

**SEABRIDGE**  
INVESTMENT ADVISORS, LLC  
**SeaBridge Inflation Fighter Strategy**  
Fourth Quarter 2016  
Commentary

2016 was a challenging year for the Inflation Fighter Strategy. There were a number of holdings that went against us and few that went in our favor.

The year began with a market panic and, as that ended, the Spring saw a market rush to safety and yield stocks. As those started fading in June, cyclical stocks put in a strong year-end rally. Inflation Fighter is a strategy of companies which we perceive to have rapid, sustainable growth, trading at reasonable prices in terms of the growth rate. The bad news is that performance lagged in 2016; the good news is that the falling multiples but continuing growth brought the prices of previously “unreachable” companies into a buying range. We added starter positions in **Regeneron, Cognizant Technology, Red Hat, Amazon** and five of the digital cloud REITS.

We got it wrong on the energy sector. We owned **Wasion Group** (a Chinese electrical grid equipment supplier) and **SunPower** (a solar developer in the US) in an effort to take advantage of the secular shift to cleaner and more efficient energy. We misjudged the rapidly changing landscape and sold them in January and August respectively at losses. We sold them in January and August respectively at losses. We were skeptical that the Saudis, Russians, and Iranians would get together for an oil production cut, so we also missed the benefits of the oil price recovery.

Early in the year, we held **WisdomTree Japan Hedged Equity Fund**, which is a Japanese market proxy with the currency hedged out. This was based on the expectation that the BOJ would have to cut rates again in March, the Yen would fall, and the Japanese stock market would rise. The BOJ did cut rates but the Yen went up and the market went down. We covered at a loss.

We held a number of health care stocks in spite of the campaign rhetoric about “excessive” drug price hikes driving stock prices down. Health care was the only money losing sector in the market in 2016. Given the advances in drug discovery and healthcare we still like the sector and are hoping that it will bounce back in 2017.

We sold the travel booking leader, **Priceline**, due to multiple risk in the market swoon at the beginning of the year and failed to buy it back – it recovered strongly. We owned and still own three John Malone stocks. Two of these have been a significant drag on performance for the year. **Liberty Global LiLAC** (a Caribbean and Latin American cable consolidator) is getting hurt by emerging market sentiment, and **QVC** is suffering from reduced spending by its online buyers. We think each has a good business model and is cheap. We are standing by Malone’s ability to wring profits from his leveraged subscription buyer models.

In the positive category, our big winner was **Bank of America** as the whole financial sector received a lift from an anticipated steepening of the trajectory for interest rate hikes. **CP ALL** performed well. It is the 7-Eleven convenience store operator in Thailand which dominates the market. We also had gains from our technology holdings – **TenCent** and **Broadcom**. As noted above, we made substantial additions to our technology holdings as stock prices rose less rapidly than earnings.

The Trump victory and what it means dominate the outlook for 2017. Given the strength of the market rally in the fourth quarter, it would be foolish to take a view adversarial to “things will be better starting January 21, 2016.” “Animal Spirits” and hope for the future matter a lot. At the same time, what has changed is public confidence, enthusiasm, and market prices, and most of the underlying economic forces remain the same aging, indebted, deflationary mix – at least so far.

1. Much of the proposed Trump agenda seems to be a series of “deals” to help business. These include lower corporate taxes and reduced regulation. Importantly, all variations of the Trump tax plan include a fuller, current

expensing of capital goods purchases. If enacted, such a provision increases the probability that the much awaited capex cycle in the U.S., absent since the Great Recession, will begin.

