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July 9, 2013

Edited copy of letter sent to individual clients of SeaBridge Investment Advisors for the Second Quarter 2013

"Why Now, Ben?"

You may remember that the title of our last letter was, "Thank you, Ben!" The thank you was for the Fed policies which were lifting the stock and bond markets faster than corporate earnings were growing. On June 19th Chairman Bernanke held a press conference at which he made clear the Fed's expectations for ending "Quantitative Easing" (printing money to buy bonds to suppress interest rates to support economic growth.) His key points were:

- The Fed's future decisions regarding monetary policy will be driven by conditions in the economy generally, and especially conditions in the employment market
- With the improvement in the economy now going on, we expect to slow the current bond purchase rate of $85 billion per month. Starting in the fourth quarter of this year, we would begin buying lesser amounts of bonds.
- With continuing improvement, we would expect to end bond purchases and begin withdrawing money from the economy starting a year from now.

This statement seems reasonable and measured. **If** the economy continues to improve as we foresee, **then** we would expect to take these actions. The reactions of stock and bond markets around the world seemed to be a near panic. The rates on 10 year Treasury bond rates soared from 1.7% to 2.5% - a huge percentage move. The equity markets in the U.S. and Europe fell, and both equity and debt markets in emerging countries took a big dive. Importantly for our weak expansion led by a recovery in housing, mortgage rates increased from roughly 3% to 4%. This will not help! Moreover, past money easing in the U.S. has been transmitted throughout the world and any prospect of reversal causes capital to head for home. This slows global growth and U.S. exports.

Why did the FOMC (Federal Open Market Committee of the Fed which sets interest rate policy) decide to be so specific, **now?** And why were markets reactions so negative? We do not know for sure, but in the following week two Fed governors and six Regional Fed bank Presidents held press conferences trying to explain and to calm the markets. Here are some conclusions drawn by the commentators who studied the "damage control press statements" in great detail:

1. The Fed truly sees the economy improving. In spite of the significant tightening hitting the economy from the fiscal cliff and sequester actions of January and April, growth is persistent and broadening. They want the market to see tightening coming and get prepared for rising rates. If the economic progress does not occur, tightening will be delayed. Tightening is conditional, no big deal.
2. It appears Chairman Bernanke will be ending his term at year-end, and he wants the wind-down of his controversial Quantitative Easing (QE) to be well established by then.

3. There is growing dissent in the FOMC about whether QE has been a wise policy. For example, if you measure employment in ages 15 to 65, there has been no progress in the per cent of the population employed since 2008. In spite of huge monetary stimulus, all of our apparent improvement in employment has come from the "participation rate" – the decline in the number of people looking for a job. The public statement of a timetable to end QE is sop to the dissidents. The end is coming, and the Chairman does not want to lose control of the FOMC vote in his final semester.
4. Quantitative easing has succeeded in lifting the equity market and substantially inflating the debt market**. However, even if the impact on employment is debatable, it probably is inflating the securities markets. We should not risk market bubbles, or other economic distortions which may cause damage as they unwind.** The near zero cost of money discourages savers and encourages inventory building. Small example: oil experts estimate that corporations and speculators are carrying roughly 100 million barrels of oil inventory in storage which they would not carry if financing were more expensive. **"Limited benefits and growing distortions"** is the argument of the growing number of FOMC dissenters in point 3 above.

The sharp market reaction was influenced by the large speculative leveraged positions (equity, but especially debt), which had been built on the twin assumptions that low interest rates made the carrying cost very small, and the weakness in employment meant that the Fed would stay with QE for an indefinite period into the future. An actual timetable means speculators would likely begin unwinding those positions and, if that were to happen, investors may conclude it would be better to get out immediately rather than to wait and risk a long period of eroding prices. When debt prices start falling, margin calls accelerate the process.

In July, the markets have generally stabilized, but the thinking is different. The expectation is rates will be going up, and the questions are when and how fast. With time, thinking may revert, but more and more managers are eyeing their portfolios with the expectation that 10 year Treasury rates will move up another quarter to half per cent by year-end.

Our own view of the economy is that growth is broad and proceeding well in spite of the drag of roughly 1.7% per year coming out of the fiscal tightening of the fiscal cliff and sequester. As those fade late in the year, we expect the economy to continue to expand led by housing, auto sales, and the shale energy boom. The revision of 1Q GDP growth from 2.4% to 1.8% was a disappointment, especially as the reduction was caused by a cut in consumption growth. However, this was an improvement on the 0.4% growth in 4Q12. Moreover, almost 1% was taken out of the 2013 growth rate due to reductions in state and local spending. So, even with the fiscal drag, the private economy was growing at almost three per cent and we think that is likely to accelerate in the fourth quarter. Outside the U.S., the problems in Europe and China's difficult transition away from its debt financed spending boom of the past ten years leave room for shocks to global psychology.

See the attached commentaries with more details about our various portfolio strategies.

We hope that the tempest of late June will fade as the summer goes on. However, the markets are on notice that the FOMC wants to end the money printing, and the ending of QE programs in 2011 and 2012 resulted in significant market weakness in those periods. We will be watching developments carefully.

