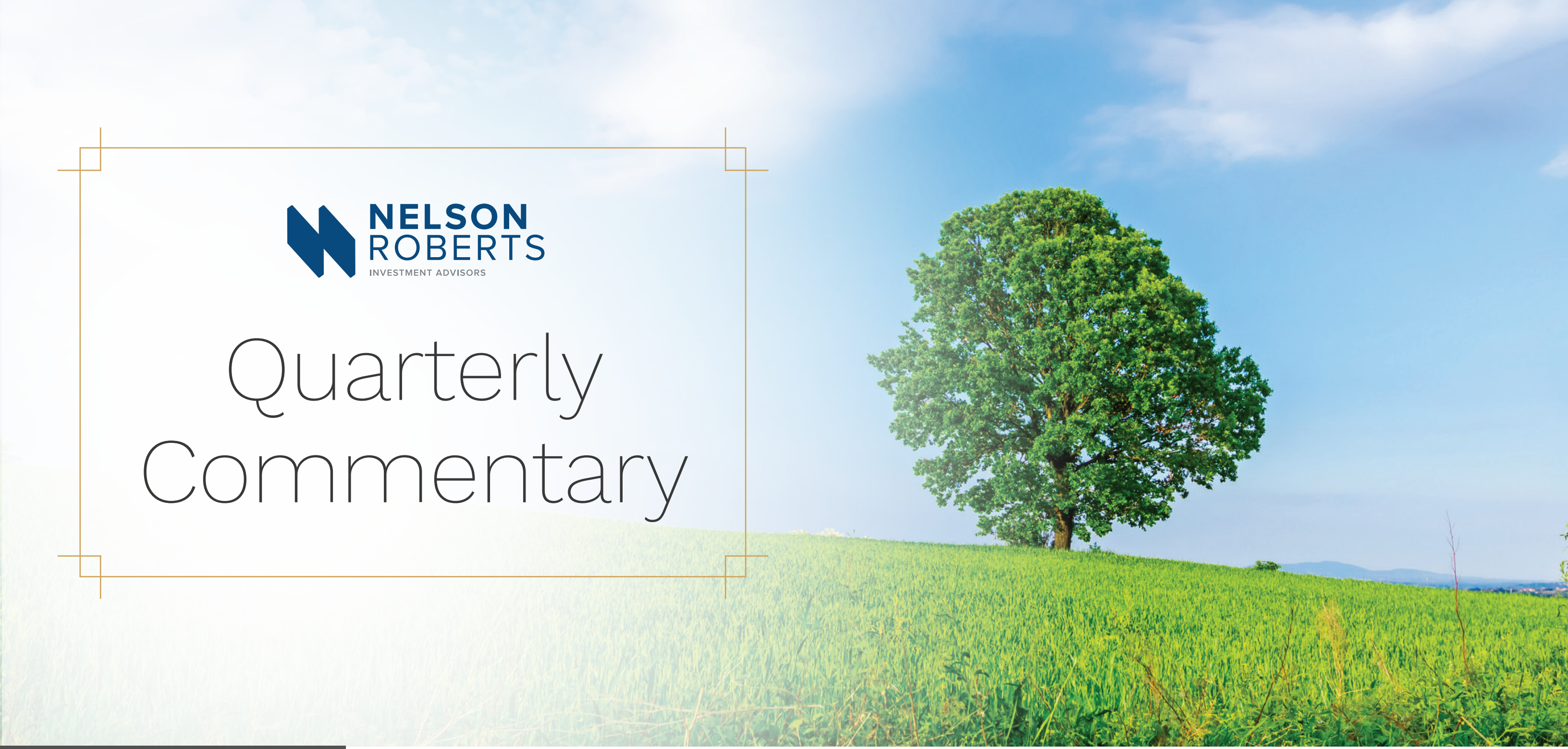

NELSON ROBERTS
INVESTMENT ADVISORS

Quarterly Commentary

2017 | Q2

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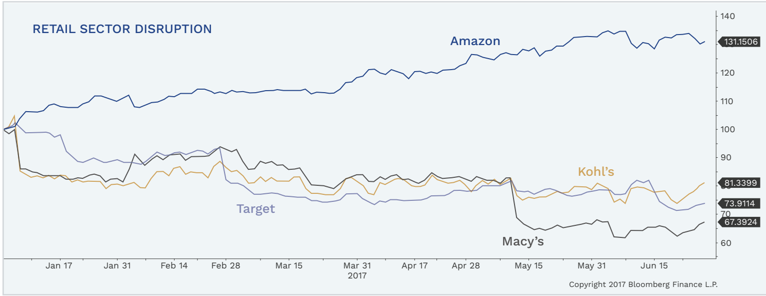
ECONOMIC OVERVIEW

