SeaBridge Yield Growth 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 expectation 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 the Yield Growth portfolios to a more defensive stance as the 2nd quarter went on. We exited more volatile equities (**Blackstone, Lennar, Oaktree, CK Hutchison,** European Hedged ETFs, and emerging market equities). Instead, we added more defensive assets offering what we believe to be secure cash flows and/or higher yields such as Pfizer, Nestle, Fairfax Financial.

- We added **Pfizer** as a defensive growth name during the quarter. Pfizer offers inexpensive valuation, an attractive dividend yield of 3.5%, free cash flow yield of 7.5%, and an excellent management team that has a history of unlocking shareholder value. Pfizer offers defensive growth characteristics in a slow growing volatile market.

- We also 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, 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 Yield Growth portfolios, we ended the quarter with cash levels of 14% and 12% in fixed income assets. *Note weightings in some Yield Growth accounts differ due to client specific factors*. Other defensive positions include bond-like equities, **Fairfax Financial** (the Canadian insurance vehicle that bets on a global deflationary outcome), and a position in a short Nasdaq ETF (the ETF should go up when the Nasdaq 100 declines).

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

- Year to date, our fixed income and the bond-like equities have done much better than “growth equities.” Our move into fixed income assets in the 1st quarter when rates increased significantly has helped offset some of the volatility in the portfolio from 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.
- 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.
- Emerging market consumer names have done well for us, year to date. Some of our Japanese names (**Pigeon, Misumi, Kao**, and **Zojirushi**) with growth ambitions in China have significantly outperformed not only on a local level, but have also benefited from a strengthening yen which translates back into more U.S. dollars.

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 estimated return of 8% to shareholders. We currently have **Wells Fargo**, **JP Morgan, Citibank**, and **Bank of America**. We think the value in our Financials 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 will not be a major attack on the more responsible end of the U.S. Pharma industry in 2017.

In terms of direct portfolio exposure to the U.K and EU, we have three stocks: Shire, Liberty Global and Kennedy Wilson. Shire is doing well post Brexit; Liberty Global was roughly flat, but its spin-off, LiLAC depreciated; and Kennedy Wilson fell sharply.

- **Shire** (market capitalization of $36.6bn) is a U.K. based pharmaceutical company that recently acquired Baxalta to enhance its position as a leading rare and specialty disease franchise. Shire earns over 95% of its income outside the U.K. with approximately three quarters contributed from the United States. Trading at an attractive forward P/E multiple of 12.4x for the pharmaceutical sector, Shire is expected to have earnings per share growth of 13-15% for the next two years.

- **Liberty Global** is U.S. cable czar John Malone's cable empire in Europe. In the cable industry, the key to creating value is to maximize both operating leverage and financial leverage, and the best way to do so is to build scale. With the consolidation phase in Europe mostly complete, Liberty is now focused on organic growth and margin expansion. In the quarter, Liberty Global spun off its Latin American cable company **LiLAC**. After spin-off, the LiLAC shares fell in price. A recent Liberty joint venture in Netherlands, that combines its Dutch assets with Vodafone's assets, is expected to deliver $1B+ in cash flow. Liberty's mature asset base should result in steady reliable EBITDA growth. We think LiLAC should recover as it grows its Latin cable assets.
- The stock that hurt us most this year was **Kennedy Wilson** (KW), an international real estate fund and services company. KW's value proposition is to invest in distressed real estate assets (property and/or loans) that can be upgraded and leased to create value. KW went public in December 2007 with the intention of buying real estate as the financial crisis unfolded in the U.S. Kennedy Wilson also has a 21% ownership in Kennedy Wilson Europe (KWE), a property company that was established in 2011 to buy distressed properties in Europe. Upon BREXIT, KWE's price collapsed, and KW was in the market buying shares of its European subsidiary. This is in line with KW's philosophy of investing when forced selling of assets cause divergence between market price and the long term value of holdings. KW's management own 15% of the KW's stock, so we trust their value judgment. We have confidence that KW's European values will be recognized, but the UK-EU upset has been hard on the stock.

We have been buying more defensive stocks and are carrying a higher cash level in our portfolios 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 tax losses for taxable accounts where appropriate before year-end.

Thank you for your support.
Howard Chin
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