



## SeaBridge Cautious Core Strategy

Second Quarter 2016

Commentary

The U.S. expansion continues to be the most sound of all major economies. Factory activity in June expanded at the strongest clip in more than a year. The ISM index (The Institute for Supply Management's Index) rose to 53.2 in June from 51.3 in May. Bookings and productions also reached three month highs, suggesting sustainable gains ahead. Although the U.S. job numbers have been fairly strong with inflation slowly creeping up, we still expect interest rates in the U.S. to remain very low for the foreseeable future given geopolitical risks, weak global aggregate demand, and high debt levels. We expect Central Banks to remain accommodative to help offset potential aftershocks from the Brexit outcome.

We had been cautious on the global markets prior to Brexit, and Brexit reinforces that view. Overall, macro data has been mixed across the globe with the U.S. and China showing some stability while Europe and Japan continue their malaise. Volatility in the markets was dampened by moves from China and the U.S. to stabilize their economies in February and March, but pending events (the prolonged exit of Britain from the EU, the outcome of the U.S. Presidential election, the rise of EU skepticism and future elections in Europe, Japan's need to address the strengthening yen, ongoing currency devaluation in China, and interest rate policy in the U.S.) suggest that volatility will remain high for the remainder of 2016.

In the second quarter, while we were impressed by economic improvement and the sustained market recovery, we were also concerned that the U.S. investors were getting complacent in a low growth environment while the market valuation was getting higher and higher. We think U.S. equities are fully priced with expectations that earnings will pick up in the second half. The forward price to earnings ratio is near a cycle high of 17x versus its historical average of 15x.

Overall, we tilted Cautious Core portfolios toward a more defensive stance as the 2nd quarter went on. We exited equities (e.g. **Lennar**, **Oaktree**, **Ck Hutchison**, and a European Hedged ETF) that were not well positioned for this market environment. Instead, we moved into more defensive assets offering what we believe to be secured cash flows and/or yields such as **Nestle**, **Fairfax Financial**, and some closed-end bond funds that are yielding 5-7%.

- We added Nestle as a defensive growth name during the quarter. Our purchase of Nestle is in spite of its history as an underperformer in the consumer staples industry. Our rationale is that under a new CEO from German based Fresenius Medical Care, Nestle will be able to get expenses under control and substantially increase its margins and profits. 44% of Nestle's sales come from rapidly growing emerging markets. Nestle yields 3.5%.

For most Cautious Core portfolios, we ended the quarter with cash levels of 11% and 48% in fixed income assets. Other defensive positions include bond-like equities and defensive equities. We also have a position in a short Nasdaq ETF (the ETF should go up when the Nasdaq 100 declines) that is not listed in the table below. *Note the table below presents weightings for the typical Cautious Core portfolio; not all portfolios managed in our Cautious Core strategy have exactly the same weightings due to client-specific factors.*

| Defensive Assets Allocation   |              |
|-------------------------------|--------------|
| Short Duration                | 16.2%        |
| Unconstrained                 | 12.9%        |
| Preferreds                    | 7.4%         |
| Inv. Grade                    | 7.0%         |
| High Yield/Bank Loans         | 2.5%         |
| Mortgages                     | 1.4%         |
| Munis                         | 0.3%         |
| Asia Credit                   | 0.2%         |
| <b>Total Fixed Income</b>     | <b>47.9%</b> |
| Bond-Like Equities            | 7.3%         |
| Defensive Equities            | 6.3%         |
| <b>Cash</b>                   | <b>11.0%</b> |
| <b>Total Defensive Assets</b> | <b>72.5%</b> |
|                               |              |
| 6/30/2016                     |              |
| Source: FactSet Data          |              |

*Short duration: bonds with a short period (e.g. 2-4 years) until final maturity of the bonds.*

*Unconstrained: with changing market conditions, the bond portfolio manager has discretion regarding which bond categories to use in the portfolio. Our "Unconstrained" holdings include funds run by some of the highest quality fixed income managers (PIMCO, DoubleLine, Guggenheim, and Alliance Bernstein.) They have flexible mandates to invest across fixed income assets classes.*

