stock prices in anticipation that the impact of reduced regulations and fiscal stimulus would substantially boost corporate earnings.

Source: Bloomberg

The Trump administration worked quickly after inauguration day to sign executive orders delaying implementation of new regulations such as the Department of Labor's Fiduciary Rule that was set to go into effect this April (see Nelson Roberts Q2 2016 Commentary). As White House efforts turned toward more substantive and permanent changes, the administration suffered its first legislative setback. This caused the market to decline 2% during the month of March.

Over the 7 years since the Affordable Care Act's passage, a major focus of the Republican Party has been its repeal. The American Health Care Act, which would have repealed and replaced the ACA, was the first piece of legislation that the Republican majority in Congress and the Trump administration attempted to pass. On March 24, Speaker of the House Paul Ryan pulled the bill from consideration, stating that there were not enough votes for passage. This calls into question whether the Trump Administration has the ability necessary to get a bill through our political process.

The post-election market gains were largely driven by an expansion of price-to-earnings valuations. With a lack of confidence in Congress and the administration's ability to pass legislative reform, we worry that we will see market valuations contract to pre-election levels.

Higher interest rates also put pressure on stock market valuations. In mid-March, the Federal Reserve raised its benchmark rate for the third time since the financial crisis, although this was only the second raise in three months. The benchmark range was raised 0.25% to 0.75% – 1.00%. The Federal Reserve is responding to the underlying strength in the U.S. economy. We anticipate that this is the first of three rate increases in 2017.

INDEX PERFORMANCE	Q1'17	YTD
Dow Jones Industrials	5.19	5.19
Standard & Poor's 500	6.07	6.07
EAFE (international stocks)	7.91	7.91
Russell 2000 (small stocks)	2.20	2.20
Barclays Interm. Gov/Credit	0.77	0.77
Barclays Municipal	1.58	1.58

INSIDE THIS ISSUE

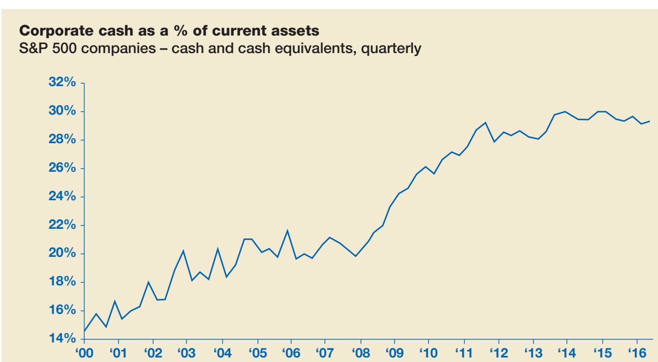
TOP FIFTEEN HOLDINGS

ISHARES S&P SMALL-CAP ETF
AMAZON.COM INC.
COSTCO WHOLESALE CORP.
VANGUARD EMERGING MARKET ETF
UNITEDHEALTH GROUP INC.
SCHLUMBERGER LTD.
FIRST REPUBLIC BANK
UTILITIES SECTOR SPDR
AKAMAI TECHNOLOGIES INC.
ALPHABET INC.
CISCO SYSTEMS INC.
STRYKER CORP.
TRAVELERS COS INC.
T ROWE PRICE GROUP INC.
TJX COMPANIES INC.

ECONOMIC OVERVIEW

Trump Trade (cont'd)

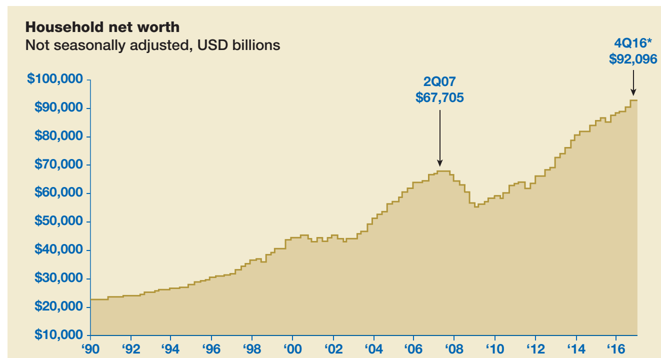
Regardless of whether or not we see further legislated stimulus, strong economic fundamentals should drive earnings higher. After oil sector earnings declines over the last two years, corporate earnings as a whole are now poised to rise. S&P earnings are projected to rise from $108 in 2016 to $129 in 2017. These estimates are probably overly optimistic in light of the recent political stumbles. However, corporations are in good shape: cash as a percentage of assets has doubled since 2000 and payroll growth has been strong.



