NELSON ROBERTS QUARTERLY COMMENTARY

2015 | FOURTH QUARTER

ECONOMIC OVERVIEW

Quickly Going Nowhere

In the first half of 2015, the US stock markets saw intraday volatility, although they traded within a relatively narrow band through the end of June. Then, a slow decline began in mid-July, which culminated in a "Flash Crash" type of drop on August 24th, 25th and 26th. For the next month and a half, news reports incorrectly attributed this decline to worries over the slowing Chinese economy. Proof that this attribution was incorrect lies in the October rally, which took the market back to its earlier range despite no change in the Chinese economy. In our September 30th commentary, we discussed the stock market liquidity issues that caused such volatile declines at the end of the summer. One could equate the August/September "Chinese panic" decline to the "Ebola panic" decline of 2014. Recall in the fall of 2014 when the markets fell over fears that an Ebola epidemic might start in the US (of course, this never actually happened). Both "China" and "Ebola" were hotly-discussed topics in the media, yet neither was the real root cause for the stock market decline.

Stocks were not the only market to suffer from impaired liquidity. Bonds rated lower than investment grade, or so-called "junk bonds," declined significantly in the fourth quarter due to illiquidity among the riskiest issues. This decline created a crisis, which forced a large fund, the Third Avenue Focus Credit fund, to liquidate.

For 7 years, the longest period on record, the benchmark Federal Funds rate has been virtually 0%. On December 16th, the Federal Reserve raised interest rates for the first time since August 2006. This move had been anticipated for years, and was probably the most widely telegraphed move the Fed has ever made. The Fed started the process of applying monetary restraint in the fall of 2014 when they stopped adding to the bonds on the Fed balance sheet. This bond buying was the stimulus program known as Quantitative Easing. In December, Fed Chair Janet Yellen finally took the long-anticipated step of raising short-term (one day) rates from the 0-0.25% range to a target of 0.25-0.50%. Now the focus is on when the next 0.25% increase will occur. Notice on the long-term chart how truly miniscule this move was (see next page).

Unemployment has declined steadily from a high of 10% in October 2009 to the November reading of 5%. This level is generally regarded as the "full employment" rate and has given the Fed motivation to raise their target interest rate. However, since wage growth has been subdued, increasing from 1.8% in 2010 to a meager 2.3% in the last report, the Fed's move to restrain was small.

INDEX PERFORMANCE	Q4'15	YTD
Dow Jones Industrials	7.70	0.21
Standard & Poor's 500	7.03	1.37
EAFE (international stocks)	4.80	-0.21
Russell 2000 (small stocks)	3.59	-4.41
Barclays Interm. Gov/Credit	-0.69	1.07
Barclays Municipal	1.51	3.30

INSIDE THIS ISSUE

TOP FIFTEEN HOLDINGS

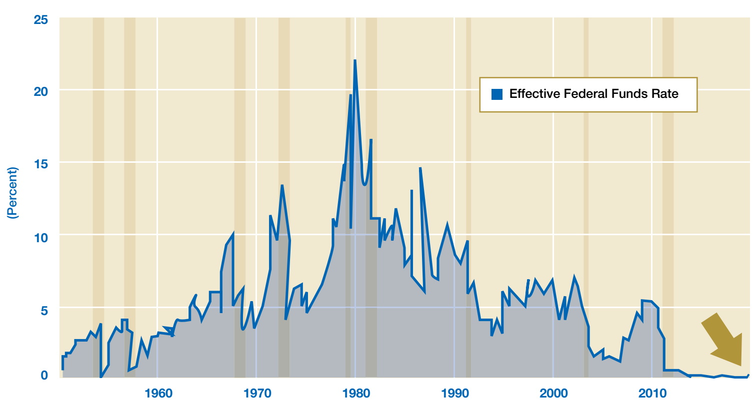
- iSHARES CORE S&P SMALL CAP
- AMAZON.COM INC.
- COSTCO WHOLESALE CORP.
- WALT DISNEY COMPANY
- UNITED PARCEL SERVICE
- TJX COMPANIES INC.
- iSHARES CORE MSCI EMERGING
- SCHLUMBERGER LTD.
- T ROWE PRICE GROUP INC.
- ALPHABET INC.
- INVESCO LTD.
- AKAMAI TECHNOLOGIES INC.
- WHOLE FOODS MARKET INC.
- UTILITIES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

