SeaBridge Investment Advisors LLC

450 Springfield Avenue, Suite 301 • Summit, NJ 07901-2610
Tel: (908) 273-5085 Fax: (908) 273-6297
Garnett L. Keith, Jr.
Chairman & CEO

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

The third quarter continued the transition from strong global expansion to a global slowdown. Slowdowns have a way of bringing crises to the surface. So, tightening credit helped bring a **jump in risk awareness in the second quarter**, with a related drop in emerging markets and other risky investments.

Following in train, **in the third quarter**, U.S. housing prices started a long-predicted sharp decline. There were also some “blow-ups”, recited below, and the prospect of a possible recession fed further declines in oil and commodity prices. Watching this, the Fed halted the relentless climb in short term rates during the quarter. The prospect of a slowdown caused long term bond buyers to jump in, driving long term Treasury rates back below 5%.

The “blow-up” and liquidation of the $8 billion Amaranth hedge fund in late summer was taken in stride by the markets, in noticeable contrast to the 1998 “blow-up” of the similar-sized Long Term Capital Management hedge fund. The earlier event precipitated a financial crisis. The difference can be partially attributed to the developments for financial risk diversification in the intervening eight years. It is probably also a commentary on the excess liquidity still sloshing around the U.S. financial system. In that regard, even though the Fed halted rate increases in the second quarter, they continued to drain the excess liquidity from the financial system. By the end of the quarter, growth in U.S. MZM (the monetary base on which one can write checks) had dropped to 1%, year over year. Compared to 4% GDP growth, a 1% growth in MZM is a 3% shrinkage in the financial oil lubricating the system relative to the size of the system. If pursued over time, this relationship would make money more dear – meaning the price of U.S. financial assets would decline. This is not a near term forecast, but one which deserves careful watching.

Almost every newspaper has headlines about housing and I will not repeat them all here. The bottom line is that housing starts are off 20%, and probably headed lower. The unwinding of housing-related jobs in the economy has just begun. Given that housing was the largest provider of jobs in the past four years, the U.S. unemployment rate of 4.6% will likely be heading up.

In corporate news, Ford’s problems reached a “blow-up point” with a new non-Ford-family CEO coming in. News at Chrysler was scarcely better, with lots all over Michigan filled with unsalable Jeeps with monster V-8 engines. Perhaps Detroit will get the message that $3.00 gas and 5,000 pound passenger vehicles do not mix.

Not surprisingly, with problems popping, some forecasts for U.S. GDP growth in 2007 have now been cut to 2% and for CPI inflation to 2%. In the rest of the developed world, growth is also slower and, even though interest rates are heading up, they are below U.S. rates and monetary ease is substantial. For the six major countries outside the U.S., 2007 GDP growth is forecast at 1.6% and the CPI increase below 1.5%.

With storm clouds gathering at home and no end to trouble in Iraq, the U.S. equity markets did surprisingly well in the quarter. This seems to have been caused by confidence lifts from declining gasoline prices and falling interest rates. (No doubt, the excess liquidity still in the system played a role too.) The S&P was up

5.7% for the quarter, with the broader Russell 3000 Index up 4.7%, the MSCI global index up 4.6%, and the MSCI index excluding the U.S. up 4%[*].

Against this backdrop, we have been moving portfolios away from pro-cyclical holdings and toward non-cyclical growth stocks and bond-like equities removed from the immediate credit problems of excess consumer debt. Specifically, we have sold some commodity providers. We have bought companies providing consumer staple products. We have bought REITS lending against office properties and Business Development Companies (BDCs) lending to businesses.

We have also added to our bank holdings. One could reasonably argue that banks are exposed to consumer credit problems. If growth drops below 2%, this would be a pressing concern. However, with moderate growth, we think banks are positioned to avoid major increases in provisions for non-performing loans. Following the pattern of past "mid-cycle slowdowns," equity markets have rallied. Hoping this will continue to be the case again, we have also added to our positions in money manager companies.

Unless housing totally collapses (or some other unexpected negative event occurs), we expect 4Q06 to be a good quarter for equities. The composition of Congress, beyond the November election, is unpredictable. However, with the White House in Republican hands for two more years, we do not expect too much anti-business legislation. In this environment, we expect to target cash in your portfolio below 10%, and focus on companies with non-cyclical growth and financial companies with low credit risk. If we can find suitable holdings, we will also continue our tilt away from the U.S. toward Asia.

Garnett L. Keith, Jr.
October 10, 2006

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.

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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.