The Only Thing Missing is Euphoria

In the second quarter, world stock markets rose slowly but steadily, building on the first quarter's gains. Except for two trading days in June, volatility was very low. Bond yields declined marginally, from 2.4 to 2.3% for the 10-year US Treasury, after reports showed tepid economic growth and benign inflation. Real bond yields, the difference between nominal rates and inflation, have ranged between 0% and 1% for nearly a decade, well below the long-term average of 2.5%.



Since the beginning of the year, the S&P 500 Index is up 9.4%, but over 30% of that gain is concentrated in 5 stocks: Alphabet, Amazon, Apple, Facebook, and Microsoft. These so-called "Fab 5" technology stocks had seemed invincible, yet, on Friday, June 9th and the following Monday, these stocks dropped between 3% and 6%. Although they have stabilized since, when this momentum trade changes, the correction could be significant.

The pace of change in business is accelerating. For example, in the retail sector, Amazon appears to be taking over the world. Traditional middle-market retailing's existence is threatened by this accelerating change. Year to date, Macy's shares are down 27%, Target shares are down 22%, and Kohl's shares are down 20%. Meanwhile, Amazon shares are up 35%.

The stock market is inexorably rising while Republican intra-party divisiveness imperils the Trump agenda. This is reminiscent of the market's behavior during the 2nd Clinton administration. Bill Clinton's impeachment ran from late 1998 to early 1999, during which time the market continued climbing into "overvalued" territory, reaching a P/E of 33x. By comparison, today's market P/E is one-third lower, at 22x.

We often mention price-to-earnings ratios as a stock market metric. Higher P/E ratios mean the market is more expensive. But how do P/Es relate to bond yields? If you invert the P/E, it becomes earnings as a percent of the market value (E/P). This earnings yield is the sum of three factors: Inflation + real bond return + the equity risk premium (ERP). The last factor is the amount of extra return an investor demands for taking the greater risk inherent in buying a share of common stock. In 1999, the market P/E was 33x, or an earnings yield of 3%. With inflation running at about 2%, this implied no real return and a 1% ERP.

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

ECONOMIC OVERVIEW

The Only Thing Missing is Euphoria (cont.)

The "normal" level of these variables is considered to be "2.5% times 3": inflation of 2.5%, plus the real return at the 50-year average of 2.5%, plus the equity risk premium of 2.5%, giving a total of 7.5% earnings yield. This equates to a P/E of (1/.075), or 13.3x. Today, the market is trading at a P/E of 22x. With inflation of 1.5%, real bond return of 0% and a "normal" ERP of 2.5%, we would have an earnings yield of 4% which is equal to a P/E ratio of 25x. We acknowledge that this seems like mind-numbing math, but the bottom line is that the market is not a bargain, particularly if real bond return or inflation rise back to normal levels. However, as we learned in the late 1990s, overvaluation can persist for a long time. Eventually, valuation matters.

First quarter economic growth was weaker than expected at 2.0%, but unemployment dropped below 5%, giving the Fed room to continue inching rates higher. The Janet Yellen-led Fed moved on June 16th for the fourth time since December 2015 to increase the Federal funds rate to a range of 1-1.25%. Some speculate that the Fed is raising rates so that it can give itself room to cut in the future, should economic growth weaken. Furthermore, the Fed is deliberating how long it will take to unwind the post-crisis quantitative easing (QE) additions to the balance sheet. John Williams, the San Francisco Fed President, has stated he thinks it will take 5 years.

Politics has become synonymous with conflict. There seems to be no room for compromise. The Senate invoked the "nuclear option" to approve Neil Gorsuch as a Supreme Court justice. Now it only takes a simple majority to approve justices. Meanwhile, the Trump administration still has many vacant staff positions and is bogged down with media scrutiny and the politics of special investigations. The global phenomenon of rising populism and nationalism abated, at least temporarily, with Macron defeating Le Pen in the French election. German-French solidarity contrasts with the disunity in the UK. British Prime Minister Theresa May called for snap elections on June 8, but this backfired and her party lost the majority. This calls into question her long-term viability as Prime Minister.

