*SeaBridge Investment Advisors LLC*
450 Springfield Avenue, Suite 301 • Summit, NJ 07901-2610
Garnett Keith, John Conti, David Descalzi, Susan Boyd
Tel: (908) 273-5085 • Fax: (908) 273-6297

*Copy of letter sent to individual clients of SeaBridge Investment Advisors for the Second Quarter 2008.*

The second quarter started out strong after the first quarter decline, but ended very badly, setting an ominous tone for the rest of the Summer. Most of our portfolios had small gains for the quarter in spite of the major decline at the end of June, but had negative returns for the six month period.

The market averages[1] we look at did even worse: for the **second quarter**, the S&P 500 was down 2.72%, the broad U.S. market Russell 3000®index was off by 1.69%, the global MSCI World Index fell 1.36% and the MSCI World Index ex USA was down 0.87%.

For the first **six months** of 2008, the S&P 500 was down 11.91%, the broad U.S. market Russell 3000®index fell 11.05%, the global MSCI World Index was down 10.41% and the MSCI World Index ex USA returned a negative 9.86%.

As the second quarter progressed, economic news in the U.S. pointed toward a protracted period of very slow growth, squeezed profit margins and consumer distress. News in the financial sector went from bad to worse and announcements of further asset write downs appeared every week.

The U.S. is caught between two powerful deflationary maelstroms – the collapse of house prices and the collapse of the financial sector. Yet, the looming concern in the financial markets during the second quarter has been *in*flation not *de*flation. In summary, we fear the remainder of 2008 will be difficult in the financial markets as the challenges of dealing with recession and inflation at the same time become clearer to investors. Our President-elect will need a clear economic plan as he takes office in January 2009 to overcome some of the immediate and pressing problems.

Faced with these problems, we raised cash during the quarter, selling some securities that we felt were likely to encounter problems in this environment. However, for taxable accounts, we also tried to consider the tax impact of realizing short term gains. For certain style portfolios, we bought mutual funds designed to go up when sectors of the markets go down. These funds use derivatives to go in the opposite direction of the market. We have not used these instruments yet in our Core Diversified Equity style portfolio, although we may do so selectively in the future.[2]

Some of these steps in the direction of caution helped the portfolios during the quarter.
What did not work was holding anything carrying financial assets, anything associated with aviation, and Asian companies. Continued unwinding of leveraged hedge funds, exacerbated by the reduced financing available to carry financial assets, is extending the downward spiral of yield assets.

Our view is that growing weakness in our economy will prevent any meaningful monetary tightening in an election year unless the inflation news is disastrous. Essentially, the Fed will try to jawbone the dollar up, but keep rates down until some slowing in house price declines appears.

We view the weakness of China related markets as an opportunity in disguise.

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[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.
[2] **If you would prefer that we not use instruments like these in your portfolio, please let us know.**

- Yes, China is having big problems with snows, earthquakes and floods
- Yes, China is having inflation problems
- Yes, there will probably be a slowdown after the Olympics
- Yes, exports to the U.S. are slowing and margins are being squeezed in factories in the Pearl River Delta.

However, seldom does one get the opportunity to buy major companies growing at 25% per year at 15 times forward earnings, which multiples are down from 30-40 times earnings. (We refer specifically to the companies building railroads, harbors, expressways, not only in China but in Africa and the Middle East as well.) We are still cautious because we think that the direction of prices is still down. With U.S. and European markets weak, investors are pulling back from perceived risk, and Asia looks risky. But once risk tolerance stabilizes, the shopping opportunities among Asian equities are as exciting as we have seen them in 25 years. This assumes, of course, that China continues to grow at 7% per year. But, if that is not so, one should probably avoid all equity markets.

The malaise among Americans regarding our energy situation enters almost every conversation. High energy prices are realigning relative asset values with stunning speed.
The country is ready for Presidential leadership on energy.

Our going-forward strategy assumes a difficult summer. We remain concerned that our market will struggle as the economy tries to recover from our twin maelstroms and the Fed worries about inflation. In general, we still prefer companies working in parts of the world which are growing. We prefer companies from countries which are lenders to the U.S. rather than companies which are mostly limited to the U.S. domestic economy. Foreign markets have been falling sharply even when their economies are doing well. However, we believe that recovery will come first to parts of the world with a good growth outlook. Our preferred way to access those is via stocks which trade in the U.S., but these are not always available. We continue to hold relatively high cash balances.

The key tests for moving to more adventurous positioning are:

1. A plan from a Presidential candidate that addresses our energy and spending issues
2. A sign that Asian economies can grow in spite of a U.S. recession, plus an upturn in the downward momentum in Asian markets
3. A decline in energy and food prices

So you can be assured that our minds are on “How do we protect capital during difficult times?” With large cash holdings we may miss some of a strong sudden market rally but, until we see the outlines of the solutions to larger problems, that is the risk we prefer to take.

This is likely to be a difficult summer in markets in the U.S., but we hope it will be a joyful one for you and your family.