SeaBridge Investment Advisors, LLC

SeaBridge Yield Growth Strategy

Third Quarter 2017
Commentary

Equity markets continued to post solid returns in the 3rd 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 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 injected massive liquidity into the financial system, pushing up stock prices and suppressing 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, Yield Growth portfolios benefited from an 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 own a healthy selection of banks: **JP Morgan, Bank of America, Citibank, 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 stocks/life science companies have lagged the overall market for the last two years despite producing solid revenue and earnings results. We held two companies in this sector that have contributed to our performance this year**. 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. **Amgen (AMGN)** is a diversified biotechnology company with an underappreciated pipeline while offering a dividend yield of 2.5% and a divided growth rate of 10-13%.

Performance detractors this quarter included **Axalta** (a company making auto and industrial coatings which had a disappointing earnings report due to raw material headwinds), **QVCA (**a John Malone company that is the leading TV retailer of consumer goods), and **IBM**. **QVCA** was subsequently sold in the 1st week of the 4th quarter. We still like Axalta's ability to use its free cash flow to acquire smaller companies in a consolidating coatings industry. The IBM investment is based on expectations of re-accelerating growth and margin expansion from Watson, its artificial intelligence engine.

In terms of portfolio activity during the quarter, we initiated a small position in **Gilead Sciences**. Gilead (market cap of $104 billion) is a biopharmaceutical company that specializes in treatments for the human immunodeficiency virus (HIV) and cures for the Hepatitis C virus (HCV). The stock has been punished in the last two years reflecting concerns of a faster than expected sales run-off in its Hepatitis C franchise and a lackluster pipeline. In August, Gilead announced a $11 billion purchase of Kite's Pharmaceutical, the leading **biotech** company using the CAR T autoimmune enhancement therapy for cancer. This move lifts a big uncertainty about "what will GILD do with all that cash" that has accumulated over the last three years. Having controlled HIV infections and cured HCV, it is moving on to cancer.

Gilead's stock is trading at 11.4X P/E next year, a valuation that still reflects skepticism about GILD's drug pipeline and a discount to other established biotechnology companies. After the Kite purchase, Gilead will have at least $55 billion (cash plus additional debt capacity) at its disposal to build out its cancer platforms and other attractive therapeutic areas. Most big-cap biotechnology companies with healthy drug pipelines are trading at a P/E of mid-teens versus a 11x multiple for Gilead. GILD also offers a dividend yield of 2.5%. We initiated a small position in Yield Growth and will see how the pipeline unfolds to rebuild growth in the next 3-5 years.

We added to **Kennedy-Wilson (KW)**, a global real estate company that has a knack for identifying and capitalizing on undervalued real estate markets. KW has been one of our bigger detractors of performance in the last year. This is likely due to the pending deal to acquire Kennedy-Wilson Europe in which it currently owns a minority stake. The uncertainty surrounding Brexit is also an issue for the company which has substantial UK holdings. We viewed the pull back in share price as a buying opportunity. The acquisition adds an international diversification to the property portfolio much of which is currently tied to the West Coast of the U.S. We have held this company since 2013 and are confident of managements' ability to navigate the real estate market. Management owns roughly 17% (Chairman/CEO owns over 10%) and **Fairfax Financial's** Prem Watsa (the "Warren Buffet" of Canada) also owns 11.5% of the company. Kennedy Wilson is currently yielding 3.6%.

We sold our losing position in **Zojirushi,** a small-cap well-established Japanese manufacturer of rice cookers and stainless steel flasks. Our thesis had been based on the company's opportunity to grow its rice cooker business in the Chinese market, where the middle-to-high income consumers have a strong affinity for high quality "Made in Japan" consumer products. Over time, we underestimated the competition from Chinese manufacturers, hurting Zojirushi margins as the company had to ramp up promotions to drive sales.

Positioning

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 diversification and 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 and income. 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 41% of the Yield Growth composite. The current yield on the portfolio is approximately 3%, comparable to a yield of an investment grade bond portfolio.

Over the last three quarters, we have moved away from fixed income, but still have exposure to short duration fixed income funds and flexible opportunistic closed-end bond funds. We are also positioned in REITs that appear to be able to weather a rising rate environment. For our equity positions, we look to hold large, high-quality dividend yielding companies which generate consistent free cash flow and dividend growth.

Thank you again for your support.

Howard Chin
10/01/2017