Our economy is chugging along at a slow pace, extending our weak and long recovery from the 2008 financial crisis. The media highlights nationalism, populism, anti-establishment forces, terror fears, and trade protectionism, but our bond and equity markets have been relatively immune to these fears. Markets react, people buy the dip, and we move on. Political risk does not seem to matter to earnings or the real economy. We worry, "are we being lulled into something?" But as there are no signs of irrational exuberance or euphoria, we are staying fully invested, although now is the time to be more vigilant.

Index Performance	Q2' 17	YTD
Dow Jones Industrials	3.95	9.35
Standard & Poor's 500	3.09	9.34
EAFE (international stocks)	7.02	14.98
Russell 2000 (small stocks)	2.52	4.98
Barclays Interm. Gov/Credit	0.94	1.73
Barclays Municipal	1.96	3.57

ASSET MANAGEMENT

An Active Quarter

The stock market momentum continued through the second quarter. While the “Fab 5” (Alphabet, Apple, Facebook, Amazon, Microsoft) led the market, nine of the ten economic sectors represented in the S&P 500 posted solid returns in the first quarter. The lone sector with negative returns both in the second quarter and year-to-date was the energy sector. Energy has been challenged by the low price of oil and the high cost of extraction and transportation.

Technology and healthcare sectors led the way in the second quarter. Technology’s increase is not a big surprise as the aforementioned Fab 5 surge ahead, but healthcare stocks have experienced a recent bounce after two years of under-performance relative to the market. It is difficult to pinpoint where the optimism is stemming from in healthcare, but the sector entered 2016 with attractive valuations and anticipation that the regulatory environment would adjust toward benefiting the companies in the sector.

In the second quarter, we swapped a couple of our positions in the healthcare space, exchanging Novartis (tkr: NVS) for Bristol-Myers Squibb (tkr: BMY). Novartis was a long-time holding of ours that performed well over our ten-year holding period, but it was struggling with the turnaround of its Alcon eye care business. Rather than wait out the turnaround, we shifted toward a more promising growth story in Bristol-Myers Squibb and its immuno-oncology portfolio and pipeline of drugs. We believe that immuno-oncology drugs will have an important and growing role in cancer treatment and that Bristol-Myers Squibb is well-positioned to participate in it.

In the technology space, we purchased a position in Mindbody (tkr: MB). Mindbody is a cloud-based (Software-as-a-Service, or SaaS) business management software and payments platform that caters to wellness companies, including spas, salons, fitness and yoga studios. It is this quarter’s featured stock (see page 5, Featured Equity).

In the financial sector, we exited our position in T. Rowe Price (tkr: TROW). We elected to sell our position given the disappointing net flows of investment dollars away from active asset managers, including T. Rowe Price. The company’s lack of exposure to the increasingly popular passive index fund market exposed the company negatively to that trend. We also found increasing evidence that the company’s previously very sticky offering of target date assets were coming under pressure from outflows.

Lastly, we trimmed our profitable position in Disney. The company’s theme park and studio business are doing great. However, a more significant contributor to earnings is their media networks business, particularly the ESPN brand. Currently, 55% of Disney’s operating income comes from that business segment. After years of dictating terms in the cable industry and driving growth at Disney, ESPN is slogging through a dramatic drop in cable subscribers as viewers are choosing to go “over-the-top” and digitally stream their viewing content. ESPN maintains expensive long-term rights to broadcast premium sports content, like NFL, MLB, and NBA games, but those deals were negotiated during a period of rising cable subscribers. We maintain confidence that Disney will navigate these challenges, but we reduced our exposure to a market weight.

> "As we learned in the late 1990s, overvaluation can persist for a long time. Eventually, valuation matters."

FIRM UPDATES

Nelson Roberts is excited to announce the release of our new website as well as our new commentary format beginning this quarter.

We would also like to congratulate Sarah Sinclair and Erin Rodriguez on officially becoming notaries public. Nelson Roberts is now able to offer complementary notary services to clients.

