NELSON ROBERTS QUARTERLY COMMENTARY

2016 | SECOND QUARTER

ECONOMIC OVERVIEW

Brexit!

Wait, was there a Brexit? Second quarter market activity was fairly staid until June 24, when the world received the results of the referendum in the United Kingdom on whether it should remain or leave the European Union (EU). The “Leave” campaign won unexpectedly by a narrow margin. In reaction, stock markets around the world dropped, high-grade bond yields fell, the British pound fell, and the price of oil declined. European stock markets were down 9% on average, with the Spanish and Italian markets each down 12%. Japan’s major stock index also dropped 8% on June 24. After a second down day on Monday June 27, the US markets rallied over the following three days to finish the quarter up about 2%, and bonds were up. (See the box on page 1 for 2nd quarter and year-to-date return data). In spite of the stock markets’ immediate rally back, the Brexit is a momentous event, as shown by the behavior of the British pound versus the US dollar (see chart on page 2.)

Bonds traded in a narrow band during the quarter before rising sharply on June 24. The yield on the 10-year US Treasury declined from 2.3% on January 1 to 1.47% at quarter’s end. Real bond yields are turning negative again. The Federal Reserve will likely take no action between now and our fall presidential election. Depending on how the world stock markets stabilize over this period, the odds are high that the Fed will resume increasing rates after the election. Unemployment is now down to 4.7%. The Consumer Price Index (CPI) indicates that price inflation is running at 1.0%, but the Personal Consumption Expenditure index (PCE), which figures more strongly into the Fed’s decision making, was up 1.6% as of the last reading.

The Brexit vote was clearly a repudiation of the status quo. Many powerful figures including the leaders of the top five British political parties, over 1,200 corporate CEOs including JPMorgan CEO Jamie Dimon, half of the leaders of the FTSE 100 (the biggest companies in the UK), UK Prime Minister David Cameron, and President Obama, all strenuously argued for “Remain,” to no avail. In the near term, we believe stock market volatility will continue as the implications of the Brexit emerge. Market observers are already commenting that the US markets will be viewed as the only safe haven, providing buying support to our markets.

Speculation has begun over who might be the next country to leave the EU. This likely will precipitate questions regarding the long-term viability of the euro as a currency.

INDEX PERFORMANCE	Q2’16	YTD
Dow Jones Industrials	2.07	4.31
Standard & Poor’s 500	2.46	3.84
EAFE (international stocks)	-1.23	-4.04
Russell 2000 (small stocks)	3.79	2.21
Barclays Interm. Gov/Credit	1.59	4.07
Barclays Municipal	2.62	4.33

INSIDE THIS ISSUE

TOP FIFTEEN HOLDINGS

iSHARES CORE S&P SMALL-CAP	T ROWE PRICE GROUP INC.
AMAZON.COM INC.	AKAMAI TECHNOLOGIES INC.
COSTCO WHOLESALE CORP.	GILEAD SCIENCES INC.
SCHLUMBERGER LTD.	TRAVELERS COMPANIES INC.
TJX COMPANIES INC.	WHOLE FOODS MARKET INC.
VANGUARD FTSE EMERGING MARKETS	ALPHABET INC.
UTILITIES SELECT SECTOR SPDR	CISCO SYSTEMS, INC.
UNITEDHEALTH GROUP INC.	