ECONOMIC OVERVIEW

Quickly Going Nowhere (cont'd)

The price of crude oil declined from $100 per barrel in mid-2014 to just below $50 by the first quarter of this year. The price then rose to $60 in the second quarter as it looked like it was stabilizing, but it has since declined to around $35 per barrel. As a consequence, energy stocks performed very poorly in 2015, as did the low-rated bonds of some energy companies, which led to the problems referenced above at credit funds such as Third Avenue's.

In the fall of 2014, as the price of oil began its decline, economists predicted that consumers would receive a benefit from much lower gasoline prices and that this "gas dividend" would boost consumer spending. So far, it seems that the "gas dividend" has been saved, not spent. This is contributing to the tepid nature of the economy. Many of the retailers have provided dismal outlooks for the year, with a few notable exceptions, including the online retailing giant, Amazon (tkr: AMZN).



Source: Board of Governers of the Federal Reserve System (US)

The US dollar began rising in the last half of 2014, continued its rise through the first quarter of 2015, and traded sideways in a somewhat volatile fashion through the remainder of 2015. We anticipate that the US dollar's strength will continue this year alongside additional monetary restraint by the Fed, whether via higher rates or a reduction in its balance sheet. Consequently, we believe now is not the time to overweight foreign equities.

Meanwhile, we have all been entertained by the newest reality TV show: the Primary Debates. For the Democrats, it is most likely that Hillary Clinton will be the nominee. She is leading the Iowa caucus by a substantial margin. Who will emerge as the eventual leader on the Republican side is anyone's guess. So far, it has mostly been the Donald Trump show. Ted Cruz has tripled his standing in Iowa in the last 2 months and now leads Trump, with Marco Rubio in third. Meanwhile, Ben Carson, who was leading in late October, has dropped to a distant 4th. Look for more lead changes as we come into the first turn of this horse race.

Late last quarter, on September 25th, John Boehner resigned his position as Speaker of the House. On October 29th, after much politicking and uncertainty, Paul Ryan was finally elected Speaker. Ryan is viewed as a policy wonk with deep expertise in financial issues, so we hope for the possibility of future tax simplification. However, we remain concerned about the consequences of the Republican Party losing all semblance of unity.

Today the P/E ratio on the S&P 500 is about 18.3 times and the 10-year US Treasury is yielding 2.2%. Real estate capitalization rates (the rate of return on a real estate investment property based on the income that the property is expected to generate) are below 5% on institutional quality commercial properties. Money is in ample supply and any investment with yield is expensive. We are optimistic that the US economy will lead the world, but we acknowledge that the current rich valuations could keep returns modest in 2016.

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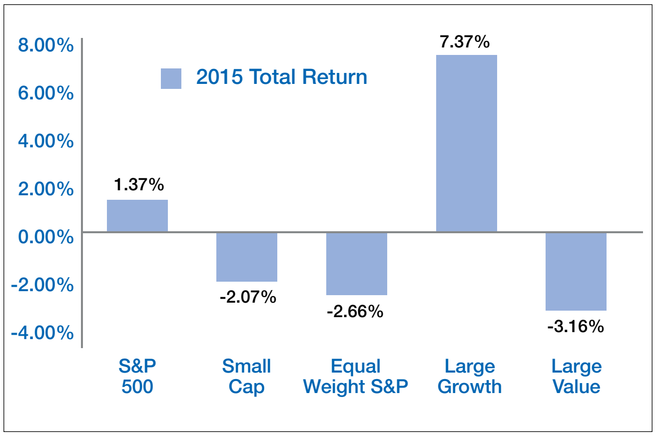
ASSET MANAGEMENT

