NELSON ROBERTS QUARTERLY

C O M M E N T A R Y

2016 | FIRST QUARTER

ECONOMIC OVERVIEW

Market Recovers as Economy Strengthens

After the markets muddled along in 2015, investors greeted 2016 with similar pessimism. Through February 11th, the S&P 500 had fallen over 10.5%. The same tired refrains dominated the headlines, which featured China, emerging market weakness, and low oil prices. These factors were also blamed for causing the market's declines in the fourth quarter of 2014 and the second half of 2015.

Concurrently, the debt markets showed signs of deterioration beyond the expected weakness in energy. In January, Standard and Poor's outlook for corporate borrowers was the worst it had been since the financial crisis. The debt market challenges would have been exacerbated had the Federal Reserve followed last year's rate increase with another. However, rates were held steady at the January and March meetings. Furthermore, healthy bank earnings allayed these fears as banking leaders suggested credit fears were overblown. JP Morgan CEO Jamie Dimon confirmed that the core of its banking business was "pristine" and that "consumers are in increasingly good shape." Alongside these developments, the market recovered through the end of the quarter.

After a year of campaigning by candidates on both the Republican and Democratic sides, the races to the nomination accelerated in February with the Iowa caucuses. Abhorring uncertainty, the markets feared that extreme candidates on both sides of the aisle could pose a threat to the U.S. economy. The Wall Street Journal conducted a survey of economists asking how each candidate would affect their economic forecasts for 2017. The anti-establishment candidates, Bernie Sanders on the Democratic side and Donald Trump on the Republican side, were predicted to have the most negative impacts on the economy. More concerning is that with over half of the delegates pledged, the nominees for the 2016 election are still undetermined. The outcomes are less certain at this late stage compared to any election in the past 25 years.

On the Republican side, there is an increasing chance that front-runner Donald Trump will not be able to obtain the necessary delegates to secure the nomination before the Republican Convention in July. This would result in a brokered convention, which consists of at least two rounds of voting. In the initial vote, most of the delegates are required to vote consistent with their state's primary or caucus results. If no candidate receives the necessary 1,237 (50% + 1) votes of the 2,472 delegates, a second round of balloting ensues. Depending on the state, during the second and any subsequent rounds, delegates are allowed to vote however they want, resulting in side deals and bargaining for delegate votes.

INDEX PERFORMANCE	Q1'156	YTD
Dow Jones Industrials	2.20	2.20
Standard & Poor's 500	1.35	1.35
EAFE (international stocks)	-2.86	-2.86
Russell 2000 (small stocks)	-1.53	-1.53
Barclays Interm. Gov/Credit	2.45	2.45
Barclays Municipal	1.67	1.67

INSIDE THIS ISSUE

TOP FIFTEEN HOLDINGS

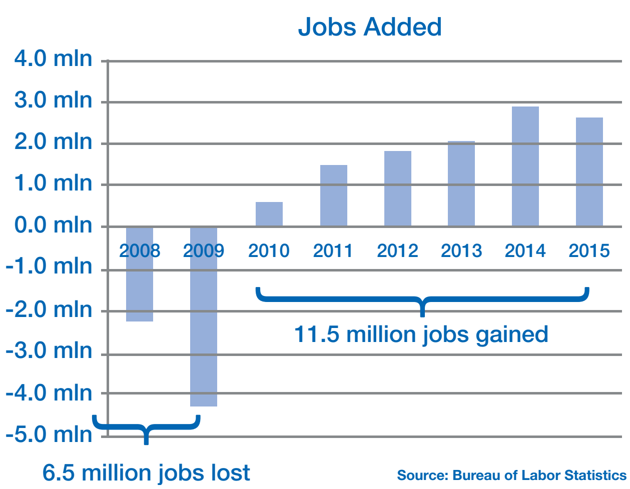
iSHARES CORE S&P SMALL-CAP
AMAZON.COM INC.
MASCO CORP.
COSTCO WHOLESALE CORP.
TJX COMPANIES INC.
VANGUARD FTSE EMERGING MARKETS
SCHLUMBERGER LTD.
GILEAD SCIENCES INC.
UTILITIES SELECT SECTOR SPDR
T ROWE PRICE GROUP INC.
AKAMAI TECHNOLOGIES INC.
ALPHABET INC.
INVESCO LTD.
UNITEDHEALTH GROUP INC.
TRAVELERS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

ECONOMIC OVERVIEW

Market Recovers as Economy Strengthens (cont'd)

Brokered conventions are rare in the post-WWII modern era. The last truly brokered convention occurred in 1952. In the absence of a candidate of their choosing, the Republican establishment would prefer a brokered convention. However, this could lead to a lack of unified support in the party, and might ultimately lead to a third party candidate and/or the nomination of a nonviable Republican candidate.