Source: JPMorgan, FactSet, Standard & Poor's

The economy is also in good shape. March unemployment claims of 223,000 were the lowest in 44 years. The labor market looks good, inflation is just starting to pick up and consumers as a whole have recovered from their financial crisis woes.

Consumer households continue to strengthen. Household net worth is at an all-time high. Consumer confidence and sentiment measures indicate that the consumer spending should continue unabated. Foreign developed markets performed well in the first quarter, however the overseas markets are being affected



Source: JPMorgan, Bureau of Economic Analysis
*JPMorgan estimates

by political changes. British Prime Minister Theresa May triggered Article 50, the provision that puts in motion the UK's official exit from the European Union. This occurred amidst negotiations with Scotland and Northern Ireland about their participation in the economically independent UK.

The upcoming French election will provide another interesting data point for the global trend of rising nationalism. The leader of the National Front Party, Marine Le Pen, has been a vocal critic of the European Union and has pledged to seek an exit for France. We think these issues create headwinds for developed foreign economies and stocks.

Earnings growth should support current market levels or potentially push it slightly higher. The downside risk is that we do not see legislative progress towards regulatory and tax reform, which we think we could cause P/E contraction to pre-election levels of 19 times. If this occurs, and if earnings growth continues as projected, the market would likely hover around current levels.

> Since the election, investors bid up stock prices in anticipation that the impact of reduced regulations and fiscal stimulus would substantially boost corporate earnings.

ASSET MANAGEMENT

Adding to Small-Cap and Maintaining Low Turnover

The first quarter was fairly quiet in terms of trading as we maintained low turnover in our portfolio. We made a decision to increase our small-cap stock exposure by adding to our position in the iShares Core S&P Small-Cap exchange-traded fund (tkr: IJR). Small-cap stocks tend to be more volatile than large-cap stocks, which can be beneficial in an overall rising stock market. Smaller stocks also generally have more domestic exposure, which we believe will be a positive attribute given the demonstrated strength of the US economy. More domestic exposure also means that smaller stocks are usually less susceptible to adverse effects due to strength in the US dollar. When the US dollar strengthens, US products become more expensive to foreign buyers, making US products less competitive on the global market. This is why multinational corporations will often see international revenues fall when the US dollar strengthens.

In addition to adding to our small-cap position, we decided to trim two of our other holdings. F5 Networks (tkr: FFIV) has performed very well over the past year, rising about 50% due to optimism about several new networking hardware product releases. Over that timeframe, its price-to-earnings ratio expanded from 17 to 26 as investors cast aside the macro worries, including a challenging European sales environment, which had plagued the stock throughout much of 2015. Over the longer term, we see a potential threat to F5 if some of the larger cloud vendors, including Amazon, develop more sophisticated cloud-based load balancers. For now, F5 offers a customizable and high-performance hardware solution that gives it an advantage in a hybrid cloud environment, but if cloud-based load balancers begin to command a larger percentage of the Application Delivery Controller (ADC) market, this will impact F5's growth. We still believe F5 will continue to perform well in the short term with its new products, particularly because it will have easy year-over-year comparisons in the coming quarters. For this reason, we trimmed our F5 position, but still maintain an overweight relative to the S&P 500 Index.

We also decided to trim TJX Companies (tkr: TJX) to bring our consumer discretionary weighting in line with our target weight. TXJ Companies, which includes TJMaxx, Marshalls, and HomeGoods stores, has performed very well in spite of a secular decline in retail. The company has managed to increase its top and bottom lines as well as its comparable-store sales by effectively managing inventory and fostering a "treasure hunt" mentality. Inventory turns over rapidly, and customers never know what they might find. As larger department stores deal with declining sales and inventory glut, off-price retailers such as TJX Companies benefit as they can scoop up that inventory at a lower cost. However, department stores have begun attempting to boost sales by making changes, including tightening inventory, which could affect TJX Companies down the road. Nevertheless, we maintain an overweight position in TJX Companies relative to the S&P 500 Index since we believe it is an extremely well-managed company that has demonstrated it can weather the storm even through a secular retail decline.

