NELSON ROBERTS

QUARTERLY

COMMENTARY

2016 | THIRD QUARTER

ECONOMIC OVERVIEW

Bull Market has Further to Run

Last quarter ended with the Brexit shock, which initiated a two-day 800-point drop in the Dow Industrial Average on June 24. This was immediately followed by a 4-day, 800-point rise, effectively reversing all of the Brexit's impact on the US stock market. The first two weeks of July produced a 3% rise in the Dow and the S&P 500. Then, from the middle of July to September 8, the stock market went through one of the calmest periods in over a decade. Volatility returned September 9 when Boston Federal Reserve President Eric Rosengren, a longtime supporter of lower rates, stated that the time to increase interest rates was nearing. His statements, coupled with the negative election rhetoric, ended the summer's calm.

We have not detected any signs of optimism, let alone euphoria, suggesting that the bull market has yet to peak. The banter between two of the least-liked presidential candidates in modern history has led investors to focus on the negatives. Interest rates are stuck in the basement, yet the Fed is saying that higher rates are coming, oil is dragging around $45 a barrel, stocks feel risky and volatile, and the election will likely be a circus. In the US, these factors are generating significant apprehension.

The rest of the world looks far worse. The world's second largest economy, China, continues to retrench following a period of excessive overbuilding. This has caused commodity prices worldwide to fall for most of the last two years. Consequently, economic growth continues to languish in the developed world. In response, central bankers in Germany, Japan and Switzerland have pushed interest rates below 0% for maturities of up to 10 years. Who, you might ask, would buy a bond that implies a loss, albeit a small one? No rational investor would. Buyers of these bonds are either issuing governments or banks obliged by regulation. Hence, it is central banks and financial institutions that are driving rates into negative territory. The volume of bonds with negative rates has gone from zero in mid-2014, to nearly 30% today. Of the $40 trillion bonds outstanding, $11 trillion now yield rates that guarantee losses.

These central bankers are pushing on a string. If anemic growth is a product of low commodity demand in China, lowering rates in Japan and Europe will have no effect. The Chinese only borrow internally. Pushing rates ever lower in the developed world has not had the desired effect of stimulating their economies, so continuing this course of action is truly insane.

INDEX PERFORMANCE	Q3'16	YTD
Dow Jones Industrials	1.85	7.21
Standard & Poor's 500	3.03	7.84
EAFE (international stocks)	6.81	2.50
Russell 2000 (small stocks)	9.05	11.45
Barclays Interm. Gov/Credit	0.82	4.24
Barclays Municipal	-0.31	4.01

INSIDE THIS ISSUE

ECONOMIC OVERVIEW
Bull Market has Further to Run.

ASSET MANAGEMENT
A New Sector and a Busy Quarter

FIXED INCOME
Premium Bonds

FEATURED EQUITY
Allergan (tkr: AGN)

SPECIAL TOPIC
Hedging Volatility in November

TOP FIFTEEN HOLDINGS

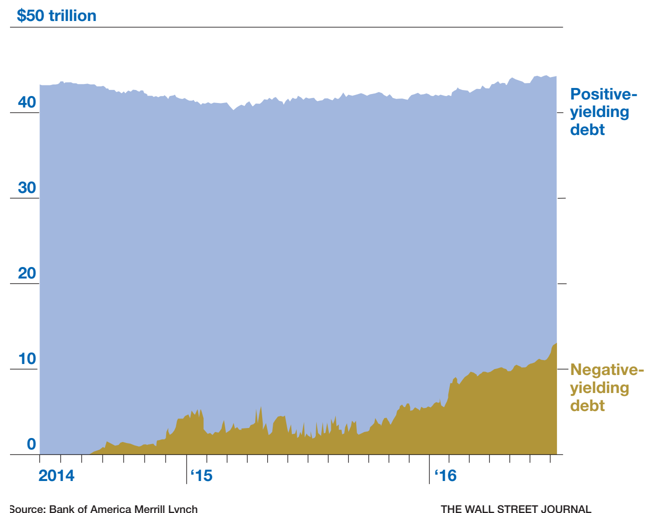
AMAZON.COM INC.
ISHARES S&P SMALL-CAP ETF
VANGUARD EMERGING MARKET ETF
SCHLUMBERGER LTD.
COSTCO WHOLESALE CORP.
TJX COMPANIES INC.
UTILITIES SECTOR SPDR
UNITEDHEALTH GROUP INC.
ALPHABET INC.
QUALCOMM INC.
CISCO SYSTEMS INC.
AKAMAI TECHNOLOGIES INC.
T ROWE PRICE GROUP INC.
TRAVELERS COS INC.
FIRST REPUBLIC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