As Hillary Clinton collects delegates at a consistent clip and the Republican Party turmoil continues, the markets have begun to discount a victory for the Democrats in November. Beneath the political headlines and concerns about economies abroad, the domestic numbers showed signs of strength. Americans bought a record 17.5 million cars in 2015, fueled by low gasoline prices, loosening credit, and improvements in the labor market. The employment statistics have been particularly encouraging, outstripping expectations. U.S. nonfarm payrolls



increased by over 2.6 million in 2015, on top of the 2.9 million jobs added in 2014. Not only are there more people with jobs, but those workers are making more money. Hourly wage growth has inched up, growing 2.3% over last year. More employment opportunities, higher pay for those opportunities, and reduction in household expenses due to lower gas prices all lead to more robust U.S. consumer spending power. That is good news for the stock market.

However, questions remain about the health of the labor market. Alternative work arrangements have grown significantly, which may be inflating the job numbers. Many analysts have attributed the growth in the "gig economy" to the Uber-style mobile application-generated jobs, but a recent study by Alan Krueger at Princeton and Lawrence Katz at Harvard suggests that most of the growth in these jobs has happened offline. The study indicates that traditional industries like manufacturing, healthcare, education, and public administration have experienced double-digit growth rates in the number of workers with alternative work arrangements. Workers with these types of jobs are counted in the labor statistics, but they do not enjoy the benefits of a predictable work schedule, health insurance, social security or a retirement plan. Without these benefits and the safety net they provide, consumers may remain reluctant to increase spending.

Buoyed by corporate earnings and employment data, the stock market recovered from its 10% decline in the first half of the quarter to end the quarter up just over 1%. We are encouraged by this resilience and we believe contributions from the broader corporate sector and a strengthening consumer will outweigh the continued pressure from the energy sector. Global conditions will be the wild card. We will watch for developments leading up to the United Kingdom's June referendum on whether or not it should exit from the EU, a so-called "Brexit," which would disrupt its cross-border commerce. The market has remained pessimistic thus far due to growth deceleration in China, but if we begin to see stabilization or an acceleration of growth, this would be a positive market event that would lead to higher demand for commodities and an overall increase in inflation.

> “Beneath the political headlines and concerns about economies abroad, the domestic numbers showed signs of strength.”

ASSET MANAGEMENT

An Active Start to the Year

The first quarter of 2016 presented several trading opportunities as we reevaluated our companies' strategies and valuations. We sold United Parcel Service (tkr: UPS) after Amazon.com's (tkr: AMZN) entry into the logistics business. Amazon clearly intends to bring more of its shipping in house, with reports that it will lease freighter jets and add thousands of trucks to its fleet. As a rule, Amazon entering a business portends poorly for competitors.

To replace UPS, we added to Masco (tkr: MAS), which continues to benefit from the recovery in the housing market, and bought Roper Technologies (tkr: ROP). Roper is a diversified industrial conglomerate, manufacturing equipment including pumps and water meters, highway tolling systems, and digital imaging software. Roper's strategy is to acquire small, niche industrial companies in technology and health care, pivoting away from heavy industry. Its software as a service (SaaS) solutions now contribute nearly a third of the firm's revenue. We think Roper's diversification will help it weather the rocky climate for industrial companies, and its focus on high-margin, quickly growing businesses should add value in the long run.

Recent negative performance in the international markets presented an opportunity to reposition our holdings in international exchange-traded funds (ETFs). We swapped the Vanguard FTSE All-World ex-US ETF (tkr: VEU) for the Vanguard FTSE Developed Markets ETF (tkr: VEA). We also swapped the iShares Core MSCI Emerging Markets ETF (tkr: IEMG) for the Vanguard FTSE Emerging Markets ETF (tkr: VWO). Our international exposure stayed constant, continuing to provide diversified exposure to the developed and emerging markets. The differences in the underlying indices are minor, but we expect the trades will minimize ongoing fund expenses and let taxable accounts realize a tax-loss benefit.

In our health care holdings, we trimmed our position in Celgene (tkr: CELG) and added to Gilead Sciences (tkr: GILD) (see “Featured Equity” page 5). Seventy percent of Celgene's revenue comes from one drug, Revlimid, which is used to treat multiple myeloma. The company is expensive at a price-to-earnings ratio of 57, lacks a dividend, and addresses a smaller potential market. Conversely, Gilead trades at seven times earnings despite its significant growth potential and addressable market. We added to our Illumina (tkr: ILMN) position, selling part of our position in the Health Care Select Sector SPDR ETF (tkr: XLV) to raise cash for the trade while keeping our healthcare exposure constant. We think the stock's recent downturn is unwarranted given the success of its sales model and its diversification into non-invasive prenatal testing.

