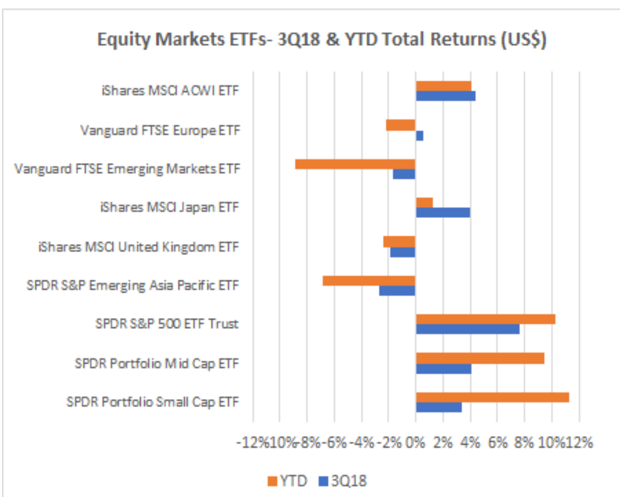
# SeaBridge Yield Growth Strategy

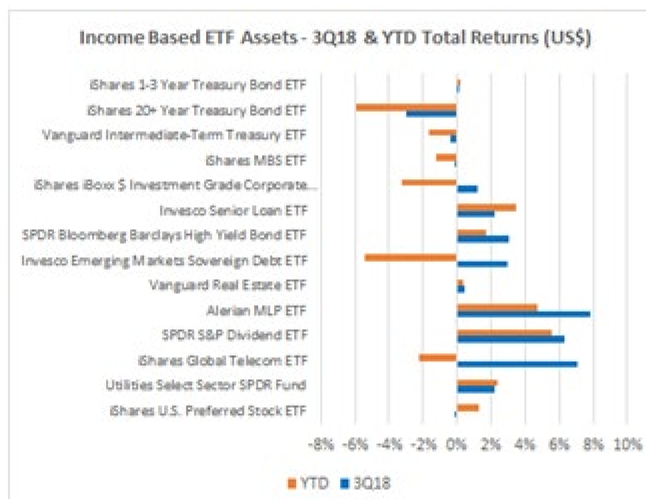
Third Quarter 2018

**Market Results**

U.S. markets were up strongly in the quarter, generating the best quarterly returns since 2013, while international indices were mixed. Europe eked out a very small gain for the quarter while emerging markets declined. Escalating trade tensions and the strong dollar hurt the emerging markets.

Income-based assets, such as dividend-paying equities, MLPs, REITS, Telecoms, and Utilities continued to rebound after a terrible first quarter. Most fixed income assets are still posting small negative returns YTD, reflecting the impact from rising interest rates. Bank loans with their shorter duration, floating rate nature, and higher correlation to economic growth have registered small gains YTD.



