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Copy of letter sent to individual clients of SeaBridge Investment Advisors for the First Quarter of 2007.

Dear Client:

We came through the first quarter of 2007 better than I would have expected in light of the market volatility of late February and early March. Most portfolios had positive returns for the quarter. The market averages behaved in a similar way, with foreign markets performing better than the U.S. market in dollar terms.

For the quarter, the S&P 500 was up 0.6%, the broad U.S. market Russell 3000®index returned 1.3%, the global MSCI World Index was up 2.6% and the MSCI World Index ex USA was up 3.8%.[1]

The volatility of late February and early March caused us to reexamine our strategy. In some portfolios, we held a number of smaller companies in emerging markets and balanced that risk with what we thought were high quality debt positions – namely fixed income REIT's holding commercial mortgage debt. As markets bounced around, the small emerging market companies behaved about as we would have expected. However, the debt holdings were, in many cases, much more volatile than we expected. Upon reflection, we concluded that while mortgage debt securities are credit-worthy, some have also become over-priced. This is the result of more and more money pouring into the markets looking for premium yields.

As a result of this reexamination, we made some changes to the portfolios and continue to review all holdings with an eye to making some money in 2007 if markets advance, but cutting vulnerability if markets head down again in the summer. (*Of course, we may not be successful in that endeavor*).

Since quarter-end we have noted that most Central Banks around the world are raising interest rates. In China, the PBOC is also raising reserve requirements and putting quantitative limits on various kinds of lending, especially for securities speculation. Japan also raised rates, which was a bit surprising because inflation is benign and Japan's recovery is sputtering. One suspects the BOJ is unhappy with the amount of borrowing in Japan for speculation in other markets, especially in Asia.

Have we become pessimists? Not quite, but we have become more cautious about what we own as we go into what appears to be the final phase of a bull market. *What would take us back to our frame of mind prior to February?* We would want to see whether the three most unusual conditions (**the big anomalies**) could evolve without causing a significant drop in equity prices.

First, we get very mixed readings on how serious the U.S. housing slump will be as 2007 goes on. The world economy moves ahead persistently and carries our slowing economy with it. However, the papers are full of stories about abusive lending in our sub-prime debt market. Beazer, a large home-builder, is under Grand Jury indictment and has almost every housing regulatory agency pouring over

[1] Results for these indices (S&P 500, Russell 3000®, Morgan Stanley Capital International All Country (MSCI) World Index and MSCI World Index ex USA) are quoted as being somewhat representative of the broader equity markets for comparison to SeaBridge U.S., global, and foreign portfolios. The SeaBridge portfolios differ from these indices (in number of securities held, industry, sector and country weightings, etc). Therefore, in any given period, results for SeaBridge portfolios are likely to differ from the results for these market indices.

their records. Clearly, having mortgages financed by the forgiving markets rather than by banks and having mortgage originators controlled by home builders combined to create a loss of control in the mortgage debt market. With rates on something like $500 billion of adjustable rate mortgages indexing upward in 2007, we may have rising defaults and falling home prices. A "housing scandal" of large magnitude could sock U.S. consumer confidence, which has remained resilient to date.

Second, world markets are awash in money, which can be borrowed for almost any purpose at historically very low rates. The competition among intermediaries to lend usually leads to inadequate care and rates which do not compensate for risk. Either a tightening of credit standards or an increase in rates to compensate for risk could impair the **main force supporting the U.S. market**. This force is **corporate repurchase of stock.** Buying is coming directly from companies using their record cash flow to buy back their shares; it is coming ever-more-frequently from LBO funds acquiring companies with borrowed money. Both of these shrink the pool of listed securities and support securities' prices. The "money-game chatter" on CNBC about today's "big LBO bid" blinds one to seeing that the forces supporting the market are fewer and fewer. Anything which would break the big banks' headlong competition to lend money to the LBO funds would be quite damaging to the equity markets.

Third, everyone from pension funds to individuals seems to be taking more risk in the search for another good year in the financial markets. Asia, where I spent last week, is awash in money looking for venture capital deals in China, or housing deals in Vietnam, or resource deals in Indonesia. Individuals, via the Exchange Traded Funds, have been pouring money into these markets. It may be true that the Chinese boom will sustain all this for months and years to come. However, in the past, a mood like this has frequently been followed by a bad surprise. Certainly, the markets are no longer paying one well to take risks in risky places. With Central Banks tightening – especially in China and Japan – I think a caution flag should be flying.

So, the **big anomalies** have to do with "**excess credit, too-cheap debt, and high enthusiasm for risk taking."** Both lenders and borrowers, and the U.S. as a nation, seem to think that ever more debt can be carried with impunity. I would like to see this structure stressed, survive, and more sobriety introduced among both borrowers and lenders. Until then, we will probably remain cautious about the health of the financial markets.

This caution has taken the form of what we own and may result in somewhat higher levels of cash in the future. (I realize this is not a new song from me as my letters since October 2005 have expressed fluctuating levels of concern.) We have continued to do fairly well in spite of the caution, and I hope that can continue to be the case – *no guarantees*!

The portfolio changes in the past month have brought the yields on our "Yield-Growth" portfolios to historic lows. We hope we have taken a step in the direction of lower volatility as we have given up yield. However these remain equity portfolios and will go down if markets go down. We are trying to focus all of our portfolio styles on companies which can advance their business in the face of tighter credit and turbulent markets.

In sum, I feel cautiously optimistic about 2007. But, before we can make much progress at home, we must endure the housing bubble clean-up. Overseas economies should have stronger growth, but as credit tightens, we could have financial market stresses in Asia.

As I travel abroad, I am often reminded of the strengths of our nation:

- Democracy,
- Freedom,
- Innovation,
- Education,
- Rule-of-law, and
- Strong institutions.

Our global companies, working around the world, are a national asset. They also help most of countries in which they do business. Our national strengths make foreigners want to invest in the U.S. Their investments in our markets support our tendency to consume with borrowed money. Someone said, "Americans have been so fortunate that they just do not believe there are any rainy days ahead."

So, we go forward, cautious, but hopeful that 2007 can proceed without major market dislocations. If they come, we hope our portfolios will yield value reluctantly against the ebb-tide. When I study the businesses of our portfolio companies I am reassured that their profits are likely to rise in the next 18 months, helping push portfolio values upward.

With best wishes,

Garnett Keith