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Yield Growth, Global Trusts, and Cautious Core Strategies

Second Quarter 2013 Commentary

These portfolios are what we call "all asset class and all geographies" portfolios. By this we mean we look all over the world and try to find attractive securities which we can use to build portfolios with two salient characteristics:

1. Lower volatility than the stock market – using the S&P 500 as a reference point
2. A higher yield than the stock market – a target of 3% minimum portfolio yield, although we may dip below that under circumstances where bonds are unattractive. (Like right now!!)

Over a full economic cycle, we hope that these portfolios will have less volatility than the stock market: Yield Growth roughly two-thirds the S&P 500's volatility; Global Trusts roughly 80% of the volatility; and Cautious Core roughly 35% of the volatility.

In the case of Global Trusts we also try to use fund vehicles managed by others to express our investment themes. However, if we cannot find an appropriate fund, and we think a particular company expresses the theme well, we can "elect the company CEO as our fund manager" for capital committed to his industry. The recent development of the Exchange Traded Fund (ETF) presents some new opportunities for this strategy, but, as we are finding now, ETF's attract uninformed money which comes pouring into "hot" sectors, and then goes pouring out in a panic when the tide turns. This is happening now with the Gold and some emerging market ETF's, and is highlighting the increase in market volatility which comes from asset flows in and out of the ETF's.

We have been moving out of bond vehicles for roughly a year as gains from falling interest rates were stalling and the potential to lose money in bonds with longer maturities was growing. So, when Ben Bernanke blew the whistle for the end of good times for bonds on June 19th, we mostly held bond funds owning short duration bonds or bank loans with interest rates which float up and down with the market and thereby protect principal values somewhat. We owned few long duration bond funds. That is the good news! The bad news is that we did own some Real Estate Investment Trusts which did get hit hard and higher yielding equities also suffered. Our Master Limited Partnership holdings held up well and have been a good contributor to performance year-to-date. The pull-back in yield investments brought down the returns in Yield Growth, Cautious Core and Global Trust accounts for the second quarter. Ironically, the more the portfolio was tilted to conservative income the worse it did from mid-May to the end of June.

We are reviewing the portfolios to see how we can get the yields back above 3% - with bonds out and no return on the cash, Yield Growth portfolio yields are generally 2.5-2.8%. Our goal is to contain volatility and generate growth and income.

Garnett L. Keith
Howard Chin
July 6, 2013

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International and Inflation Fighter Strategies

Second Quarter 2013 Commentary

Both of these portfolio styles are composed primarily of companies generating large proportions of their revenues and earnings outside of the United States. For the past 18 months, with uncertainty in Europe and Japan, we have held over half the portfolio in global companies which are domiciled in the U.S. but generate most of their revenues overseas. This has proven to be a good choice, especially in 2013, when emerging markets have trailed the U.S. market significantly. We continue to retain a significant exposure to emerging market companies, though we have recently scaled back our exposure at the margin. We have emerging market companies focused on rising consumer spending – a mega-trend which appears to us to be one of the most reliable over the next decade.

We expect the earnings of the emerging market stocks in our portfolios to grow faster than the earnings of the developed market companies in the portfolios (16.0% versus 11.2%). However, the reliable consumer growth aspect is not lost on other investors and their high prices cause the emerging markets holdings to trade at a higher price-to-earnings multiple (18X versus 16X) than the developed market holdings. These averages are not directly comparable as our developed market holdings have more industrial and service companies, which grow more slowly and trade at lower multiples. But the multiples do give a general sense of the portfolio segments' growth and valuation levels.

We continue to look for high quality companies around the globe trading at attractive valuations. We would like to find more Japanese companies to invest in, especially in light of Prime Minister Abe's attempt to galvanize the Japanese export sector via currency depreciation. In Japan we are currently invested in two auto companies (Nissan and Honda) and some portfolios have a position in Calbee, a Japanese snack food maker. However, we now feel that Calbee is fairly valued and are not investing for new or smaller portfolios.

We are concerned about the impact of growth challenges in China as the government attempts to successfully manage the transition from growth driven by infrastructure building to growth driven by consumer spending. The portfolios have roughly 10-12% of their holdings trading in Hong Kong – none in China itself. In addition, a significant proportion of portfolios revenues are related to sales in China and the growth that China drives elsewhere in the world economy. We are mindful of the risks of a China slowdown and are looking carefully at the composition of portfolio companies' revenues and earnings.

We have about 5% of the International portfolios and +10% of the Inflation Fighter portfolios invested in companies positioned to benefit from the recovery in real estate values overseas and in the U.S. These stocks performed very well early in the second quarter, but took a hit in June when The Fed announced its targets for the tapering of quantitative easing. We believe the real estate recovery in the U.S. has strong fundamentals and growing momentum and are comfortable holding the stocks.

The portfolios are yielding about 1.7% with earnings growth in the mid-teens. We are currently targeting a relatively high cash level of between 10-12% in order to take advantage of any buying opportunities that may arise during what we expect to be a volatile period as the markets adjust to higher interest rates.

Garnett L. Keith
Denise Clayton-Purvis
July 6, 2013

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