SeaBridge Investment Advisors, LLC

SeaBridge Asia Strategy

Second Quarter 2014
Commentary

During the second quarter of 2014, the MSCI AC Far East ex Japan Index* (the "Index") gained 6.8%. Year to date, the Index rose 5.25%.

The real estate holdings in our Asia strategy performed well during the quarter. With the market believing that interest rates generally will stay lower for longer, cap rates declined; NAV's rose and were reflected in higher stock prices of both developers and investment companies. Industrials also were also generally stronger. Worries over global growth put downward pricing pressure on a variety of commodity inputs into the manufacturing process; manufacturers, who have now long wrestled with rising costs, particularly wages, generally enjoyed a rare period of margin expansion. Further boosting sentiment, the most recent export data coming of China surprised on the upside suggesting strengthening end demand for manufactured product.

Our disappointment with the quarter can be summed up in one word: handbags. Our holding in Coach weighed on the portfolio. Coach is in the midst of a major corporate transformation from a North American handbag retailer to a global lifestyle brands company. There have been sweeping changes at the company not the least among which are a new CEO and lead designer. There will be a complete overhaul of both the retail and wholesale store formats creating a more inviting atmosphere for the shopper. And most importantly, the product lineup is being revitalized and will feature modern forms while staying true to the firm's traditional design roots. In a recent conference call with investors, the company indicated the obvious, that the transition would take time and not be painless. Non performing stores will be shut down and cap ex ramped up in pursuit of the new vision. The shares reacted negatively. Coach is a "hold" now but we will likely look to increase our position in this venerable fashion brand operating in a market that grows at more than twice the world's GDP and with ample corporate resources to effect its transformation and still pay a healthy dividend.

During the quarter, we added a new name to Asia Strategy portfolios. Omron Corporation is an industrial company, based in Japan, specializing in factory automation equipment, electronic components and healthcare equipment. We like the company for its position in automation, a growth industry, an electronics business whose product lineup emphasizes energy efficiency in mobile communication, robust growth prospects in the emerging markets, generally, and a healthcare division that is a small but reliable contributor. We have eliminated holdings in two companies, on price strength—China Overseas Land & Investment, a China property company, and Astra Agro Lestari ("AALI"), the Indonesian palm plantation. The residential property market in China is facing headwinds of oversupply and generally tighter credit conditions so we thought it prudent to divest ourselves of this "best in class" company. We had held AALI for many years and have long been

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* The **MSCI AC (All Country) Far East ex Japan Index**[SM] is a free float-adjusted market capitalization index that is designed to measure equity market performance in the Far East, excluding Japan. It consists of nine developed and emerging market country indices: China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore Free, Taiwan, and Thailand. The SeaBridge Asia Strategy does not attempt to match index weightings in these countries. Its mandate allows it to invest around the world in companies which are expected to benefit from Asia's growth or wage advantages. Therefore, performance for the portfolios managed in this strategy is likely to differ from performance for these indices in any period.

impressed by its operational efficiency in an industry challenged by the vagaries of weather and the easy availability of crop substitutes. As a long term holder, we were very well aware that in the "old days" AALI traded at 5x p/e; today it is 27x, far in excess of a multiple that should incorporate the inherent underlying price volatility of an agricultural commodity. The stock simply became too rich for us and hence our decision to eliminate it.

China remains a focus for us. We obsessively re-evaluate our investment approach to arguably the most important economy and have a keen interest in the progress the country has made toward realizing the goals of it ambitious five year plan unveiled late last year. The plan was nothing less than a proclamation of a country attempting to reinvent itself – more private economy, less government control, cleaner air, less corruption, more value-added industry, less low-end manufacturing, and fewer bridges to nowhere. To the extent that China could pivot from its state-centered, one-sided, mercantilist past, the better the prospects for the country and for investors. Below, we review the progress China has made in the reforms needed to place it firmly on a less volatile, sustainable growth path. We have highlighted editorial remarks, the tenor of which we generally agree, from a variety of media that have reported on the subject:

1. Last summer, China scrapped controls on lending rates and indicated that full interest rate liberalization would be completed within one or two years. Borrowers say that **this policy change hasn't made much difference in the banks' practices.**

2. In the second quarter, China took a major step toward making the yuan a freer currency by further loosening its daily trading limits, indicating the leadership's belief that the country's economic growth, though slowing, is strong enough for exchange-rate reforms to move forward. The central bank said the currency now may move up or down by 2% daily. At the same time, **there was disappointment that the PBOC indicated that it won't allow full flexibility of the yuan's trading anytime soon**.

3. China would like to invite more foreign investment into areas that are currently banned or significantly restricted. Recently, it has eased curbs on foreign investment in joint venture hospitals, as it deepens a sweeping overhaul of its health-care system aimed at cutting costs and sprucing up overloaded public services. It has also announced a similar change for auto companies. **There were no details given on the timing of the moves**.

