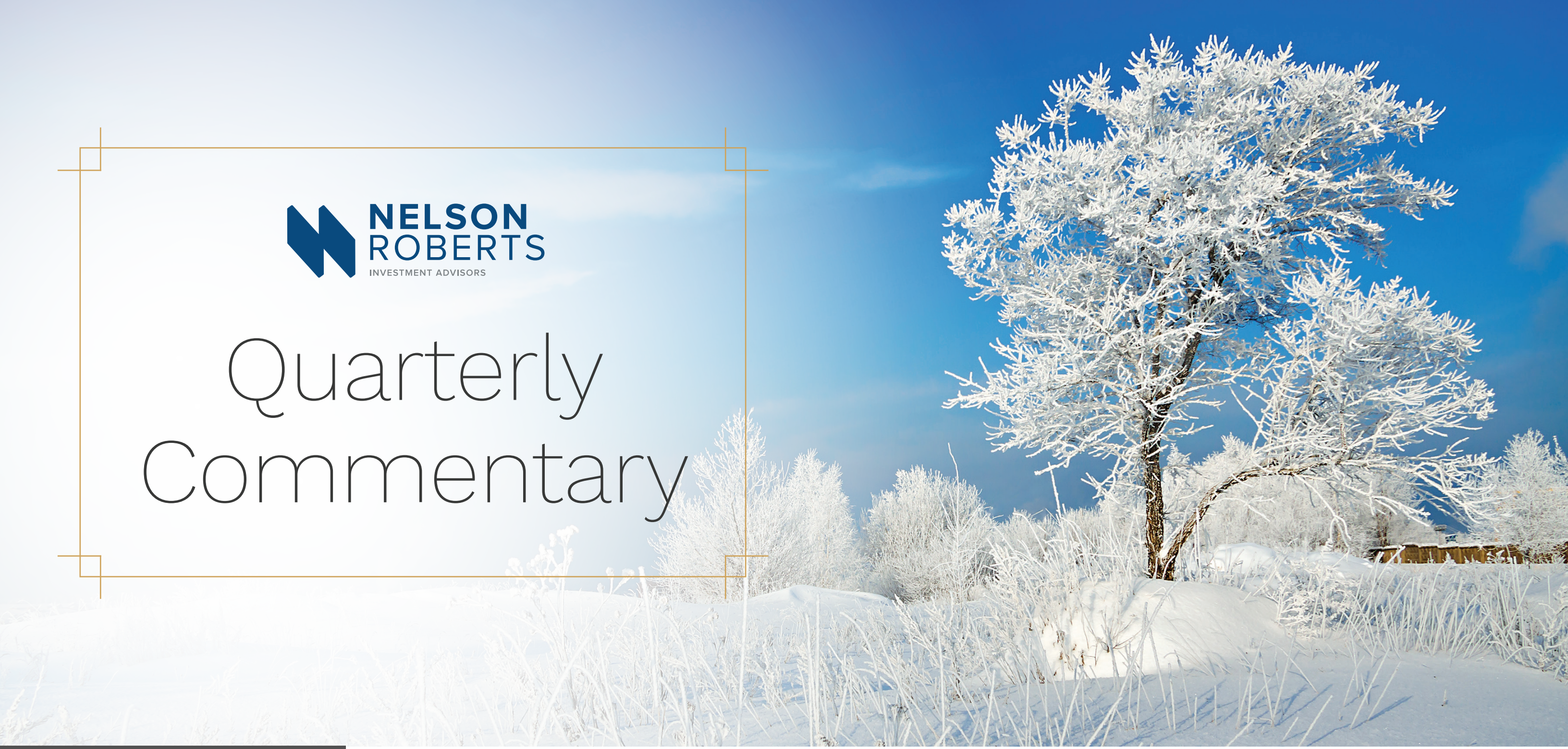

NELSON ROBERTS
INVESTMENT ADVISORS

Quarterly Commentary

2019 | Q4

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Global equity markets had a surprisingly positive fourth quarter, with most markets up about 8% to new all-time highs. Stock prices climbed the proverbial wall of worry, ignoring tariffs, impeachment, Brexit, slowing manufacturing data, a brief August yield curve inversion, and a controversial resumption of quantitative easing.

