NELSON ROBERTS
INVESTMENT ADVISORS

Quarterly Commentary

2018 | Q1

IN THIS ISSUE:

ECONOMIC OVERVIEW

A Return to Volatility

2018 began with the U.S. markets posting a record 15th consecutive month of positive returns. The Dow Jones Industrial Average rose above 26,600, its highest level ever, by the end of January. Since then, investors have been on a roller coaster ride. From the high, the Dow Jones declined 10%, falling 2,756 points, bounced back 7.7% to 25,700, before ending the quarter at 24,103. For the entire quarter, the Dow Jones fell 1.96% and the S&P 500 fell 0.76%

The last ten weeks of the first quarter were not for the faint of heart. This volatility feels especially painful following a prolonged period of unusually quiet and steadily rising stock markets.

In spite of the market gyrations, there are plenty of signs that this bull market is not over. Projections for U.S. GDP growth were recently revised upward to 2.7%. Global growth estimates are equally optimistic, driven by improved confidence, increased investment and robust global trade. Unemployment remains low at 4.1%. Wages rose 2.9% in January, the biggest year-over-year gain since 2009. U.S. corporations are expected to benefit from the significant tax cut that took effect in 2018, with analysts estimating that corporate earnings will grow over 18.5% this year. Companies are returning their improved earnings to shareholders through share buybacks and higher dividend payments. Inflation has climbed toward the Federal Reserve's stated 2% goal. In March, the Fed hiked its benchmark Federal Funds Target Rate by a quarter of a percentage point to 1.5-1.75%, maintaining its path of raising interest rates alongside a rosy growth forecast.

So what caused the volatility? The first jolt came during the first week of February, after the better-than-expected wage growth number sparked concerns that inflation might be getting out of hand, which could cause the Fed to increase rates at a more rapid pace. Furthermore, Congress passed a two-year spending deal, increasing defense and other forms of discretionary spending. Coupled with the tax cut, the government is anticipated to add over $1 trillion to the deficit in the coming fiscal year, adding more fuel to the U.S. economic engine.

The second bout of volatility came a few weeks later alongside headlines detailing a brewing trade scuffle with China. In March, President Trump announced trade measures including tariffs on

Index Performance	Q1 '18	YTD
Dow Jones Industrials	-1.96%	-1.96%
Standard & Poor's 500	-0.76%	-0.76%
EAFE (international stocks)	-1.62%	-1.62%
Russell 2000 (small stocks)	-1.16%	-1.16%
Barclays Interm. Gov/Credit	-0.27%	-0.27%
Barclays Municipal	1.92%	1.92%

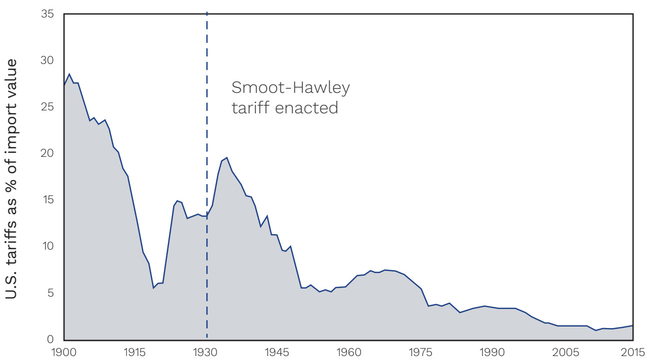
We apply rigorous analysis in asset selection so you can focus on your passion

ECONOMIC OVERVIEW

A Return to Volatility (cont.)

various goods imported from China. These tariffs will target up to $60 billion of annual imports to the U.S. from China, centered largely on the steel industry. China, in turn, responded by imposing tariffs on about $3 billion worth of U.S. imports.

The markets, fearing that this trade scuffle could escalate into a trade war, fell over 1,000 points over two trading sessions.



Source: U.S. International Trade Commission, Vanguard

The trading relationship between the U.S. and China is important for both countries, and disrupting it could have lasting ripple effects through the global economy. However, the U.S. remains the most open market, and we do not see that position changing anytime soon. U.S. tariffs as a percentage of import value have been falling since the 1930s and have been below 5% for more than four decades. The Trump administration enacted tariffs on steel and aluminum—products that together represent less than 2% of total imports to the U.S. Furthermore, with several countries now exempted from these tariffs, the actual number of imports affected is even lower. At this point, we believe that talk of a "trade war" is, in fact, simply posturing by the Trump administration to negotiate better trading terms with China.