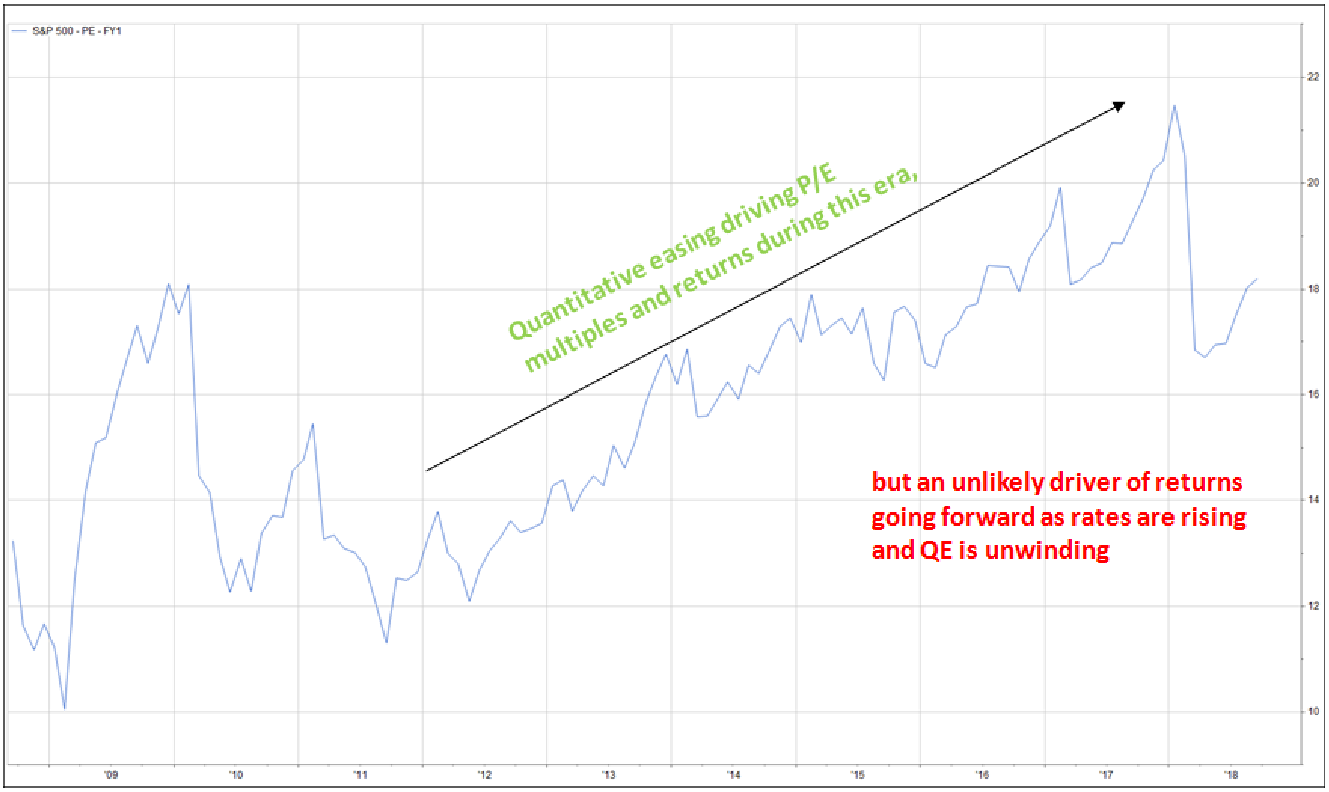




***Source: Factset***

**Economic Environment**

U.S. economic data is showing considerable strength and resilience though concerns about trade, global growth, and politics have tempered positive sentiment. Relatively low interest rates, solid earnings growth, and moderate inflation continue to serve as the basis for equities to trend higher. Credit (i.e. businesses' ability to service debt) has not shown any signs of the deterioration that usually occurs during the late economic cycle. Meanwhile, trade tensions between the United States and China continue to escalate and any meaningful dialogue between the two countries is not likely to occur until after the midterm election.

Volatility in the markets took center stage earlier in the year, but it has faded recently. Volatility is always unnerving, but we think our disciplined approach that relies on fundamentals will continue to benefit our clients. Although S&P 500 earnings are forecasted to grow 10% next year, global market conditions look to become more challenging, characterized by fading fiscal stimulus, stretched valuation across all asset classes, a shift toward less global central bank support, higher interest rates, and a potential rise in inflationary pressures.  Comparable to this year, we suspect market returns in 2019 should once again come below earnings growth as rising rates and less accommodative monetary policy are likely to pressure P/E multiples. Our goal is to remain defensive and opportunistic to investing as we navigate a more difficult macro environment.




**Source: FactSet**

## Portfolio Activity

We purchased a small starter position in **BBA Aviation (BBA LN)** in early August, getting a good entry point after the company missed earnings.  The stock continued to muddle downward since the initial purchase, providing an opportunity to add to our position in mid-September.  BBA aviation is a fixed based operator (FBO) providing aviation services at airports around the world.  Services include refueling, maintaining and stowing private and charter aircraft. BBA is the industry leader with 198 locations around the world.  The other big player in the industry is Atlantic Aviation, owned by Macquarie Infrastructure Corporation.   Most FBOs are mom and pop entities that operate only one or two airports, leaving room for BBA to drive consolidation in the market of 3000 independent operators.  Barriers to entry are high as FBO leases expire every 15-20 years and opportunities to displace a high-quality operator like BBA are infrequent.  The yield is around 3.3%.  BBA is producing a FCF yield of 6% and looking to grow cash flows at 8-10%.

We trimmed **Microsoft (MSFT)** after the company delivered another stellar earnings report in the third quarter.   Despite the reduction, MSFT is still one of our top 10 holdings, reflecting our view of MSFT's sticky customer base, annuity-like revenues, and the enormous cloud-based growth opportunities in Azure and Office365.   As of June 2018, Microsoft had $134 billion in cash and short-term investments (15.5% of its current market cap) on the balance sheet at its disposal while generating $32billion in free cash per year and forecasted FCF growth of low double digits. This is the type of high quality durable cash generative company that we look to have in the Yield-Growth portfolio.

We trimmed **AIA**, Hong Kong-based insurance company with a strong presence in Emerging Asia, but which may become a source of headwind due to the current in volatility in China and Southeast Asian countries. The company has held up well in the downturn in Asia markets.

We eliminated **Aberdeen Asia-Pacific Income Fund, (FAX).** We think there are better yielding and less costly income alternatives in the market.

**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 global 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 (e.g. REITs, Business Development Companies, and German real estate), fixed income, closed-end bonds funds, Master Limited Partnerships and cash currently make up 38% of the Yield Growth composite. MLPs are one of the few asset classes that are offering attractive yields. The current yield on the portfolio is approximately 3.1%, comparable to a yield of an investment grade bond portfolio. We look to increase the yield of the portfolio as interest rates are expected to rise in the coming year.

In fixed income, we have exposure to short duration fixed income funds and 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 cap, high-quality dividend growing companies with a management team that is focused on maximizing value thorough prudent capital allocation. The characteristics of large cap, quality, and income should also serve as a buffer in a stressed market environment. We use equities primarily to help grow the principal of the portfolio and provide inflation protection. We prefer dividend growers (for example companies with only 2%-3% dividend yield, but growing cash flow at 8-10%) versus high yield equities (for example 5%-6% dividend yield, but very little cash flow growth) in a rising rate environment.

The recent earnings season for our holdings was one of the strongest we have seen in years with many of our holdings reporting better than expected results on strong organic growth.

Thank you for your continued confidence in SeaBridge.

Howard Chin
10/4/18

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