

SEABRIDGE

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"Caught between a Chinese rock and a Fed place"

That quip was how Macro Research Board, an economic research group whose work we receive, described the current market volatility. Unfortunately, it is a lot more complicated than just China's slowdown and the Fed's need to raise interest rates.

Before I get into the complexity, which sounds discouraging, I am happy to report that the U.S. recovery continues, banks and consumers are liquid, auto sales are making records, and housing continues its sustained recovery. Our service sector economy is the envy of the world! The jobs report for September was disappointing, but job creation continues at a pace which should reduce unemployment further. As I go through a laundry list of problems, I want to make sure the positives have been registered first.

For the complexity, we have about seven forces converging. No one or two forces are enough to cause a bear market or global recession, but the path they follow in resolution is unclear, and the market dislikes uncertainty for which there is no near term solution:

- The Fed does need to raise short term interest rates. Interest rates are currently at recession levels, and the U.S. economy is far beyond a recession. In fact, employment is close to the level where wages and inflation should start rising. We do not know how distorted our financial system is from having zero interest rates for six years, and we may find hidden problems as rates start to rise. (Some would say a correction in the stock market will be the first problem uncovered.)
- China is slowing as it tries to shift from a manufacturing/construction economy to a service/consumption economy. Beijing's attempt to refinance municipal debt via a stock market bubble backfired and made their financial management look inept. The stock bubble's collapse and China's un-pegging the Yuan from the Dollar fed fears that China's whole economy is out of control and unwinding faster than Chinese leaders admit. Subsequent data implies that manufacturing is slowing relentlessly, but retail spending is still growing at roughly ten per cent per year. So for now, we believe that China hit a big speed bump in their transition, but the basic course has not changed.
- China's slowing is taking a dreadful toll on commodity prices and the emerging markets which grew fat between 2001 and 2007 supplying raw materials to China. Not only did Brazil, Malaysia, Indonesia, et al fail to make needed reforms, but graft and corruption associated with the long boom is still coming to the surface. The Brazilian stock market has collapsed from a value of \$1.53 trillion in April 2011 to \$0.461 trillion this week. This reflects huge disarray in both company values and currency rates. Petrobras, Brazil's huge oil company, is teetering on the edge of bankruptcy with massive debt, an "inconceivably low" oil price, and a bribery scandal reaching the highest levels of Brazil's government. Signs of excess supply and deflationary price trends are everywhere. The risk of an emerging market recession boiling over to a global recession is worrying the IMF and other global watchdogs. This explains their pressing our Fed to delay increasing U.S. interest rates in September. (Emerging market companies have borrowed over \$1 trillion in Dollar bonds in the past six years. A rise in our interest rates strengthens the U.S. Dollar and weakens EM currencies, creating a "debt service shock" which EM companies can ill afford.)
- The strong Dollar between January and August has been taking its toll on earnings of U.S. corporations. This occurs both via weakening our exports, and also via the translation of foreign earnings back into Dollars at a lower equivalent. With the earnings of our oil sector getting hammered by the falling price of oil, it is a bad time for our multinational

corporations to have eroding earnings. Our stock market is fully priced, and doubts about earnings increases in 2016 are one of the factors causing our stock swoon.

- In spite of much lower oil prices, U.S. oil production has not diminished as expected. The result is a continuing global oil glut. Low gasoline prices help the consumer, but the growing potential for exploration company bankruptcies in 2016 is undermining confidence in our bond market - where much of our shale drilling was financed.
- In addition to these economic challenges, our stock market has some internal structural problems. Exchange Traded Fund flows are being gamed by the hedge funds. For example, Exchange Traded Funds (ETFs) have replaced mutual funds as the most convenient instrument for individuals to own equities. In mutual funds, there is generally a fund manager who is weighing the prices versus the earnings of companies in the fund. ETFs are cheaper, but one of the cost savings is the elimination of the manager - most ETFs are put together by computers to replicate industry slices or market indices. People buy them in response to comments on CNBC or their own observations - "buy small caps, buy biotechs, or buy high yield bonds." The "brakes" of judgments about price versus value are not there. The market becomes a "momentum game whose players chase popular themes (e.g. biotechs), causing certain sectors of the market to soar; or conversely, to collapse if everyone decides to exit a theme at once (e.g. oil stocks). A missing sense of value and high uncertainty are a volatile mix and hedge funds can spot a change in direction and front run ETF buying and selling.
- Finally, changes in values this summer - especially oil prices below \$50/bbl - have created flows which have wrecked some financial structures which had seemed stable. For example, the financing vehicles for the oil and solar industries have been pushed to levels where they no longer work. This causes some companies which had been growing well to go "ex-growth." The master limited partnerships (MLPs) are an important example. Oil companies financed infrastructure growth by "dropping down" pipelines into master limited partnership (MLP) subsidiaries. These got favorable tax treatment and hence had a lower cost of capital. With the demand for pipelines growing, the MLPs traded on a combination of yield and growth expectations. But with oil growth stalling, the MLPs' growth outlook shrank. A combination of ETF selling and hedge fund front running pushed prices down to levels where oil companies no longer find it profitable to add new pipelines to their MLPs. So MLPs are still paying their tax deferred dividends, but there is a massive dislocation from ETFs who need to sell MLPs to meet redemptions, and very few buyers until the price of oil begins to rise. The more the price falls, the more frozen the sector becomes. A similar result has hit the "YieldCos," which own completed solar farms delivering electricity to utilities. The fear of falling gas prices has caused a massive exodus from the solar, so that what had been our fastest growing industry until March 2015 is now grinding to a halt.

