SeaBridge Cautious Core Strategy

Fourth Quarter 2016
Commentary

The SeaBridge Cautious Core Strategy has a strong mandate to dampen volatility and protect portfolio principal. 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. We use income dampening assets (i.e. fixed income, closed-end funds, master limited partnerships, and other bond like surrogates), as well as hedges and cash to try to meet our volatility objective (1/3 of equity market risk). Our clients have chosen this style for capital preservation with a yield potential and some capital appreciation through our equity allocation. Therefore, we see protecting values when the storm clouds are dark as an important part of our mandate.

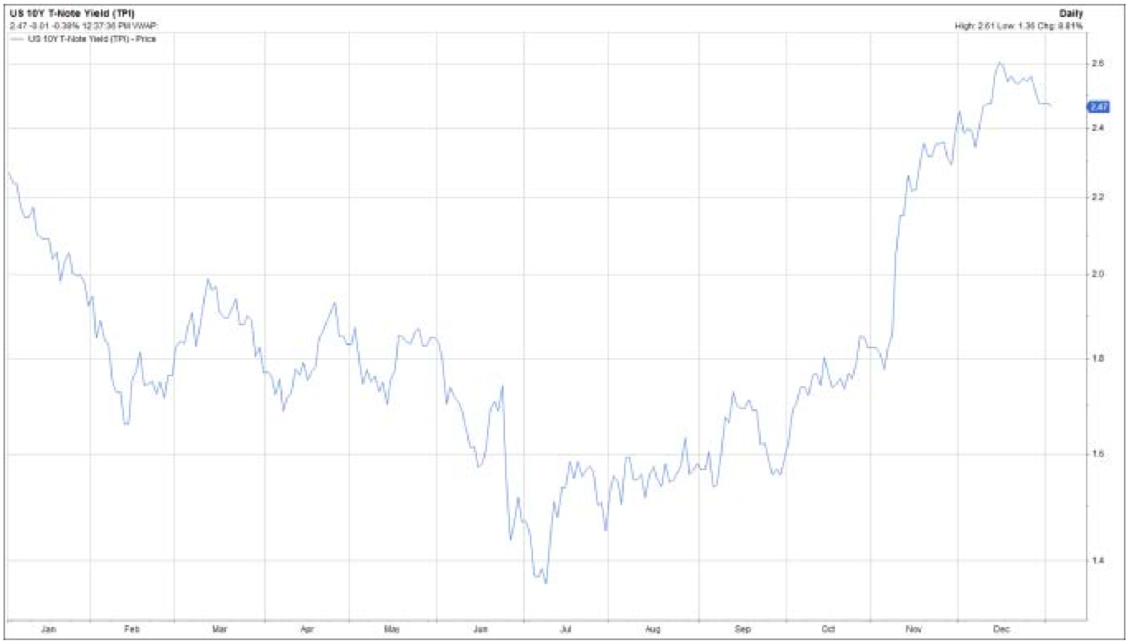
We entered 2016 with a fully priced market where recent gains had been driven mostly by multiple expansion (as opposed to earnings growth). With the Fed raising rates, we focused on protecting capital and positioned the portfolios defensively, using hedges, income-based assets and the stocks of high quality non-cyclical companies.

During the first week of January, the market pitched into a sharp drop and it looked like we were heading into another major market downturn. Oil prices were declining rapidly, money was fleeing emerging markets, especially China. The U.S. Fed had raised rates in December 2015, and were talking of further aggressive tightening. This spooked the markets and caused the U.S. dollar to soar. We continued our defensive stance using hedges to reduce market volatility.

However, by mid-February, global central banks panicked as they viewed the market collapse and went on a major “we did not mean it” speaking campaign. Unbeknownst to the rest of the world, The Peoples Bank of China pumped $1 trillion of liquidity into the Chinese economy to halt its slide. As these emergency measures converged, the markets recovered strongly. Although our defensive posture cost us some performance relative to the U.S. stock market over the course of the year, we felt that these were prudent moves to try to protect capital in very uncertain times (high equity valuations, low interest rates, the 1Q16 market downturn, the Brexit vote, and the U.S. election) for clients in this strategy.

During the first quarter market swoon, we added to fixed income Closed-End Funds (CEFs) because fear in the markets caused their discount to net asset values to widen considerably. Fixed Income and Bond-Like equities did well for the 1st half of the year as rates declined to historical lows, but gave back some of the gains as interest rates started backing up in the 3rd quarter and accelerated upward after the election of President Trump. After the election, we sold some of the funds and Bond-Like equities to reallocate to less sensitive interest rate ideas.

US 10 Year Treasury Note Yield (2016)



Source: Factset

Equities had a mixed performance in the Cautious Core portfolios. The election of Donald Trump kicked off a huge rally in cyclical stocks. The Presidential campaign rhetoric about controlling drug prices weighed on the performance of our healthcare holdings (**Shire, CVS, and Thermo Fisher)**. CVS stock got hammered when Walgreens bid away the pharmacy business of government workers, transferring 40 million drug accounts from CVS' pharmacies.

Rising interest rates caused some of our housing related stocks (**Home Depot, Lowe's and Lennar** (we exited in the 4th quarter)) to languish even though reported results were good.

