SeaBridge Cautious Core Strategy

First Quarter 2016
Commentary

Global stock markets declined and bond spreads widened significantly in January and in early February as the markets were pricing in a global recession, a potential China devaluation in response to a much slower economy, and increased debt defaults. A more dovish Fed and easy-money policies from the centrals banks of Europe and Japan reversed the downward trajectory of the markets in mid-February and risk assets rose significantly. Data on the U.S. recovery have come in positively, lifting fears that a strong Dollar was about to push the U.S. into recession.

Cautious Core performed flat to slightly down for the quarter. In the first quarter, the markets rotated to defensive sectors that we did not have exposure to, such as telecom, utilities, and consumer staples. Our bond holdings served as a haven of stability, but were offset by our exposure to the financials and some residual MLP holdings. The prospect of a flattening yield curve and its impact on net margins hurt our financial stocks. The financials should go up in a rising rate environment – the opposite of what rising rates would do to our fixed income holdings. We have significantly reduced our MLP exposure, but have kept what we consider to be two of the highest quality MLPs in the space, Magellan Midstream and Enterprise Product Partners.

In March, with the January/February panic subsiding, we reduced substantially our hedges in the portfolio and have exited our Japanese yen-hedged ETFs. Yellen's dovish stance has weakened the dollar while the yen strengthened, reducing the attractiveness of currency-hedged products.

During the quarter, we continued to allocate to fixed income in investment grade bonds via closed-end bond funds and mutual funds, mortgage bonds, and short duration bond funds. We added another 10% exposure to the fixed income allocation during the 1st quarter. Fixed Income and cash now make up around 50% of the portfolios versus 40% in the beginning of the year. By adding to credit products, we believe we are getting an acceptable yield and hopefully assets to help dampen the volatility in the portfolios.

Early in the first quarter downturn, corporate bonds dived relative to Treasury bonds. This presented us with the opportunity capture both the yield and the discounts to NAV (Net Asset Value) of some corporate bond funds. In a world where central bank stimulus is driving government bond yields toward or below zero, corporate bond products providing higher yields and good quality products should remain in demand. With European Central Bank head Mario Drahgi's adding corporate debt to his bond buying program and Fed Chair Janet Yellen's signaling that she will take a lower for longer approach to raising interest rates, we expect that investment grade bonds should continue to be attractive.

On the equities side, we initiated positions in companies renting out German residential (LEG Immobilien) and commercial (Dream Global) real estate.

Residential rents in German cities are growing steadily, but still offer the best value, relative to incomes in the Western world. In addition, the influx of immigrants to Germany and an under-supplied rental market should be supportive of rental demand and prices. **LEG Immobilien** invests in the North-Rhineland-Westphalian market, where we think rents have more upside.

According to the Wall St. Journal, Germany has taken over the U.K as Europe's most attractive investment for commercial real estate. **Dream Global Real Estate** is a Canadian REIT that invests in commercial real estate in Germany. The stock currently offers a 9% dividend yield and trades at a large discount to its local commercial real estate peers. We also initiated a small position in German based, Deutsche Post, the 2nd largest global and logistics provider in the world after UPS. Concerns related to Amazon in-sourcing initiatives and temporary operational setbacks have derated the stock to around 12x P/E on 2016 earnings. We think the fears related to Amazon are overdone and that current valuation offers a compelling entry point for a defensive growth stock that is yielding 3.6%.

We hope recent policy adjustments have helped to mitigate the market's downside risks, but think they are not sufficient to drive global growth higher. We think the U.S. offers the best balance of growth and innovation among the developed countries, but it is also the most expensive of the developed markets. With elevated valuation levels, the markets will need earnings growth to come through this year in order to move higher.

In a lower for longer rate environment, we think that income-based vehicles, such as fixed income, real estate investment trusts, and higher yielding equities will be back in favor.   We have added to these three areas in the first quarter in an effort to increase the overall yields and the defensiveness of the portfolios

Fixed Income, bond-like surrogates, and cash currently make up 58% of Cautious Core to reflect our defensive posture. Yields in the portfolios are running at better than 3%.   In addition, we have tilted toward what we believe to be higher quality conservative growth equities in the portfolios. Despite the macro gyrations, we believe that the companies that we own should continue to grow their earnings and free cash flow streams.

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