So with that background what have the markets done in the third quarter - it is not pretty¹:

During the quarter, the S&P 500 dropped 6.4% and the Russell 3000® Index was -7.2%, while the MSCI All Country World Index was down 9.3%, the MSCI World Index ex the U.S. returned -12.1% and the MSCI AC Far East ex Japan Index lost 18.0%. For the nine month period, the S&P 500 return was -5.3% and the Russell 3000® return was -5.4%. The MSCI All Country World Index lost 6.7%, the MSCI World Index ex the U.S. was down 8.3% and the MSCI AC Far East ex Japan Index return was -13.1%.

Early in the quarter the problems described above were daily becoming more apparent. As our interim notes to you reported, we started raising cash and then putting in hedges.² In terms of market exposure, each dollar we short is the cash equivalent of two dollars of cash in that it neutralizes the market exposure of some other holding in the portfolio - leaving, we hope - the superior earnings growth of our stock held, rather than being sold to raise more cash. The exact combination used to reduce volatility varies among our different styles, but the net result is that in most portfolios we are holding the cash and short

¹ Results for these indices (S&P 500, Russell 3000®, Morgan Stanley Capital International All Country (MSCI AC) World Index, MSCI AC World Index ex USA and the MSCI AC Far East ex Japan Index) are quoted as being somewhat representative of the broader equity markets for comparison to SeaBridge U.S., global, foreign and Asian portfolios. The SeaBridge portfolios differ from these indices (in number of securities held, industry, sector and country weightings, etc.). Therefore, in any given period, results for SeaBridge portfolios are likely to differ from the results for these market indices.

²The hedges we are using are ETFs which do the opposite of what the market does. If we like the value of our stocks better than the average of those in the S&P 500 index, we can "short" the S&P 500 by buying an ETF that goes up when the S&P 500 goes down. The ETF holder's liability is limited to the invested amount. This is different from shorting specific stocks where one has unlimited liability if the stock price soars.

equivalent of more than 20% cash. Unfortunately, this has not been sufficient to keep the portfolio values from declining, but it has reduced the decline from what it otherwise would have been.

A few of specific valuation issues have also bothered us during this quarter. In Core Global, which holds a significant number of industrial companies, the market's focus on growth stocks totally bypassed the industrials, and values fell as money went elsewhere.

Yield Growth portfolios holding Master Limited Partnerships (MLPs) were heavily penalized as the outlook for future oil drilling diminished. (In hindsight we might have been better to sell MLPs, but the tax consequences of MLP sales are heavy as their cost basis is reduced by past dividends. So an MLP sale incurs heavy tax bills.) As described earlier, with slower oil drilling, fewer pipelines are needed and the growth of MLPs is questioned. MLPs have been extremely popular in the past three years, and heavy ETF selling of MLPs since May has pushed their prices down to levels implying no future growth at all. We believe this is too severe, but we will need answers to the country's oil future to add a growth dimension to the solid yields that MLPs provide.

Our Asian strategies, and many of our other portfolio styles as well, hold Hong Kong companies taking advantage of growth in Asia. With the collapse of the Shanghai stock bubble, Hong Kong companies have been punished - driven down to valuations not seen since the market crisis in 2009. We believe companies making and selling consumer products in Asia are well positioned, but the market is not reflecting that now.

So we sit with plenty of cash to buy good companies at attractive prices when we think the correction has come to an end. But we are nursing our bruises and watching carefully to get a signal that it is safe for us to move out of our highly defensive posture. Since we feel that the U.S. expansion is still proceeding solidly and that housing and consumer spending will sustain the expansion, we have a generally positive outlook for 2016 and beyond. However, the resolution of the problems listed above will not become clear immediately, and our guess is the market upset can go on for another month or more. Beyond that, we hope the market can end the year on an up-note.

Sincerely,

Garnett L. Keith, Jr.

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