SeaBridge Investment Advisors, LLC

SeaBridge Inflation Fighter Strategy

First Quarter 2016
Commentary

We entered the New Year with Inflation Fighter portfolios substantially hedged. Our reasons were:

- Market breadth was narrowing, with most stocks down significantly in 2015 but with a few large, high growth, high multiple stocks, like Amazon and Netflix up significantly.
- The market appeared fully valued and the outlook was for lower earnings in 2016. Earnings expectations were declining with oil companies a negative driver but even outside the oil sector, profits appeared to be topping out. With rising wages on the horizon, it was looking unlikely that earnings were going to be able to rebound and support the elevated market multiples.
- The Fed was starting to increase interest rates (0.25% increase in December) at a time when Europe and Japan were lowering theirs to below zero and increasing money supply through quantitative easing. The impact was likely to be a stronger Dollar, which would slow the U.S. recovery and erode the value of foreign earnings of U.S. corporations.
- In addition to the direct impact on oil company earnings, sustained low oil prices have wider implications as oil company's hedges on future production continue to roll off and debts come due in the summer 2016.
- Money was flowing out of the Chinese currency (RMB) at an alarming rate and there were fears that China would drop the value of the RMB significantly to regain control.
- The 2016 presidential campaign rhetoric was taking an anti-business tone, with many candidates targeting banks, the healthcare sector, and companies with foreign operations and earnings.

In the face of this, we started the quarter at roughly 14% cash. In addition, we had a 6% hedged position in short index exchange traded funds, which move inversely with the markets. If the markets go down this holding would increase in value.

The following chart compares estimates over the next three years of certain growth and return metrics of our portfolio vs. the S&P 500:

Estimated (over next 3 years)

	S&P 500	SeaBridge IF portfolio
revenue growth	5%	10%
earnings growth	9%	14%
yield	2.2%	1.0%
return on equity	16%	20+%
P/E	17	19
P/E to growth	1.9	1.4

The numbers are based on analysts' forward estimates, which, of course, can be wrong. However, they illustrate a striking performance differential: the Inflation Fighter portfolios would be paying 19 times earnings to get growth of 14% while the S&P 500 is estimated to pay just over 17 times earnings to get earnings growth of only 9%. If these estimates hold true, there should be a big difference in the appreciation of IF asset values vs. the S&P over time.

The elevated P/E to Growth ("PEG") of the S&P 500 is due to the inflated prices of "safe" consumer staples companies (for example, Procter & Gamble is at a PEG of 3.8X) and utilities (Southern Company at a PEG of 5.5X). Although the strategy has a few holdings in these categories, Inflation Fighter as a whole holds more companies which we think have a stronger growth profile than that of the average company in the S&P 500 and much stronger than that of the so called safe stocks, but which trade at about the same valuation as the overall market.

In the first six weeks of the year, the market unexpectedly corrected. The downward trend seemed relentless. Convinced that the market had fallen beyond reason, we started nibbling at stocks in mid-February.   We either bought or added to positions in Alibaba (China), Level 3 Communications (U.S.), Softbank (Japan), Bank of America (U.S.), Astellas Pharma (Japan), Man Wah Holdings (Hong Kong), CP ALL (Thailand), Deutsche Post (Germany), and Naspers (South Africa).

We also added Fairfax Financial (Canada), which is an insurance company that owns a “bear market investment portfolio” which generally does well when the world is fighting deflation. We decided it was a better hedge than some of the index hedges.

What caused the market change?

In spite of aggressive easing by the European and Japanese Central Banks, the Euro and Yen started rising against the Dollar. Large export surpluses in Europe and Japan and clear and continuing dovish signals from the Federal Reserve weighed on the U.S. dollar. In tandem with dollar weakness, the price of oil turned up encouraging a huge short covering rally in oil and other commodity markets.

Dollar weakness and strength in commodities are bullish signals for the U.S. economy. In March, we removed our hedges and reduced cash. In retrospect, while our hedges helped dampen the fall that the portfolio would otherwise have taken in the first half of the quarter they detracted in the latter part of the quarter. We approximately broke even using these instruments. Overall, primarily because of market rotation into safe stocks as noted above, our portfolio which has a lower weighting in these names lagged the market for the quarter.

With most economic data either benign or pointing to a growing U.S. economy, we are encouraged that the risk-on trade is reappearing with money again rotating into faster growing companies. We think our companies fit this category but are a trading at a reasonable price to market multiples. To dampen volatility we have modestly hedged our portfolio bets by adding two low duration fixed income ETFs, which reduces the exposure to a move in interest rates while at the same time picking up some yield.

We hope the markets have stabilized, but given the cross-currents of a strengthening U.S. recovery and slow-to-no-growth overseas, the markets will undoubtedly continue to be volatile.

Matt Falkowski
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4/6/16

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There are differences among portfolios managed by SeaBridge in each strategy based on client-specific factors. Not all portfolios hold the same securities. Not all stocks held in the portfolio perform similarly. SeaBridge manages portfolios in several styles.