Alongside this tariff news, we saw distressing headlines over possible geopolitical instability with the appointment of John Bolton as National Security Advisor. Bolton is known for his very hawkish views, and his appointment, combined with that of Mike Pompeo as CIA director, caused many to speculate that the president is building a "war cabinet." However, we currently have no reason to suspect there is cause for imminent concern.

Fifteen months of positive performance with little volatility had escalated valuations to the brink of euphoria. However, this recent downturn brought market P/Es to more reasonable levels. Market volatility has clearly returned, and it seems particularly uncomfortable after such a prolonged period without it. Markets tend to fear uncertainty, and even though underlying fundamentals are healthy, there are plenty of unknowns. Heightening trade conflict with China *could* escalate to a trade war. The carousel of presidential advisors *could* lead to geopolitical instability. The Fed *could* increase interest rates too rapidly, disrupting economic growth and leading to a recession. At this point, none of these pressures are significant enough to derail the current global economic expansion, but each is worthy of our attention. In any case, the volatility in the markets is likely to persist as long as the headlines continue to focus on these unknowns.

We maintain our assertion that the next recession will ultimately be caused by the Fed overtightening, but this is not something we anticipate happening in the near term. In the meantime, rates are going to chase inflation up, and until inflation peaks, bonds will not have much of a real return. For now, the continued volatility in the market allows active managers like us to identify opportunities to enter the market at more attractive valuations.

ASSET TRANSACTIONS

An Eventful First Quarter

We had an active first quarter, making several changes across various sectors. In our healthcare sector, we decided to sell Celgene (tkr: CELG). We originally bought Celgene based on the growth prospects from its key multiple myeloma drug, Revlimid. Multiple myeloma is more common in older people and an aging population drives an increase in the number of cases. However, key Revlimid patents are set to expire next year, and although Celgene has begun selling other drugs, such as arthritis medication Otezla, it is still heavily reliant on Revlimid sales. Furthermore, its latest earnings announcement revealed major problems, including slowing Otezla and Revlimid sales as well as a clinical trial failure for a drug Celgene had been developing in its pipeline. Celgene was a very small position in our portfolio, and we decided to sell it given the lack of revenue growth drivers on the horizon.

In our consumer discretionary sector, we bought the Guggenheim S&P 500 Equal-Weighted Consumer Discretionary ETF (tkr: RCD, see Featured Equity). As we discussed in our commentary last quarter (Q4 2017 Quarterly Commentary), improved liquidity and lower expense ratios have made ETFs a more attractive tool to complement our core holdings. Typical market cap-weighted consumer discretionary sector ETFs hold over 20% in Amazon (tkr: AMZN). We wanted to bring our consumer discretionary sector up to our target weight without adding further outsized exposure to Amazon, so we chose this equal-weighted sector ETF.

We decided to trim the Utilities Select Sector SPDR Fund (tkr: XLU), reducing our exposure to the utilities sector. We believe this sector will face challenges as interest rates rise. Utility companies are sensitive to interest rates rising for two reasons. First, they are dependent upon borrowing large amounts of capital to maintain their infrastructure, and as interest rates rise, borrowing money becomes more expensive. Second, utilities stocks often pay large dividends and are viewed as "bond-like" investments that offer a yield. When overall rates are low, utilities stocks are attractive to investors looking for bond exposure who are otherwise unable to find any return in the bond market. As rates rise, these investors will often sell utilities stocks because they can earn a return in the actual bond market.

We trimmed our position in Akamai (tkr: AKAM) following a significant increase in the stock. In late 2017, activist investor Elliott Management disclosed a large stake in the company based on the belief that the company was dramatically undervalued. Elliott began working with Akamai management to push for shareholder-friendly changes, including cost-cutting measures aimed at boosting margins and a large buyback program. We believe that Akamai is well positioned to benefit from the increase in global data traffic over the next several years, but given the rapid spike in valuation, we took the opportunity to trim our position a bit.

We added to our position in Allergan (tkr: AGN), taking advantage of a decline in the stock that we felt was unwarranted. Allergan had declined due to an upcoming patent loss of eye medication Restasis, which only accounts for about 8% of Allergan's total revenue. The stock had also faced headwinds on rumors of a biosimilar competitor to Botox, Allergan's popular cosmetic drug. However, this biosimilar is at least a decade away from being ready, and Allergan still maintains a very healthy portfolio of cosmetic drugs, all of which are a cash business. We had a small position in Allergan and we decided to add to it in order to make it a more meaningful position in our healthcare sector.

> "Market volatility has clearly returned, and it seems particularly uncomfortable after such a prolonged period without it."

