SeaBridge Investment Advisors, LLC

SeaBridge Yield Growth Strategy

Fourth Quarter 2015

Commentary

2015 was a challenging year for the Yield Growth (YG) strategy. The YG strategy was primarily hurt by our investments in Master Limited Partnerships (MLPs). Income and yield based names struggled, but GARP (Growth at Reasonable Price) and emerging consumer names were relative outperformers. Recall that the goal of the YG strategy is to provide a return over a full market cycle that captures benefit from equity exposure but with dampened volatility so that the risk is less than that of the equity market over the cycle. We use income dampening assets, hedges and cash to meet our volatility objectives. We believe that our investment principles of value plus the macro flexibility to invest across all asset classes, all market caps, and all geography give us a sustainable framework in which to operate.

In the table below, we present our thematic allocations for the YG strategy which highlights our current positioning and how our positioning has changed in 2015. We will be referencing themes and numbers from this table in our year-end review.

Yield Growth Composite
Thematic Allocations

Themes	1/1/2015	12/31/2015
Emerging Consumer	10.1%	6.5%
Emerging Financial	0.0%	1.9%
Infrastructure	0.4%	1.8%
EC + EF + Infra.	10.5%	10.2%
Intl. Hedged ETFs	0.0%	7.4%
GARP Healthcare	8.1%	8.1%
GARP Industrials	4.2%	3.2%
GARP Financial	8.3%	10.7%
GARP Technology	8.9%	9.6%
GARP Consumer	14.8%	14.8%
GARP	5.7%	2.8%
GARP Total	50.0%	49.2%
Bond Like	19.6%	9.4%
MLPs	9.4%	3.6%
Defensive	0.0%	0.4%
Bond Like + MLP+Def.	29.0%	13.4%
Hedges - Short ETFs	0.0%	5.8%
Fixed Income	1.2%	2.1%
Cash	9.3%	11.8%
FI +Cash	10.5%	13.9%
Total	100%	100%

Master Limited Partnerships are midstream companies that operate as pipelines, storage containers, and processors for the oil and gas industry. In the 4Q of 2014, we exited all our positions (around 4-6%) in the oil and gas exploration industry, but we still came into 2015 with a sizeable 9.3% MLPs weighting (based on the YG composite; individual client portfolio holdings vary based on client specific factors including account preferences, tax situation, etc.) The Alerian MLP index was down 33% for the year. MLPs were ravaged in the last two months of the year as tax loss selling and redemptions from mutual funds and closed-end funds contributed to the significant decline in prices. MLPs have been serial outperformers prior to this year for the last decade, but the industry collapsed in 2015 due to concerns about overcapacity and reduction in growth prospects. However, the reduced cost basis of long term holdings means that sales would create a large tax liability. As a result, we sold some of our holdings in 2015 but held most. The catalysts for MLPs to recover will be contingent on the recovery of oil and gas prices, the spending plans of exploration and production companies, and the accessibility of the capital markets to finance growth.

In the past few years, income-based assets have benefited greatly from quantitative easing and low interest rates as investors were hungry for yield in low interest rate environment. In 2015, income-based assets gave back some of the recent inflows and struggled as the Fed initiated the normalization process by raising interest rates by 25 basis pts. The table below highlights the returns in 2015. As you can see, it was a tough year for yield names.

ETFs (Ticker)	Asset Class	2015 Total Return
IET	7-10 Year Treasury Bond	-1.50%
LQD	Investment Grade	-1.25%
HYG	High Yield	-5.03%
MUB	Municipals	2.91%
PPF	Preferreds	4.30%
REM	Mortgage Real Estate	-9.24%
IDU	Utilities	-4.83%
VNQ	REITS (Retail, Commercial & Hotel)	2.41%
SDY	S&P Dividend	-0.73%

We were light in fixed income in 2015 and ended the year with a 2.1% allocation, all in the preferred space. We started the year with a 20% exposure to Bond-Like names. These are equity vehicles that invest in income producing assets around the world. Companies such as Blackstone, Starwood Property, Oaktree and Kennedy Wilson were slight detractors in 2015. We exited positions in our German real estate companies (Deutsche Annington and Deutsche Wohnen) and our mortgage real estate names (Northstar Real Estate and Northstar Asset Management). Overall, we reduced our holdings in Bond-Like names and ended the year with a 9.4% exposure.

We had a good year with our GARP stocks and ended the year with a 49.2% exposure to this theme. Our GARP consumer names (15% wt.) which have a heavy allocation to the housing industry (Lowe's, Home Depot, Mohawk and Lennar) outperformed while our media names had mixed returns. GARP Technology benefited greatly from Google, up 47%, but was offset by Apple, which was down 2% for the year. GARP Healthcare (Amgen, Shire, Thermo Fisher, and CVS) was a slight outperformer, but GARP Financial (JP Morgan and Wells Fargo were on the plus side, but Bank of America and Citigroup were negative) was mixed bag. We were light in the industrials sector because of the impact of the strong dollar and the slowdown coming from the emerging world.

