SeaBridge Investment Advisors, LLC

SeaBridge Cautious Core Strategy

Third Quarter 2017
Commentary

Equity markets continued to post solid returns in the third quarter. The U.S. equity market, measured by the S&P500, delivered a return of 4.5% in the quarter, while Europe and Asia posted even stronger returns. Investment grade bond and high yield indices returned about 1.4% and 1.7% respectively. Large cap equities have done well this year, but small cap U.S. equities, which had lagged, had a strong month in September as Trump tax plans revived reflationary bets with an expectation that the proposed policies would boost the U.S. economy and inflation, putting an upward tilt on government bond yields.

The global economy continues to improve with developed countries leading and expanding at a healthy pace. We continued to see improved manufacturing data, rising global trade, and healthy employment growth. Global GDP growth estimates continue to surprise favorably, reversing the multi-year trend of downward revisions of expectations of GDP growth. Europe's economy has been a bright spot this year. Supported by the revival in credit growth, Europe's manufacturing industry is now growing faster than manufacturing in the U.S. We are encouraged that global growth is more balanced and synchronous today than at any point in the last five years. We believe that the absence of headwinds from deleveraging, fiscal austerity, and weak global trade – all drags since the global financial crisis - makes this expansion sustainable.

Although the outlook for growth is favorable, risks and volatility may be on the rise as global central banks are entering a period of tighter monetary policy and shrinking their inflated balance sheets. Specifically, the U.S. central bank (the "Fed") is starting in October to gradually unwind its $4 trillion balance sheet. The Fed is also looking to increase the interest rate again in December and potentially three more times in 2018. In Europe, although the economy is strong now, the recovery has been much slower than in the U.S. Probably before yearend, the ECB will likely signal it will slow bond purchases and start shrinking its balance sheet in 2018.

Central bank bond buying has pushed up stock prices and suppressed market volatility. Investors' current concern is how the swing from expanding to shrinking global liquidity will weigh on the performance of risk assets. The Fed and the ECB have telegraphed their plans well ahead to avoid surprising the market, and importantly, this initial incremental unwinding is taking place in an environment of healthier and stable growth. We like the continued expansion, growing earnings, and the prospect of a tax cut, but we recognize that a changing monetary regime could some day spook the stock market.

Highlights and Portfolio Activity

In the quarter, Cautious Core portfolios benefited from exposure to banks and life science companies. Banks got a nice boost as the Fed's stress test results cleared the way for increased dividend payouts and stock repurchases. We have a healthy selection of banks: **JP Morgan, Charles Schwab, and KRE,** an ETF investing in U.S. regional banks. Financials offer the potential to benefit from rising rates, capital returns from both dividends and share buybacks, and an improving regulatory backdrop. Healthcare /life science companies have lagged the overall market for the last two years despite producing solid revenue and earnings results. We hold two companies in this sector that have contributed to our performance this quarter. **Thermo Fisher (TMO)** is the largest supplier of research instruments and consumables to life science companies and has been rolling up smaller companies to become the one stop provider in the industry. Pfizer (PFE) is one of the largest pharmaceutical companies with an underappreciated pipeline while offering a dividend yield of 3.6%. In the near-term, **Pfizer** may find success with Xeljanz, potential game-changer in rheumatoid arthritis and Ibrance, a potential blockbuster in breast cancer.

Performance detractors this quarter included **Axalta** (a company making auto and industrial coatings which had a disappointing earnings report), **IBM**, and Master Limited Partnership (MLP) funds. The IBM investment is based on expectations of re-accelerating growth and margin expansion from Watson, its artificial intelligence engine. MLP fund performance was affected by distribution cuts at several major midstream oil and gas master limited partnerships. However, we think the yields of MLPs are still very attractive with distribution growth forecasted to still have higher growth in 2017 after the cuts (4% estimated growth) than in 2016 (2% growth).

Positioning

We use diversification and income dampening assets (i.e. fixed income, closed-end funds, master limited partnerships, and other bond-like surrogates) to try to achieve lower volatility (historically, an annualized volatility of 6.2%) and higher income. In Cautious Core portfolios, we generally allocate 20-30% to cash and cash alternatives, 25-40% to fixed income and bond-like equities, and the rest to high quality equities. Dampening assets such as bond-like equities (i.e. REITs, Business Development Companies, and German real estate), fixed income, closed-end bonds funds, Master Limited Partnerships and cash currently make up 67% of the Cautious Core composite. The current yield on the portfolio is approximately 3%, comparable to a yield of an investment grade bond portfolio.

Over the last year, we have moved away from fixed income, but still have positions in short duration fixed income funds and flexible opportunistic closed-end bond funds. We have been rewarded nicely this year by capital appreciation from our equity positions. We hope to continue to find large, high-quality dividend yielding companies which generate consistent free cash flow and dividend growth. We are also positioned in REITs that appear to be able to weather a rising rate environment. The income component of REITs is still very important, but we are more focused on companies that have attractive growth prospects. Of course, there are no guarantees that any of the positions in the portfolio will not lose money in the future.

Thank you again for your support.

Howard Chin
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