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

Estate Tax Changes

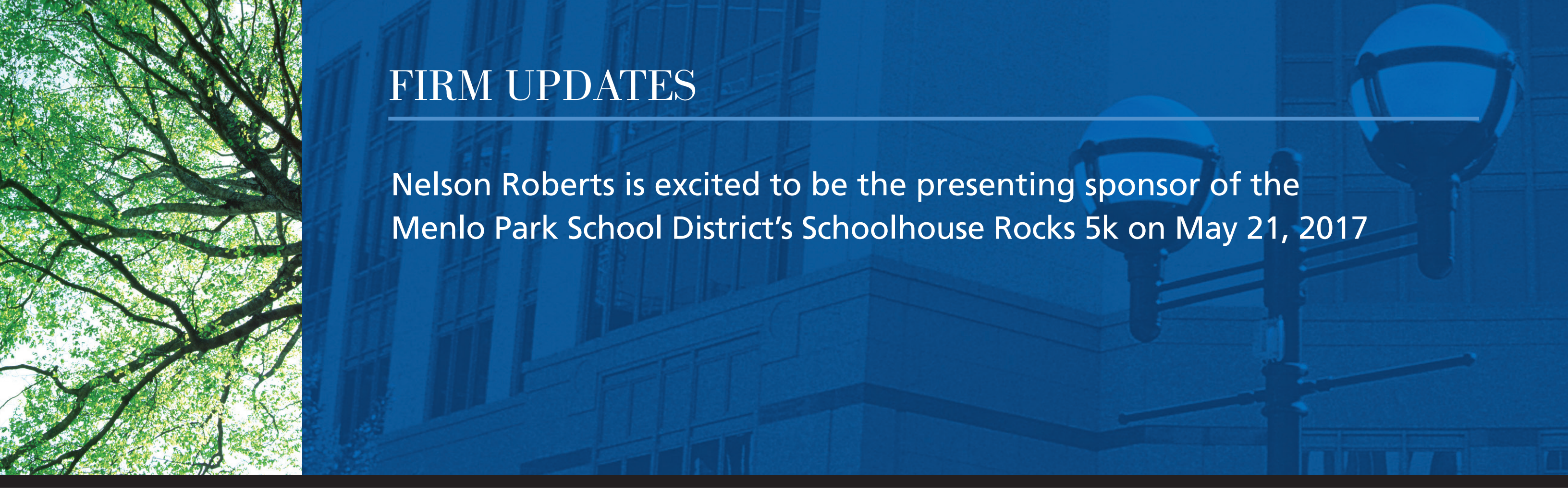
Our colleagues in the estate planning business have reported the rumors and rumblings coming out of Washington DC. The Republican Party has long held the repeal of the "Death Tax" as a part of the policy platform. With the turmoil created by the March 24th withdrawal of the healthcare vote, much is in question, but if tax reform does come to the House and Senate floors, there is a good chance that changes to the estate tax could be a part of the vote.

What might this look like? Speculation is that the current estate tax would be replaced by a Canadian-style capital gain tax due at death on any amount beyond the lifetime exclusion. If the exclusion was set at $5 million, then the tax would only be due if the decedent's taxable estate was in excess of this amount. This might then produce a capital gains tax of 20% beyond this amount. Under our current income tax code, capital gains taxes for those with taxable income above $470,000 is 20% plus an additional 3.8% levied under the Affordable Care Act on gains above $250,000 ($200,000 for single filers). Whether this additional tax gets repealed is in doubt, given the March 24th turmoil.

Considering the various possibilities, the effect of these speculated changes would be to reduce the estate tax burden by nearly half. The only catch is that marriage exclusion may not survive. If it does not, then this capital gains tax would be payable on the estate of the first spouse to pass, and that could be significant for some taxpayers.

For example, a couple with a combined taxable estate of $20 million would have a tax due on the estate of the first spouse of $1,190,000. If the survivor's estate is also then taxable at $5 million, an additional $1,190,000 would be due on the survivor's passing. Contrast this with the $4 million that would be due on the passing of the survivor under the current law.

Bottom line, the best advice we have been given is to be patient and see how the changes evolve. For those of you with a liability under the current law, continuing to use your annual exemption probably makes sense, as long as you are completely financially secure. The annual exemption allows each of us currently to give $14,000 a year to any individual without paying gift tax. This is a "use it or lose it" exemption and does not rollover into future tax years. The gift and estate taxes are currently unified, meaning that the tax is due regardless of whether we make the gift during our lives or at death. Though this tax can be a significant impact, more than 99% of all estates are not large enough to be subject to the tax. So if you are subject to it, please celebrate your good fortune while we work with our colleagues to minimize its impact.



FIRM UPDATES

Nelson Roberts is excited to be the presenting sponsor of the Menlo Park School District's Schoolhouse Rocks 5k on May 21, 2017

FEATURED EQUITY

Qualcomm

Qualcomm (tkr: QCOM) has been a core holding in our technology sector based on the thesis that it should benefit from continued expansion of global smartphone usage. Qualcomm not only sells chips that go into smartphones, but it also collects license revenue for phones that connect to cellular networks using its patented license technology. Qualcomm's revenue is broken down in two segments: chip revenue and licensing revenue. Although the licensing segment accounts for about 30% of total revenue, it brings in nearly 70% of Qualcomm's pretax income.