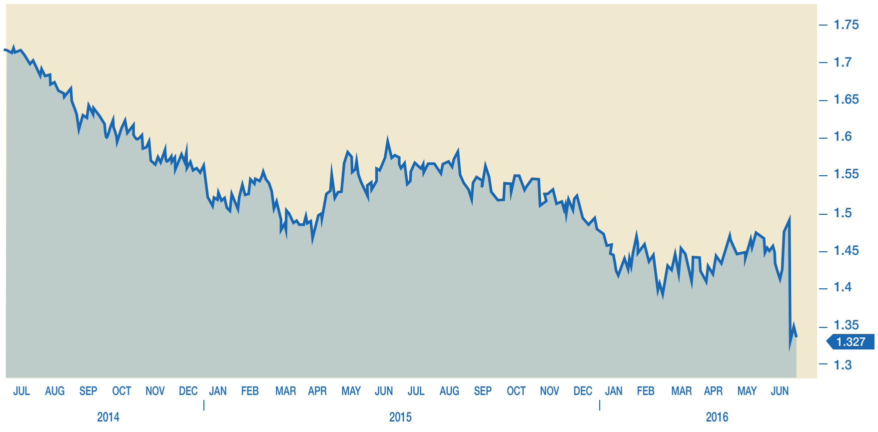
ECONOMIC OVERVIEW

Brexit! (cont'd)

As discussed in the article below on International Allocation, we have long rejected the conventional thinking that 30% of one's equity portfolio should be invested in non-US securities. The Morgan Stanley All-World index, a popular benchmark index for advisors like Nelson Roberts, has non-U.S. exposure of 46.5%. Today, we have an extremely small position of 2% for the foreign developed market ETF and 3% for emerging markets. The impact on our portfolios from the reaction to the Brexit will be significantly muted by this relatively low exposure.

How will all of this play out? The day after the Brexit vote, UK Prime Minister David Cameron went to Buckingham Palace to tender his resignation to the Queen. However, we do not believe anything substantive will happen until his replacement takes office in October. The UK's relationship with the US will remain unchanged. It will probably take years for the UK to negotiate new trade agreements with all of the remaining EU members. In the meantime, it will probably be trading as usual. Longer term, further disassociation amongst members will raise barriers to EU member growth in aggregate. This vote can be seen as a majority statement by UK voters that "whatever was working was not working for me, so I want something else." This sentiment is prevalent here in the US on both sides of the aisle, evidenced by the support that both Donald Trump and Bernie Sanders garnered throughout the election primaries. Pre-vote polling in the UK did not detect this sentiment very well, which leads us to ask, "Could something like that happen here in the US?" For 35 years, the wealth and income gaps have grown steadily wider to levels today that compare to the late 19th century. This trend is ripe for a change. Unless Hillary Clinton can alter voters' perception that she is the status quo candidate, it may work to her disadvantage.

£1 in US Dollars



Source: Bloomberg LP

Stepping back further, we see this sentiment as a global phenomenon which, at its core, represents the pendulum swinging between globalization and nationalization. The apogee of nationalization precipitated the last world war. Since then, trade barriers have been steadily reduced. We believe the Brexit marks a turning point, and that future developments will further raise economic barriers between countries.

While the U.S. is not devoid of challenges, on a relative scale, we are perceived as a safe haven for global investment. Our view continues to be that the US will be the best place to invest for the foreseeable future.

> “Market observers are already commenting that the US markets will be viewed as the only safe haven, providing buying support to our markets.”

