SEABRIDGE
INVESTMENT ADVISORS, LLC

SeaBridge International Strategy

First Quarter 2016
Commentary

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

- International equity markets were under pressure for many reasons, one of which was the weakening of the Chinese yuan, which signaled a significant slowdown in China's economy and called into question the competitive currency devaluation exercises being conducted by the Bank of Japan (BOJ) and the European Central Bank (ECB).
- Migrant problems were a visible sign of European chaos, calling into question the viability of the European Union and increasing the odds that Great Britain and Greece exit the Union.
- The November 13th Paris massacre contributed to the notion that the European Union was becoming increasingly unstable.
- Abenomics, named for the massive economic stimulus program put in place by Japanese Prime Minister Shinzo Abe, was looking increasingly ineffective.
- The December easing by the ECB had underwhelmed the market. However, ECB President Mario Draghi quickly followed with "more to come" talk.
- The Fed was starting to increase rates (0.25% increase in December) at a time when Europe and Japan recognized their failing recoveries and double downed on stimulus measures. The impact was likely to be a stronger Dollar, a head wind for U.S. companies, falling commodity prices and more investor skepticism of emerging markets.
- The oil price decline continued, despite periodic rumors of talks between Saudi Arabia and Russia. Both would benefit from oil in the high $30's, a price low enough to curtail U.S. shale production.
- The 2016 presidential campaign rhetoric, at least on the Republican side, showed a populist tilt to isolationism.

In the face of this, we started the quarter at roughly 16% cash with an additional 7% "hedges" – short index exchange traded funds which move inversely with the markets. If the markets go down these should increase in value.

Our conservative positioning was further reinforced by our international economic outlook. Deflationary forces are powerful, and foreign countries have not had the successful deleveraging we had in the U.S. Some, like China, are increasing leverage at an alarming rate. Therefore, our mission is to find companies with special characteristics which can compound capital in a generally unfavorable environment.

Despite a generally defensive positioning, we did not move into defensive stocks like Nestle and Unilever because, on a valuation to growth basis, they seem very expensive. Europeans want to protect capital too, and the values of defensive stocks are at very high levels. There are defensive stocks in Japan, but since the culture is not one of returning capital to shareholders, we have not sought safety in Japan.

The approximate weighted average revenue growth estimate for the securities in our International portfolios are as follows:

Estimated (over next 3 years)

	SeaBridge Intl portfolio
revenue growth	11%
earnings growth	14.50%
yield	1.30%
return on equity	20+%
P/E	20
P/E to growth	1.4

These estimates are based on analysts' forward estimates, which, of course, can be wrong. However, if they are right, paying 20 times earnings to get growth of 14.5% seems like good value in any market – the question is whether our companies can deliver on the growth in an inhospitable environment.

We have avoided some quality defensive names because of their high valuation, for example: Unilever NV, growing about 6.5%, trading at 21 times earnings, with a P/E to growth of about 3.2X. We think this gap, 3.2X for Unilever vs. 1.4X for the International portfolio, will make a big difference in the appreciation of these assets over time. However, in a market panic our portfolio may go down while Unilever goes up as flight capital lands there.

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), Softbank (Japan), Astellas Pharma (Japan), CP ALL (Thailand), Deutsche Post (Germany), LEG Immobilien (Germany), Naspers (South Africa), Delphi (UK), Kennedy-Wilson (US/Europe), and Liberty Global (Europe).

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

One position which did hurt us during the quarter was DXJ, our Japanese market index with the currency hedged out. We made money on this hedged instrument last year as Japan implemented QE. However, this year, the currency strengthened and, consequently, the market rolled over. We took a loss and closed out the position.

During the quarter we increased our position in Allergan which hurt. It is an excellent company, but the U.S. government changed the tax inversion rules and the stock got hammered in early April. The risk-arb spread had implied that the deal had risk. But, due to the quality of Allergan's drug pipeline, we believed that the drop on a busted deal would be much less than has occurred. We will reevaluate the position when we think the risk-arb unwind is over.

The market has improved since mid-February. 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. Their large export surpluses weighed on the positioning of traders. The price of oil turned up and a huge short covering rally commenced. The Fed, undoubtedly sobered by the plunge following their December rate increase, began making speeches with a tone that significantly reduced the probability of another rate increase coming in April. Data on the U.S. recovery came in positively, lifting fears that a strong Dollar was going to push the U.S. into a recession.

In March, we removed our hedges, and our purchases brought cash into the mid- to- high-single digit range. In hindsight, the hedges helped dampen the fall that the portfolio would otherwise have taken in the first half of the quarter but, since we did not have the courage to eliminate them in mid-February, they hurt on the rebound. We approximately broke even using these instruments.

With a calmer tone in the economic news, money appears to be rotating back toward faster growing companies in the U.S. We are looking for stocks which can prosper in hostile environments but, since the problems overseas have not been solved, we deployed some of the cash into two low duration fixed income ETFs. These should allow us to dampen volatility while picking up some yield as we evaluate market trends and individual companies.

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
Garnett Keith
4/6/16

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