SeaBridge Inflation Fighter Strategy

Second Quarter 2016
Commentary

The BREXIT jolt at the end of the quarter was disappointing in that it gave back some of the ground we had been gaining in the second half of the quarter. We still have confidence in the portfolio which has forward earnings growth of roughly 15% if our companies deliver on projected growth. This is based on blended averages of analyst estimates (which of course can be wrong). We are rechecking these assumptions now in light of slower world growth resulting from European uncertainties.

Our largest exposure (20+% of the portfolio) and one of the best performing themes in 2Q16 was our investment in global and emerging market consumer companies. This theme includes consumer discretionary, consumer staples, and an auto component manufacturer. We think the U.S. consumer is in good shape with the demographics of housing being a major driver of spending. Our foreign consumer holdings (**Zojirushi**, a Japanese rice cooker maker selling to Chinese; **Man Wah**, a Chinese recliner chair manufacturer selling in China and the United States; and **CP ALL**, a Thai convenience store operator) are all growing well. **Delphi** is the former General Motors parts supplier which specializes in products related to fuel economy, safety, and lower emissions. There are some concerns about the pace of auto sales growth in the coming years due to the questionable loans that have pulled demand forward, but the company is very cheap and we believe its specialty products will let it grow at a faster rate than the overall auto market in the future.

Technology - hardware, software, and services - is our second largest exposure (slightly under 20% of the portfolio). This includes core positions in stocks like **Apple** and **Google** as well as **Microsoft** which is one of the cheapest major players in cloud databases in our opinion. We also have **NXPI** and **Broadcom**, which are specialty chip companies with big exposure in autos, internet of things, enterprise networking/storage, and mobile phones. With the exception of Broadcom, these hurt performance during the quarter as money moved away from the tech giants and chips makers. This area also includes **TenCent** and **Naspers**, the South African venture firm that helped found TenCent. We also bought a position in **Softbank** in Japan this year which, like Naspers, funds high tech startups around the world (it is a major owner of Alibaba in China, which it funded at the start-up.) We think that our world is driven by technological change, and we want positions in the leading companies. However, tech stocks can be very volatile and, with a possible recession in Europe, we are considering whether to trim these positions in the second half of the year.

Biotech and Health Services is our third largest exposure (around 15% of the portfolio). We believe this is a strong growth area for the next five years, but this Spring the stocks have been derating as the Presidential candidates have been ranting about high drug prices. While there have been abuses (Valeant, Turing Pharmaceuticals, etc.) we believe that unless the Republicans lose control of the House, there will not be a major attack on the more responsible end of the U.S. Pharma industry in 2017.

We have three companies (totaling 3.4%) led by John Malone, the global cable czar: **Liberty Interactive** which runs the QVC home shopping channel in the U.S. and similar programs overseas; **Liberty Global**, (Malone's largest cable company in Europe); and a spin off from Liberty Global, **Liberty Global LiLAC,** its

Latin American cable company. Liberty Interactive and Liberty Global (after adjusting for the effects of the spin off) both were about neutral to overall portfolio performance. LiLAC, on the other hand, was one of the poorer performers in the portfolio. We believe that a portion of this underperformance is due to the fact that many Liberty Global shareholders received a meaningful amount of this much smaller Latin America company in the spin off, and they were either not familiar with it or it fell outside of investment managers' mandates, creating temporary selling pressure. We expect LiLAC to grow rapidly via bolt-on acquisitions and achieve the scale necessary to create a sustained advantage in the cable industry. The internal cash flows of all three of these companies give us confidence that John Malone can continue to compound capital in the cable business at around 15%.

We have a good position (11+%) in financial services. We say "good" because we think they are very cheap relative to their value in a "normalized world." However, they have been bad performers recently because the rise in interest rates, while being jawboned by the Fed, never actually comes; the stocks need a rise in interest rates to perform well. In addition to **Bank of America** and **MasterCard**, which are conventional "cheap" and "growth" financial services holdings, the three others deserve a comment. **Fairfax** is a Canadian insurance company run in the manner Warren Buffett runs Berkshire. It has compounded its net asset value at roughly 15% over the years. Currently it has a "slow growth" bet on which should do well if the world slows down, and we like that as a hedge to some of our other growth stocks like MasterCard. We think **HDFC** is the best bank in India – expensive but we think it has the fundamentals to warrant the valuation. HDFC has low non-performing loans, which are the nemesis of other Indian banks. It had a good quarter and was a positive contributor to overall portfolio performance.

Finally, **PrivateBancorp** HOORAY!! This is a high quality smaller bank that was staffed by the team from LaSalle Bank in Chicago. We bought it as a small growth bank with knowledgeable leadership. But the stock had been declining as the Fed kept postponing a rate rise. Just before quarter end, CIBC from Canada announced an acquisition of PrivateBancorp at a price that takes us out with a small profit. Justice lives!

Finally, a word about our largest frustration – energy-related holdings. Good companies, but their prices keep going down (fortunately only 2.4% of the portfolio). **Calpine** is one of the most efficient combined cycle gas turbine electricity suppliers. The stock is down with gas prices and they keep using their stable cash flow to buy back stock. It is trading at 7 times cash flow, but the stock will not go up, we think, until gas prices rise. We show a gain in taxable portfolios, but that is only because we booked a loss for tax purposes and bought new shares at a lower price. Likewise, our solar holdings **SunPower** and **TerraForm** have been problem children. SunPower is the top solar producer in the U.S., with the highest panel efficiency and a strong balance sheet. Production is sold out for 2016. There are a number of negative industry issues that have impacted solar stocks now, but we have confidence in SunPower. TerraForm is the "Yieldco" orphaned by the bankruptcy of Sun Edison. It holds good contracts (note the 12% yield) and control has just been taken by Brookfield, the major Canadian infrastructure investor. Although performance has been poor since inception, the stock had a good quarter. Better times ahead we think.

That covers most of the portfolio. We are counting on the inherent growth to lift the value, but keeping a bit of extra cash and two small hedges for unexpected jolts from the world economy. We also plan to harvest tax losses for taxable accounts where appropriate before year-end.

Garnett Keith
Matt Falkowski
7/5/16

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