NELSON ROBERTS QUARTERLY COMMENTARY

2013 | SECOND QUARTER

ECONOMIC OVERVIEW

I. The Tapering Tantrum

Baseball fans might call it a “June Swoon” but stock market insiders are calling it the “Tapering Tantrum.” Since the fall of 2008, central bankers around the world have been pouring on the monetary stimulus in a bid to revive the global economy and forestall potential deflation. Market watchers in the US have debated for many quarters the timing of when the Fed should and will begin reducing the stimulus. The minutes of the June 18th-19th Fed meeting said that the Fed would continue stimulating the economy at the same pace; however, Chairman Ben Bernanke commented afterwards that the central bank would likely begin easing back on the stimulus later this year. Mind you, no one is talking about hitting the brakes but even the notion that the Fed foot will come off the accelerator later this year sent the markets tumbling. The Dow Industrials were down more than 600 points over three days in the third week of June.

The S&P Index had been up almost 6% for the quarter through June 18th, but it gave most of that back by June 24th. This was followed by a classically perverse “bad news is good” reaction to a weak GDP report on June 26th which produced a rally sufficient for the market to end the quarter up 3%. The bond market fared much worse. The Barclay’s Aggregate Index was up 1% in April but since the April 30 high, the Index has fallen over 4.5%. The 10-year US Treasury yield has risen from its low of 1.6% in April to over 2.5%. Bond yields are now higher than the rate of inflation for the first time in over a year. We think that interest rates have much further to rise.

The fickleness of the market never ceases to amaze us. Last year, the market was stressing about the Fiscal Cliff. Last quarter, the concern was Sequestration. Now we are worrying about the end of the monetary stimulus and what the Fed will do after Ben Bernanke’s term ends in January.

Notwithstanding the market’s mid-June decline, it has been a good year to be invested in US stocks. Almost every other type of investment lost value in the first half of the year. Large capitalization international stocks were down just under 1%. Emerging market stocks were down over 9.6%. Gold fell during the quarter from $1,600 per ounce to below $1,250.

Other than the Tapering Tantrum, not much is different in the world this quarter. The US economy continues to recover at a slower than average pace and politicians remain divided and uncooperative. Inflation expectations remain low but US workers are paying ever more for gas and groceries. We think the decline in gold prices is significant and may foretell the end of this extraordinary period of global monetary stimulus. The resiliency of the US economy and low corporate debt levels set the stage for further economic gains. Stock prices never go straight up and rising interest rates will create a headwind, but we nonetheless think that equity returns will be at least average in the decade to come.

INDEX PERFORMANCE	Q2’13	YTD
Dow Jones Industrials	2.92	15.19
Standard & Poor’s 500	2.91	13.82
EAFE (international stocks)	-0.74	4.54
Russell 2000 (small stocks)	3.08	15.85
Barclays Interm. Gov/Credit	-1.70	-1.45
Barclays Municipal	-2.96	-2.69

INSIDE THIS ISSUE

TOP FIFTEEN HOLDINGS:

- ISHARES MSCI EMERGING MARKETS
- DIAGEO PLC ADR
- ISHARES S&P SMALLCAP 600
- INVESCO, LTD.
- VERIZON COMMUNICATIONS
- AMAZON.COM, INC.
- COSTCO WHOLESALE CORP.
- CHEVRON CORP.
- INGREDION, INC.
- QUALCOMM, INC.
- ADOBE SYSTEMS, INC.
- PAYCHEX, INC.
- UTILITIES SECTOR SPDR
- AKAMAI TECHNOLOGIES
- WALT DISNEY CO.