Large-Cap Domestic Tech Leads the Market

Although the major stock indices ended the year nearly unchanged in value, 2015 was volatile and returns were unusually concentrated. Growth stocks out-performed value, large-cap stocks outperformed small-cap, and developed markets outperformed emerging. Amazon.com (tkr: AMZN), which is our largest stock holding, plus four other large technology companies, Alphabet (formerly known as Google), Microsoft, Netflix and Facebook, dominated the S&P 500 performance. As a group, those five stocks drove the outperformance of large-cap and growth stocks. In addition to Amazon, we also owned a market-weighted position in Alphabet, but we missed out on the other three. Our technology hardware and infrastructure investments underperformed, particularly Qualcomm, which has had trouble enforcing its contracts in China.

Amazon, Alphabet, Microsoft, Netflix and Facebook posted exceptionally high returns and disproportionately affected the market because they already composed so much of it. The S&P 500's significant outperformance relative to its equal-weighted counterpart emphasizes this year's lopsided distribution of returns. In 2015, the S&P 500 outperformed its equal-weighted counterpart by nearly 400 basis points. This was the largest difference in performance between the two since 2010. It is worth noting that those five stocks mentioned above comprise over 8% of the S&P 500 but only 1% of the equal-weighted counterpart. This was a large reason for the meaningful outperformance of the S&P 500.

2015 also saw substantial outperformance among developed markets relative to emerging markets. Some countries, like Brazil, the world's ninth-largest economy and a former high flier in the emerging markets, have suffered from governance concerns and corruption. But more so, many developing countries' economies depend on revenue from natural resources and basic industries. The price of oil and other basic commodities fell dramatically this year, causing related profits to evaporate and squeezing suppliers of products like steel and heavy machinery. The mining industry was also caught in the rout. Many mining companies overbuilt to meet surging Chinese ore demand, but have suffered as demand growth has fallen. Developed economies are often service-based and therefore less exposed



to the flagging materials, energy, and industrial sectors. We took a conservative, domestically-focused approach to our investments in those sectors, and will continue to do so going forward. We maintain a small position in the international markets via two large exchange-traded funds.

value *[val'yoo]*

n. a quality having instrinsic worth

HOW DO WE MEASURE VALUE?

By producing it — in the growth of assets, in how our clients view us, in how we create partnership.

FIXED INCOME

The Fed Finally Makes Its Move!

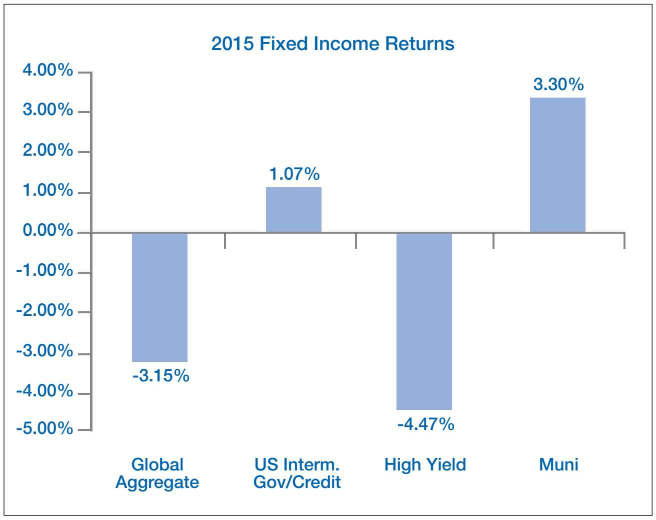
2015 was a difficult year for the US bond market and we expect 2016 to be the same. It was a period that featured the Federal Reserve announcing an interest rate move for the first time in seven years, fallout in the high yield market, and Puerto Rico declaring that it didn't have enough cash to pay some of its debt holders.