4. Beijing ended a 14-month moratorium on IPOs in January, allowing 48 companies to list in the first two months of this year. But the new issues stopped abruptly in March. Analysts say the halt may have come as a result of lackluster market conditions, and because loopholes were discovered in new IPO rules issued late last year. Forty-three companies were listed in January, followed by five listings in February. However, no IPOs have taken place since then, leaving more than 600 companies on the waiting list**. Skepticism surrounds the IPO calendar for this year.**

5. In an early attempt to increase foreign ownership inside the SOE complex, China Petroleum and Chemical Corporation, known as Sinopec, said in February that it would open its distribution chain to 30% outside investment, a landmark change to the state's monopoly on the oil sector. On the same day, Gree Group, an appliance maker owned by the city government of Zhuhai, followed suit, saying it would establish a new company and sell 49% of that to strategic investors. **It is debatable whether**

such measures will be thorough enough to change the operating efficiency of SOEs fundamentally, or more radical measures such as selling out the majority ownership of the SOEs may be required to achieve the purpose.

6. Shanghai has become the center for liberalizing economic policy in China. With much fanfare, the Shanghai Free Trade Zone was launched on September 29, 2013 with the backing of Chinese Premier Li Keqiang, It is the first free-trade zone in mainland China, a bold experiment with looser capital account controls, a freely tradable renminbi and an end to cumbersome foreign investment rules. **The details and benefits of the Shanghai Free Trade Zone are still shrouded in mystery.**

7. China's stock regulator has said that foreigners can own more than 49% of a funds management firm. **The statement, released in mid June, was thin on details.**

So there it is; reform, the China way. China is, at the same time, confident and cautious, bold and hesitant, and, proverbially, takes two steps forward and one step back, a middle course for the Middle Kingdom. Commensurate with the dual nature of China's reforms thus far, we are dismayed that reforms haven't been larger and faster in coming but are elated that there has been any reform at all.

While we eagerly await the tell-tale signs of true reform, we are wary of China's commitment to resisting the easy fix of phony stimulus. The leadership has committed to growth of 7.5% this year and our worry is that China will ease credit and build things it doesn't need in order to achieve its goal. Anxiety is building in China over the pace of growth and we are seeing some wavering on the stimulus front. Thus far, measures taken to ease credit have been modest and targeted to small and medium sized businesses. If the floodgates of stimulus were opened in earnest, this would be a clear negative for us.

As it is, however, the "stop and go" progress thus far on the five year plan and the distrust seems to validate our investment approach to China – we like it for its size and growth potential but cannot shake the insecurity of a minority shareholder in a still predominantly state-directed environment. We prefer our exposure to China to be through companies operating there, but domiciled elsewhere and run by non-Mainlanders.

We would like to comment on two other countries much in the news recently and within the fund's purview. The India market has responded enthusiastically to the election of Narendra Modi as prime minister and the parliamentary majority won by his supporters in the BJP. There are high hopes that a pro-business agenda can be enacted. However, strong populist tendencies in India run counter to a less regulated, freer market economic model. Additionally, India's central bank must solve an old emerging market conundrum and institute a finely tuned monetary policy that addresses inflation, protects the currency and grows the economy. High expectation itself is the enemy. Disappointments will take on more significance. This is all somewhat of a moot discussion for us since the portfolios do not meet "qualified" criteria for directly investing in India. If we were to see evidence of a true turnaround, like a credible budget, we would likely build an exposure to India in the portfolios in one or more of three ways – through companies listed elsewhere but whose operations are in India, U.S. listed ADR's or a country ETF.

In Thailand, a prime minister has been deposed, the army has taken control and martial law has been declared. So what's new? The Thai market has shrugged off this all too familiar tumult, and, incredibly, the SET and the baht have risen since the May coup. Tourism reacted negatively at first and there was a sharp fall off in long haul and inter- regional arrivals. Recently, there are signs that the industry has stabilized and thus has surprised on the upside. Manufacturers may think twice about setting up or expanding in a country with a failed government; on the other hand, with Thailand having superb manufacturing infrastructure in place and a history of managing though political upheaval, we doubt there will be a wholesale abandonment of the country. All this said, we are wary of the calm and prefer the sidelines now. We would, however, be inclined to buy into a severe market downturn that might result from political deterioration.

We close with an observation on the pace of change in Asia. From Japan to India, one gets the sense that a reliance on the old order of a dominant West for its export markets, for its capital, for its reserve currency, even for its defense is fast abating. The new order is Asia-centric, inter-regional, self-sufficient and China-wary. This is the inevitable outcome of a regional economy that has grown far faster than the rest of the world and is generally unencumbered by excessive debt that plagues the West. This trend should continue along with Asia's economic growth. The region's main challenge will most likely be political. With increasing wealth comes growing awareness of individual rights and freedoms which are not now uniformly available across Asia. Accommodations to the aspirations of the individual will need to occur in many countries so as to dull the sting of the increasing income divide between the "haves" and the "have-nots". Additionally, there will likely be a shifting of alliances among countries in the region as old enmities and allegiances give way to new and dominant commercial realities of trade, capital and energy security. This transition will not be easy. But the opportunity for the patient investor in this high growth environment is undeniable. We hope to realize this opportunity in the Asia Strategy portfolios.

David Descalzi
July 7, 2014

See general disclosures at the end of the document

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