SeaBridge Yield Growth Strategy

First Quarter 2017

Commentary

Yield Growth 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 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 to 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 we think global growth should stay firm for the remainder of the year. The implication is that top line and earnings growth would 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. We have approximately 15% of our portfolios in securities traded outside the U.S.

Beside 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 our remaining position in **Man Wah**. Since our purchase of Man Wah three years ago**,** the company has gained market share by executing on its strategy to become the leader in motion recliner sofas in the U.S. and China. The stock has been a big winner for us. However, we see risks for Man Wah in the U.S. market as Chinese exporters are taking down prices to gain share in the U.S. President Trump's potential threat of tariff on imported goods from China is also a risk to the stock. That seems less likely after the Obamacare replacement debacle, but until the possibility clears completely, Chinese exporters to the U.S. have an extra hurdle to clear.

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’s 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 sold **Terraform Power,** the solar YieldCo, which owns and operates contracted clean power generation assets. The company's objective is to acquire assets with contracted cash flows primarily from owning solar and wind generation assets serving utility, commercial, and residential customers. SunEdison was the parent/sponsor of this YieldCo vehicle. Numerous issues including Chinese companies finding ways to dump excess panel production into the U.S. market and the SunEdison bankruptcy weighed heavily on companies across the industry. We misjudged the rapidly changing landscape early in the decline. We sold the position as several bidders for Terraform emerged, but the winning bid from Brookfield Asset Management was disappointing.

On the buy side, we initiated a small position in **Ladder Capital** Corp (**LADR**)**,** an internally managed commercial REIT that is yielding 8.2%. We think LADR is well-positioned for a range of different market conditions given its three complementary business lines: loan origination and securitization, commercial mortgage investments, and net lease of properties and other real estate assets. The earnings stream should be more predictable as **LADR** expects to rely less on the volatile gain on sale conduit business going forward. On balance sheet loans and real estate gains are expected to increase core earnings per share. Ladder has a large portfolio of floating rate assets that should benefit in a rising rate environment. Ladder is also trading at a P/B discount of 12% to its high quality commercial REIT peers in the portfolio **(Starwood Property Trust** (STWD) and **Blackstone Mortgage** (BXMT)). Recently, Ladder Capital and Related Companies announced a strategic investment in which Related purchased 5.3% of LADR stock from certain pre-IPO shareholders. Related is run by Steve Ross, a successful real estate investor and the owner of the Miami Dolphins.

Portfolio Thoughts and Positioning:

The Yield-Growth composite is yielding 3.1% 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 certain yield names when the opportunity arises.

We are defensive in our positioning of the portfolio. Our defensive assets in REITs (Real Estate Investment Trusts), MLPs (Master Limited Partnerships), other bond-like equities, fixed income, and cash totaled approximately 42% of the portfolio. The REITs and MLPS provide not only 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). Fixed Income is 5-10% of the portfolios. They are primarily focused on credit sensitive sectors.

Equities make up 58% 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 also own companies with management teams that have a high level of stock ownership.

We are interested in companies that could benefit from household formation and a strengthening housing market. Currently, we investing in housing growth through the home improvement retailers **(Home Depot** and **Lowe's)** and a flooring company, **Mohawk (MHK)**. 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. Mohawk is the market leader in flooring. MHK is led by CEO Jeff Lorberbaum who is well-regarded by investors for his ability to capture market share by acquiring flooring companies around the world. He currently owns 15% of the company. Home Depot's most recent quarterly call highlighted the strong demand they are seeing in flooring projects.

We own companies (**Apple, Microsoft, Alphabet, IBM,** and **Taiwan Semiconductor**) 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%, **IBM** at 8.5%, and **Taiwan Semiconductor** at 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 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 should 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.

We still hold a moderate position in drug stocks **(Amgen (AMGN), Pfizer (PFE),** and **Shire (SHPG)**). Despite the uncertain political outlook on drug pricing, we believe that the market is making a distinction between companies that have strong therapeutic franchises and innovative drug pipelines vs. those companies that have relied on pricing to drive sales. An aging population and the basic need of more medicine are the main drivers of the healthcare industry. This coupled with attractive valuations appear to more than compensate us for the political risk in these companies. Amgen also has $34 billion of overseas cash that it would be able to repatriate.

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 (**Bank of America, Citibank, J.P. Morgan,** and **Charles Schwab)** will benefit over time. We also own an ETF (Exchange Traded Fund) holding regional banks (**KRE**), as that is the sector which should benefit most from an increase in lending and reduced regulation.

Although we have reduced our international holdings, we still own some companies we view as highly attractive. Some of these companies delivered very strong returns in the most recent quarter:

- Pigeon - A Japanese company that is a market leader in baby bottles and accessories sold in the Chinese market.

- Taiwan Semiconductor - The leading semiconductor foundry in the world.

- Com Hem - A cable company in Sweden with a shareholder yield of 10% (Dividend of 4% and Buybacks of 6%) and growth. We think it is also a future buyout target for larger players.

-Liberty Global - John Malone's cable company in Europe. John Malone is regarded as one of the best investor/CEOs in the telecom, cable, and the media space.

-AIA Group - the leading insurance company, spun out of AIG, which serves the underpenetrated insurance markets in Asia.

- **Ascendas REIT -** The largest REIT in Singapore, which owns business parks and industrial projects in Singapore and Australia.

Thank you again for your support and confidence in the Yield Growth portfolio.

Regards,

Howard Chin
4/1/2017