SeaBridge Investment Advisors, LLC

SeaBridge Global Growth Strategy

Second Quarter 2017

Commentary

We saw positive quarterly performance for the style as we benefited from our allocations to technology and emerging markets. We had about average level of turnover in the style as we trimmed some of our positions into strength and used the proceeds to fund new positions. Our cash levels remained relatively constant over the period. Given the level of the markets, we are comfortable with the amount of cash we are holding at this time.

At a high level, the most notable event was the flattening yield curve in the US (i.e. short rates rising and long term rates falling). At one point, the spread between the 10Y and 2Y Treasury yields narrowed sharply and we saw complete retracement of the steepening in the curve that occurred following the presidential election in Q4 2016. This proved to be a negative development for most stocks as it is sign that investors believe economic growth may be stalling. With inflation data also giving back some of the gains it reported earlier in the year and GDP growth remaining stuck at ~2%, who can blame them? The "Trump" growth premium baked into valuations following the election in many of the cyclical stocks, like banks, has proven tenuous.

Fortunately for our portfolio, the technology sector appeared to benefit heavily from the flattening yield curve while cyclical stocks like industrials and financials tended to underperform for much of the period. This makes sense as technology stocks derive much of their intrinsic value from future growth that must be discounted at prevailing rates to arrive at a present value, thereby benefiting from lower long term interest rates. During the quarter, the S&P 500 returned 3.09% while the S&P 500 Information Technology sector returned 4.14%. Looking forward we may reduce our technology allocation if valuations become increasingly unappealing, no longer warranting such an oversized weighting as we favor areas with seemingly more attractive opportunities like Energy.

Some of our best performing holdings included **Tencent Holdings** (700-HKG), **Fairfax India** (FFXDF), and **Alphabet Inc** (GOOG). All rose between 9% and 25% during the quarter. Some of our least performing positions were **Liberty Global** (LBTYK), **Twenty First Century Fox** (FOX), and **Kennedy Wilson** (KW) with each falling between (11%)-(14%).

One of the better performing positions was Fairfax India (**FFXDF**). We view this as an interesting way to gain access to the growing and healthy Indian economy. This is an investment vehicle formed and sponsored by Fairfax Financial (FRFHF), a Property & Casualty (P&C) insurance company managed by Prim Watsa, with an explicit mandate to invest in public & private Indian assets. To date the fund has raised $1.5 billion USD including $450 million from the sponsor, FRFHF. The company has deployed >85% of funds raised into 7 total assets ranging from an agriculture trader to leading diversified investment banking company. All but two investments represent minority stakes backing management with long term records and heavy insider ownership.

Our biggest underperformer during the quarter was Liberty Global (**LBTYK**). LBTYK is the largest European cable operator with assets across Europe including the UK, Germany, and Switzerland. It has the leading position in many of its markets for broadband and video services. The weakness during the quarter was driven by a soft earnings report that saw management reduce the guidance issued in January. The growth concerns weighing on the stock should prove transitory as management increases cash flows in the UK, its largest market, on the back of a new build capital expenditure program. We continue to have a high level of conviction in the management team that has a long record of navigating through these competitive markets and we also appreciate the high levels of insider ownership in the business by the leadership. At just below a 2.0% position, we consider LBTYK to be a core holding.

Another large underperformer was 21st Century Fox (**FOX**). FOX is a diversified media company operating production & distribution assets globally. We viewed the weakness as an opportunity to increase our position. We view the pending Sky acquisition as a potential game changer for the business. Currently, FOX has a 39% interest in Sky, which is one of

Europe's largest media companies with operations focused in the UK. FOX has offered to acquire the remaining 61% interest in Sky it does not already own and is currently seeking approval from regulators. We believe the acquisition could be a major positive for the company which is not reflected in the current valuation. The company knows the Sky asset well as it has held a minority stake in Sky for 25 years. The current CEO of Fox, James Murdoch, ran Sky for many years in the early 2000's. Pro-forma the total revenue mix shifts to >60% recurring revenue from businesses like cable & internet subscriptions, while the more volatile transactional type of revenues like advertising drops significantly. Further, we consider FOX's legacy core assets to be franchise brands with dominant market positions in key markets (e.g. Fox News in US). Lastly, the Murdoch family owns large interests in the company, aligning management's interest with minority shareholders. Bottom-line, Fox is a higher quality company post Sky merger and should be in an advantaged position to benefit from media consumption trends globally.

During the quarter, we added 4 new positions including **Advance Auto Parts** (AAP), **Fairfax Africa Holdings** (FFXXF), **Now, Inc**. (DNOW), and **Paypal Holdings** (PYPL) and eliminated 4 positions including **Accenture Ltd**. (ACN), **Crown Holdings** (CCK), **Gilead Sciences** (GILD), and **Zojirushi Corporation** (7965-TKS).

We initiated a 1.0% position in **DNOW** in May following a solid earnings report and continued to increase our position through the quarter as the price continued to weaken driven largely by a collapse in oil prices. DNOW is an oil & gas parts distributor operating within a favorable industry structure where they control 25% of the market with their competitor controlling another 25%. The remaining 50% of the market is highly fragmented and ripe for consolidation. Further, we view DNOW as offering investors low cost options relating to an oil price recovery, parts inflation, achieving internal management targets, and improving working capital efficiency. Lastly, this position increases our limited exposure to the price of oil at a time when the sector is depressed and offering compelling valuations in certain names.

We realized a nice profit while eliminating our ~1.5% position in Crown Holdings (**CCK**) in May. Concerns over valuation and input cost inflation led to the removal of this holding. CCK is an aluminum canning manufacturer operating in a consolidated and oligopolistic industry benefiting from "regional moats" due to shipping barriers and economies of scale. However, it is a capital intensive manufacturing business with very low gross margins leaving profits vulnerable to changes in raw material prices, which consume >50% of sales. A small change in input prices can have a leveraged impact on the bottom line. Unfortunately, this industry has a history of distress during times of rapid increases in input costs and a lot companies almost went bankrupt in the 1999-2001 period, including CCK. We consider that the current peak multiples, peak margins, and high leverage levels at CCK present an unattractive risk reward equation at current levels, thereby stoking our decision to sell the position.

Finally, you should note we have decided to change the name of the "Inflation Fighter" style to "Global Growth" in order to more clearly describe the approach in which the assets are being managed. We should make clear that there is NO change in the actual investment process and the only change to the strategy is in name only.

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