SeaBridge Yield Growth

Fourth Quarter 2016
Commentary

The goal of the Yield Growth ("YG") strategy is to provide a total return over a full market cycle that benefits from some global equity exposure, but dampens portfolio volatility such that the risk of a major drawdown in value is less than that of the equity market. 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 (2/3 of the market risk). We are very much aware that people have chosen this style for increased income and less volatility. Therefore, we see that protecting values when the storm clouds are dark is an important part of our mandate. That is our goal, although with high uncertainty in a fast changing world, there are no guarantees that we will be successful.

Results for 2016 were disappointing. Our strategy of adjusting a mix of equities and dampening assets to protect capital and realize growth based on our analysis of prospective economic and market factors did not deliver the hoped for results this year.

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 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. 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 and selling some of our most volatile holdings.

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 People 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. Our defensive posture hurt performance relative to the U.S. stock market during the first half of the year.

In May and June, we remained cautious as Britain's BREXIT vote approached. But the U.S. market continued to recover. We specifically did not reestablish positions in oil or pipelines, because we doubted that OPEC would agree to production cuts and maintained our focus on trying to avoid significant market drops in the portfolio. Oil actually continued to recover throughout the year, ending the year as the best-performing sector, up 24%. In late November production cuts were agreed upon that pushed oil back into the $40-55/bbl price range.

The election of Donald Trump kicked off a huge rally in cyclical stocks. 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.

The Presidential campaign rhetoric about controlling drug prices weighed on the performance of our healthcare holdings (**Amgen, Shire, CVS, and Pfizer).** CVS stock got hammered when Walgreens bid away the pharmacy business of government workers, transferring 40 million drug accounts from CVS' pharmacies. The healthcare sector declined 4% in 2016. It was the worst performing sector.

Rising interest rates caused some of our housing-related stocks (**Home Depot, Lowe's and Mohawk**) to languish even though reported results were good.

So even though cyclical stocks were rallying, a number of factors converged to pull down our portfolio returns in 2016.

Fortunately, we did have some bright spots in the portfolio, which for the year as a whole roughly offset our disappointments. First, the earnings growth from the stocks in the portfolio means that the portfolio as a whole has a value that is increasing at about six percent a year. So, with the passage of time, if the market holds steady, portfolio values should rise. Another positive was that, during the first quarter market swoon, we added to fixed income Closed-End Funds (CEFs) because fear in the markets caused their discount net asset values to widen considerably. As markets became less frightened later in the year, these discounts closed and we sold some of the funds at a profit.

Our financial stocks **(Bank of America, Citibank, J.P. Morgan, and Charles Schwab)** had been drag on performance for 18 months. We held these as a hedge against rising rates and, as rates rose in the summer and fall, their prices advanced 25-40%.

Finally, the pending acquisition of Time Warner by AT&T contributed a 25% positive surprise for the portfolio.

However, for the year as a whole, the bad news and the good news roughly offset each other and the portfolios were about flat.

<u>Recent Portfolio Activity</u>

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 those bonds and bond surrogates which would likely be hurt by rising rates. We replaced them with businesses which provide not only a good yield but we hope will benefit from rising rates.

We added to Mortgage REITS **(MFA Financial and Blackstone Mortgage Trust)** 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.

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 will be spared that inconvenience for these securities.

Bank stocks have been soaring on the prospect of improving net margins and less regulation. Fortunately, we own a full roster of banks. 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 Yield Growth portfolio to do well in the environment we see developing. We try to benefit from growth opportunities but limit the downside. 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 we think 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.
- We expect we will be hedging the portfolios somewhat less in the future – if clients need significantly less volatility, they could consider switching to our Cautious Core strategy.

Thank you for your continued confidence.

Howard Chin
1/3/17

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There are differences among portfolios managed by SeaBridge in each strategy based on client-specific factors. Not all portfolios hold the same securities. Not all stocks held in the portfolio perform similarly. Some client accounts may not have as much cash reserved as other accounts managed in the strategy due to client withdrawals or other issues. SeaBridge manages portfolios in several styles.