FIRM UPDATES

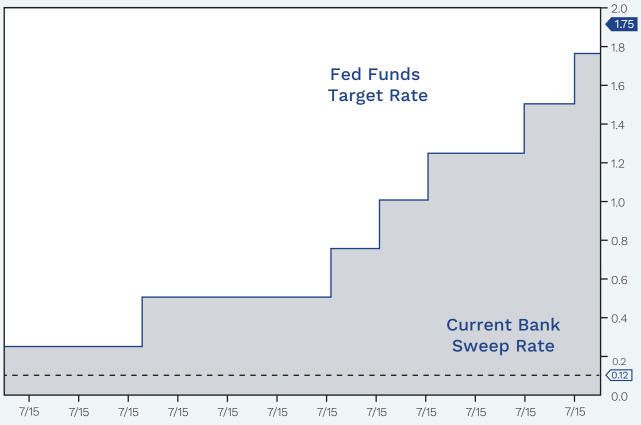
Nelson Roberts is proud to sponsor the Menlo Park School District's Schoolhouse Rocks 5k run for the fourth year in a row. The event will be held on Sunday May 20, 2018 at 9:00am at Hillview Middle School.

FIXED INCOME

A Brief History of Money Market Funds

Under the Banking Act of 1933 that was enacted during the Great Depression, the Federal Reserve established Regulation Q. This rule, which was in effect until 1986, prohibited interest payments on demand deposit accounts (otherwise known as checking accounts) and set a 5% limit on what banks could pay savings depositors. The late 1960s saw rising inflation and rising interest rates. In 1969, when inflation crossed the 5% threshold, savers effectively began losing money on their inflation-adjusted savings. In 1971, Bruce Bent and Henry Brown established the first money market mutual fund, the Reserve Fund. Like all mutual funds, these were regulated by the SEC and stipulated several requirements: no instrument could be longer than 13 months, the weighted average maturity (WAM) must be under 60 days, most instruments must be investment grade, and no non-government securities position could be over 5%. By the 1970s, these money market instruments were paying well over 5.25%. Consequently, significant disintermediation began, as banks lost their status as the primary intermediaries between savers and the markets. In 1977, Merrill Lynch began offering their cash management account (CMA). This allowed an automatic sweep of brokerage accounts' cash into a CMA money fund. As a result, a deluge of capital departed the banking industry, establishing money funds as a new intermediary.

Today, news reports are focused on rising rates, particularly the Federal Funds Target Rate. This rate represents the cost for banks to borrow excess reserves from each other for one day. After seven years of this rate hovering between 0.00-0.25%, the Fed began raising its target in December 2015. In March, the Fed increased its rate for the fifth time, bringing its target to 1.50-1.75%.



Source: FactSet

Short-term market interest rates have increased about 1.5% in response to the Fed's rate hikes, but they are still below the current rate of inflation. After earning no real return on their cash balances for the better part of a decade, investors read about rate increases in the news and look for higher interest on their bank or brokerage statements, only to find that they are often still only earning a measly 0.12%. Why?

Custodians, after a decade of not earning any fees on money market funds, have closed their funds and forced investors into "bank sweep" vehicles that do not earn market rates. It is almost as if we've gone back to the 1960s.

Now we have returned to the days before CMA. If we want to earn more than the 0.12%, we have to "buy" a money fund, which currently yields more than 1%. We find it annoying that custodians do not offer an automatic sweep today, although we think it is just a matter of time until an innovative competing firm offers a CMA type of account. We look forward to the ensuing competition.

TOP 15 HOLDINGS

- iSHARES S&P SMALL-CAP ETF
- VANGUARD DEVELOPED MARKET ETF
- AMAZON.COM INC.
- ALPHABET INC.
- UNITEDHEALTH GROUP INC.
- VANGUARD EMERGING MARKETS ETF
- COSTCO WHOLESALE CORP.
- CISCO SYSTEMS INC.
- STRYKER CORP.
- SALESFORCE.COM INC.
- VERIZON COMMUNICATIONS INC.
- ROPER TECHNOLOGIES INC.
- THE TRAVELERS COS INC.
- FIRST REPUBLIC BANK
- ILLUMINA INC.

FEATURED EQUITY

Guggenheim Equal Weight Consumer Discretionary ETF

We recently added the Guggenheim S&P 500 Equal Weight Consumer Discretionary ETF (tkr: RCD) to our portfolios. This exchange-traded fund (ETF) tracks an equal-weighted index of large-cap U.S. consumer discretionary stocks selected from the S&P 500. RCD provides an alternative to cap-weighted consumer discretionary ETFs, which have a tilt toward larger companies and are heavily weighted in Amazon (tkr: AMZN) given its size. RCD holds 82 companies and weights each stock similarly. Equal weighting avoids heavy concentration in large firms, while increasing exposure to smaller companies.