ASSET MANAGEMENT

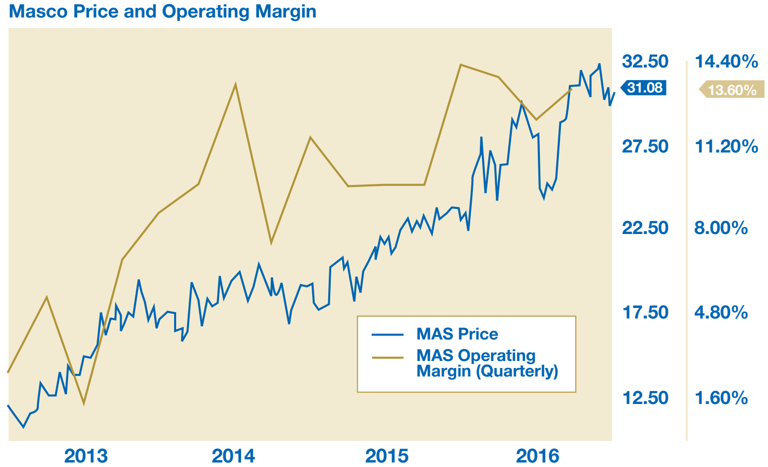
Industrial Sector Changes

Our limited trading this quarter focused on repositioning our industrials investments and managing our exposure to the sector. That included trimming Masco Corp. (tkr: MAS), which sells a diverse set of products to the home improvement and new home construction markets, and buying a position in Eaton Corp. (tkr: ETN), which sells industrial-grade electrical solutions to several different industries.

Masco was our largest overweight to the market, partly because the stock has performed exceptionally while we have owned it and partly because we added more in January. Masco turned around its money-losing cabinet business by focusing on the more profitable home center and dealer channels, it spun off its installation division, and its input costs fell. As a result, Masco’s margins have expanded tremendously over the past several years, and the stock’s valuation has increased in tandem. We trimmed Masco to a 2% position from 3.5% during the quarter because, while we still like the company and its end-market exposure, we found it appropriate to take some profit and reduce the large overweight position. We have found some evidence that leads us to believe Masco’s margins may be topping out. Management believes that the cost of materials has bottomed, including base metals, hardwood, titanium dioxide (a basic component of paints), and resins. Product mix has improved, but margin guidance suggests it will be insufficient to offset higher input costs going forward. We still like Masco as a long-term play, and continue to own more than the market. Housing data overall are on the upswing, suggesting growing revenues from the new construction market, and the company should meanwhile maintain steady cash flows from the repair and remodeling market, which makes up about 83% of Masco’s revenues.

After trimming our Masco position, we purchased a 1.5% position in Eaton Corp. (tkr: ETN). The majority of its sales derive from power generation and distribution products. It also sells electrical solutions to the more cyclical hydraulics, aerospace, and vehicle industries. Eaton is likely to benefit from the adoption of increasingly energy-efficient government standards, is undervalued relative to the industrial sector, and pays an attractive dividend. Adding Eaton helps maintain our portfolio’s industrials sector weighting (see Featured Equity, page 5).

Masco Price and Operating Margin



Source: Y charts

vision *[vizh' en] n. the ability to perceive or foresee through mental acuteness*

WHAT IS MONEY?

At its simplest, it remains a form of barter, an exchange of energy for goods. At its most complex, it's a symbol of mastery, a measure of power. At its center are people with vision, talent, skill, families, children, hope and dreams.

WEALTH MANAGEMENT

DOL Fiduciary Rule

The Labor Department issued new rules in April on how financial advisors handle their clients' 401ks and qualified retirement accounts covered by the Employee Retirement Income Security Act (ERISA). After years of clashing with big Wall Street firms that tried to stop the new regulations from going into effect, the government successfully passed rules that require all financial advisors to act in the best interests of their clients, not themselves, when dealing with retirement accounts. We, at Nelson Roberts Investment Advisors, welcome the new requirements since this is the way we have always done business.

The new rules highlight an important legal difference between stock brokers and registered investment advisors. As registered investment advisors, we are held to a fiduciary standard for all services and advice we provide to our clients. In other words, we have always been legally obligated to put our clients' best interests ahead of our own. This will be the first time that stock brokers are held to the same standard, although for brokers it will only apply to ERISA accounts. We believe the regulations should apply to all accounts.

Stock brokers are held to a "suitability" standard of care when managing client's assets. They are not required by law to offer the "best product," only a suitable one. A broker's objectivity could be easily clouded when making a recommendation between two investment products if product A pays a higher commission to the broker than product B. As long as product A is deemed "suitable" for the client, the broker can justify the higher commission. But under the new rule, brokers will be required to put their clients' interests first when managing ERISA accounts, eliminating the conflicts of interest that come from the current form of compensation. Stock brokers will continue to be regulated by the Financial Industry Regulatory Authority (FINRA) in contrast to registered investment advisors, which are regulated by the Securities and Exchange Commission (SEC).