President Donald Trump continues to use tariffs and the threat of tariffs as a negotiation tactic with all of our trading partners, especially China. The tariffs have depressed economic growth in the U.S. but the impact has been more severe on the Chinese economy. Continued market optimism for a trade agreement was the main reason for the stock markets' rise this quarter. On December 13, President Trump tweeted that the U.S. and China "will begin negotiations on the phase two deal immediately, rather than waiting until after the 2020 election." Essentially, this was only an agreement to negotiate, but it was enough for Trump to postpone the tariff increases that were set to go into effect on December 15.

Recent monetary policy changes by the Federal Reserve have created a controversy. On September 16, the day that third quarter tax estimate payments hit the banking system, the fed funds rate spiked from 2% to more than 10% overnight. The Fed responded by implementing repurchase operations (repo) for the first time since the 2008-2009 financial crisis. Good old-fashioned repos look to some like quantitative easing (QE).

In late 2008, with interest rates at 0% and the economy still falling, the Fed, under Ben Bernanke, implemented a program to expand the Fed's balance sheet extensively. When the Fed buys securities, it is essentially printing money electronically. With repos, that money comes back out of circulation in as short as a day or a month, depending on the maturity of the T-bills the Fed is buying. With QE, the Fed is buying long-term securities so that money remains in the economy for a much longer period of time.

From 2008 to 2015, in three steps, the Fed increased its securities holding from $900 Billion to $4.5 trillion. During this time (and continuing today), other central banks (European Central Bank, Bank of Japan, Bank of England, etc.) were also printing

Index Performance	Q4 '19	YTD
Dow Jones Industrials	6.67%	25.34%
Standard & Poor's 500	9.06%	31.48%
EAFE (international stocks)	8.23%	22.77%
Russell 2000 (small stocks)	9.93%	25.49%
Barclays Interm. Gov/Credit	0.37%	6.80%
Barclays Municipal	0.74%	7.54%

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

ECONOMIC OVERVIEW

A Strong Finish (cont.)

money in the same way by buying long-term bonds. Over the last decade, the amount of global liquidity has increased four-fold, from $4 trillion to $16 trillion dollars' worth. The consequence of this created a shortage of bonds and an excess of cash so extreme that the yields in foreign bond markets dropped below 0%. By August 30 of 2019, the total dollar value of worldwide negative-yielding debt reached $17 trillion. With 30% of global sovereign debt yielding less than 0%, U.S. Treasury bonds yielding over 2% attracted so much demand that rates on the 10-year note fell nearly in half from 3.22% on 10/31/18 to below 1.52% on 9/30/19. In late August, this caused an inversion in the yield curve, with the yield on the 2-year note below that of the 10-year. This lasted about 5 days and was a miniscule 5 basis points (0.05%). Traditionally, an inverted curve is a leading indicator of a coming recession. But in every instance previously, a curve inversion has been caused by the Fed increasing short rates. This time was truly different as the inversion was caused by falling long bond rates.

In 2014, the amount of global negative-yielding debt was near $0. Between 2015 and 2018, the total averaged $8 trillion. After peaking in August at $17 trillion, the total declined 35% in the fourth quarter to about $11 trillion. There appears to be impetus for a cessation of QE globally. If that is true, then we will stop worrying about a potential currency crisis such the one that occurred in post-WW1 Germany after they printed massive amounts of money to pay for the war and reparations.

On October 30, the Federal Reserve announced a cut in the target for the Federal Funds rate for a third time, to a range of 1.50 to 1.75%. These cuts reversed all of the increases they made in 2018. The Fed has since announced that they are "on hold." It is very unlikely they will do anything further until after the November 2020 election.