ECONOMIC OVERVIEW

II. Gold, Monetary Stimulus and Inflation

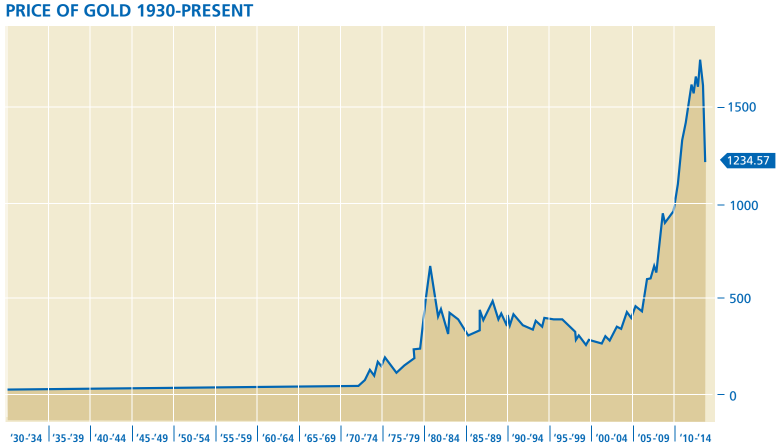
Its chemical symbol is Au. Its atomic number is 79. It is a dense, soft, malleable and ductile metal. It is called “gold.” Since the beginning of recorded history, gold has been mainly a monetary symbol. It has caused people to flock to inhospitable places like the Yukon in order to become “rich” and it has a fascinating and complex relationship with monetary stimulus and inflation.

In the US, for nearly a century the price of gold was $20 per ounce. In 1933, during the Great Depression, possessing gold coins and bars was made illegal by an Executive Order issued by then-President Franklin D. Roosevelt. Owners were paid $20.65 per ounce to surrender their gold. A year later, in an effort to stabilize falling prices, especially farm commodities, the US government raised the price of gold to $35 per ounce.

In 1971, the US government declared that the US dollar was no longer convertible to gold at a fixed price, ending what was known as the “gold standard.” The rampant inflation of the 1960s and 1970s effectively devalued the US dollar and consequently gold rose suddenly and steeply, peaking at $850 an ounce on January 21, 1980. Paul Volcker had been appointed as Chairman of the Fed in August 1979. Under Volcker, the Fed increased interest rates to a peak of 20% in June 1981, effectively breaking the back of inflation. This returned purchasing power stability to the US dollar and gold subsequently traded down to a range of $300-$400 per ounce for the next twenty years. Toward the end of the dot.com bubble, the price of gold hit a low of $255/ounce. After the tech bubble burst, the Fed, under Alan Greenspan, embarked on a period of unprecedented monetary stimulus. This led to the residential housing bubble of 2006-2007. And the rest is more recent history…

The bursting of the housing bubble was a worldwide phenomenon and globally governments responded with the most massive monetary stimulus program ever seen. The post dot.com and post-housing bubble stimulus effectively devalued all major currencies around the globe. The Dollar, the Euro, the Pound and the Yen all maintained their relative exchange rates but gold prices in all denominations rose nearly 10-fold

PRICE OF GOLD 1930-PRESENT



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to $1,900/ounce in September of 2011. We believe that the subsequent decline to $1,235 is a sign that the period of currency creation is coming to an end. If this is true, then gold is not likely to climb back to its recent highs for many years.

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ASSET MANAGEMENT

Time for the Equity Market to Take Off?

The momentum generated during the first quarter in the US equity markets came to a screeching halt eleven weeks into the second quarter, as volatility rose and liquidity declined. Without the rally in the last week of June, stocks might have been down for the quarter.

In late 2012, we began shifting our portfolios to better position for an environment of accelerating corporate spending and stronger economic growth. That environment has been slow to materialize. Corporations have been tightfisted with their improved profitability, choosing higher cash balances over increasing headcount or capital projects. The economy continues to grow, but not at a rate that would validate our belief that we are in the early stages of an extended bull market.

After years of negative money flows for equities, funds are slowly moving into stocks primarily of large companies with stable revenues and above market dividends. Through the first half of 2013, the sectors generating the greatest returns were those that have historically been considered the most defensive. The sectors up the most thus far this year have been Healthcare, +20.2%, and the Consumer sectors, both Discretionary (+19.7) and Staples (+15.1). The recovery in the Financial sector has also continued as large money-center banks restored revenue sources and solvency. This sector is up 19.4% through the first half of the year.

Our portfolio has underweighted these sectors and overweighted the more growth-oriented technology sector (which is up 6.4% year-to-date) in anticipation of a stronger recovery. Our performance has thus lagged the return of the S&P 500 so far this year. Further hampering equity performance has been our allocation to international stocks. Both developed (+4.1%) and emerging markets (-9.6%) significantly underperformed compared to US markets.