WEALTH MANAGEMENT

The Drawbacks of Annuities

The lure of a guaranteed income stream for the remainder of one's life leads many Americans to invest billions of dollars in annuities each year. In 2016, over $220 billion of annuities were sold. Who wouldn't want stable and secure income during their retirement years? Most of us would, but the insurance companies that create these products attach a big price tag and the draw-backs of having your money locked up often leaves investors with buyer's remorse.

What is an annuity?

An annuity is a contract between the policy holder and an insurance company. Depending on the type of annuity purchased, the owner can elect to receive guaranteed payments for life or to have payments made over a specified length of time.

Are there different types of annuities?

There are two basic types of annuities: deferred and immediate. With a deferred annuity, your money is invested for a period of time until you are ready to begin taking withdrawals, typically in retirement. For an immediate annuity, you begin receiving payments soon after you make your initial investment.

Fees

One of the biggest disadvantages of an annuity is the expensive fee that is often attached. Annuities are cash cows for insurance companies and the brokers that sell them. The commissions and annual expenses associated with annuities can be very high and very difficult to understand. Typically, the fee earned by the broker selling an annuity is around 5% to 6%, but it can be as high as 10%. In addition, there are annual expenses that can run between 2-3%. The lack of transparency in these products allows brokers to take advantage of investors who are worried about outliving their assets. This is a big reason why annuities have garnered such a bad reputation.

Liquidity

After buying an annuity, that money is locked in for a certain period of time, typically from six to eight years. You can technically take the money out, but you pay a surrender charge for access to your money. You may also pay penalties if you withdraw before age 59½, in addition to any applicable taxes. If an unexpected event occurs and you need a lump sum of your money, the cost of getting your money back can be quite high.

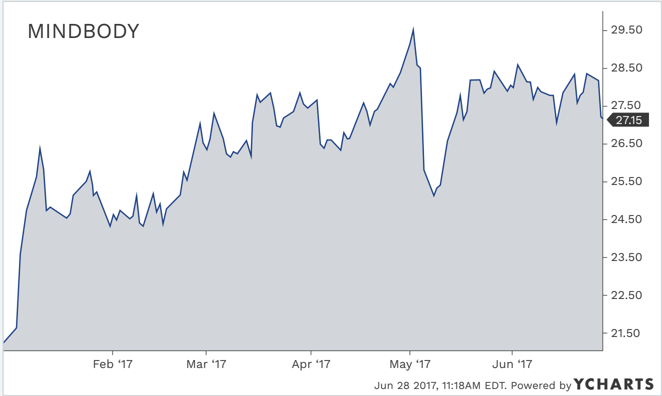
What should you do if you own an annuity?

We typically do not recommend annuities because of the aforementioned drawbacks, but if you already own an annuity, we can help. If the annuity has been held longer than seven years, it may be possible to find and transfer your money to a lower-cost annuity through what is known as a 1035 exchange. A 1035 tax-free exchange is the IRS tax code that allows for the rollover of a non-qualified annuity to a new annuity or life policy of equal or greater value. Capital gains and/or income taxes will not be realized from this type of transfer when completed properly. Please feel free to contact us if you have further questions.

FEATURED EQUITY

Mindbody

Mindbody (tkr: MB) is a cloud-based, software-as-a-service (SaaS) business management software and payments platform that caters to wellness businesses, including fitness and yoga studios, spas, and salons. Its customers include local wellness businesses, national wellness chains and international franchises. Mindbody software enables its customers to easily manage class and appointment schedules, staff members, client information, online bookings, inventory, payroll and retail sales.



Mindbody has around 60,000 subscribers out of roughly 4.2 million wellness businesses globally. With only about 1% penetration, Mindbody has an opportunity to capture a larger market share in a growing global market. Mindbody's vertical integration gives it a deep level of knowledge in the wellness industry space. The company estimates that over 90% of the addressable market currently uses on-premise, basic, non-tailored solutions such as notebooks, Microsoft Excel, or Microsoft Word documents. Mindbody has begun to benefit from the network effect of its growing subscriber base, attracting new partners like Google and Fitbit. Mindbody had its IPO in mid-2015, and although the company is not yet profitable, the CEO has predicted that they will be by the end of 2017, and earnings trends indicate that this should be an achievable goal. On a price-to-sales valuation basis, Mindbody is relatively inexpensive at about 7x sales, especially considering that many comparable SaaS companies trade closer to the 10-12x range.