2. Trump's proposed plan to let international businesses repatriate cash with a 10% or 15% tax would almost certainly unleash a return of the \$2 trillion sequestered overseas. The taxes on this repatriation would help close the fiscal deficit caused by other tax cut and spending plans. This is a virtuous circle with little net cost. If enacted, it would be, almost certainly, a positive for business. If the capital repatriation is tied to certain types of spending it could further boost the economy. Seizing such opportunities are examples of the "pro-business agenda" that makes imaginations soar regarding "more to come."
3. The Federal Reserve has been "waffling" on when to raise rates, with the December increase widely telegraphed. Trump's fiscal proposals put the Fed on notice that they may be "behind the curve" on increases, and one of the uncertainties for 2017 is how many times the Fed will increase rates. In any case, it is clear that "lower for longer" has morphed into "higher, more quickly". What this does to the housing recovery is one of the questions looming over the 2017 outlook.
4. The combination of relatively full employment, Fed rate increases, and Trump's fiscal stimulus plans have pushed the Dollar higher against the currencies of most trading partners. This means that foreign earnings will be translated into fewer Dollars, so the earnings growth outlook for global companies is diminished. This has been one of the factors weighing on many of our growth companies. The fact that many of these companies are still able to report double digit earnings growth, in spite of weak foreign currency translations, underlines how powerful a few technology trends are in driving growth in this era.
5. So what are the drivers on which we are focusing the portfolio?
  - a. Technology generally, and mobile communications specifically, remain driving forces in many facets of life. Social media, retailing, work patterns and family interaction are all evolving as the cell phone becomes "the central gadget" in lives. Our portfolios are focused on various aspects of changing technology. We believe growth in this sector will continue to drive the economy.
  - b. Cloud computing is a new topic in investment categorization. During the summer, the swoon of the "digital REIT" stocks (companies that own the physical buildings that house the server farms for Amazon Web Services, Microsoft, and other cloud providers as well as enterprise clients) gave us an opportunity to accumulate positions. We now have initiated positions in five stocks within this category. Late in December, our work in this area convinced us that **Amazon** is not as overpriced as we had thought, considering the leading position of AWS (Amazon Web Services). We added a 0.75% starter position to the portfolio.
  - c. Repressed interest rates, namely the rebound therefrom, is in early stages. After 35 years of falling rates it is hard to see all the ways that "lower for longer" has been baked into our lives. The strong rally in financial stocks has been the first responder to a change in the interest rate outlook, and more will probably follow. Our "long suffering" exposure to financials finally started turning the corner.
  - d. Biotech and Healthcare are changing rapidly. Drug development is rapid, but FDA approvals are unpredictable; the Obamacare system is up for major revisions; politicians are pounding on the theme of getting health care costs down. Our exposure to the biotech and healthcare sectors was a major drain on portfolio performance this year. But opportunities seem great; stocks seem very cheap; and we are sticking with our emphasis in this sector.

In terms of the portfolio line-up against these macro-drivers, it has been an active quarter as we have added the following new holdings:

1. Technology (most heavily weighted sector in the portfolio):

- a. **Cognizant Technology Solutions** – They are an IT consulting and IT outsource firm. It was spun out of the Dun & Bradstreet IT department in the 1990s with an Indian CTO. He built a strong offshore workforce in India to supplement the on the ground consultants in the U.S. It is a heavy user of H-1B visas for installing cloud and other programs for customers. For years CTSH grew fast and traded at a premium to comparable stocks. In the last few years, it has grown revenues but not gotten the margin expansion that one would expect from increased operating leverage. The financial sector is its largest customer vertical which has been suffering. Recently Paul Singer at Elliott Management announced a \$1.4 billion activist stake and plan to boost margins and capital returns.
- b. **Red Hat** – They are a leader in the open-source software movement. The company leverages a vast community of developers/programmers as well as internal R&D to continually improve their “free” open-source software. They bundle this “free” software with a paid service and support program. The flagship product is the Red Hat Enterprise Linux (RHEL) Operating System (OS). RHEL continues to take share from other operating systems such as Windows and UNIX.

## 2. Cloud Computing:

Digit REIT Sector - During the first half of 2016, data center REITs and providers appreciated rapidly due to elevated buildout activity from the hyperscale cloud computing providers. When companies started reporting softer bookings in the 2H of the year, the group experienced a 10-20% correction to date and are back at we believe are reasonable valuations. Even though booking levels will likely not gather the same momentum as early 2016, we believe there are secular tailwinds for continued adoption of the cloud. Global IP traffic is growing over 20% per year. Combining this with capacity available for sale being at a 4-year low and pricing metrics slowly ticking up from the lows made in mid-2016, provides a good entry point, we think.