On December 16th, the Fed announced that it would raise its benchmark rate a quarter of a point after keeping rates at zero percent since the financial crisis. The Fed warned of a possible rate increase earlier in the year, so its recent move was well anticipated. It also announced a plan to gradually lift rates over the next three years. The current Fed target is a range between 0.25% and 0.50%. New projections expect the Fed-Funds rate to creep up to 1.375% by the end of 2016, to 2.375% by the end of 2017 and 3.25% in three years. This implies four quarter-percentage-point interest rate increases next year, four the next and three or four the following year. Future adjustments by the Fed will greatly depend on the direction of the economy and inflation. The Fed is walking a fine line between undermining the current recovery and defending against future risks, including higher inflation.

The high-yield bond market was hit hard in 2015 as investors who invested in speculative grade oil, energy and mining companies experienced significant losses. On December 10th, fund manager Third Avenue Management LLC announced that it had shut down its Focused Credit fund and blocked investor redemptions amid losses of 30%. In the past few years, the percentage of bonds issued by low-rated energy and natural resource companies has surged. Energy, metals and mining companies more than doubled their share of the Barclays US Corporate High Yield Bond Index, to 16% in 2015 from 7% in 2005. Those that chose to chase higher yields are now regretting that move.

Municipal bonds finished the year in positive territory and performed better than most other bonds with the national muni index up 3.3%. We believe municipal bonds are one of the few bright spots in a bleak bond market and we believe they will perform well on a relative basis in 2016. States and local governments, with the exception of places such as Puerto Rico and Illinois, are experiencing stronger tax revenue as real estate values have increased and unemployment rates have fallen.

We avoided the troubles in the high yield and municipal bond markets by focusing on buying high quality investment grade debt and by not chasing yield. Our concerns over liquidity in the bond market have not abated, and we continue to put a premium on liquid assets. 2016 will be another tough year for the bond market as yields are low and opportunities to make money are limited. We continue to believe keeping durations short and holding some cash or cash equivalents is prudent.



FIRM UPDATES

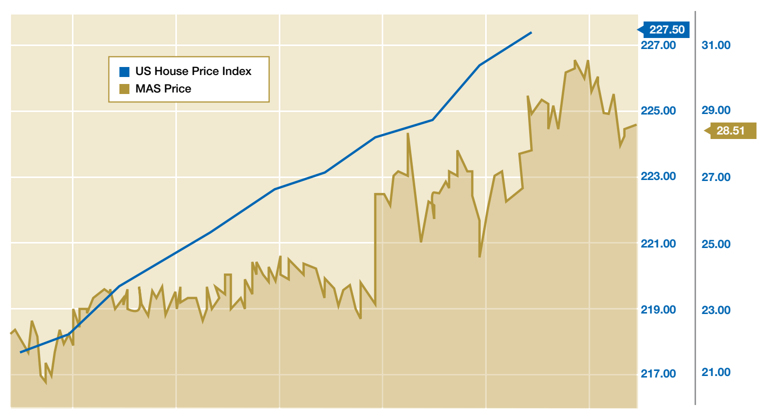
Nelson Roberts is pleased to announce we will be moving in February to our new office at 545 Middlefield Avenue, Suite 200, Menlo Park, CA 94025. This new location is 2.5 miles Northwest of our current office space, consistent with our firm's historical Mid-Peninsula location, and the larger space will allow for future headcount growth.

