SeaBridge Investment Advisors, LLC

SeaBridge Yield Growth Strategy

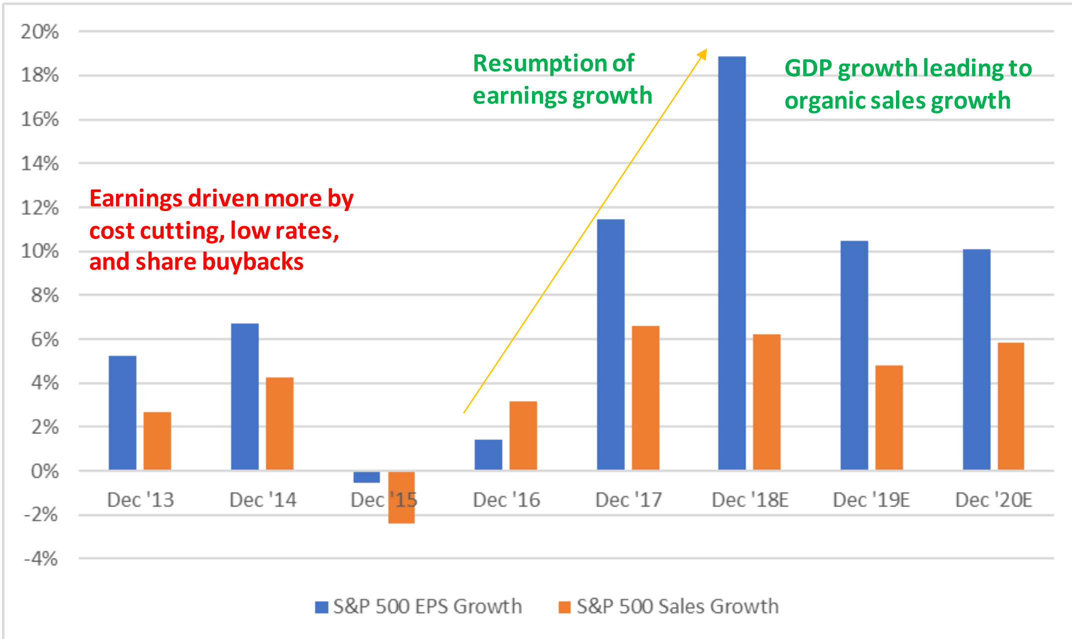
First Quarter 2018

2017 was not only an exceptional year for returns for global equities, but also for unprecedented low volatility and market complacency. However, in the first quarter of 2018, volatility returned with a vengeance as the S&P 500 gained or lost 1% or more in a single day 23 times in the quarter versus only 8 times in all of 2017. Market volatility is back!

January's tax-cut jubilation took markets to all-time highs but quickly dissipated in the first week of February behind inflation concerns and the prospect of higher than expected interest rates. Positive corporate earnings and a benign report on inflation stabilized the markets in early March. This Goldilocks (solid growth plus mild inflation) narrative quickly gave way to Trump's tariff and trade protectionist concerns. Lastly, we ended the quarter with a technology tantrum fueled by a potential regulatory crackdown on some mega-cap technology darlings such as Facebook, Alphabet, and Amazon.

Although markets ended down a little bit in the quarter, most major averages underwent intra-quarter gyrations and experienced intra-quarter declines of more than 10%. **S&P 500** delivered a total return of -0.8%. **MSCI ACWI** (a global index) returned -0.9%. Performance in the income oriented asset classes was negative across the board. Fixed income markets declined, driven by the increase in interest rates across the entire yield curve and exacerbated by widening corporate credit spreads. **Investment grade (LQD ETF), high yield credit (HYG ETF)**, and **preferreds (PFF ETF)** returned -2.9%, -1.0%, and -0.4%, respectively. **Utilities (XLU ETF)** and **telecom (IXP ETF)** sectors, fixed income proxies in equities, were down 3.3% and 5.3%, respectively. **Dividend equities (SDY ETF)** struggled and were down - 2.9%. **Master Limited Partnership (MLPs: AMLP ETF)** had a difficult start to the year with a return of -11.5% in the quarter, while the **U.S. real estate investment trusts (VNQ ETF)** returned -8.2%. **Senior loans (BKLN ETF)** were a bright spot, up 1.3% for the quarter.

Against the intense pickup in volatility, the global economy remains healthy, even if the pace of growth has come down from the highs of 4Q17. In recent weeks, the U.S. has reported better than expected industrial production and business and consumer confidence at cyclical highs. Equity valuation levels (17x forward P/E) have declined more than 15% from its peak, back to levels seen before the presidential election, and no longer look so pricey. While stocks prices have been pressured, corporate sales continued to be revised upward, pointing to a 6.2% increase for 2018 and 4.8% in 2019. S&P 500 earnings are forecasted to increase about 18.9% and 10.6% in 2018 and 2019, respectively. Please see chart below. This is important because we think earnings growth and dividends are now the key drivers of returns going forward and may need to offset a potential compression in P/E multiples from higher interest rates.



