SeaBridge Investment Advisors, LLC

SeaBridge Yield Growth Strategy

Third Quarter 2015
Commentary

Between 2012 and 2014 P/E expansion drove more than half of the returns in the S&P 500 index and more than seventy percent of the returns in the MSCI world index. So, going into 2015, stocks were fully valued unless earnings growth was solid. After six years of monetary and fiscal stimulus, the Fed was ready to lift rates. However, no wage growth in the U.S., decelerating growth in China, the lack of inflation in the U.S. and faltering economies in most emerging markets caused the Fed to hold rates at zero so far this year. Nonetheless, the prospects of a rate rise have been seen by all as likely to upset market equilibrium. The lack of growth momentum, both in the U.S. and elsewhere, combined with equity markets volatility, have resulted in our taking a more cautionary positioning in the Yield Growth portfolios.

In our Yield Growth portfolios, we expressed our cautious view of the world and the markets by reducing our exposure to the emerging markets, raising cash levels, and buying hedges which do the opposite of what the market indices do. This lets us hold stocks of companies whose earnings growth we trust, but cut our exposure to declines in the overall market. The hedges are not held as long-term investments, but are used tactically. To do this we used three hedge ETFs:

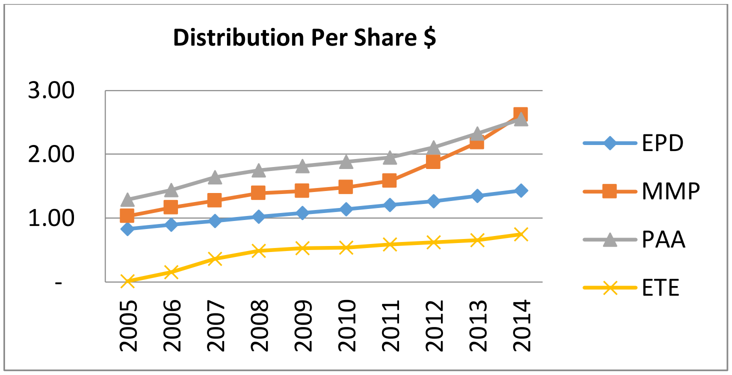
- RWM -Short Russell 2000 - this ETF reflects an inverse position to the Small Cap market, where valuations are fairly elevated;
- PSQ -Short QQQ - this ETF reflects an inverse position to the Nasdaq 100, an index that contains some of the highfliers in this market, such as the Biotechs, Social Media and Technology names; and
- EUM -Short MSCI Emerging Markets - this ETF reflects our fear of the economic contagion in the Emerging Markets stemming from the weakening growth prospects in China.

Uncertainty about China's growth prospects was also a factor pressing on the market more and more as the year progressed. In China's defense, China has foreign exchange reserves, a trade surplus and limited dependence on foreign capital. But it also has grown rapidly based on exports and building of domestic infrastructure. It is currently trying to make the shift to growth based on services and domestic consumption, and this is a big threat to countries like Brazil whose trade balance is dependent on supplying raw materials to China. We believe that the decline in demand and commodity prices will continue to create tensions in these commodity export-oriented economies that have large U.S. dollar denominated debt burdens.

With that back drop, we have reduced our exposure in companies dependent on growth in the emerging markets. We are still positive about our theme of selectively choosing companies that we think are positioned to benefit from the increasing numbers of emerging consumers. But, overall we think that cash flows from the emerging world will be discounted at lower multiples, given the lack of predictability and uncertainties of their economic outlook.

The net result of these various actions is that in most portfolios we are holding the cash and short equivalent of more than 20%+ cash. Unfortunately, this has not been sufficient to keep the portfolio values from declining, and we have been particularly hurt in 3Q15 by our holdings in Master Limited Partnerships (MLPs).

Historically our Yield Growth portfolios have benefitted substantially from MLPs as an asset class. From 2006-2014, the Alerian MLP Index provided annualized total returns of 10% vs. 5.5% for the S%P, 5.5% for the Dow Jones, 3.1% to the MSCI World. MLP yields of 5-7% have supported portfolios needing income in a yield starved world. The following graph shows the income growth of some of our MLP holdings:



Source: Factset

However, the shale oil renaissance in recent years and the appetite for income resulted in unprecedented inflows of money into this asset class. Closed-end Funds, Mutual Funds and ETFs have been created to allow investors to take advantage of what was a relatively unknown asset category prior to 2007.

Starting in April 2015, we have had a vicious unwind of these inflows as a result of "lower for longer" oil prices, and a pessimistic view of growth prospects. Hedge funds have observed the outflows from MLP ETFs and jumped in to sell ahead of the crowd.

As MLP prices weakened we repeatedly asked ourselves. "Do we sell and incur big tax bills for clients who have held for a long time and have very low cost bases, or do we ride it out?" Given the magnitude of the fall, we wish we had sold more, but we have been running cash flow valuation models on our midstream MLPs names and current prices seem to discount no-growth scenarios far into the future. We think that the recent decline in the prices of MLPs is too severe, and if oil prices return to the $60s in 2016-17, MLP prices should resume their growth. In the meantime, we are getting a tax deferred yield of 8%, on average, while we wait for the markets to price in revised growth prospects. It is possible that our outlook is too optimistic and we are being influenced by MLP's strong recovery after their 50% drop in 2008-09. However, the Saudi government had to sell $70 billion of assets last week to cover their fiscal deficit, and we think they will eventually let oil prices come up off the floor. Valuations are looking more attractive, but the space will need a stabilization of energy prices before fundamental players step back in**.** So for now we are still holding MLPS as we are not envisioning a no-growth scenario, but rather a moderation in growth going forward.

This market is still adjusting to a lower growth world and the Fed has not yet begun to raise interest rates. Recent weakness in the September U.S. jobs reports suggests that interest rates will likely remain at zero for the rest of 2015. The market repricing of all asset classes to a lower growth world should present us with opportunities to invest in higher yielding instruments and stocks with solid growth outlooks.

As we find attractive securities, we plan to unwind our hedges and invest our substantial cash holdings. Thank you for your patience in a difficult market.

Howard Chin
October 5, 2015

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There are differences among portfolios managed by SeaBridge in the Yield Growth strategy based on client-specific factors. Not all portfolios hold the same securities. Not all stocks held in the portfolio perform similarly. SeaBridge also manages portfolios in other styles. These portfolios differ from the Yield Growth strategy portfolios.