The new rules go into effect April 2017, but they are already having an impact on financial firms. Rather than comply with the new standards and the higher cost of compliance, many large banks and insurance firms are exiting the wealth management business or no longer selling annuity products. Barclays, Credit Suisse, Wells Fargo and AIG have all announced such changes to their businesses.

Registered Investment Advisors	Stock Brokers
Fiduciaries	Non-fiduciaries
Legally must operate in the "best interest of the client"	Must provide "suitable investments", a looser standard
Regulated by SEC	Regulated by FINRA

Supporters of the new fiduciary law say it will protect investors from high-fee products that are recommended by advisors, but there is still a wide difference between how registered investment advisors and stock brokers care for their clients. The new regulations are a good first step, but we do not believe they go far enough. The fiduciary standard should apply to all client interactions.

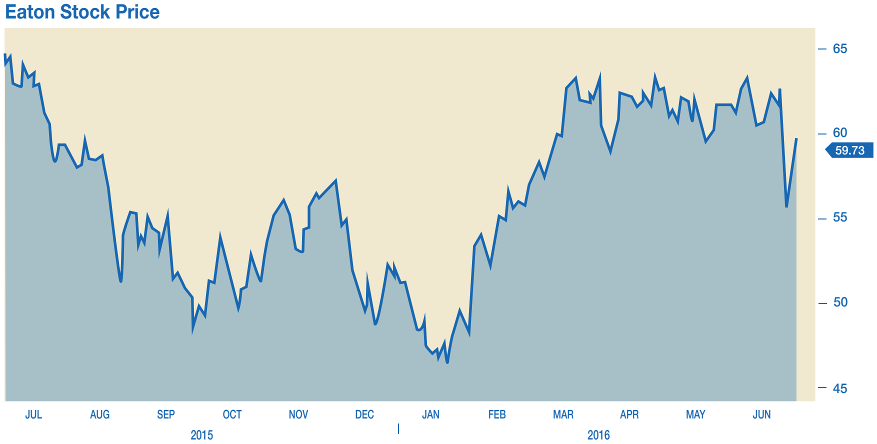
> "Even in an era when globalization is thought to be an inexorable force, national sovereignty still matters. It was national political decisions that created the European Union and may end up dismantling it."
>
> — William McGurn, Wall Street Journal columnist

FEATURED EQUITY

Eaton Corporation

Eaton Corporation (tkr: ETN) is a power management company that provides efficient solutions to help its customers manage electrical, hydraulic and mechanical power. Eaton operates in five primary segments: electrical products, electrical systems and services, hydraulics, aerospace, and vehicle. The two electrical segments make up the largest portion of Eaton's revenues (about 60%), and include lighting and wiring products in addition to distribution and control services. In 2012, Eaton acquired Irish company Cooper Industries for $11.8 billion. This acquisition allowed Eaton to establish its new headquarters in Dublin, Ireland, garnering a lower effective tax rate. It also expanded Eaton's exposure in the electrical utilities market. Eaton's electrical segments offer architects and building designers a one-stop shop solution that includes everything from power transmission to light units. Eaton should benefit from retrofits to older buildings, a trend driven by the adoption of energy-efficient standards.

Eaton Stock Price



Source: Bloomberg LP

Approximately half of Eaton's sales come from outside the US, which has caused foreign exchange headwinds due to a strong US dollar in recent years. Furthermore, Eaton's end markets, particularly the hydraulics segment, have been hurt by low oil prices since mid-2014. However, we think the dollar's strength and oil's fall have plateaued for now. In response to these challenges, Eaton has undertaken a three-year restructuring program to drive down costs, which has included plant closings, workforce reductions and re-engineering production processes. Eaton has already realized higher cash flow and higher operating margins in some segments. As Eaton continues to restructure, the company should see a leaner cost structure and better operating leverage.