Guggenheim S&P 500 Equal Weight Consumer Discretionary ETF

Source: FactSet

The consumer discretionary sector includes companies that sell goods and services that are typically not deemed essential, but are desired when consumers feel optimistic about their financial circumstances and have sufficient discretionary income to purchase them. Examples include clothing merchants, makers of exercise equipment, hotels, restaurants and purveyors of entertainment.

As consumers continue to prosper and confidence remains high, the demand for consumer discretionary goods and services is expected to increase, which should boost sales and stock prices. Furthermore, with the unemployment rate hovering near 4%, a tightening labor market gradually pushing wages higher, and the added benefit of the recent tax cuts, we expect retail sales to remain strong.

As a result of this positive outlook, the Nelson Roberts equity research team decided to increase our exposure to the consumer discretionary sector. After researching and passing on several individual companies, the decision was made to gain broader exposure by using an ETF. However, we wanted to choose an ETF that would not significantly increase our Amazon holdings. Since Amazon is the largest individual company position in our portfolios, we elected to use an equal-weighted ETF. The average weighting of Amazon in a market-cap weighted ETF is 20% compared to 1.3% in an equal-weighted sector ETF. RCD's bias toward smaller firms is limited to the universe of companies in the S&P 500, which excludes small companies. RCD maintains its equal-weight focus with quarterly rebalancing. The discipline of rebalancing forces the ETF to trim stocks that have done well and reallocate funds to stocks that have underperformed. This structured approach helps maintain proper diversification and is similar to the strategy we utilize in our core portfolio.

(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

Brooks Nelson, CFA
Brian Roberts, CFA, MBA
Steve Philpott, CFP®, MBA
Ann Oglesby, MD, MBA
Darcy Nelson Smoot, CFA
Evan Nelson, CFP®
Sarah Sinclair
Erin Rodriguez
Chrissy Domingo

SPECIAL TOPIC

Reviewing Homeowners Insurance Coverages

2017 brought deadly and devastating natural disasters across the country. In the Santa Rosa fires alone, over 7,500 structures were destroyed, causing over $12 billion in damage. Many of these homes were underinsured, leaving the residents liable for the difference between their coverage and the actual replacement cost. Because of this, we are recommending our clients review their homeowners insurance policies to ensure they are properly covered in the event of a catastrophe.

The main consideration when analyzing a homeowners insurance policy is the dwelling limit. In the past, some policies came with guaranteed replacement costs meaning the insurance company would replace the full value of your home with no deduction for depreciation, even if you were underinsured. This type of policy was abused by some insurance brokers and resulted in large payouts by the insurance companies after the Oakland Hills fire in 1991. Because of this, guaranteed replacement cost polices are no longer available and you need to make sure you have enough coverage on your home to rebuild it. If you have an old policy, it is important to remember the increased cost of building up to current codes and to include any remodeling you have done. Many mass market insurance companies will offer an extension up to 20%; however, this may not be sufficient if your dwelling limit is too low. For example, if your home is insured for $1M and is destroyed in a fire, the most you can receive from a claim is $1.2M. If the actual replacement cost for your home is $1.5M, you will need to pay $300k out of pocket to rebuild a home of the same value.

You must also consider the loss of use. Many homeowners insurance policies have riders which provide for loss of use for up to 12 months. Building a home can take longer than 12 months and there are often delays in construction. In events where entire neighborhoods need to be rebuilt, such as the Santa Rosa fires, building materials and contractors are in short supply, increasing the overall replacement cost and the time until completion. Residents without unlimited loss of use would have to pay for the cost of staying in a hotel past 12 months until their new home is built.

Some people may not want to rebuild in completely destroyed neighborhoods and may wish to buy a new home elsewhere. If your policy contains a cash settlement option, you are able to take the funds you would have received to rebuild your home and purchase or build a home in a new area. Without this option, you are restricted to using the funds to rebuild on your lot and would lose the funds if you decide to move away.

While having appropriate limits and options on your homeowners policy are important, it should be noted that not everything is covered. There are separate insurance policies for hurricanes, floods, and earthquakes. If you live in an area prone to these natural disasters, it may be prudent to get coverage for these events.

NELSON ROBERTS
INVESTMENT ADVISORS

545 Middlefield Road, Suite 200 • Menlo Park, CA 94025 • 650.322.4000
www.nelsonroberts.com • invest@nelsonroberts.com