SeaBridge Investment Advisors LLC

SeaBridge Asia Strategy

January 2014
Commentary

SeaBridge's Asia strategy turned in a modest performance during the quarter, with gains driven by our holdings in industrial companies. This sector had been a stealth winner for us all year as a number of our industrial holdings fit nicely within our over-arching investment theme of the rise of the middle class in Asia. Because wages are rapidly rising, process industries are fast improving their productivity through increased automation and, on the margin, becoming less reliant on increasingly expensive labor, which is migrating to better paying service industry jobs. Among the losers are our holdings in Thailand, which is in the midst of yet another political storm, sending foreigners scampering out of the Thai market. Prominent among other losers are a few retail related companies. Each, however, has company specific reasons that underlie the stock's lagging performance. Retail remains one of our favorite themes, one that is again tied to the rise in per capita incomes in Asia. We are in no way dismayed by the behavior of these stocks during the quarter. Instead, we are looking to add to our retail positions in the portfolio.

In our last quarterly commentary, we said that we expected markets, absent the traumatic exogenous event, to be directionless. This has been the case due to the dominant countervailing forces at work in the region –on the plus side, better economic data coming out of China and the US vs. on the downside, the threat of Fed tapering of its quantitative easing program and a rise in yields in the long end of the yield curve. A slowing China and the prospect for higher interest rates have capped market advances in Asia all year long. The subdued market environment, while disappointing on the surface, does provide a stable environment for disciplined investors seeking to outperform. With this in mind, we would take the opportunity to make two observations about the way we manage money. First, SeaBridge and its sub-advisor, J. W. Childs Asia Equities, have a proprietary portfolio construction system for our Asia strategy that produces both buy and sell signals, with the sell signal being the harder to achieve for most managers. During the quarter, we took the opportunity to trim positions in names whose price targets were reached and increased our holdings in companies whose stock prices declined on poor news flow. Secondly, all of what we do is based on fundamental analysis of companies. We may find our companies based on our macro view of the world, but we will only commit ourselves after a thorough analysis of the companies that goes well beyond the numbers. Utilizing the Hong Kong based staff of J. W. Childs Asia Equities, we conduct a lot of field work which allows us to assess company operations in a very hands-on way. Because of our belief in the theme of rising consumption in China, for example, we often visit malls, hotels and stand alone retail outlets in any number of cities in China and elsewhere in the region. These are not idle visits. We assess, among other things, the foot traffic, the quality of the displays, the thoughtfulness behind the layout of the stores and the fetching nature of the goods. We think about the attractiveness of the locations and the surrounding competitive threats. Our site visits are often the last box checked in the decision matrix for investment in a company. On the other hand, such a visit could produce grave doubts about the prospects for success. During the quarter for example, we checked a Shanghai outlet for a baked goods company we have owned for a while in the portfolio. We had been a believer in the firm as a purveyor of high quality goods at a very reasonable price. On our last trip, however, we noticed many more competitors offering similar fare at competitive price points. With new doubts about the company's competitive advantage, we decided to sell down our holding at near cost basis and move on.

Our discipline and on the ground presence in Asia through our sub advisor should serve us well in the coming quarters as we believe that Asian markets will continue to exhibit the staid characteristics of more developed markets. Asia should continue to be a stock picker's market.

China held its Third Plenum, a kind of general assembly for the politically connected, during the quarter. Statements emanating from such a meeting can be thought of as a long term country mission statement. This Plenum was heavy on reforms: to the economy, fiscal policy and the system of urbanization. As such, they contain important insights into the direction leadership wants to take the country but are unreliable as a roadmap to the variety of reforms to which China aspires. They say nothing about the timing or the quality of execution. That said, we are pleased by the market friendly statements made in the communiqués. The free market and property rights figure prominently in the Plenum's rhetoric. Some reforms, such as those related to migrant treatment, local government finances, excessive regulation, and, perhaps most importantly, the one child policy, are specifically designated. On the margin, the Plenum statements give us more confidence that China will successfully move from an economy heavy on assets and exports, to one of consumption of goods and services. And what is good for China is good for the region. We have gone long on hope with respect to the Plenum. Time will tell if it is long on results.

Looking into 2014, we see no major changes to the portfolio as we feel we are well positioned to benefit from rising incomes and the accompanying spending power in the region. Our view is that China will continue to defy the naysayers and surprise on the upside, that rising interest rates will not derail growth in the region, and that Asia will become a destination market for investors looking for stocks at a reasonable price. We look forward to the new year.

David Descalzi
December 31, 2013

The portfolio management approach used in the Asia strategy differs from that used in other SeaBridge strategies.