A review of some of our winning and losing positions may be useful:

- Year to date, our defensive assets (Fixed Income, Defensive and Bond-like Equities) have done much better than our "growth" equities. We have a large percentage of the portfolio in a diversified basket of fixed income assets that have helped to offset some of the volatility in the portfolio caused by Brexit. The market price discounts to net asset value in our closed-end bond funds have narrowed nicely, increasing market prices. Negative yields on bonds, prevalent in Europe and Japan, have driven savings flows from those countries to the U.S. This buying has lifted prices and reduced yields here. We believe this trend will likely continue. What concerns us is that leverage in the economy has increased as a result of income shortfalls and share repurchases. At the same time, credit risk fears are subsiding with the spreads between yields on high yield bonds and Treasuries compressing 300 bps to 600 bps since the middle of February.
- Investors are moving into names that are offering a reliable income stream - which includes our positions in Bond-like equities. These include **Crown Castle Intl Corp** (Wireless tower operator yielding 3.5%), **Starwood Property Trust** (Commercial real estate lender yielding 9.3%), **Dream Global Real Estate Investment Trust** (German commercial real estate owner yielding 8.6%), and **LEG Immobilien AG** (German residential real estate owner yielding 2.7%). German real estate is expected to be a beneficiary of money moving out of U.K. real estate due to Brexit. In addition, German real estate offers a hedge against a possible breakup of the EuroZone. In this event, German assets would almost certainly appreciate in price as the Deutsche Mark would replace the Euro.
- Defensive equities such as **Comcast**, **AT&T** and **Fairfax Financial** have also done well in this environment.

In the "hurting performance category", we had several U.S. groups:

- For U.S. banks, concerns about persistently low interest rates impacting net margins, weak capital markets activities, credit concerns, and negative sentiment spilling over from Brexit continue to pressure the share prices of financials. However, U.S. banks are trading at only 10x earnings and less than 1x price to tangible book value. They are also now well capitalized to absorb external shocks. Most banks have also passed the Fed's stress tests giving banks permission to return more than 2/3 of their income to shareholders in the form of dividends and stock buybacks. Some of the banks are now paying a 3% dividend yield along with a buyback yield of 5% for a total return of 8% to shareholders. We currently have **Wells Fargo** and **JP Morgan**, arguably the two highest quality large banks in the U.S. We think the value of these banks will ultimately prevail, but we are mindful of the risks for banks in a powerfully deflationary world.
- Large cap technology companies (e.g. **Apple**, **Google**, and **Microsoft**) have been underperforming this year as investors have moved from high quality growth names to sectors perceived to be safer such as Utilities, Telecom, and Consumer Staples. We understand the rationale for the outperformance of safe sectors. However, after strong year-to-date performance and lofty valuations, we believe the safe sectors are very fully valued and may experience price declines if the U.S. expansion continues. Nonetheless, with all the uncertainties outside the U.S., we are considering trimming technology stocks as well as financials.
- Health Care stocks are usually an outperformer in a defensive climate, but they have struggled this year. Drug stocks have been de-rated as the Presidential candidates have been ranting about high drug prices. While there have been abuses (e.g. Valeant, Turing Pharmaceuticals, etc.) we believe that unless the Republicans lose control of the House, there should not be a major attack on the more responsible end of the U.S. Pharma industry in 2017.

Our move into Fixed Income has helped to support the portfolio with income and protect the portfolio from volatility. We have been buying more defensive stocks to generate some growth in our portfolios, and are carrying a higher cash level to provide both a cushion to dampen volatility and dry powder to take advantage of market dislocations. We will continue to look for attractively priced income streams, reliable in an uncertain world, as we proceed to the second half of the year. We also plan to harvest some tax losses for taxable accounts before year-end.

Thank you for your support.

Howard Chin  
7/7/16

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*There are differences among portfolios managed by SeaBridge in each strategy based on client-specific factors. Not all portfolios hold the same securities. Not all stocks held in the portfolio perform similarly. Some client accounts may not have as much cash reserved as other accounts managed in the strategy due to client withdrawals or other issues. SeaBridge manages portfolios in several styles.*