SeaBridge Investment Advisors

450 Springfield Avenue, Suite 301 • Summit, NJ 07901

Garnett L. Keith Tel: (908) 273-5085
Chairman and CEO Fax: (908) 273-6297

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

The markets survived two tests in the second quarter. *First*, ten year interest rates jumped sharply as global growth and Fed comments made a future cut in interest rates appear less likely. *Second*, mortgage credit conditions continued to deteriorate. Specifically, Bear Stearns had problems with two large hedge funds as the collateral values of sub-prime mortgages declined relative to huge bank loans carrying the mortgages. A liquidation crisis was averted as Bear invested an additional $3.2 billion in the funds to provide more collateral. After brief sharp drops, the market bounced back and closed the quarter only modestly below the highs set in early June.

Is this “test passing” a sign of strength or a harbinger of more difficult tests ahead? I do not think the tests have ended, and whether the markets’ resilience will survive is uncertain. On the positive side, interest rates have backed off their highs by about ¼%. So long as they stay around 5% and housing/mortgage problems are moderate, the markets will probably trend higher.

Last quarter I characterized my view as “cautiously optimistic.” I am still optimistic beyond November. Until then, I remain cautious about more housing debt explosions but hopeful that tests can be passed as the summer and early fall go by.

For the quarter, the S&P 500 was up 6.3%, the broad U.S. market Russell 3000®index returned 5.8%, the global MSCI World Index was up 7.4% and the MSCI World Index ex USA was up 8.4%.[*] Our portfolios generally participated, to a greater or lesser extent, in the market rise for the quarter. Our goal, possibly unattainable, is to keep up with the market while taking less risk than the overall market as further tests are encountered.

Some of the most serious risks arise from the less favorable trends in the credit markets. In addition to widely publicized sub-prime mortgage problems, banks are pulling back on the “cov-lite” LBO loans (large loans with fewer protective covenants for the lender.) Several large Leveraged Buy Out deals, currently in the process of syndication, are finding money raising more difficult than had been anticipated. Stock purchases in connection with LBO’s and corporate stock repurchases have been major contributors to the market strength this year. Threats to the availability of loans for those purposes put the markets in increasing danger.

Elsewhere conditions are healthy. Business confidence in Europe continues to rise, and capital spending is carrying Euro economies forward in spite of rising interest rates. In Asia, conditions are nearly ideal. Liquidity is plentiful. Exports remain strong. Inflation is low. Capital spending is a powerful force. Domestic spending is supplementing exports as a growth driver. The RMB has appreciated at a 10% annual rate in the past two months, taking some currency pressure off China’s neighbors. Only Japan finds trends

[*] 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.

turning down. Wage increases are weak and domestic spending is flagging. However the export sector is booming on the back of the very weak Yen. As a result of strong growth outside the U.S., foreign companies and U.S. companies with substantial foreign business are prospering as never before.

While we had strong performers in the portfolios in the quarter, in the negative column we held Annaly Capital Management widely and in large size. Annaly provides a 6.5% yield and our belief, then and now, is that Annaly is a very good hedge against a blowup in financial markets. (It owns a government guaranteed mortgage portfolio which should move up in price if there is a flight to safety in a financial crisis.) Moreover, if housing problems get bad, the economy slows and the Fed cuts rates, Annaly's earning power should increase substantially from the resulting steeper yield curve. Unfortunately, a lot of other people owned Annaly on the hope of an interest rate cut resulting in a steeper yield curve. When it became clear the Fed would not cut rates, the yield curve steepened, but by ten year rates rising instead of short rates falling.

Annaly's stock responded to this with a 15% drop in price from its high in the quarter. With the subsequent ¼% retracement in ten year rates, Annaly's stock price bounced back about 4% from its low but, with a low prospect for further rate cuts, did not recover completely. The stock ended the quarter down over 5% on a total return basis. We remain optimistic about earnings increases for Annaly in the future due to the steeper curve.

The Asian holdings in our portfolios generally performed well in the second quarter. Prices in Asia are no longer cheap, but growth is substantially faster than elsewhere and three times as fast as the domestic U.S. economy. For example, the S&P 500 is trading about 14.5 times forecast 2008 earnings. Earnings growth, 2008 over 2007, is forecast to be about 11.4%. (This includes the more rapid growth that many S&P companies get from activities in Asia.) China, on the other hand, is trading about 15 times 2008 earnings, but growth, 2008 over 2007, is forecast to be about 27%. (*These numbers are consensus estimates reported in Morgan Stanley's July 2 book on Global Asset Allocation*.) The risks in Asia are higher than in the developed economies. But we continue to scout for good companies taking advantage of the more rapid growth.

As we go through the summer testing period we continue to generally carry somewhat higher cash levels than we normally would. Our hope is the markets will have taken the measure of housing problems by the end of the third quarter and we can go back to a less cautious stance.

We hope you and your family will have a most pleasant summer.

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.