ECONOMIC OVERVIEW

Bull Market has Further to Run (cont'd)

Meanwhile, in the US, job growth is excellent, earnings are mostly coming in on target, housing prices continue to rise, and personal income is rising, as evidenced by the Census Bureau's recent report of a 5.2% gain for 2015. Still, investor sentiment reflects a glass half empty.

The upcoming election looms large. The parties are very far apart and unwilling to compromise. Historically, the best political result has been achieved when the two sides engage in give and take.



The 1986 Tax Reform Act is a great example. We desperately need a repeat performance, but given the current divisive political environment, there is little chance of that. We think the worst election outcome would be a clean sweep of the presidency, Senate and House by either party. But, if we can believe the polls, this looks exceedingly unlikely. Therefore, whether Hillary Clinton or Donald Trump is elected president, we believe the chance of extreme policy change is low.

One can lament that the status quo is likely to continue. There are big problems that need fixing, including the out-of-control costs of healthcare and education. Additionally, persistent low interest rates are making it nearly impossible for municipalities and states to earn the rate of return implicit in their pension and healthcare benefit plans. If we see many more years of this, we, the taxpayers, will be asked to bail out effectively bankrupt sponsoring municipalities. With our political parties moving ever further apart, there is little chance that solutions to these pervasive problems will be implemented in the foreseeable future.

You might think that lethargic world growth, divisive politics, and investor apprehension would cause us to be cautious and defensive. On the contrary, we see opportunity in our domestic stock markets. The bond market will continue to be challenged to produce a real return, providing, at best, a safe haven for funds earmarked for near-term expenditures. We concede that the fear of rising interest rates will cause the stock market to stumble occasionally, as seen on September 9. However, good economic indicators, muted sentiment, and few signs of froth suggest that the bull market has further to run.

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ASSET MANAGEMENT

A New Sector and a Busy Quarter

The quarter's most significant asset management news is that Standard and Poor's (S&P) changed how it categorizes companies, splitting the former financials sector into the real estate and financial services sectors. The first consists almost entirely of real estate investment trusts (REITs), companies that own, and sometimes build and operate, income-producing real estate such as malls, apartments, and office buildings. Because real estate produces income, most pay high dividends. However, those dividends are taxed as ordinary income, making REITs less attractive for taxable portfolios. The new financial services sector consists primarily of banks, insurance companies, and asset managers; it is vastly larger than the new real estate sector.

In July, Danone announced that it would buy WhiteWave Foods (tkr: WWAV), a holding of ours for nearly two years, for $10.4 billion in cash. Following the announcement, the stock jumped 19% above the previous day's closing price. We decided to lock in our gains and sold the stock.

We added United Technologies Corp. (tkr: UTX) to our industrial sector holdings. It specializes in elevator and escalator manufacturing; heating, ventilating and cooling (HVAC) and refrigeration solutions; aircraft engines, and other advanced aerospace products. Nearly half of its revenue comes from high-margin, recurring aftermarket services. The company benefits from worldwide urbanization, emerging market economic growth and commercial building development. We like its low P/E, high dividend, and stability as an established industrial company with lots of cash on hand.

We sold Varian Medical Systems (tkr: VAR) and purchased Stryker Corp. (tkr: SYK). We like Stryker specifically because it is a well-managed company that is larger, more diverse, and less volatile than Varian and it pays a dividend, whereas Varian does not. Varian's stock price reached a five-year high after its last quarterly earnings report, which presented a good opportunity to sell it in favor of Stryker.

We sold our position in the Health Care Select Sector SPDR fund (tkr: XLV) for a position in Allergan Inc. (tkr: AGN, please see "Featured Equity"). The trade brings our health care subsector distribution more in line with the market by adding another big pharma name. More than 60% of Allergan's business is in the United States, its cosmetics unit (a quarter of revenues) is a cash business, and it recently sold its generics business to focus on higher-margin drugs. The stock declined precipitously after its pending acquisition by Pfizer (tkr: PFE) fell through. We believe the market significantly undervalued the stock and that it was an opportune time to establish a position.

