SeaBridge Investment Advisors, LLC

SeaBridge Yield Growth Strategy

Third Quarter 2016
Commentary

The global economy started off this year staring at a potential recession:

- An aggressive tightening of monetary policy forecast by the Federal Reserve was dampening appetite for risk assets (early in the year, Stanley Fisher, Vice Chair of the Federal Reserve, was calling for three to four rate hikes in 2016).
- A faster than expected slowdown in China with accelerating flight capital raised worries that the second largest economy was about to have a crisis.
- A meltdown in the oil prices raised the specter of large loan defaults by smaller exploration companies in the U.S.
- The U.S. dollar continued to strengthen slowing domestic economic growth and pressuring emerging markets with large dollar denominated debts.

By the end of the third quarter, most of these pressure points dissipated due to strong responses by the Fed and Chinese government:

- The Fed fell over itself with an outpouring of dovish comments to placate the collapsing markets. It now looks like we will have one ¼% rate increase in December, 2016.
- China unleashed a $1 trillion fiscal spending program, which continued to buoy China through 2016 and also most of Southeast Asia.
- Oil prices have stabilized at the $45-50 range and Saudi Arabia’s fiscal problems make it appear that they are willing to agree to production cuts.
- With oil higher, a credit crisis seems less likely, and an easier money outlook has money flowing into bonds. This eases rates and narrows credit spreads.
- The U.S. dollar stabilized, providing relief to U.S. companies’ foreign earnings and boosting activity in the emerging markets.

With more favorable conditions, equity and fixed income markets have posted respectable returns from the February lows. However, earnings growth has been anemic and we think the prices of both stocks and bonds are very full.

3rd Quarter Contributors/Detractors

The detractors (Financials, Technology, and Healthcare) in the 1st half of the year outperformed in the 3rd quarter. The prospect of a rate hike supported our names in the financial sector, led by the large cap banks plus **Kennedy Wilson** (a global manager of real estate), and **Charles Schwab** (a high quality brokerage firm.) However, the prospect of a rate rise dampened the outlook for **Crown Castle** (a REIT owning cell phone towers with a 3.8% yield) and **Dream Global Real Estate** (Canadian REIT owning commercial real estate in Germany with a 9% yield.)

Our positions in **Microsoft** and **Alphabet** benefited from favorable second quarter earnings reports. Microsoft has moved into the number two position in the internet cloud with rising prospects. Apple benefited from an unexpectedly successful launch and reception of its iPhone 7 and the second generation of the Apple Watch. We do not hold Mylan, but its EpiPen pricing fiasco fed the politicians' crusade against high drug prices. Some of our healthcare stocks (**Amgen, Shire**, and **Thermo Fisher**) did surprisingly well in spite of the negative rhetoric.

Some of our growth at a reasonable price (GARP) consumer names (**Lowe's, Home Depot**, and **QVCA**) struggled after weaker-than-expected earnings reports. Our emerging consumer companies continue to grow and execute on new initiatives, but gave back some of the strong gains from the first half of the year. In fixed income, our closed-end bond funds did well as the discounts to NAV (Net Asset Value) continue to close.

Portfolio Activity

We have four new high dividend yield positions in the Yield Growth portfolios which we hope will do well in the "lower for longer" world interest rate outlook; three of the four are outside the U.S:

- **Ascendas Reit (AREIT)** is Singapore's first and largest listed business space and industrial real estate investment trust. AREIT has a well-diversified portfolio of 102 properties in Singapore, 29 properties in Australia and 1 property in China. AREIT offers an attractive yield of 6.5%. Sixty two percent (62%) of its tenant exposure is in business parks with a stable lease profile. We believe AREIT will benefit from improving supply/demand dynamics in Singapore and overseas diversification into Australia, where valuation for properties have room to improve.
- **Taiwan Semiconductor (TSM)** is the world's largest contract chip manufacturer (fab) making integrated circuit chips for design companies that do not have their own fab. It has become the exclusive supplier of the A10 chip which powers the Apple iPhone 7. TSM's 50% plus market share is 5x greater than its next largest foundry competitor. Its economies of scale and leading innovative technologies give TSM the potential to earn excess returns. The company has a yield of 3.3% with dividends growing at rate of 12% in the last five years.
- **Vodafone (VOD)** is a leading wireless and fixed line operator in Europe with a strong presence in India and South Africa. The stock has underperformed its telecom peers in the past due to fear that the cost of keeping its networks up to current technology would weigh heavily on earnings. VOD is coming out of a period of heavy spending and free cash flow is expected to grow and adequately cover its 5.3% dividend yield.
- **MFA Financial (MFA)** is a well-managed company in the residential mortgage industry. MFA has a 10 year total return of 13% versus the S&P's total of 7.25%. MFA's management team is currently positioning the portfolio to credit sensitive residential mortgage assets. Their belief is that improving house prices will allow more job relocations, and that will accelerate mortgage repayments. MFA is buying mortgages below par, and getting accelerating repayments at par should give strong returns. Obviously, a fall into recession and a decline in house prices would be damaging to this strategy. The stock is yielding 10.5% and is trading at a Price to Book of .95x.

We sold **Wells Fargo** after concluding that the recent fallout from the fake accounts scandal will present headwinds to the stock from a legal, reputational, and financial perspective. Wells Fargo still has attractive banking franchises in corporate and mortgage banking, but we would rather have other banking stocks for the foreseeable future.

Outlook

We want to move the yield on the Yield Growth portfolios above 3%. Our challenge is to find good income plus growth in a fully priced U.S. market, with the rest of the world having greater economic challenges. A recent study by Cambridge Associates, the pension fund consultant, found only health care and banks to be reasonably priced in the U.S. Outside the U.S. the recovery of China allows Southeast Asia some breathing room. Europe has big political problems and Japan has deflation problems. Within this framework, to get yields up:

- We are looking at the senior debt, bank loan market. Floating rates senior bank loans offer yields in the range of 4-5% and are a defensive credit play because yields on holdings rise as interest rates go up. Closed-end funds that invest in senior bank loans use some cheap borrowed funds to leverage their portfolios, which brings their average distribution rate up to 5.5% – 6.0% range.
- With oil prices stabilizing we are doing an in-depth review of the MLP and energy spaces. Some companies are still distressed financially, but others may have turned the corner and provide adequate dividend coverage and a better growth outlook.
- Within equities, we are finding attractive valuation opportunities in dividend-paying GARP stocks. Our GARP companies are trading at free cash flow yields of 5.5% (Free cash flow is what the management has on hand to pay dividends, make stock repurchases or invest in the growth of the business.) That free cash flow is forecast to grow at 15% next year – although we know too well such growth prospects may not be realized. Dividend yields are below 3% and debt levels are reasonable. We look to these companies to provide the growth element in our portfolio. Examples are **Microsoft, Nestle, Amgen, Home Depot** and **Alphabet**.

The high level of cash and defensive positions in the portfolio reflect not only our cautious mindset in a market that is fully priced, but they also give us the flexibility to buy new positions and/or add to existing positions during times of volatility and market disappointments.

Thank you again for your support.

Howard Chin
10/4/16

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