- a. **InterXion** - European data center provider.
- b. **CoreSite Realty** - Smaller U.S. digital REIT.
- c. **QTS Realty Trust** - Smaller U.S. digital REIT.
- d. **CyrusOne** - Smaller U.S. digital REIT.
- e. **DuPont Fabros Technology** - U.S. digital REIT specializing in the largest wholesale clients – AWS, Microsoft, et al.
- f. **Amazon** - One of the many factors that we consider when evaluating a company is the size of the economic moat: in other words, the special characteristics that allow a company to maintain a competitive advantage over a sustained period of time, which in turn allows for outsized profits and/or market share. They come in many forms: efficiencies of scale, network effect, brand names, high switching cost, etc. Amazon has wide moats (most notably - efficiencies of scale – network – even brand). In Amazon’s core businesses, Prime, Marketplace and AWS are killing the competition. We know Prime well as the boxes come to our door in accelerating numbers.

What has kept us away from the stock is the “80 times earnings” valuation. However, as we were taking apart their growing advantage in cloud computing, we observe that stripping out the growth in capital expenditures as well the massive amounts of capital leases, a rough valuation for the earnings power looks more like 30+ times 2017 cash flow, but growing at 25% a year. This seems like a reasonable valuation. Rapid grow companies with high valuations do provide an “extra multiple risk.” We decided to try to control that risk by taking a small starter position. If the market swoons and the AMZN falls sharply, we can add.

## 3. Repressed Interest rates:

- a. **SPDR Regional Banking ETF** – Banks in general should benefit from a rising rate environment, and regional banks we believe will benefit most from deregulation.
- b. **Citigroup** - We bought in early November, but sold after a nice gain due to possible impact of a proposed Trump tax cut on the present value of Citi’s large deferred tax asset – the loss carry-forward that Citi is still carrying from the Global Financial Crisis.

## 4. Health Care:

- a. **Regeneron** - Although market share growth in Eylea (macular degeneration) is slowing, Fovista (highly anticipated drug from competitor Ophthotech) failed phase 3 studies. This should ease some of the

pressure on Eylea. The company has a strong pipeline of other drugs and is confident about the upcoming approval of Dupixent (eczema). Even with the recent pullback, REGN is trading on the expensive end (roughly 25 times earnings) but accompanied by high teens to low 20s growth. As with Amazon we took a starter position.

Additions to other themes:

5. Consumer Staples:

- a. **HRG Group** – We sold Spectrum Brands (a consumer products company specializing in defensive categories such as batteries) and redeployed the proceeds into HRG group. HRG’s main asset is its 58% ownership interest in Spectrum Brands. The company is trading at high teens discount to NAV. The Board is reported to be focused on collapsing the discount by considering options including selling the company. This potentially not only removes the discount, but also possibly gets a premium for the control block of Spectrum Brands.

6. **iShares MSCI Mexico** – Taking this position is based on the theory that the Trump bashing of Mexico has pushed this portfolio of leading Mexican companies and the peso down too far. Mexico is heavily integrated into the U.S. economy. We believe after the election fervor has passed, if the U.S. economy does well, Mexico should do well.

As we enter 2017 we have a portfolio of companies which, based on consensus estimates, are growing sales about 9% and growing earnings about 16% per year. They are earning about 20% on their book equity, and trading about 16 times cash flow. There are some “one-off” positions in the portfolio, but in general these are “the achievers” leading the advances in technology. We are aware that if the market takes a dive or there is a loss of confidence in the new Administration, these companies’ prices could fall a lot. However, we believe they are secular leaders, and we have limited the size of several of our positions which we would be glad to increase at lower prices if given the opportunity.

We believe that our clients investing in the Inflation Fighter strategy have substantial means and can take the risk of higher multiple stocks for a small portion of their portfolio. If we have misjudged the appropriateness of this strategy for you, please let us know and we can discuss shifting your assets to a more conservative strategy.

You will likely notice sales of some holdings early in January. Our cash is a bit lower than we would like, given the uncertainties and the market’s overall valuation. We have been letting the Trump rally run, postponing gains until the new year.

Best Wishes in 2017,

Garnett Keith  
Matt Falkowski  
1/4/17

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