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Copy of letter sent to individual clients of SeaBridge Investment Advisors for the Second Quarter of 2006

Markets started the second quarter strong, but the final seven weeks were turbulent. After being oblivious to problems and risks in the prior two quarters, investors' attention in May focused on inflation and deterioration in the housing sector. In spite of early signs of economic weakness, the Fed made more aggressive comments about fighting inflation. Aggressive investors, led by hedge funds, began to pull back from stocks which had been benefiting from strong global growth. Selling was particularly heavy in industrials, commodity producers and emerging market stocks. Buyers (since for every seller there is a buyer) were long term investors who felt that stock prices were reasonable and world growth still solid.

Our high levels of cash and prior trimming of commodity and emerging market holdings contained the damage to our portfolios somewhat. Nonetheless, a significant portion of the gains achieved between January and early May eroded. More conservative portfolios generally lost less while more aggressive portfolios lost more.

For the quarter the S&P 500[*] lost 1.4%, the broader U.S. Russell 3000® Index was down 2.0%, and the MSCI World index was down 0.6% while the MSCI World index *excluding the U.S.* was up 0.2%. For the first six months of 2006, the S&P500 had a positive 2.7% return, the Russell 3000 3.2%, the MSCI World Index 6.4% and the MSCI World Index ex U.S. 10%.

I am not very hopeful that the markets can head back up in a consistent way before election day. Summers during mid-term election years are frequently bad periods for the market. In addition to worrying about changes in the legislative agenda if control of the House and/or the Senate passes to the Democrats, the market has larger worries about exactly how the transitions in inflation, house prices, debt payments and consumer spending will unfold. It is hard to think of a scenario where conditions are as good for stock prices as the past three years have been. That subdued outlook is why stocks are trading at reasonable prices in spite of three years of exceptional earnings growth.

There are growing complaints about Fed Chairman Bernanke during his six months in office. He has changed tone two or maybe three times this year. When he first assumed office, he made investors feel interest rate increases were coming to an end; then he confided to CNBC's Maria Bartiromo that the market did not understand that he was really a hawk on inflation. In mid-June almost every Fed Governor was on the road making speeches about the threats of rising inflation.

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[*] 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.

But when they acted on June 29, the ¼% rate increase was accompanied by wording which led Fed watchers to conclude that the Fed sees the economy slowing, knows inflation is a lagging indicator, and is therefore near the end of rate increases.

The problem, I fear, is not in our leaders' words, although the confidence elicited by Alan Greenspan's enigmatic observations is missed. Rather the problem is in our policies. We are fighting a major war without raising taxes to finance it. We are keeping money plentiful and interest rates so low that house prices exploded – this following the "irrational exuberance" in stock prices which was subsequently followed by a collapse. With the "good times mania," consumer spending has grown to the point where our own consumer savings is negative. As a result, we require roughly 80% of world savings to finance both our military campaigns and our roaring consumption. This has been good for world growth, but has left us in a situation which was best summarized by the late economist Herb Stein: "That which can not go on forever, must surely end." It is *how* it ends that has the markets worried more than Chairman Bernanke's choice of words.

Several Fed Governors have said they will be "data-driven" in their future actions. At the risk of making this letter too long, let me elaborate on the data the Fed is pondering.

Inflation has picked up a bit, but is still remarkably low in light of soaring gasoline and commodities prices. Among the Fed's primary fears is that inflationary expectations plus full employment will result in rising wage increases. Compensation is increasing between 2.5% and 3.9% depending on which data series one examines. Productivity has been increasing at a pace which has limited the increase in unit labor costs to 0.1% in the first quarter, measured against the prior year. These numbers are acceptable unless compensation is trending up and productivity is trending down. With unemployment down to 4.6%, the Fed has reason to be worried about the trends.

A significant factor in inflation expectations is the outlook for housing costs. The Core Consumer Price measure uses a "rental equivalent" to measure the changes in the housing component of the cost of living. This is not insignificant because housing represents almost 40% of the core inflation figure which excludes food and gasoline prices. With interest costs so low, everyone bought a house, and the rents of rental units languished. This kept reported core inflation low for the past five years. Now with mortgage rates up, houses are becoming less affordable and rental units are in greater demand. The rent equivalent measure for housing is therefore is moving up significantly. So actually, inflation was higher than reported in the past and somewhat lower than currently reported. However, the reported Core number is increasing at a rate that has alarmed the Fed in the past.

Gasoline prices, while outside the core number, remain stubbornly high. Oil remains above $70/bbl and premium gasoline is expected to stay above $3.00 through the end of the summer driving season. Economists use the phrase "demand destruction" to describe reduced driving due to the high price of gasoline. So far we are not seeing much demand destruction. One expects to see higher spending on gasoline reflected in lower spending on other items, but the consumer has yet to cut back in a major way.

Finally, what about house prices? The rate of sales has slowed and the rate of listings is up. As a result, unsold inventory numbers are soaring. Prices have held up reasonably well so far, but are beginning to fade as some sellers are pressed and cut prices. So, falling house prices are likely. Falling home values erodes consumer confidence and lower spending leads to a drop in economic momentum - possibly a very significant drop in economic momentum.

Therefore, it seems to us highly likely that the economy will slow as 2006 proceeds. In our opinion, either 1) weak housing, lower consumer confidence and the high cost of gasoline will cut into consumer spending, or, 2) if economy keeps rolling along at 4%, the Fed will keep raising rates to slow the economy before wage inflation accelerates.

Neither a slowing economy nor a Fed tightening interest rates is good for securities prices. As a result, at this point, we intend to keep high levels of cash reserves. A four percent return on cash does not look bad when the market is going down. We will also likely shift the holdings toward companies which benefit from business spending. Textron, which makes private aircraft for corporations, helicopters for the military and capital goods components, is a recently purchased example.

In our lower risk "Yield Growth" portfolios, we will keep even larger amounts of cash while waiting for a clearer signal that the economy is slowing enough to end Fed rate increases. At that point, we would likely move some cash into REIT's holding high grade debt or non-consumer debt such as commercial mortgages. Most companies are generating large amounts of cash and the general increase in dividends is strong. Dividends on the S&P 500 are up 12% year over year, and up 32% over the past nine quarters. This should be an excellent environment for Yield Growth, and we expect to use some of those type stocks in most of our portfolios.

For all portfolios we are looking for quality companies which have a significant proportion of revenues in foreign economies. We expect the dollar to weaken as soon as it is clear that the Fed is ceasing to raise rates. We expect to have a growing number of Asian companies in our portfolios. After 15 years of recession, Japan is recovering and China continues to grow apace. Therefore, the outlook for Asia is brighter than for the U.S. over the next year, in our judgment.

No promises, but we will do our best to maintain portfolio values as we go through this transition.

Garnett Keith

Note: this is a copy of a quarterly letter sent to clients of SeaBridge Investment Advisors. It is presented in order to illustrate the current thinking of the investment manager. This does not represent an offer to buy or sell securities.

This letter discusses, in general, results for client portfolios. SeaBridge manages portfolios for clients in several different styles. Results for individual clients may differ. Results in the future are likely to be different. Please contact Susan Boyd if you wish to see more details on the after-fee returns for any of our investment styles. Please refer to the Form ADV Part II for SeaBridge Advisors LLC (or our website www.SeaBridge.com) for a complete fee schedule. The views presented here represent the opinion of Garnett Keith of SeaBridge Investment Advisors based on his analysis of publicly available information. The opinions of other analysts based on these data may differ. There are no guarantees that the expectations expressed here will be realized in the future.