On the international side, we have exposure to some region specific ETFs and companies that can benefit from the emerging consumer, primarily the Chinese consumer. Man Wah, which makes recliners in China for the U.S. market and Pigeon, baby bottles and accessories, were the big winners in 2015. Leading the detractors were L'Occitane, a cosmetic retailer, which we recently sold, and Baidu, a Chinese internet search engine. With strong internet growth, Baidu remains a core holding in the portfolio despite the loss. We exited our position in Samsonite and have initiated new positions in Kao (a Japan based company that sells diapers and cosmetics in China), AIA Insurance, and Zojirushi (Rice cooker expansion in China). Although the industrial side of China is slowing dramatically, the consumer and services areas are growing at a low double-digit rate as China continues to rebalance to a more consumer friendly economy.

Early in the year we took advantage of exchange traded funds (ETFs) which provide exposure to the European and Japanese indices with their currencies hedged out. These provide a means to get the benefit of the money printing by the ECB and BOJ. Because their money printing inflates local markets while weakening their currencies, these ETFs are attractive on an interim basis. These vehicles produced excellent 1H results, up 16.8% for DXJ (WisdomTree Japan Hedged ETF) and up 12.5% for HEDJ (WisdomTree Europe Hedge ETF), but gave back half of the gains in the 2H. We continue to look for growing companies world-wide to replace the ETFs. We ended the year with a 7.4% allocation to these WisdomTree hedged ETFs: Japan Hedged Fund (DXJ), Europe Hedged Fund (HEDJ), Small Cap Europe Hedged Fund (EUSC), and Japan Financial Hedged Fund (DXJF).

In our Yield Growth portfolios, we ended the year on a cautionary note. We are spooked by the volatility in August stemming from the growth and devaluation concerns in China and the emerging world. We have expressed our cautious view by reducing our exposure to the emerging markets, raising cash levels, and buying hedges which are designed to do the opposite of what the market indices do. This lets us hold stocks of companies whose earnings growth we trust, but cut our exposure to declines in the overall market. The hedges are not held as long-term investments, but are used tactically. To do this we used three hedge ETFs:

- RWM -Short Russell 2000 - this ETF reflects an inverse position to the Small Cap market, where valuations are fairly elevated;
- PSQ -Short QQQ - this ETF reflects an inverse position to the Nasdaq 100, an index that contains some of the highfliers in this market, such as the Biotechs, Social Media and Technology names; and
- EUM -Short MSCI Emerging Markets - this ETF reflects our fear of the economic contagion in the Emerging Markets stemming from the weakening growth prospects in China.

Overall in 2015, the RWM has helped us, but we ended the year with a slight loss to the EUM short position. There is also a slight loss in the PSQ short position, but going into 2016, we think that it could protect the portfolio if some of the highfliers (Netflix, Amazon, Tesla, and Facebook) in the index begin to unravel.

In terms of market exposure, each dollar we short is the cash equivalent of two dollars of cash in that it neutralizes the market exposure of some other holding in the portfolio - leaving, we hope - the superior earnings growth of our stock held, rather than being sold to raise more cash. The exact combination used to reduce volatility varies among our Yield Growth portfolios, but the net result is that in most portfolios we are holding the cash and short equivalent of more than 20-25%% cash going into 2016.

In YG, we still prefer cash over fixed income as upcoming rate hikes and reduced credit market liquidity have the potential to cause volatility that can overwhelm the slim coupon currently being offered in the markets. Preferreds and municipals were the two best performing assets classes in the fixed income space and they both still warrant investment scrutiny in the New Year. We are monitoring for potential contagion in the high yield space, especially in the energy industry, that may lead to wider spreads in the closed-end bond funds and present potential investment opportunities. In equities, we still like domestic consumption stories in the U.S. An improving labor market, low energy and gas prices, rising home prices, and low inflation bode well for the consumer wallet in 2016. However, valuations for some sectors in this area are fairly elevated and will need strong earnings to come through again.

Other bright spots include companies that are embracing new technologies (cloud, internet of things, e-payments, robotics, e-commerce, etc) to drive sales and take market share. Despite potential Fed hikes in the coming year, monetary policies across developed countries should still be accommodative, but we are not certain that it will be sufficient to maintain the gap between valuation and fundamentals. In other words, we think market multiples are more likely to contract than expand in a slow top-line growing world and potential peak margin environment in 2016. We will continue to look for companies with growing and reliable cash flows and solid balance sheets as a way to offset potential multiple contraction risk in the markets.

Thank you again for your support and we hope to serve you well in 2016. I wish you a Happy and a Healthy New Year.

Howard Chin
January 5, 2016