SeaBridge Yield Growth Strategy

Fourth Quarter 2017

2017 was an exceptional year for global equities. Equities kicked into overdrive in 2017, galvanized by synchronous global growth, accommodative central banks, deregulation fueling the optimism of U.S. small businesses' spirits, and the passage of tax cuts. The markets were surprisingly resilient throughout the year with investors buying every slight pullback. After a two-year earnings recession, corporate earnings were robust and were led by improving top line prospects. S&P 500 earnings growth in 2017 is expected to be 10.3%.

A steady global economic backdrop has fostered an environment where we think equities should continue to perform into 2018. Improving GDP growth is expected to translate into solid organic sales and earnings growth for companies. Corporate earnings growth has been elusive in the three years prior to 2017 with S&P profits flat during that period at around $118. S&P 500 earnings per share are currently forecasted to increase to $147 in 2018, according to Factset. The S&P 500 is now trading at 18.4x 2018 earnings, high compared to history, but not high relative to interest rates. We do have an upward bias on interest rates based on expectations of unwinding policy accommodation from central banks, rising inflationary pressures, and robust economic growth. However, we acknowledge that the sustained appetite for yield and a lack of persistent inflationary pressures may keep yield increases modest and gradual.

Equities significantly outperformed the credit markets by a significant margin in 2017. S&P delivered a total return of 21.8%. Non-U.S. market exposure was rewarded as shown by the MSCI All World return of 24.6%. Emerging markets had a stellar year with 30%+ returns. Investment grade (LQD ETF), high yield credit (HYG ETF), and preferreds (PFF ETF) returned 7.1%, 6.1%, and 8.1%, respectively. Among other income oriented investments, utilities (XLU ETF) generated a 12% return. Dividend equities (SDY ETF) returned 15.8%. Lastly, Master Limited Partnership (MLPs: AMLP ETF) had a difficult year with a return of negative 7.9%, while U.S. real estate investment trusts (VNQ ETF) returned 4.9%.

Quarterly Highlights

In the quarter, Yield Growth portfolios benefited from exposures to banks, industrials, and housing related companies. We hold a healthy selection of banks/financial services companies: **JP Morgan, Bank of America, Citibank, Charles Schwab,** and **KRE**, an ETF investing in U.S. regional banks. Banks got a nice boost at year-end as interest rates increased. Our financial holdings should also benefit from future capital returns (from both dividends and share buybacks) and an improving regulatory backdrop.

Our industrial companies benefited from solid 3rd quarter earnings reports for **Honeywell, Deustche Post, and Misumi.** These three companies generated better than expected organic growth along with continued margin improvements. **Axalta,** a global paints and coatings company, was the beneficiary of two takeout offers, one from Akzo Nobel in Netherlands and the other from Nippon Paint in Japan. Both were left at the altar as Axalta deemed the takeout price inadequate for shareholders. Recent takeout multiples for paint and coatings industry suggest a takeout value of $42-$44 for Axalta, a 34% premium to its current share price. Warren Buffet's Berkshire Hathaway currently owns 9% of the company. Axalta could be a natural buyout target for Mr. Buffet at some point.

Our housing related companies, **Home Depot, Lowe's, and Mohawk**, continue to benefit from a strengthening housing market and favorable home improvement cycle. Improving home prices, rising home equity and home sales have led consumers to invest more in their homes. It's also a market well-insulated from e-commerce. We do note that Lowe's is trading at a 25% discount, the widest gap in years, to Home Depot, and has the potential to close some of the gap if they could improve on margins.

Performance detractors in the quarter included some of our bond-like names and the Master Limited Partnerships (MLP). Although our bond-like equities had a mixed 3rd quarter as interest rates rose, they significantly outperformed their peers for the year. We estimate that our bond-like equities (19% of the YG composite portfolio) generated a total return in the high teens. Yield-Growth's bond-like equities have exposure to "growthy" REITS in data centers, tower communication, and commercial/industrial real estate exposure in the U.S., Germany, Singapore, and Australia. The flexibility to allocate to yield ideas outside the U.S. was a big plus in 2017. However, we are considering harvesting some gains in the new year after the strong run in some of these names.