If an inverted curve is the leading indicator of a coming recession, it will be confirmed by the deceleration in year-over-year job growth, a coincidental indicator. The labor market continues to maintain moderate strength, with 266k new jobs created in November. Therefore, it looks unlikely that the economy will turn down anytime soon.

Running up to the election, clients from both sides of the political divide call asking if we think politics will cause a market decline. The Economist, in "Figuring out the 2020 Race," correctly points out that the economy has more impact on politics than vice versa. When GDP is rising during an election year, the incumbent president running for re-election has not lost since 1892.

On December 19, the House of Representatives voted on party lines to impeach President Trump. Since there is a Republican majority in the Senate, it is very unlikely that the president will be convicted. Consequently, we are likely to have President Trump through 2024.

In the management of our client portfolios, we put aside the dramas of impeachment, trade wars, and monetary policy controversy. Instead, we focus on whether one should desire to buy a 2% IBM note or the stock yielding 5%—obviously, we choose the latter. But remembering that we are in the longest running expansion ever, it makes sense to focus on undervalued stocks with higher dividend yields. Our pivot to value continues.

ASSET TRANSACTIONS

Increasing Dividend Income

As the longest bull market in history continues, Nelson Roberts has found opportunities to reduce portfolio risk and increase dividend income through the addition of value-oriented stocks.

In the technology sector, we brought our exposure up to our target weight with the addition of International Business Machines Corporation (tkr: IBM). Typically, technology names are thought of as growth stocks. However, IBM trades at a forward price-to-earnings (PE) ratio of 11x which is very low relative to the PE ratios of its technology peers. Its core hardware and software business is profitable and it has started to invest in new initiatives such as analytics and cloud computing. Recently, IBM purchased Red Hat which will position the company as the leading hybrid cloud provider. Furthermore, it pays an attractive 4.8% dividend which increases our overall portfolio dividend yield.

We increased our exposure to the Real Estate Investment Trust (REIT) sector with the purchase of Ventas (tkr: VTR). Ventas provides a portfolio of senior housing, medical office buildings, life science buildings and hospitals. Recently, management diversified the business away from caring for patients and focused more on housing. Therefore, the addition of Ventas increases our exposure to the large aging baby boomer demographic. The company pays a 5.5% dividend and REITs tend to outperform late in the economic cycle and during recessions.

We trimmed one of our oldest holdings, Costco Wholesale Corporation (tkr: COST). We believe Costco has good management, will continue to grow, and is relatively recession-resistant. However, its growth had made it one of our largest portfolio holdings and largest overweight relative to the S&P 500. We decided to take some money off the table while it was trading near an all-time high.

Similarly, we cut our position in TJX Companies (tkr: TJX), the parent company of off-price department stores: TJ Maxx, HomeGoods, and Marshalls. TJX has done extremely well over the last couple years as one of the few retailers that has withstood the intense competition from Amazon. With high inventory turnover, TJX creates a “treasure hunt” mentality, as shoppers never know what they are going to get. This draws customers in and helps maintain high same-store sales. We have long maintained TJX as a core holding in our consumer discretionary sector. However, we decided to trim our large overweight position slightly as it was trading near its all-time high.

Over the course of 2019, we executed 13 buys (5 of which were adding to existing positions) and 15 sells (7 of which were trimming existing positions), representing portfolio turnover of 19.5%. We increased our portfolio’s dividend yield from 1.48% in the beginning of the year to 1.79% at year-end.

> As the longest bull market in history continues, Nelson Roberts has found opportunities to reduce portfolio risk and increase dividend income through the addition of value-oriented stocks.

FIRM UPDATES

The firm welcomed Hannah Ruth Smoot, daughter of Darcy Nelson Smoot and Cliff Smoot, and granddaughter of Brooks Nelson. Hannah was born on October 7, 2019, weighing 7 pounds 12 ounces. She and her parents are doing well.