Though our pace slowed from a busy first quarter, we did have activity. In April, we added a position to T. Rowe Price (tkr: TROW). T. Rowe Price is a well-known asset management company with over $575 billion under management. We believe that T. Rowe Price and Invesco, in which we also hold a position, should benefit from the heightened values of the equity markets. T. Rowe Price has a broad product line of mutual funds, with 75% of managed assets in equity or balanced funds.

In May we bought more F5 Networks. F5 was our featured equity in the fourth quarter 2012 commentary and will benefit from corporate investment in cloud infrastructure. We decided to add to our position when the stock dipped after an earnings report. We now have a 1.5% position in the stock.

We bought Ingredion in June. Prior to May of 2012, this company was known as Corn Products International. The name change was made to reflect the company's focus on the starch and sweetener ingredient manufacturing business which generates 70% of the company's $6.5 billion in annual sales. We sold our position in Heinz after the announcement that it would be acquired drove the stock price up.

We also sold our successful investment in Thermo Fisher Scientific. Thermo announced a $13.6 billion acquisition of Life Sciences, a deal more than four times larger than any of the company's previous acquisitions. Thermo Fisher's stock had performed very well for us. However, while this acquisition may turn out to be a good strategic move, we decided that an acquisition this size was a big elephant to eat and we were better off on the sidelines.

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

WHAT IS MONEY?

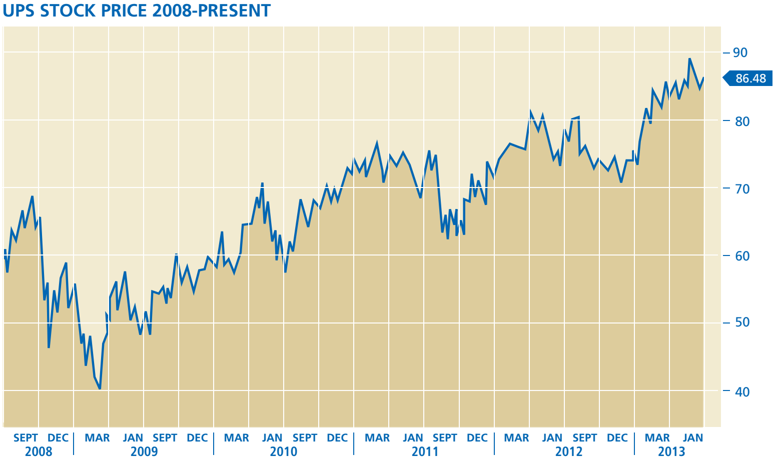
At its simplest, it remains a form of barter, an exchange of energy for goods. At its most complex, it's a symbol of mastery, a measure of power. At its center are people with vision, talent, skill, families, children, hope and dreams.

FEATURED EQUITY

UPS

UPS is the world's largest package and freight delivery company. We think it is remarkably innovative and nimble for a company its size. Last year, UPS processed and delivered an average of 16 *million* packages each day, for a total of over 4.1 *billion* packages for the year. UPS accomplishes this extraordinary feat through its nearly 400,000 employees, 500 planes and 100,000 trucks. Its other business segments include less-than-truckload freight delivery (for example, if you order new patio furniture from an online catalogue, a UPS freight truck might deliver it), freight forwarding, logistics (helping companies figure out what shipping method will be most cost-effective, getting packages through customs, etc.) and retail stores.

UPS STOCK PRICE 2008-PRESENT



UPS was founded in 1907 as a private messenger and delivery service in Seattle. It is now the third largest employer in the US. The company has a superior reputation for reliability, competent and friendly service and a technologically advanced package tracking system. The company culture promotes employee ownership and "coming up through the ranks." Many members of senior management started out at UPS as package sorters or truck drivers.

Revenues are now $54 billion annually, with 60% from the US, 22% international and 18% from the supply chain and freight division. By way of comparison, UPS' most significant competitor, Federal Express, had revenues of $44 billion last year.

UPS has focused heavily on the "business-to-consumer" (B2C) segment of package delivery in the last two years, creating services such as UPS MyChoice delivery, working with retailers to make deliveries and returns as painless as possible and using retail stores to increase visibility with consumers. This has been a good strategic decision, as the prevalence of web shopping has dramatically increased the need for package delivery.

UPS wisely initiated negotiations with its unions well in advance of the expiration of the current contract on July 31. A five-year master contract was recently approved which covers over 235,000 employees. However, UPS freight employees rejected their proposed agreement decisively and will continue to negotiate while operating under the current contract.