FEATURED EQUITY

Masco

Masco (tkr: MAS) is one of the largest manufacturers of products for both home improvement and new home construction markets. Its four main businesses are plumbing, cabinets, windows, and decorative architecture (paint). Masco owns plumbing brands such as Delta, Brizo and Hansgrohe, cabinet brands Kraftmaid and Merillat, Milgard windows and Behr paint. After the housing crisis of 2008-2009 caused several difficult years for the company, Masco went through a massive restructuring. Since then, it has emerged a much leaner, more agile company that continues to demonstrate disciplined cost management in an improving housing environment. More recently, Masco has begun to reward shareholders with greater returns: since the beginning of 2014, Masco has increased its dividend twice after over four years of leaving it steady at $0.075 per share post-restructuring. Late in 2014, Masco also initiated a buyback program of around 50 million shares, or 14% of outstanding shares. Masco's stock performed very well in 2015, increasing about 28% even as the greater industrial sector floundered, falling 6% this year. Over the past several quarters, Masco has seen significant margin improvement alongside healthy revenue growth across all segments.

While most of Masco's segments have been profitable since the 2009 restructuring, the cabinet business has been a source of pain for Masco, as the segment had been losing money for several years. Returning this segment to profitability was a long-term goal of management, and it finally happened in 2015. Masco deliberately exited the low-margin direct-to-builder business and refocused cabinetry sales with the more profitable home center and dealer channels. This has been an impressive turnaround story that boosted Masco's stock price in 2015.



Source: Federal Housing Finance Agency

We own Masco because we think it will continue to benefit from an improving housing market. As the values of existing homes rise in many areas across the country, the repair and remodel market grows stronger. Although the new home construction data has been somewhat inconsistent, we believe it is on a long-term upswing, and in the meantime, we particularly like Masco's exposure to the robust repair and remodel market. Masco recently spun off its installation segment into a separately traded company, called TopBuild (tkr: BLD). We believe this was a prudent move that increased Masco's exposure to the repair and remodel segment, as the installation segment was almost entirely servicing the new home construction market. We sold the spinoff because we felt it was better to focus on Masco's other core businesses. Since TopBuild began trading in June of 2015, Masco has outperformed significantly.

(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

What Happens When Unicorns Lose Their Horns?

"Unicorn" is the moniker given to a privately-held startup company that achieves a valuation of $1 billion or more. Like the mythical beasts they are named after, lofty valuations applied to unprofitable or unproven business endeavors should be exceedingly rare. Recently, however, unicorns have become relatively commonplace, especially in Silicon Valley.

In January 2014, the Wall Street Journal began tracking these unicorns. At that time, there were 43 venture capital-backed private companies with valuations of $1 billion or more, valued at a combined total of $110.7 billion. Today, that number has exploded to 131 companies worldwide. In Silicon Valley alone, there are now 48 unicorns valued at a combined total of $209.3 billion.

The dramatic increase in both the number and value of unicorns suggests that these valuations have become frothy. Recently, both private and public market valuations have started to come down at companies like Snapchat, Dropbox and Square (tkr: SQ). If the valuations being applied to unicorns are indeed fantasy, how would the various company stakeholders be affected if unicorn valuations fall?

Venture Capital Investors: One would think that the venture capital investors funding these companies at their peak valuations would be most adversely affected. Often, however, VC investors assure themselves positive return through 'ratchet' provisions, which force the company to issue additional shares to these investors if valuations fall in the future. Without these ratchet provisions, VC investors at the peak valuations would face a decline in the value of their holdings, although it seems that most of the time, ratchet provisions are in place.

Early Investors/Founders: Early investors and founding employees in highly-valued companies may not reap the outsized returns they might have penciled in at peak valuation. But while this would mean that they make less money, it does not necessarily mean that they lose money.

Employees: The employees of these companies who participate in the company's success with stock issuances would see the value of their holdings diluted by the ratchet provisions negotiated by the company to secure late-stage financings.

Companies: The companies themselves rely on their valuations to secure liquidity (e.g. from an IPO), to fund future expansion projects. The companies could see their coffers diminished if valuations tumble, which would curtail their ability to expand their businesses.

Ancillary Services: Supporting services like commercial real estate, legal, and accounting have experienced an increase in demand for their services alongside the growth of these companies.

If we see a plunge in these lofty unicorn valuations, it is likely that the greatest negative impact would be felt by the employees of the companies and the demand for supporting services.

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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