WEALTH MANAGEMENT

Changes to Retirement Account Rules (The SECURE Act)

The SECURE Act (Setting Every Community Up For Retirement Enhancement), which passed the House with overwhelming support in a 417-3 vote earlier in 2019, was signed into law on December 20th. This is the biggest overhaul to retirement rules since 2006. We wrote about the proposed changes in our 2nd Quarter commentary, but below is an overview of the notable modifications that take effect January 1, 2020.

Increasing the Retirement Age to 72 from 70 ½

Retirement age is extended by two years, so savers will be required to begin taking their required minimum distributions from 401(k)s and traditional IRA accounts at age 72 instead of 70 ½. In addition, the age limit for contributing to a traditional IRA, which is currently capped at 70 ½, is repealed. More people are working beyond age 70 either by choice or necessity, so savers can take advantage of tax-deferred accounts for a longer period of time and keep up with increasing life expectancies.

No More Stretch IRAs

The ability to "stretch" an inherited IRA will be shortened to 10 years. Previously, when an IRA was inherited, the non-spousal beneficiary was able to stretch the required distributions and tax payments over their lifetime. Under the new bill, non-spousal beneficiaries will be required to withdraw the full balance of the account within ten years of inheritance, accelerating the income taxes due and reducing growth potential.

Qualified Charitable Distributions Still Allowed at 70 ½

The Secure Act makes no change to the date at which individuals may begin to use their IRAs to make charitable distributions. The rule allows IRA owners who have reached the age of 70 ½ to make charitable contributions of up to $100,000 and avoid reporting the distribution as income on their tax returns.

Annuities in 401(k) Plans

Individuals with 401(k) plans will be allowed to buy annuities through insurance companies in exchange for contracts that guarantee a monthly income stream. This is an attempt to offer working Americans a product similar to a pension that many corporations used to offer. What workers need to keep in mind is that annuities can drastically reduce the growth potential of their money and eliminate the opportunity to pass excess retirement money to heirs (unless they pay extra). 401(k) statements will also be required to project how much the participants current savings would generate over a lifetime of monthly payments at least once per year. This will give savers an expensive alternate perspective on current progress towards retirement goals.

Children with Investment Income

The 2017 Tax Cuts and Jobs Act stated that minor's interest, dividends and other unearned income is taxed at the trusts and estates tax rate. This will be repealed and the "kiddie tax" would return to the parents' marginal tax bracket.

New Parents

New parents will be able to withdraw up to $5,000 penalty-free from their IRA or 401(k) plan within one year of the birth or adoption of a child to help accommodate addition expenses associated with having a child.

Employers Without Retirement Plans

Employers without retirement plans will have the option to band together to offer 401(k) plans with less fiduciary liability concern and reduced costs.

Part-time Employee

Employers will be required to grant access to 401(k) style plans for part time employees working 500+ hours per year and have been with the company for over 3 years.

529 Plans

Qualified education expenses for 529 plan funds are expanded to cover student loans.

FEATURED EQUITY

IBM

In previous commentaries we have articulated a desire to pivot toward value-oriented stocks. One result of that effort is the initiation of a position in IBM.

IBM (tkr: IBM) is one of the oldest companies still standing in the ever-evolving world of technology. The company began in New York in 1911 as the result of a merger of several companies manufacturing tabulators, employee time-keeping systems and punch card equipment. Today, IBM offers application, technology consulting and support, process design and operations, cloud, digital workspace, and network services, as well as business resiliency, strategy and design solutions. It operates in more than 170 countries across the world and has a market cap of $118 billion. In the last four quarters, IBM saw nearly $80 billion of annual revenues with over 65% of revenues originating from outside the United States.

International Business Machines Corp.

Source: FactSet

IBM currently operates under the following business segments: Cloud & Cognitive Software (29% of revenue), Global Business Services (23% of revenue), Global Technology Services (37% of revenue), Systems (8% of revenue) and Global Financing (2% of revenue).

Over the past several years, IBM has invested heavily in new initiatives such as analytics and cloud computing. In July 2019, IBM closed its $34 billion acquisition of Red Hat, an open source enterprise platform, in one of the largest tech acquisitions in history. Together, Red Hat and IBM will accelerate innovation by offering a next-generation hybrid multi-cloud platform.

