SeaBridge Cautious Core Strategy

First Quarter 2017

Commentary

Cautious Core portfolios are off to a good start in 2017. Equities markets delivered solid returns in the quarter with the international markets outperforming the U.S. markets. Fixed income in the U.S. markets yielded muted returns as the Federal Reserve begins to normalize interest rates. Investment grade bond and high yield bond indices returned 0.50% and 1.5%, respectively.

Overall, the global economic backdrop delivered strong data points in the first quarter. We are seeing more consistent and positive economic data coming from the four major regions of the world: U.S., Europe, China, and Japan. Economic surprise indicators and inflation data have been surprising to the upside. The decline in the commodity sector (especially oil) investment is recovering after dragging down global growth in 2016. Fears of a hard landing in China have subsided as the China government continues to support the economy through fiscal stimulus. China just reported a manufacturing index of 51.8 in March, the highest reading in 5 years!

In the United States, corporate borrowing costs (i.e. high yield) have eased substantially to 6% after peaking at 10% during the mini crisis in early 2016. After five consecutive quarters of negative year over year profit growth, corporate profits are now trending positive and increased 6% year over year in the fourth quarter of 2016. Indeed, we saw evidence of solid profit growth in our portfolio companies during the 4Q16 earnings season. The consumer is spending again due to a strong labor market and some wage growth. Retail sales growth just hit its highest level in 5 years. U.S. home prices appreciated 5.7% year over year to a three year high.

A synchronized global acceleration appears to be underway and global growth should stay firm for the remainder of the year in our opinion. The implication is that top line and earnings growth will be constructive for stocks. However, U.S. equity valuations are not cheap, but neither are they euphorically expensive. We need to monitor potential margin pressures in our companies as expenses, especially wages, are beginning to increase. Currently, equities outside the U.S. offer cheaper entry valuations with improving growth prospects.

Besides valuation concerns, the political situation in the U.S. remains uncertain. Despite the GOP's health care setback, we expect that some form of a tax package is likely to be passed this year. However, ongoing political turmoil may continue to result in episodes of market volatility. In the last year, we have noted that market volatility from political events (Brexit, the U.S. presidential election, and the recent Obamacare replacement debacle) has been short-lived and has presented investors with opportunities to "buy the dip" in the equity markets. We think that the market's "buy the dip" mentality will persist as long the economic data and corporate profitability continue to improve.

Portfolio Activity

We sold **CVS** after client losses in its retail pharmacy prescription and PBM (Pharmaceutical Benefit Management) businesses highlighted increased competition and lack of upside in margins and returns in CVS main businesses. PBMs are middlemen in the drug supply chain which manage drug benefits for insurance companies and corporations. They negotiate discounts from pharmaceutical companies which they partially keep and partially pass along to reduce drug costs for the insured. We are concerned about the PBMs' role in drug discounting and pricing. While PBMs such as Express Scripts and CVS say they deliver lower prices for their clients, drug companies have also begun accusing them of keeping drug prices high and running the system to pass on higher costs to Medicare. With President Trump tweeting about "murderous drug costs," we decided to step back from this controversial area at this time.

We exited our position in **Shire**. Shire is a large-cap fast growing company that is a leader in developing and marketing drugs for rare diseases. Drugs for rare diseases carry a very high price tag ($100K + per year) and serve an unmet medical need, but Trump's war on high drug prices and Shire's high debt load (from its $32 billion purchase of Baxalta) make us wary of holding this name for risk averse accounts.

We initiated a new position in **Berkshire Hathaway.** Berkshire has a great record of superior growth, delivering +19.0% annualized book value per share growth in the past 5 decades vs. +only 9.7% for the S&P 500. Berkshire owns a wonderful and diversified collection of businesses that possess sustainable competitive advantages. Berkshire's managers are incentivized to act as owners to generate long-term sustainable growth. Berkshire possesses a fortress balance sheet (over $80 billion in cash) to absorb financial shocks and to deploy in the aftermath. However, management succession after Warren Buffet is a key uncertainty for investors.

Portfolio Thoughts and Positioning:

The Cautious Core composite is yielding 3.0% versus the S&P 500 yield of 2% and an investment grade bond index yield of 3.2%. We look to increase the yield of the portfolio as interest rates are expected to rise in the coming year. We have a healthy level of cash to deploy in select yield names when the opportunity arises.

We are defensive in our positioning of the portfolio. Overall, our "defensive assets" in **cash and short duration bond funds** (together about 36% of the portfolio), **fixed income** (in credit sensitive areas like mortgage back securities, high quality investment grade bonds, floating rate loans, and high yield bonds), **REITs** (Real Estate Investment Trusts), **MLPs** (Master Limited Partnerships) and **other bond-like equities** totaled approximately 75% of the portfolio. The REITs and MLPs should not only provide good yields, but also some growth to offset the impact of rising interest rates. (All recent investments in MLPs are in vehicles which deliver 1099s for taxes rather than K-1s).

Equities make up 25% of the portfolio. In equities, we heavily favor high quality companies that generate consistent free cash flow and dividend growth, have strong balance sheets to weather a downturn, and are less susceptible to the negative impact of higher interest rates.

We are interested in companies that could benefit from household formation and a strengthening housing market. Currently, we are investing in housing growth through the home improvement retailers **(Home Depot** and **Lowe's)**. In the most recent quarter, Lowe's delivered better than expected comparable sales growth, highlighting greater spending in appliances and projects from professional contractors. We currently prefer Lowe's over Home Depot because we think that the valuation discount between Lowe's and HD could close on better prospects for margin improvement and a pickup in comparable sales growth.

We hold companies (**Apple, Microsoft, Alphabet, IBM)** in technology which could benefit from the growth of cloud, mobile computing, and artificial intelligence. These companies have good sales growth, trade at attractive FCF yields (**Apple** at 7%, **Microsoft** at 6%, **Alphabet** at 5%, and **IBM** at 8.5%) and have pristine balance sheets.

Some of our technology companies could be major beneficiaries of the Trump/House Republican plan to have companies repatriate corporate cash held overseas at a favorable tax rate. Under current tax law, corporations bringing back foreign earnings to the U.S. trigger a tax liability of 35%. According to Bloomberg, 217 of the S&P 500 Index companies hold overseas cash balances for a total of $966 billion. Our portfolio companies, Apple, Microsoft, and Alphabet, are the top 3 with an overseas cash balance of $406 billion, amounting to 42% of the overseas cash held in companies in the S&P 500 index. Apple's $216 billion in unrepatriated income would make it the biggest winner under Trump's tax repatriation plan. If cash repatriation becomes law, these companies would have a significant amount of capital on their balance sheets to return to shareholders and/or deploy to increase the intrinsic value of their growing businesses.

Immediately after the election, bank stocks soared on the prospect of improving net margins and less regulation. However, after dovish comments from the Fed following the March rate increase, some of the gains eroded. We believe that the general direction of interest is upward, and that our financial holdings (**J.P. Morgan and Charles Schwab)** will benefit over time. We also hold an ETF (Exchange Traded Fund) holding regional banks (**KRE**), as that is the sector which we think should benefit most from an increase in lending and reduced regulation.

Thank you again for your support and confidence in the Cautious Core strategy.

Howard Chin
4/1/2017

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