The prospect of rising interest rates from faster growth and higher inflation has pushed the Dollar to further new highs in the fourth quarter. The strong dollar hurt our international holdings by reducing their values, expressed in Dollars. We hold those stocks for their quality or growth potential based on factors outside the immediate U.S. context – i.e. their risk diversifying characteristics.

Fortunately, we did have some bright equity spots in the portfolio, which for the year as a whole more than offset our laggards. First, the earnings growth on the equities gives the overall portfolio a growth rate of about 4% percent a year. So with the passage of time, if the market holds steady, hopefully portfolio values should rise. Our financial stocks **(JP Morgan and Charles Schwab**) had been a drag on performance for 18 months, but we held these as a hedge against rising rates and, as rates rose in the summer, their prices advanced 25-40%. AT&T, Comcast, Microsoft, Deutsche Post, and Misumi also generated healthy capital appreciation for the portfolio. Finally, the pending acquisition of Time Warner by AT&T contributed the highest return for the portfolio.

For the year as a whole, most Cautious Core portfolios provided a modestly positive return. Given the stock markets' elevated level, and the shift to rising bond rates, that is about the return we hope to achieve in

Cautious Core. Our concern for 2017 is that the reality of growth under a Trump Administration does not meet the soaring hopes. That could cause the stock market to sell off sharply and interest rates to fall again. We hope our portfolio balance can continue to deliver positive returns in such event.

Recent Portfolio Activity

The Trump victory, with the prospect of fiscal stimulus on top of full employment, shifted the outlook for interest rates from "lower for longer" to "rising fast sooner". As we communicated with you, in mid-November we did a major shuffle of holdings to remove hedges **(Gold and Fairfax Financial)**, bonds (**Preferreds and longer duration investment grade bond funds**) and bond surrogates **(Vodafone, Leg Immobilien, and Medical Property Trust)** which would be hurt by rising rates. We replaced them with businesses which provide not only a good yield but which we hope will benefit from rising rates.

We added to Mortgage REITS **(MFA Financial, Blackstone Mortgage Trust, and NRZ Residential)** and Business Development Companies **(Ares Capital)**. These companies offer 8-10% dividend yields and benefit from a higher interest rate environment due to their floating rate loan and mortgage portfolios. We also added to floating rate income bond funds that are offering yields of 5-7%.

During the second half swoon in real estate investment trust prices, caused by rising rates, we initiated positions on two data center REITs, **CyrusOne and CoreSite Realty**. Data center REITs house the server farms for cloud computer companies like Amazon Web services. They offer attractive yields (3-4%), and also double-digit growth prospects driven by growing global internet traffic and accelerating cloud storage adoption.

We had reduced our positions in MLPs during 2015, but the drop of oil prices below $30/bbl caused remaining positions in Enterprise Products, Magellan Midstream, and Maingate MLP fund to fall further during the January-April oil price collapse. With the Saudi/Russian oil pumping agreement late in the year, oil prices have returned to levels that give the MLPs a positive outlook. We think both yields and growth should be attractive from here, and we have again added to the sector. Enterprise Products remains the highest quality MLP in our judgment, with a strong growth outlook as exports of natural gas liquids commence. For new additions, this time, we are buying MLPs through closed-end funds which avoid the K-1 tax filing problems, so clients should be spared that inconvenience for these securities.

Bank stocks have been soaring on the prospect of improving net margins and less regulation. We added an ETF holding regional banks as that is the sector which should benefit most from an increase in lending and reduced regulation.

Conclusion

We continue to focus on analyzing what's going on in the world and trying to position the Cautious Core portfolio to do well in the environment we see developing. We try to incorporate some growth opportunities in the portfolio, but our primary emphasis is on capital protection. Based on our current outlook, the changes in portfolio positioning (2016 to 2017) as we enter 2017 are:

- A somewhat higher portfolio yield (3.1% vs. 2.2%), driven by businesses which should not be badly hurt if interest rates continue rising.
- More U.S. holdings, which should suffer less if the Dollar remains strong.

- Several companies which are pro-cyclical and should benefit from accelerating domestic business activity as the Trump agenda gains traction.

- Expanded exposure to oil and pipelines, which should benefit from operating leverage as $45 oil causes domestic drilling to resume and exports of refined chemicals begin.

- New exposure to data center REITS, which should grow with the expansion of cloud computing.

- In the box below is a sample allocation of a Cautious Core portfolio at year-end. Cash and income-based assets make up 68.5% of the portfolio. We have an allocation to fixed income assets in floating rate loans, investment grade bond funds, high yield, and flexible opportunistic bond funds. We try to find bond funds with shorter duration to protect against rising interest rates. Bonds are still an important component of Cautious Core because they serve as a defense against a deterioration of economic conditions and provide downside protection relative to equities.

Bond- Like Equities (REITS (Residential, Commercial, and Data Center) and Business Development Cos.)	19.7%
Fixed Income	18.0%
Master Limited Partnerships	5.8%
Equities	31.4%
Cash (incl. short duration bonds)	25.1%
Total	100.0%
Portfolio Yield	3-3.4%

Note, weightings in your portfolio may differ from these sample weightings due to various factors.

Thank you for your continued confidence.

Howard Chin
1/3/16

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