SeaBridge Asia Strategy

First Quarter 2014
Commentary

The SeaBridge Asia Strategy declined in the first quarter in line with the MSCI AC Far East ex Japan Index* which lost 1.45%. A look at our winners and losers for the quarter reveals a desultory market in search of direction. Our holdings in a variety of industries turned in mixed results. Within the commodities area, agriculture was strong; but copper, coal and energy related were weak. Likewise, our industrial companies (primarily business to business suppliers of a variety of product including automated equipment components, power supply components and engineered product for the oil and gas industry) produced divergent outcomes. Clearly, geographic footprint mattered. Companies geared more to the China market and the US generally performed well; those with a larger presence in Europe and Japan, less so. Portfolio results also suggest that the consumer, broadly defined, remains subdued. Discretionary consumption of hard and soft goods remained challenged, while our services companies generally turned in a credible performance.

During the period, our management can be largely summed up as opportunistic. We added to our positions in some very high quality companies whose shares declined either on the basis of disappointing quarterly results or in concert with broader market declines. Prominent among industries to which we increased our exposure was automation. We firmly believe that automation is an enduring theme in Asia as the focus on factory efficiency intensifies in a rising wages environment. At the same time, the bias toward rising interest rates created a condition for reducing on a net basis our holdings in real estate, an asset class that is vulnerable to higher discount rates and lower valuations. In initiating a position in a gold miner and trimming our copper miner, we essentially increased our exposure to an already beaten down commodity and reduced our exposure to a metal that we think is a bit more vulnerable given current supply demand forecasts for the remainder of the year.

We recognize that emerging markets have had a more difficult start to the year than was anticipated. The Argentine peso devaluation early in the year has stoked contagion concerns especially among emerging market investors. The Federal Reserve continues to taper its purchases of long dated securities and hinted that the Fed Funds rate, now near zero, could rise as early as the beginning of next year. Finally, China skepticism is perhaps at an all time high with investors concerned that the country's well documented credit excesses cannot be unwound without destabilizing the economy. We will address each of these worries separately.

Emerging Markets Contagion

There were moments during the first quarter when veteran investors in Asia were probably unhappily recalling the 1997 Asia financial and market crises that were precipitated by the Thai baht devaluation and which eventually affected all countries in the region. Capital fled the region in response to troubling economic developments in other emerging parts of the world, particularly South America. It is our view that the risk of contagion from those countries now struggling to avoid precipitous currency devaluations and capital deficiencies such as Argentina and Venezuela is remote for two reasons. First, the countries with serious problems are insignificant on the world stage. It would take a prodigious flexing of the imagination to construct a credible rationale for selling Hong Kong stocks because of the collapse of the Venezuelan bolivar, for example. Secondly, all emerging markets are not created equal. The fiscal profligacy of the problem countries in South America and elsewhere today is in sharp contrast to the responsible fiscal management of the public burse in most

* The **MSCI AC (All Country) Far East ex Japan Index**SM is a free float-adjusted market capitalization index that is designed to measure equity market performance in the Far East, excluding Japan. It consists of nine developed and emerging market country indices: China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore Free, Taiwan, and Thailand. The SeaBridge Asia Strategy does not attempt to match index weightings in these countries. Its mandate allows it to invest around the world in companies which are expected to benefit from Asia's growth or wage advantages. Therefore, performance for the strategy is likely to differ from performance for these indices in any period.

countries of the Asia region. All countries in Asia, except India and Indonesia, are running current account surpluses. All countries ex India and Indonesia have enough reserves to fund at least six months of merchandise imports, double the traditional IMF metric of three months FX for determining adequacy of coverage of imports. All countries in Asia ex Japan are either running primary budget surpluses or are in deficit at a level less than a commonly accepted comfort level of 3% of GDP. There is simply no fundamental reason to expect a reprise of the crisis of the nineties. We view the market decline in the first quarter as a minor correction and not the beginning of a stampede out of the region. In fact, at the time of the writing of this letter, funds are once again flowing back to emerging markets, including Asia.

The Federal Reserve

Janet Yellen has promised transparency at the Federal Reserve. She may have felt that she was too transparent at a recent press conference when she intimated that the Fed Funds rate may begin to rise as early as March of next year. Markets swooned and then recovered. Any sign of tightening monetary policy will create some market angst. However, the market knows that the Fed is not trying to address the problem of rising inflation expectations, which are non-existent, but to achieve normalcy. At the end of the day, the market will digest the inevitability of higher interest rates, and perhaps even welcome it after years of free money, so long as stocks have the capacity to stand on their own, i.e. on solid earnings growth. The upcoming earnings season should give us great insight as to what to expect for the rest of the year.

China

There is no doubt that China faces many challenges as it struggles under the weight of the indiscriminate lending that occurred in recent years and braces for the inevitable losses that will result from the easy credit created. We believe China will succeed in managing through its deleveraging challenge for three reasons. First, while China's currency, the renminbi, is increasingly being used in terms of trade, it is still largely unconvertible and the capital account is still largely closed to outsiders. As a consequence, speculators in the currency are kept at bay, and thus a huge systemic vulnerability is removed. Secondly, the bond market and, by extension, the derivatives market in fixed income securities and other forms of credit, is still relatively undeveloped in China. This mitigates systemic risk that attends more developed, interconnected credit markets. A default in a single wealth management trust, for example, should not trigger defaults in other venues, such as credit default insurance instruments, giving the authorities the luxury of time and focus in dealing with credit issues on a vehicle by vehicle basis. Thirdly, to the extent that credit losses are put back to the state owned banks, China has the financial wherewithal to deal with these losses. Our conclusion is that while China has its problems, none of them is insurmountable.

Having said all this and recognizing that Asian markets lagged developed market returns last year and are lackluster so far this year, we are constructive about the region for the rest of the year. On a comparative basis, they are cheap relative to both their developed market counterparts and their own history. If our assumptions are correct, that China turns in a year of adequate, higher quality growth while capably managing its way through the beginning of its deleveraging process and that the West grows more than it has in the past few years, we think there is no reason to believe that Asia cannot produce the investment returns we all desire

David Descalzi
April 1, 2014
See general disclosures at the end of the document.

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