We sold New York Community Bancorp (tkr: NYCB) in favor of a larger bet on First Republic Bank (tkr: FRC). We think NYCB's pending $1.9 billion acquisition of Astoria Financial Corp. (tkr: AF) is risky due to its relative size and management's inexperience with large mergers. We thought it prudent to wait on the sidelines given the risk of another dividend cut, which would decrease the attractiveness of this high-yielding stock. First Republic's continued success stems from asset growth—extending high-quality jumbo mortgages—the rapid expansion of its wealth management business, and synergies driven by its "relationship banking" business model.

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.

FIXED INCOME

Premium Bonds

Many bond investors are used to the idea of buying a bond at par value (price = $100) and receiving par value back at maturity. The idea of paying a premium, or paying more for a bond than it is worth at maturity, may seem like a bad idea. In fact, premium bonds can be better investments than non-premium bonds in a raising interest rate environment. Premium bonds return higher cash flow to the buyer which shortens the bonds' duration and makes them less sensitive to interest rate changes.

What is a premium bond?

A premium bond is a bond trading above its par value (e.g. price is more than $100). A bond will trade above its par value when its coupon is higher than current interest rates. If prevailing interest rates are near 3% and a bond has a 5% coupon then buyers will pay a higher price to receive the larger coupon rate. The coupon rate is the amount of interest paid per year to a bondholder. While the coupon on most bonds is fixed, the market price of a security changes based on market conditions. The value of a bond depends on market interest rates, credit quality, coupon rate and maturity date of the bond. While economic and market-driven events impact a bond's value, the expectation of change in interest rates typically has the strongest influence on bond prices. When interest rates fall, bond prices rise and when interest rates rise, bond prices fall.

Which is the preferred bond to own in a raising interest rate environment?

At first glance, the answer may seem simple — buy the discount bond at $95 and benefit as the price rises to $100 at maturity. Alternatively, paying $110 for a bond that is going to mature at $100 seems to make no sense. But the difference in price is made up for by the higher coupon in the case of the premium bond, and the lower coupon in the case of the discount bond. In other words, the bond trading at a premium will offer higher income payments than the bond trading at a discount, which makes up for the difference in price.

Advantages of buying bonds at a premium:

- Premium bonds have a higher coupon, and therefore return more income to the investor
- Premium bonds are typically less sensitive to fluctuations in prevailing interest rates than similar discount bonds.

Disadvantage of buying bonds at a premium:

- Premium bonds require a larger capital commitment up front

A bond's investment return cannot be judged on price alone. Premium bonds offer a fairly straightforward trade-off: you pay more up front in exchange for larger interest payments. The higher cash flows of the premium bond accelerate the return on your investment. If interest rates are rising, the accelerated return of investment allows for cash to be reinvested at higher rates.

Type of Bond	Coupon	Maturity	Yield to Maturity	Price per Bond
Discount	2%	10/1/2026	3%	$95
Par	3%	10/1/2026	3%	$100
Premium	5%	10/1/2026	3%	$110

FIRM UPDATES

Nelson Roberts is pleased to congratulate Evan Nelson on his recent marriage to Katie Ringer. Evan and Katie were married in Santa Rosa on September 10, 2016.

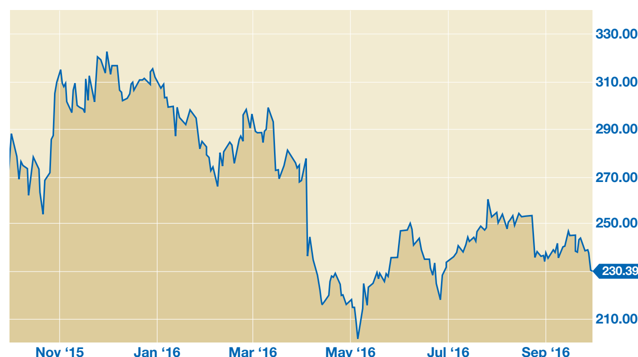
Nelson Roberts would also like to congratulate Darcy Nelson Smoot on passing all three levels of the Chartered Financial Analyst (CFA) exam. As a charterholder, she has achieved the right to begin using the CFA designation.

