SeaBridge Investment Advisors, LLC

SeaBridge Yield Growth Strategy

Second Quarter 2017
Commentary

The U.S. equities markets delivered solid returns in the quarter. Asian and European markets were strong as well, so that global equities had the best first half since 1998. Investment grade bond and high yield bond indices returned 2.1% and 2.4%, respectively. Yield-Growth portfolios delivered solid performance in the 2nd quarter.

Since the second quarter of 2016, a cyclical upswing appears to be taking place across most of the developed world, particularly in Europe. With Global GDP growing again, company profits have recovered. U. S. Corporate sales and earnings in the first quarter increased approximately 8% and 14%, respectively. According to FactSet, U.S. earnings are expected to grow in the low teens this year and in 2018.

10-year Treasury rates shot up to 2.6% after the presidential election but, with continued liquidity infusions from overseas central banks and inflation expectations coming down, rates have now fallen back to 2.3%. The Fed is forecasting gradually rising rates, reflecting in part the 4.3% unemployment rate. In the past, this has signaled rising wage inflation, although no wage inflation is visible now. But there are two other thoughts which are probably behind the Fed's thinking: a) the Fed needs room to lower rates when the next recession appears and b) the Fed is making more frequent references to rising speculation in the equities markets and they do not want to feed a stock market bubble with rates far below what normal conditions would call for.

The failure of the Republican Congress to find compromises needed to replace Obamacare continues to raise doubts about the Trump legislative agenda. It is still our base case that the U.S. economy will receive some form of fiscal stimulus from tax cuts and infrastructure spending in the coming quarters. If this occurs, we think interest rates will continue to rise slowly for the next year.

Highlights and Portfolio Activity

In the quarter, Yield Growth portfolios benefited from solid earnings reports in the international holdings (**Com Hem, Pigeon, AIA, Misumi, and Deutsche Post**) and exposure to U.S. banks and REITs. Banks got a nice boost at the end of the quarter as the Fed's stress test results cleared the way for increased dividend payouts and stock repurchases.

Performance detractors included **Zojirushi** (a Japanese company that makes rice cookers), **Liberty Global** (a European Cable company headed by media titan, John Malone), **Kennedy Wilson** (an opportunistic real estate operator), **IBM**, and **Master Limited Partnerships.** Master Limited Partnerships retreated as oil prices fell into the low $40's/bbl. We believe that throughput in U.S pipelines will continue to grow with shale drilling, but the pipelines stock prices are currently moving in sympathy with oil prices.

Turnover was low in the quarter. New names to buy were hard to find because we think valuations are full; but we did trim a few names in some portfolios. We trimmed **Com Hem** following a recent surge in its stock price. **Com Hem** is a leading cable company in Sweden that has a dividend yield of 3.3%. Management has also been buying back 4% of its stock on an annual basis. **Com Hem** shares have appreciated significantly in the last year, driven by operational improvement in its cable networks, customer churn improvements, improved pricing, and buyout rumors. In late April, Kinnevik AB (a public tech, cable, and media holding company) agreed to buy 18.5% of Com Hem for 3.7 billion kronor ($420 million USD) from private equity firm, BC Partners, to become the cable company's dominant shareholder. **Com Hem** is also a potential takeover target for rivals as it is one of the last remaining independent cable-TV providers in Europe.

We also trimmed Japan-based **Pigeon** in some accounts. The stock has appreciated significantly since our initial buy during the fourth quarter of 2012. The baby bottle and accessory businesses have exceeded expectations in China, Japan, and the U.S. In the last quarter, China's sales growth of 24% exceeded the estimate of 14%. The company also announced a marketing partnership with Disney in China, which is timely with the recent opening of Disney Parks Shanghai. Japanese analysts are conservative in forecasting earnings estimates, and there may be more room for earnings surprises, but the stock is trading at 34x forward P/E, which seems very full to us.

We also trimmed **Alphabet** (parent company of Google) in accounts that had oversized positions after the company delivered a quarter where sales and earnings exceeded 20% year over year.

One of our companies, **Nestle**, was recently in the news. We initiated a positon in **Nestle** in the second quarter of 2016. A year ago, Nestle's board went outside to hire Mark Schneider, a German with a strong record in the health care industry. Our hope was that he would 1) reinvigorate growth in the emerging markets and stabilize growth in the U.S. market, 2) shed non-core products for faster growing alternatives, and 3) improve margins by streamlining base costs. **Nestle's** gross margins rank high among large cap peers but, due to heavy management expenses, operating margin is in the bottom decile. One of Schneider's first major initiatives is to evaluate strategic alternatives for the U.S. confectionary (ButterFinger, Baby Ruth and 100 Grand) business.

In the last week of June 2017, an activist hedge fund, Third Point, announced that its hedge fund is holding a $3.5 billion positon (1% stake) in **Nestle.** Third Point is following a typical activist playbook by recommending the following: target an operating margin of 18-20% by 2020 compared to 15% in 2016; increase leverage target to 2x net debt/EBITDA for share buybacks; and sell off underperforming assets, including its 23% stake in L'Oréal. One day after the announcement, **Nestle** announced a $20.8 billion (7.5% of its market capitalization) share repurchase program.

Disappointments in top line growth, lack of margin improvement, and declining returns have caused the stock to underperform in the highly competitive packaged-food industry which has struggled under slowing growth, changing consumer moves toward healthier options, and a lack of pricing increases. It will take time to turnaround the largest consumer packaged-food company, but we are encouraged by the management team's initial efforts to restructure the company. Potential margin improvement and EPS upside do not appear to be present in the stock's current price. We think **Nestle** fits nicely in a yield and a conservative oriented portfolio.

<u>Positioning</u>

The objective of the **Yield Growth** strategy is to provide a total return over a full market cycle that benefits from global equity exposure but with dampened volatility, so that the risk of a major drawdown in value is less than that of the equity market. Of course, we cannot guarantee that we will achieve this objective. We use income dampening assets (i.e. fixed income, closed-end funds, master limited partnerships, and other bond-like surrogates) to try to achieve the lower volatility. Over the last three quarters, we have moved away from fixed income, but still have exposure to short duration fixed income credits and flexible opportunistic closed-end bond funds which we hope can navigate this interest rate and credit environment. We are also positioned in REITs we think could weather a rising rate environment. For our equity positions, we look to hold large high-quality companies that generate consistent free cash flow and dividend growth.

Thank you again for your support.

Regards,

Howard Chin
7/5/17

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