We also doubled our position in SVB Financial Group (tkr: SIVB) after the stock declined due to an overreaction by the market relative to the bank's actual exposure to deflating startup valuations. Lending is SVB's core business, and its exposure to individual companies is fractured. Furthermore, a plurality of its lending is to venture capital and private equity firms, not the startups in the headlines, and lending is not exclusive to the technology industry.

We trimmed Disney (tkr: DIS) due to our rising concern that cable “cord-cutting” would cause near-term volatility in its Media Networks segment, which includes ESPN (please see our Q2 2015 Commentary). However, we think that competitors would struggle to replicate Disney's success at monetizing content, and our position is still overweight relative to the market.

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

A Bond ETF Primer

Investors seeking lower volatility and increased safety from the stock market have been pouring cash into exchange-traded bond funds (ETFs) at a record pace, even with yields at historically low levels. But with banks and brokerage firms more reluctant to hold bond inventories and engage in trading, liquidity of the underlying securities in these funds could be an issue during the next market downturn.

Studies have shown the importance of including fixed income assets when building a diversified investment portfolio. However, some debt securities are less liquid and more difficult to buy or sell than stocks. When fixed income is traded, individual bonds are bought and sold over-the-counter (OTC). In the OTC market, there is no exchange like the New York Stock Exchange, so buyers and sellers have to negotiate a fair price, which makes the experience similar to buying a used car. As a result, bond values can be hard to calculate, and this problem is exacerbated by market stress.

Accurate bond prices are needed to calculate a fund's net asset value (NAV). Mutual funds and ETF managers rely on bond pricing services, which estimate the value of individual bonds based on reported trades. This method is not 100% accurate, since some bonds do not trade every day, but it provides a best guess based on available data. As an example of the lack of precision, bond prices can vary by as much as one or two percent depending on the pricing service used.

In times of crisis, investors sell whatever is liquid. Bond ETFs could face severe volatility if investors seek to exit their positions simultaneously, especially when the underlying securities such as municipal and corporate bonds may not be trading. In the short-term, the price of the ETF could trade at a discount to the underlying securities.

These are three of the overarching issues we consider when buying a fixed income ETF for clients:

- Premiums/discounts: When you buy or sell a mutual fund, you always transact exactly at the fund's stated net asset value (NAV). ETF prices, however, are influenced by share supply and demand. Ideally, an ETF should trade at a price close to its NAV and there are mechanisms to keep prices in line, but they are not always perfect. Factors such as market liquidity can cause an ETF to trade higher or lower than its NAV.
- Bid/Ask Spreads: Like stocks, an ETF's spread is the difference between the price you pay to acquire a security and the price at which you can sell it. For some ETFs, the bid/ask spread can be wide. Moreover, wide swings in the market can cause the prices of an ETF's underlying securities to move sharply, causing the ETF to have even wider bid-ask spreads.
- In illiquid markets, an ETF's price may trade at a steep discount to its reported NAV. The spread on the underlying holdings has a big impact on the ETF's premium or discount. Government bonds tend to be liquid, with narrower spreads making them a better fit for ETFs. Corporate bonds tend to have wider spreads causing the ETFs that own them to have larger premiums and discounts.

Bond ETFs have become very popular with individual investors as they are seen as liquid and transparent investment vehicles. We like the low expense ratios associated with most bond ETFs and the ease of access they provide to complex markets, but investors need to remember that the liquidity of an ETF is only as good as the liquidity of the underlying securities.

FIRM UPDATES

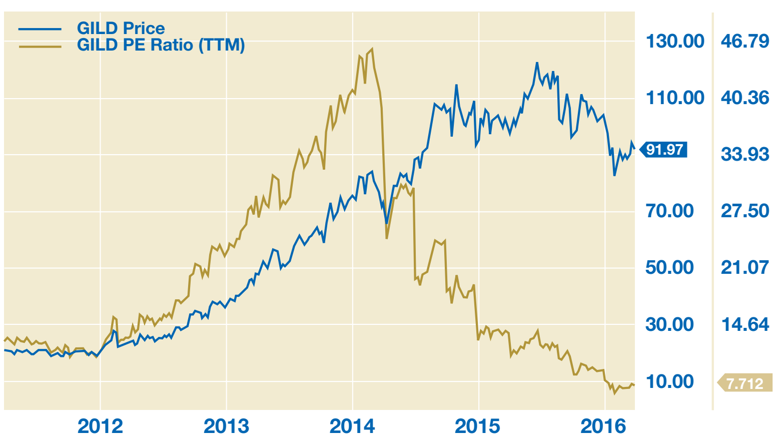
Nelson Roberts is pleased to announce that we have moved to our new office at 545 Middlefield Road, Suite 200, Menlo Park, CA 94025. This new location is consistent with our firm's historical Mid-Peninsula location, and the larger space will allow for future growth.

FEATURED EQUITY

Gilead Sciences, Inc.

