



## SeaBridge Yield Growth 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 currency devaluation in response to a much slower economy, and increased debt defaults. A more dovish Fed and easy-money policies from the central 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.

For the quarter, Yield Growth portfolios recovered in March, but not enough to overcome a tough first two months. The values of our housing, technology, and emerging consumer stocks rose nicely during the rally in the second half of the quarter.

The prospect of a flattening yield curve and its impact on net margins hurt our financial stocks. Financial and the Health Care sectors were the worst performers in the first quarter. In addition, the markets rotated to defensive sectors to which we did not have exposure, such as telecom, utilities, and consumer staples. We thought they were expensive with unexciting growth prospects prior to the rally and think they are now susceptible to underperformance as risk appetite slowly returns to the market.

In March, we substantially reduced the hedges in the portfolio and exited our Japanese yen- hedged ETFs. Yellen's dovish stance has stabilized the market and weakened the dollar while the yen has strengthened, reducing the attractiveness of currency-hedged products.

During the quarter, we shifted cash into fixed income, particularly in investment grade and higher yielding closed-end bond funds. The widening of bond spreads during the early quarter downturn presented us with the opportunity to capture both the yield and the discounts to NAV (Net Asset Value) of the funds. Closed-end bond funds utilize leverage to provide enhanced yields of 5%-10% and, in times of distress, trade at large discounts to net asset value. By adding to credit products, we think we are getting a stable yield and hopefully assets to help dampen the volatility in the portfolios. We added 6-10% of fixed income holdings across our portfolios. Fixed Income and cash currently make up around 20% of the portfolios.

In a world where central bank stimulus is driving government bond yields toward or below zero, products with some element of credit risk should remain in demand. With Mario Draghi's (European Central Bank head) adding corporate debt to its 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 will continue to be attractive. Corporate credit quality, outside of the energy and commodities sector, remains fairly healthy.

During the quarter, we increased our equity investments outside the United States. Foreign stocks now make up 29% of the overall YG composite portfolio. They represent 37% of the 79% in equities. We think foreign markets are significantly cheaper than the U.S., and foreign Central Banks are easing credit rather than tightening as is now being done in the U.S.

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 position in German-based **Deutsche Post**, the 2<sup>nd</sup> 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 also added **Fairfax Financial** (Canada), which is an insurance company which owns a “bear market investment portfolio” that generally does well when the world is fighting deflation. It has done very well over the years, and we decided it was a better hedge than some of the index hedges.

Recent policy adjustments have helped to mitigate the market's downside risks, but are probably 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 its valuation is more expensive than other developed markets. With elevated valuation levels, the markets will need earnings growth to grind higher. Overall, the U.S. consumer is doing OK, benefiting from higher wages, improved balance sheets, and lower energy costs. The consumer in Asia, particularly in China, is also doing well. Chinese consumption is growing around 10% on an annual basis. We have a healthy allocation to the U.S. and emerging consumer in our portfolios.

In a lower for longer rate environment, we think that income-based vehicles, such as fixed income, REITs, and higher yielding equities will be back in favor. We have added to these areas in the first quarter in an effort to increase the overall yields of the portfolios and to dampen the volatility of the portfolio after the higher-than-normal volatility for our Yield Growth style in the last year. In addition, we have tilted toward what we believe to be higher quality growth names in the portfolios. Despite the macro gyrations, we believe that the companies that we hold will continue to grow their earnings and free cash flows.

Howard Chin  
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