With a host of potentially volatile events on the horizon, including the US presidential election, the uncertainty in the wake of Britain's decision to exit the European Union, and a possible rate rise by the Federal Reserve, we wanted to add a stable stock to our industrial sector. As an established diversified industrial company with a solid management team, Eaton fits this description. We also wanted a stock with a low price-to-earnings (P/E) ratio and a high dividend yield to act as an anchor in these volatile times. We believe Eaton is undervalued with a P/E ratio of 13x, lower than that of its peers and below its historical average P/E ratio of 18x. Eaton also carries a substantial dividend yield of 3.7% which adds yield to our portfolio in addition to any capital appreciation.

(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.)

OUR TEAM

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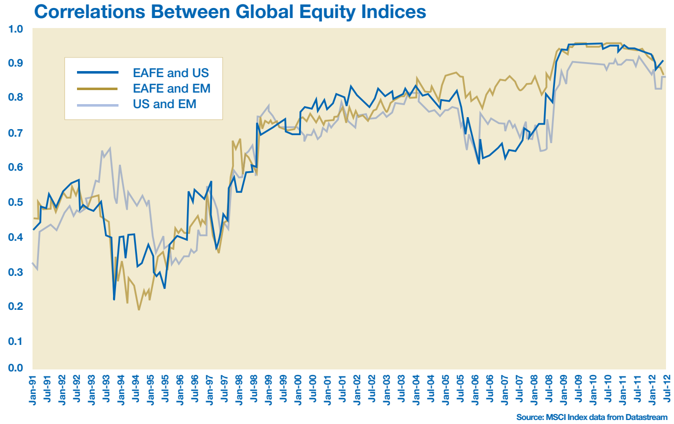
SPECIAL TOPICS

International Allocation: What is the Right Amount?

Strategic asset allocation plays a pivotal role in establishing the systematic risk exposures that are suitable for an investor. At Nelson Roberts, we perform strategic asset allocation using a number of different factors, which leads us to allocate assets among different classes, including domestic stocks as well as international and emerging stocks.

Allocating a portion of investments to international stocks benefits the portfolio due to the less-than-perfect correlation between international and domestic securities. In other words, when domestic stocks perform poorly, international stocks might perform relatively better, and vice versa. Diversification allows the better-performing asset class to offset some of the negative returns from the poorer-performing asset class, reducing the overall volatility, or risk, of the portfolio. In general, the lower the correlation between the domestic portfolio and international stocks, the stronger the volatility-reduction benefit achieved by adding international exposure to the portfolio. Although many agree on the benefits of diversified exposure, the question remains: how much should one allocate to international stocks?

Correlations Between Global Equity Indices



Ideally, we want to maximize the volatility-reduction benefit achieved by adding international exposure to the portfolio, while minimizing risk. We looked at a 2014 study by Christopher Philips, CFA, of Vanguard Research, which applies historical minimum-variance analysis using data on US and non-US stocks from 1970-2013 (please contact us for more details, or to see the study). The study concludes that the maximum volatility-reduction benefit would be achieved at around 30% exposure to international stocks. However, we believe this conclusion is predicated on the relatively low average correlation calculated over that time period. When we look at historical correlation over time, we find that increased globalization over the past 20 years has dramatically increased correlations between domestic and international stocks from around 0.40 to 0.90 (see chart below). We believe these correlations will remain high going forward, which would mean that the volatility-reduction benefit would be realized at lower percentage international allocation. Therefore, we generally assume a “neutral” international allocation of around 10%, which we adjust up or down based on our expectations for future returns achieved through macro-economic analysis. As mentioned earlier (see: Economic Overview), we are watching closely to see if the pendulum is now set in motion away from globalization towards nationalism, which could ultimately lead to lower correlations, although that would most likely take many years.

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