Gilead (tkr: GILD) develops, acquires and manufactures drugs primarily used to treat human immunodeficiency virus (HIV) and hepatitis C. Hepatitis is a viral infection of the liver that affects millions of people worldwide. We first bought Gilead several years ago because of our conviction that its first-to-market oral drug for hepatitis C, Sovaldi, would drive significant company growth. Harvoni, Gilead's second hepatitis C drug, followed closely on the heels of Sovaldi. Unlike previous medication regimens for hepatitis C, Gilead's drugs actually cure the disease in over 95% of cases. This means that people who previously would have required treatment for many years just to keep the virus in check are now permanently disease-free with Gilead's drugs.

The pricing for Gilead's hepatitis C drugs has been in the news off and on since the release of Sovaldi. There has been much hullabaloo about the $85,000 list price for a course of treatment. What the newspapers usually fail to mention is that the estimated lifetime healthcare cost for a hepatitis C patient who is not treated is $100,000. 3.2 million people in the US are chronically infected with hepatitis C, and there are 17,000 new cases per year. 70% of those infected with hepatitis C develop chronic liver disease and 20% will develop cirrhosis, or severe scarring of the liver. Hepatitis C accounts for one-third of all liver transplants, which increase the lifetime cost of treatment for an individual to $380,000. Gilead has negotiated lower prices with government payers and is now subject to competition from other drugs that have come to market.



Source: Bloomberg LP

After a very strong initial rise in the stock price following the market release of Sovaldi and Harvoni, the stock was down in 2016 despite continued strong growth in product sales and earnings. Why? In addition to the general biotechnology sector downdraft, there seems to be concern about the number of patients that still need and want treatment and the increase in competition. The numbers referenced above tell us that there are still many patients who will benefit from treatment. Since the release of Sovaldi, 400,000 patients have been treated in the US. Treatment in Europe just started in 2015 and has yet to begin in most other developed countries. Regarding the competition, it turns out that hepatitis C drugs are not just "commodities." Clinically, Gilead has the best medication in terms of side-effect profile and ease of administration. Gilead is also anticipating the launch of its next hepatitis C drug later in 2016, which will cover all six genotypes (different strains) of the virus. After considering all of this information, we believe that Gilead is markedly undervalued.

(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

High-Touch Trading

As a registered investment advisor, we have a duty to our clients to seek best execution on all portfolio transactions. In order to do this, we take into account fees, price, liquidity and speed of execution. The prescription for best execution is not always the same. What works for one stock might not work for another. We rely on our expertise to properly manage our trading in order to achieve best execution every time we trade.

If we are trying to buy Cisco (tkr: CSCO), we look at the "market" for Cisco stock, which is quoted in terms of a bid price (the price at which a market maker is willing to buy) and an ask price (the price at which a market maker is willing to sell). (For further reading on this subject, see "Understanding Market Liquidity" from the Q3 2015 Commentary.) As investors and market makers buy and sell Cisco's stock throughout the day, the bid and ask prices move up and down in tandem. Generally, if Cisco's stock price is falling, there are more trades at the bid price, and if Cisco's stock price is rising, there are more trades at the ask price.

We strive to avoid "moving the market" up or down when we are buying or selling shares. Cisco trades roughly 25 million shares daily, so 10,000 shares would likely will not move the market up or down. However, for a stock like Sun Hydraulics (tkr: SNHY) that only trades about 80,000 shares per day, a 10,000 share trade would be 1/8 of the total daily volume. Buying or selling 10,000 shares of SNHY would move the market, adversely affecting our execution.

Think of liquidity as a spectrum, with Cisco being an example of a stock at the "very liquid" end, and Sun Hydraulics being an example of a stock at the "less liquid" end. Though there are other factors involved, for simplicity's sake, we look at the average daily volume of the stock to get an idea of its liquidity. For Cisco, we enter a "market order" to complete a trade at the current market price. Given Cisco's high liquidity, we can typically complete the trade quickly without moving the market. For a less liquid stock, we have to be extremely patient, which could mean taking all day (or longer) to execute the order.

Our objective is to complete a trade for all accounts on the same day. When a stock is so illiquid that it could take more than one day, we negotiate the trade with the "high-touch" trading desks to complete the execution. In those rare cases, we may pay a higher trade processing fee through a Delivery Versus Payment or prime trade in order to get a better price on the entire order. For example, if we need to buy 10,000 shares of Sun Hydraulics, the broker might know of a seller who is looking to execute a similar amount. The broker can help match our trade against the seller to complete the trade quickly and efficiently. Alternatively, the broker might agree to offer us the shares at a price slightly higher than the current ask price, in exchange for taking on the trading risk. By paying the broker's slightly higher price, we avoid the uncertainty of the stock moving before we are able to execute our entire order. This is preferable to the scenario where being patient enough not to move the market could take several days or weeks, during which time the stock could move significantly on news or other events.

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