The stock also pays a nice 2.75% dividend. We are happy with our purchase of UPS and expect it to be a long-term holding in our portfolios.

> "If Americans behaved just a little differently, our health care costs could settle down to a sustainable growth rate that matches the economy's growth, or could even fall further. We don't need a nation of triathletes. If we would smoke and drink a little less, walk a little more, eat a few more vegetables and fruits, and lose some weight, the effect would be far more dramatic than most people suspect."
>
> Geoff Colvin, *Fortune* columnist

Are Interest Rates (Finally) Going Up?

Is this the beginning of the end of historically low interest rates?

After years of speculation that the bond market was in a bubble and interest rates were too low, it took only a few comments by Fed Chairman Ben Bernanke to send shock waves through the fixed income markets, causing interest rates to spike. The 10-year Treasury yield jumped from 1.6% on May 2nd to 2.6% on June 24th.

Bernanke, speaking at a news conference on June 19th, was optimistic about the state of the economy. He did not say anything about changing the current quantitative easing program, but the bond market interpreted his optimism as a sign that the stimulus program was nearing an end. As a result of higher rates, long-term Treasury bonds (maturities of 15 years or more) are now down 7% this year, putting this type of security on track for the worst first half of a year since 1974. Medium-term Treasuries (maturing between 2 and 10 years) lost 2.5%.

Municipal bonds have fallen 2.7% on average as spreads have widened and liquidity has diminished. Institutional investors put close to $2 billion of muni bonds up for sale on June 24, setting a single day record. Additionally, retail investors have pulled out over $5 billion from muni bond mutual funds in the past three weeks, which has accelerated the selling. The states of Georgia, New Jersey and Minnesota were forced to cancel debt offerings because of the disruptions in the municipal market.

How much higher will rates go?

Interest rates are a function of expected inflation and are difficult to forecast. Typically, bonds pay a premium over inflation. The premium is the bondholder's return and the spread is larger the longer the maturity of that bond. Historically, the spread over inflation has averaged 2.0-2.5% for 10-year US Treasuries. If inflation is running at 1.5%, that suggests that the 10-year Treasury bond should yield between 3.5-4.0%. The 10-year ended the quarter at 2.5%.

In the short-term, the increase in interest rates will hurt fixed income investment portfolios if they contain long-term bonds or long-duration bond mutual funds. Also, borrowers will pay more for business and auto loans and mortgage rates will move higher, which could slow the recovering housing market. That said, higher interest rates are a sign the economy is improving and are a welcome sight for those who are net savers looking to generate higher income.

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INVESTMENT THEMES

Why Water is One of Our Investment Themes

One of our ongoing investment themes is "water." Why? Here are some statistics from a recent Goldman Sachs report on the topic:

1. More than 60% of the world's fresh water is concentrated in 10 countries: Brazil 13%, Russia 10%, Canada 7% and the US 7%. Canada has 85,000 cubic meters of water for every person in the country; China has 2,000. This is a reflection of both the amount of water and the population density.
2. "Severe water stress" affects 3 billion people out of the world population of 7 billion.
3. Water needs are increasing rapidly in China and India, which together account for 40% of the world's population and create 33% of the world's demand for water.
4. Water resources in developing countries are deteriorating due to pollution. In the "ewww, that's disgusting" category, 90% of wastewater in developing countries is discharged untreated.
5. 1/3 of global energy demand is met by oil, which is a "water intensive" fuel source. Water is critical in all three processes involved in electricity production: extraction, refining and generation. Energy production is using a growing share of water worldwide.
6. Extraction of unconventional (shale) natural gas is also water-intensive.
7. The global water industry is estimated to be over $360 billion.
8. Agriculture accounts for 70% of water use (especially inefficient irrigation, which is why we own Lindsay), industry 18% and domestic use, 12%.
9. The world's population is projected to grow to 9 billion by 2050; by then, more than 4 billion people will be experiencing water stress.
10. Less than 1% of water on earth is fresh water. This percentage is declining due to factors such as the draining of aquifers, increased pollution and climate change.
11. Estimates are that consumption of water will double in the next 20 years.
12. Even in developed countries (like the US) with a good supply of water, the existing infrastructure is underfunded and aging.

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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