Legal and regulatory challenges to Qualcomm's licensing business model have battered the stock in recent years. Beginning in late 2013, the China National Development and Reform Commission announced that it was investigating the licensing business relating to Chinese Anti-Monopoly Law. Qualcomm was ultimately fined $1 billion and the challenge has since been resolved. However, even after the official resolution, Chinese licensees refused to pay license fees. As a result, Qualcomm faced an uphill battle of signing agreements with each individual Chinese device maker, while baking in lower revenue guidance to account for the failure to collect payments. Furthermore, similar regulatory bodies in Korea, Japan Europe as well as the Federal Trade Commission (FTC) in the US have also launched investigations, calling into question the sustainability of Qualcomm's lucrative licensing business model.

On January 17, 2017, right before the inauguration of the new administration, the FTC filed a complaint charging Qualcomm with using anticompetitive tactics. Analysts anticipate that the new Republican-majority FTC will withdraw the complaint, but Qualcomm faces this legal headache in the meantime. Three days later, on January 20, Apple filed a similar lawsuit against Qualcomm. Qualcomm will fight these lawsuits, but Apple contributes roughly 25% of Qualcomm's licensing revenue, which gives the iPhone maker leverage in the lawsuit. These two events caused Qualcomm's stock to drop significantly, taking its PE ratio from 17.5 to 14. In 2017, Qualcomm is down 12% while the rest of the technology sector is up about 10%.

At this point, we believe the bad news is in the price of Qualcomm's stock. Furthermore, we see upside opportunity as Qualcomm has just begun to diversify its revenue beyond smartphones. In October of 2016, Qualcomm announced it was acquiring NXPI Semiconductors for $47 billion. This acquisition gives Qualcomm exposure to emerging technologies such as self-driving cars and the Internet of Things. Intel (tkr: INTC) recently made a similar acquisition when it purchased MobilEye (tkr: MBLY) for $15.3 billion. Remarkably, Intel paid over 110 times earnings for MobilEye, while Qualcomm paid only 18 times earnings for NXPI. We continue to hold Qualcomm in spite of near-term challenges because we believe it carries a low valuation, pays a high dividend and it is positioned well to capitalize on the next waves of technology.

(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.)

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SPECIAL TOPIC

Advertising Revenue

Snap Inc. (tkr: SNAP), the parent company of social media company Snapchat, recently went public in the largest US IPO since 2014. Snapchat relies on revenue from advertisers who are looking to reach the younger millennial generation. Alongside this IPO, we wanted to take a look at the broader advertising revenue market to get an idea of growth trends in the space.

According to eMarketer, total media ad spending worldwide is expected to be about $575 billion in 2017, with an average annual growth rate of just over 5%. Digital media offers advertisers a way to reach a more granular audience compared to traditional media forms, such as television and print advertising. Not surprisingly, digital media's share of ad spending is growing rapidly and taking share from other traditional media ad channels. In fact, eMarketer estimates that digital media ad spending will overtake TV ad spending this year. The rapid rise in digital advertising has helped deliver impressive revenue gains for digital companies like Facebook (tkr: FB) and Alphabet (tkr: GOOG). Furthermore, digital ad growth has fueled the hype behind newer companies such as Snap, which some believe could see a boost as advertisers look to attract the coveted millennial user base. Alongside this growth, the combined market cap of digital advertising companies has grown to over $1 trillion. This is roughly 4.5 times the $220 billion digital advertising revenue opportunity. By comparison, the combined market cap of publicly-traded print advertising companies is about $15 billion, which represents just one-fifth of the $74 billion print advertising revenue opportunity. Of course, we would expect higher valuations for the digital advertising companies due to its higher growth expectations, but we cannot expect that this rapid growth will be endless.

At some point, digital media ad spending growth will likely moderate to around the 5% average total media growth rate, if we believe in the law of large numbers. We could also see a new advertising medium introduced, which could overtake digital advertising. In any case, we believe it is unlikely that digital advertising revenue will accelerate growth from current levels. While we certainly want to be invested in this fast-growing space, we also remain mindful of company valuations when choosing how to invest. We made the decision to invest in Alphabet, which is currently trading at 30 times earnings and about 6.5 times sales. We think this is a more reasonable valuation compared to Facebook, which is trading at 40 times earnings and 15 times sales. Snap Inc. is not yet profitable (Snap lost $515 million in 2016) so we do not have a price-to-earnings ratio, but Snap is trading at over 63 times sales. Furthermore, we like that Alphabet has been investing to diversify their revenue beyond the advertising market, namely with the "Other Bets" segment. This segment includes emerging technologies such as self-driving cars, artificial intelligence, and the Internet of Things, all of which could open up new streams of revenue for the company.

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