Nelson Roberts would also like to recognize Evan Nelson for passing the Certified Financial Planner (CFP®) Exam earlier this year.

FEATURED EQUITY

Allergan (tkr: AGN)

Allergan is taking a different approach than some other big pharma companies by focusing strictly on branded drugs. It anticipates revenues of $15 billion in 2016. Management has used mergers and acquisitions to transform the company into a major contender in the pharmaceutical industry. Allergan was founded in 1948, when a pharmacist developed a new type of nose drop. What really vaulted Allergan into prominence, however, was acquiring the rights to Botox in 1988. By 2013, Botox had over $2 billion in sales and accounted for one-third of Allergan's revenue. Allergan was acquired by Actavis in 2012 for $66 billion following a failed acquisition attempt by Valeant. Actavis then renamed itself Allergan. The company employs 30,000 people and is domiciled in Ireland, with headquarters in New Jersey.



Allergan organizes its business into three segments: (1) US Brands (65% of revenues) with treatments for women's health, gastrointestinal diseases, urology diagnoses, central nervous system problems and eye diseases (2) US Medical Aesthetics (15% of revenues) with major products including acne treatments, breast implants, Juvederm and Botox and (3) International (15% of revenues). Allergan has an extremely diverse product portfolio, with only three products producing sales of more than $1 billion and over 40 products with sales of around $200 million. Botox has a 76% global market share and boasts many applications beyond cosmetics. It accounts for almost 16% of revenues at $2 billion per year. AGN's other big seller is Restasis, whose revenues make up 8% of Allergan's total, which is used to treat dry eye that results from inflammation.

AGN was an attractive addition to our portfolios for three reasons. First, its proposed merger with Pfizer collapsed in April due to new rules issued by the US Treasury regarding tax inversion, driving the stock down almost 25%. Second, it recently sold its generics business and its drug distribution business to Teva, netting $36 billion after tax. It will use this money to pay down debt, repurchase shares and acquire smaller companies ("stepping-stone" acquisitions generally for less than $3 billion). Finally, owning AGN provides a relatively safe way to be in the cosmetic pharmaceutical market. Botox is difficult to make, decreasing the likelihood of a generic competitor. Only two other neurotoxins have been approved for use in the US.

(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

Hedging Volatility in November

We emailed this piece out to clients on September 16. We have updated the cost at the bottom, which is lower as of this writing due to lower implied volatility and less time to expiration.

We want to apprise you that we have the tools and expertise to hedge stock market risk over short time periods. This is not something that we are recommending for any client presently, but we want to inform you of this capability.

With the upcoming very divisive and highly contentious presidential election, some are concerned that the uncertain election result could have a severe negative impact on the US stock markets. We see parallels between Britain's vote in June on whether to stay in the European Union (the Brexit) and our presidential election this fall. In both cases, one of the choices seems more politically correct than the other, which, in the case of the Brexit, precipitated an inaccurate polling predictions. As a result, when the outcome of the vote was not what the markets had expected, global markets declined between 3% (in the US) and 12% (in Italy) in trading the following day. Some of our clients have expressed concern that markets could experience a similar negative shock here in November.

Fundamentally, US economics look healthy: unemployment is down, wages are rising, the housing market has rebounded, and consumer confidence is higher. For the majority of our clients who have a long-term investment horizon, we recommend taking no action. But those who are very concerned about potential volatility might be tempted to do something in the short term. The obvious choice is to sell some or all of one's stock market exposure. This would potentially result in a large tax liability that we would all prefer to avoid.

An alternative way to protect a portfolio against adverse short-term market reactions is to use derivatives such as put options to offset the potential loss. The put option position itself is extremely volatile, but functions as a form of "portfolio insurance" with the downside limited to the amount of premium paid. In other words, it is possible to lose the entire premium paid for the put option (100% of the investment in the position) if the downside risk never materializes. On the other hand, if the markets react negatively within the specified timeframe, the rise in the value of the put option will help offset the loss in the stock portfolio.

For example, a put option contract that expires after the election in mid-November currently costs approximately 2% of the portfolio notional. An investor could buy a put to hedge a $1 million portfolio for about $20,000. If by the option expiration date, markets do not decline from current levels, the portfolio will lose the entire $20,000 premium. But if markets decline more than 2%, the put option will rise in value, offsetting most of the overall portfolio losses during that timeframe.

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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