The $300 billion MLP industry struggled this year as some MLPs experienced distribution cuts to support balance sheets, lower equity costs, and free up cash. However, there are positives as we head into 2018. The industry is supported by continued volume growth in U.S. energy productions. Cash flow coverage is expected to improve as past projects are coming on line while capex spending ramps down. Improved cash flows should also help with distribution coverage and self financing of new projects versus relying solely on the capital markets for funding. In addition, valuations are attractive as the yield disparity between MLPs and other interest bearing assets are at an historical high. The Alerian MLP index is yielding an attractive 8%, four times the S&P 500 dividend yield of 2%.

Portfolio Activity

We added to **Ascendas REIT (AREIT)** in YG portfolios. Ascendas REIT is the largest and a fairly defensive REIT in Singapore with a focus on industrial and business parks. It is yielding 6% with a historical dividend growth of 4%. Industrial/Business park REIT yields in Singapore are lot more attractive than comparable REIT yields of around 3% in the U.S. AREIT has a 65% exposure to high value-added industrial space, where rents are expected to rise in 2018 due to the government's initiatives and a broader macro recovery. AREIT is also active in capital recycling and has a balance sheet (low leverage vs. its REIT group) to add to growth through acquisitions. Shares of AREIT have stalled in the last 6 months as the company is in the hunt for a new CEO, giving us an opportunity to add during the 4th quarter. Temasek, the Singapore Government Investment entity, owns around 20% of the company.

We added to our **Gilead position (GILD).** Since the initial purchase, GILD's stock has been weak due to the Hepatitis C sales run-off concerns and overall weak Biotechnology sentiment. Overall, sales are expected to stabilize as the growth in the HIV franchise offsets the sales runoff in Hepatitis C sometime in 2018. At trough 2018 earnings, the stock is expected to trade at an 11x 2018 P/E, a FCF yield of 10-11%, and a dividend yield of 2.8%. We find the valuation attractive and inexpensive versus its peers while not reflecting potential pipeline optionality (a new and exciting oncology platform stemming from its purchase of Kite Pharmaceutical and the NASH (fatty liver drug platform). In addition, Gilead still has at least $55 billion (cash plus additional debt capacity) at its disposal to build out its cancer platforms and other attractive therapeutic areas.

We sold the **Pimco Income Opportunity fund (PKO)**. PKO is a closed-end bond fund that invests across the fixed income spectrum. We bought this closed-end fund when credit spreads and the discount to Net Asset Value (NAV) widened significantly in the first quarter of 2016. Since the purchase, credit spreads have tightened significantly while we clipped an 8% coupon. The investment has delivered equity-like returns for a closed-end bond fund, but the risk/reward was not favorable as it was trading at a premium to NAV when we closed our position.

We sold **Shire (SPHG)** in the quarter. The company continued to struggle with high debt levels, senior management turnover, and increasing uncertainty around its drug portfolio. Despite its attractive valuation, we prefer to watch from the sidelines until we gain confidence in management's LT targets for the business.

Positioning

The objective of the Yield Growth strategy is to provide a total return over a full market cycle that benefits from global equity exposure but with dampened volatility, so that the risk of a major drawdown in value is less than that of the equity market. Of course, we cannot guarantee that we will achieve this objective.

We use diversification and income dampening assets (i.e. fixed income, closed-end funds, master limited partnerships, and other bond-like surrogates) to try to achieve the lower volatility and income. Dampening assets such as Bond-like equities (i.e. REITs, Business Development Companies, and German real estate), fixed income, closed-end bonds funds, Master Limited Partnerships and cash currently make up 41% of the Yield Growth composite. We are currently very light in our allocation to fixed income, but have a meaningful allocation to Bond-like equities and MLPs to capture yields and modest dividend/distribution growth. Currently, approximately 20% of the portfolio is allocated to companies outside the U.S.

We use equities to primarily help grow the principal of the portfolio. Although equity markets have experienced a strong run, the equity portion of the Yield-Growth portfolio is still very attractive, in our opinion. We estimate that the Free Cash Flow (FCF) yield of the Yield-Growth equity portion (excluding our financial holdings) is around 6.3% versus the 4.3% in the S&P 500. In addition, we estimate that this subset of the portfolio is expected to grow FCF per share of 14% in 2018 (*FactSet data adjusted by internal projections*) versus the S&P 500 FCF growth of 12%. However, valuations for some sectors in this area are fairly elevated and will need strong earnings to come through again. Our goal is to remain defensive and opportunistic to investing as we navigate a rising-interest-rate environment.

Thank you for your continued confidence in SeaBridge. Happy and Healthy 2018!

Howard Chin
1/5/18

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