(Source: FactSet)

Although economic and corporate data point to healthy earnings, we see some headwinds in the horizon that could offset the positive earnings picture. In the last 5 years, the Fed has been a backstop (known to the markets as the Fed "put") for the equity markets in times of volatility by employing quantitative easing (QE) and by keeping interest rates low. The Fed is moving away from that role and is currently intent on gradually reversing QE and increasing interest rates 4-5 more times in the next two years. The hope is that the Fed would be able to restore greater policy flexibility for the next downturn. So far, actions by the Fed have not been disruptive to either financial stability or economic growth, but that may change as a greater acceleration in global monetary policy is on tap for 2019. We also face potentially higher inflation. U.S. output gap, trade and fiscal policy, wage growth, and currency and commodity trends suggest that consensus may be too complacent on inflation prospects. Higher than expected inflation would upset the Goldilocks narrative and possibly lead to negative returns and greater dispersion in stocks.

Recently, protectionist fears have resurfaced after the U.S. announced tariffs of $60 billion on China imports, while China retaliated with tariffs on $3 billion of U.S. goods. Adding to the market trade jitters is the replacement of National Security Advisor, H. R. McMaster, by former ambassador to the United Nations, John Bolton, who has a reputation as a hard-line interventionist on security issues. So far, the recent decline in the markets from trade concerns is more of a negative for only equities, because high yields spreads have been resilient (we would see spreads widen if there was a deterioration in corporate fundamentals). We think a full-blown trade war is unlikely and would be very negative for equities and high yield credit. Our base case is that cooler heads will prevail as Trump's willingness to exempt select countries before the tariffs kick in suggest a propensity for trade negotiations versus escalation.

Portfolio Activity

We took a position in Warren Buffet's **Berkshire Hathaway (BRK)**. BRK is a late cycle defensive investment with a history of investing opportunistically while holding a large cash reserve of $85B (20% of its market cap). Berkshire owns a 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 also possesses a fortress balance sheet to absorb financial shocks and to deploy in distressed situations.

Recent weakness in **Lowe's (LOW)** stock price provided an opportunity to add to our existing position. Housing related stocks have been very weak lately due to concerns about the impact of rising rates. Recent activist shareholder involvement, new board changes, and a new incoming CEO are potential catalysts for improved execution and increased focus on the professional customer, ecommerce and supply chain. The stock is currently trading at a large historical valuation gap to **Home Depot (HD)**.

We sold three stocks this quarter. We took gains in **Com Hem (COMH-SEO)**, a leading Swedish cable company, after Com Hem announced a merger offer with Tele2, creating the second largest Swedish integrated telecommunication. We also sold **Ladder Capital (LADR)** after it received a buyout offer from a real estate investment company. Lastly, we exited our position in **Coresite Realty (COR)**. We found COR's valuation expensive after issuing disappointing revenue guidance in its fourth quarter earnings report.

Positioning

The objective of the Yield Growth strategy is to provide a total return over a full market cycle that benefits from global equity exposure but with dampened volatility, so that the risk of a major drawdown in value is less than that of the equity market. Of course, we cannot guarantee that we will achieve this objective.

We use diversification and income dampening assets to try to achieve the lower volatility and income. Dampening assets such as Bond-like equities (i.e. REITs, Business Development Companies, and German real estate), fixed income, closed-end bonds funds, Master Limited Partnerships and cash currently make up 39% of the Yield Growth composite. We are light in our allocation to fixed income, but have a meaningful allocation to Bond-like equities and MLPs to capture yields and modest dividend/distribution growth. We use equities to primarily help grow the principal of the portfolio. The equity portion of the Yield-Growth portfolio is still very attractive, in our opinion. We estimate that the Free Cash Flow (FCF) yield of the Yield-Growth equity portion (excluding our financial holdings) is around 5.7% versus the 5.2% in the S&P 500.

Volatility is always unnerving, but we think our disciplined approach that relies on fundamentals will continue to benefit our investors. In this environment, we prefer dividend growers over high yield low growth stocks (i.e. utilities and telecom) and no yield high P/E stocks. Asia is becoming a more interesting place for ideas because the region has structurally higher growth and higher yielding names. Currently, approximately 18% of the Yield Growth composite is allocated to companies outside the U.S. Our goal is to remain defensive and opportunistic to investing as we navigate a rising-interest-rate environment.

Thank you for your continued confidence in SeaBridge.

Have a happy and healthy Spring!

Howard Chin

4/6/18

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