We recently initiated a position in Mindbody in order to gain exposure to the growing trend of people attending studio, spin and barre fitness classes in addition to or instead of simply having a monthly gym membership. Importantly, Mindbody is not tied to the success of any particular fitness fad, but rather benefits from a more broad expansion of "boutique fitness."

Mindbody has focused on increasing its average revenue per subscriber through cross-selling and offering more integrated features and services to high-value customers. The company made the decision at the beginning of this year to stop selling its "Solo" subscription to individual practitioners, and instead focus on higher-value subscribers. This caused the number of subscribers to dip slightly relative to the previous quarter, which led to a negative reaction in the stock. We took that stock dip as a buying opportunity, because we believe that Mindbody is employing the correct strategy for long-term revenue and margin growth.

(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.)

TOP 15 HOLDINGS

- ISHARES S&P SMALL-CAP ETF
- AMAZON.COM INC.
- UNITEDHEALTH GROUP INC.
- VANGUARD EMERGING MARKET ETF
- COSTCO WHOLESALE CORP.
- ALPHABET INC.
- FIRST REPUBLIC BANK
- UTILITIES SECTOR SPDR
- STRYKER CORP.
- TRAVELERS COS INC.
- SCHLUMBERGER LTD.
- INVESCO LTD.
- CISCO SYSTEMS INC.
- ROPER TECHNOLOGIES INC.
- MASCO CORP.

OUR TEAM

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Sarah Sinclair
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Erin Rodriguez

SPECIAL TOPIC

Blockchain Technology and Bitcoin

Bitcoin has been a hot topic in recent months, and we have certainly noticed an uptick in news articles and client questions about this virtual currency. Bitcoin has piqued peoples' interest alongside a meteoric rise in its price. The value of one bitcoin is up over 400% in the past year, and up over 1000% over the past two years, as of this writing. So what is Bitcoin, exactly?

Bitcoin is one application of "blockchain" technology. Blockchain is essentially a digital ledger where transactions are recorded chronologically and publicly. Blockchain is distributed, which eliminates risks that come with data being held centrally. The blockchain ledger is purportedly cryptographically secured and immutable, meaning one can add to it, but cannot change its history. Blockchain technology can verify ownership as well as process the efficient exchange of ownership, allowing for instant, direct transactions without a middle person. This makes blockchain a natural fit for powering virtual currencies, or "cryptocurrencies." Due to the decentralization of blockchain technology, these currencies are not issued, regulated or controlled by any central bank or government.

Bitcoin became the first decentralized cryptocurrency network (note: "Bitcoin" with a capital "B" is the network, "bitcoin" with a lowercase "b" is the currency itself) when it was established in early 2009. It is still currently the most well-known crypto-currency, although it is only one of over 800 currently available for trade in online markets. Despite its impressive rise, Bitcoin has been plagued by issues such as extreme volatility, its use on black markets for nefarious purposes, and a number of high-profile heists in which millions of dollars' worth of bitcoin was stolen from third-party wallets or exchanges. More recently, newer cryptocurrency networks such as Ethereum have gathered steam in the virtual currency arena, taking market share from Bitcoin. Ethereum's popularity increased this year, as 30 companies announced they were joining together to form the Enterprise Ethereum Alliance. The goal of this organization is to develop standards and technology to make it easier for enterprises to use blockchain code Ethereum in their day-to-day operations. Ethereum has also been given the blessing of the NY Department of Financial Services, which named Ethereum as a regulated asset in March of 2017.

We see many possible uses for blockchain, primarily as the back-end technology for various types of transactions. We think that blockchain technology could be ubiquitous someday, perhaps without end users even realizing they are using it. However, at this stage we do not recommend investing in bitcoin or any other individual cryptocurrency. Out of the hundreds of cryptocurrencies trading, we do not yet see a clear winner. Furthermore, the practical issues involved with a cryptocurrency investment and the unruly volatility mean that these are not suitable for most clients. Instead, we are looking for more established companies that are taking early steps to utilize this blockchain technology. For example, JP Morgan (tkr: JPM), a financial holding of ours, is developing an enterprise-focused, distributed ledger called Quorum™, which is powered by Ethereum. This technology could potentially disrupt the company's expensive, protracted back office functions, creating huge cost savings for JP Morgan while improving overall efficiency of operations.

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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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