IBM's ability to keep up with evolving technology is demonstrated through its record patents. In 2018, IBM inventors were granted 9,100 patents, securing its leadership in U.S. patents for the 26th consecutive year. It led the industry in the number of artificial intelligence (AI), cloud computing, security and quantum computing-related patent grants. IBM's goal is to offset declines in their legacy business with rising sales of these new ventures.

This is not our first time owning IBM in our client portfolios. It was on our buylist most recently in 2014. Though IBM is in search of ways to reinvigorate its topline growth, its current revenue sources are stable. It trades at a forward price to earnings (P/E) ratio of only 10.5x, slightly above their 5-year average forward P/E ratio of 10.1x and less than half of the technology sector's forward P/E ratio of 21.4x. The low P/E limits its downside risk. Importantly, IBM boasts a dividend yield of 4.8%, sustainable due to its stable free cash flow, which averages about $12 billion annually.

Even if the growth opportunities do not pan out, clients will benefit from the hefty dividend income that exceeds that of many bonds.

(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
- VANGUARD DEVELOPED MARKET ETF
- ALPHABET INC.
- AMAZON.COM INC.
- MICROSOFT CORP.
- COSTCO WHOLESALE CORP.
- MEDTRONIC
- UNITEDHEALTH GROUP INC.
- VERIZON COMMUNICATIONS INC.
- ILLUMINA INC.
- VANGUARD EMERGING MARKET ETF
- CISCO SYSTEMS INC.
- TJX COMPANIES INC.
- FIRST REPUBLIC BANK
- JP MORGAN CHASE & CO.

OUR TEAM

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Sarah Sinclair
Erin Rodriguez
Chrissy Domingo
Marissa Wisniewski

SPECIAL TOPIC

Where is My Money?

One of the important choices an investor faces is where to custody their investment assets. Nelson Roberts Investment Advisors does not take custody of our client assets, but instead partners with third-party custodians for the safekeeping of our client assets. A custodian is a financial institution that holds clients' securities in physical or electronic forms. In addition to holding securities, custodians also perform other services, like the collection of interest and dividend payments, tax support, and money movement.

As an individual investor, there are three primary ways to hold your securities:

- **Physical Certificate** — The security is registered in your name on the issuer's books, and you receive an actual, hard copy stock or bond certificate representing your ownership of the security.
- **"Street Name" Registration** — The security is registered in the name of your brokerage firm on the issuer's books, and your brokerage firm holds the security for you in "book-entry" form. "Book-entry" simply means that you do not receive a certificate. Instead, your broker keeps a record in its books that you own that particular security. A majority of our client accounts have their securities held in street name
- **"Direct" Registration** — The security is registered in your name on the issuer's books, and either the company or its transfer agent holds the security for you in book-entry form.

For many of our client relationships, Nelson Roberts utilizes Charles Schwab or TD Ameritrade as our custodial partner. On November 25, 2019, Charles Schwab announced they have entered an agreement to acquire TD Ameritrade, a combination that will result in a company with 24 million brokerage accounts and more than $5 trillion in client assets.

The transition to a combined company will take some time. The deal is expected to close in the second half of 2020, with the integration of the two firms starting immediately after the close. One of the more surprising details of the merger will be the moving of Schwab's corporate headquarters from its long-time home in San Francisco to the Dallas-Fort Worth area.

The combination of the brokerage firms does not change the goal of Nelson Roberts to recommend the best custodial relationships for our clients' assets. We will be diligent in determining whether the combined enterprise will:

- Be a financially healthy custodian dedicated to the highest standards of security when it comes to the safeguarding of client assets.
- Provide access to the capital markets and best execution practices able to deliver the best pricing for our client transactions.
- Offer competitive account services that support our ability to serve the needs of our client relationships.
- Include access to resources and educational opportunities that support the business of Nelson Roberts Investment Advisors.

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