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Edited copy of letter sent to individual clients of SeaBridge Investment Advisors for the Third Quarter 2011

"They are fleeing!"

That is a report that a battle field commander hopes to get about the enemy. It is not a report a portfolio manager hopes to get about other stock market participants. But fleeing they are, tossing stocks over their shoulders as they disappear. Who is fleeing is fairly clear:

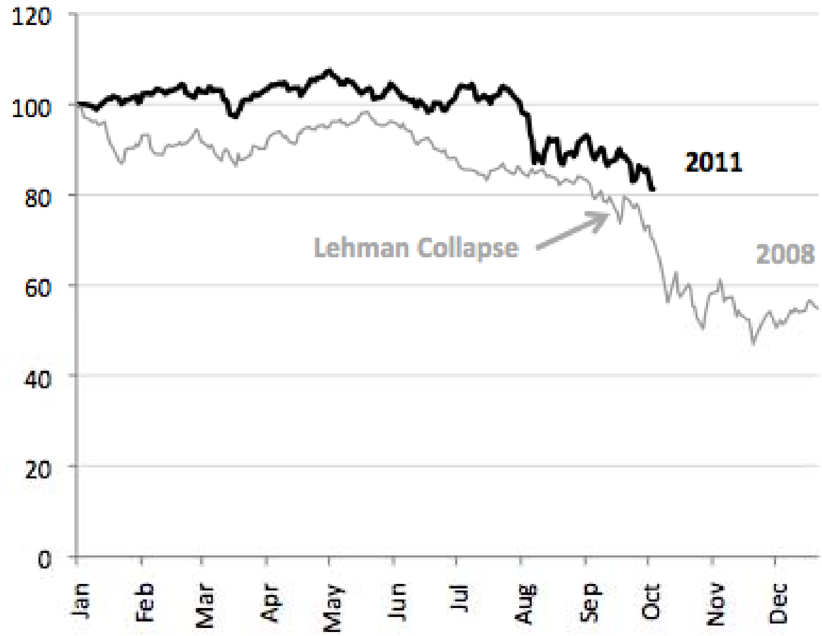
- Hedge funds who live or die on quarterly performance,
- Exchange Traded Funds buyers who have a sense of direction but little sense of fundamental values in the fund's stockholdings,
- High frequency traders who can take advantage of small price inconsistencies in the falling market,
- A growing number of longer term savers, who remember 2008 and do not want to risk another collapse in portfolio values.

What they are fleeing varies among the recently departed:

- A frozen political process, in which neither tax nor entitlement reform can make progress,
- A broken European Union (EU) which can not muster the political resolve to insure its banks against an almost certain Greek debt default,
- Slowing growth in China, as its large customers in the West pitch toward very slow growth, at best, in 2012,
- The risk of a global recession, amplified by rising protectionism and risks of currency wars on both sides of the trade imbalance

Those prospects are enough to give anyone pause, and no one can be highly confident that a breakthrough will occur on any one before the end of 2011. Stock market data such as the graph on the next page (similar to one prepared by Citibank) is shown on TV shows, in various forms, over and over again:

Graph: World equity markets 2008 vs. 2011



Source: MSCI All-Country World All-Cap Index Data (retrieved 10/5/11)

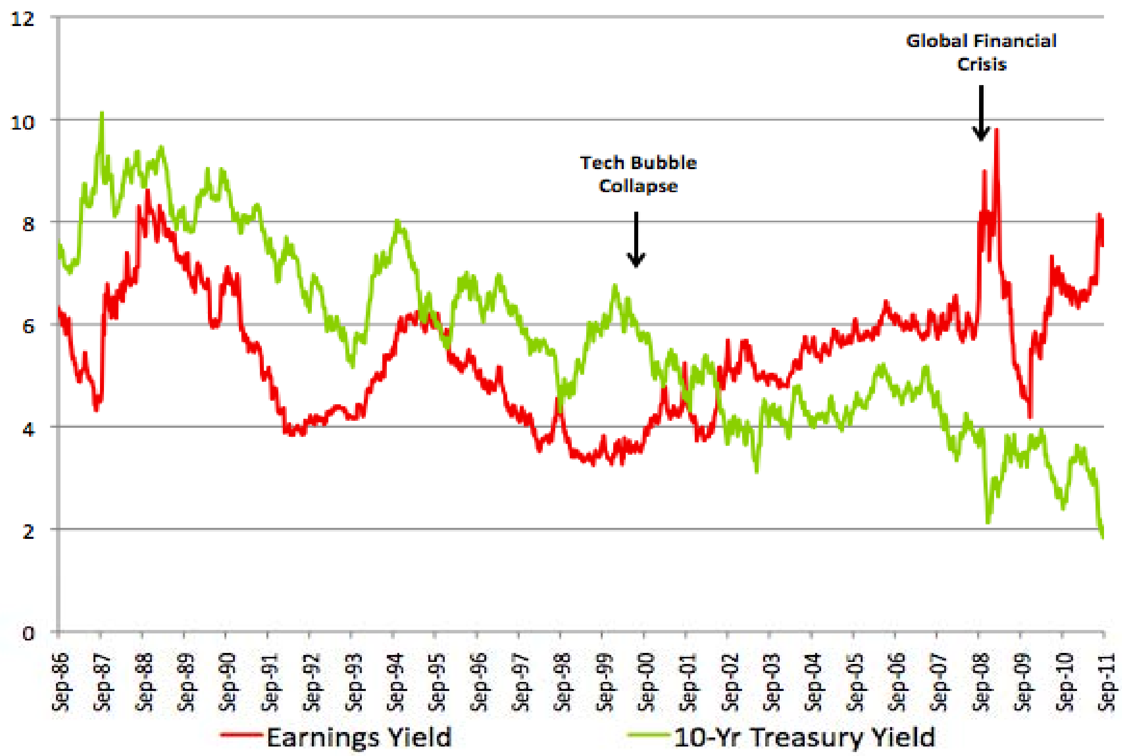
The risk that we may pitch over from a bear market to a total market collapse, as we did in 2008, is haunting. Anyone whose circumstances cannot look beyond 24 months in their investments needs to be in a defensive financial posture.

Having said that, I do not think you have to be Dr. Pangloss to see how this situation differs from 2008.

- Most U.S. corporations are in robust financial condition. Cash flow is positive, and there is ample cash on balance sheets. Unlike 2008, debt has been paid down to modest levels.
- Most forecasters see modest growth over the next 15 months: 1.5% p.a. in the U.S., 0.5% p.a. in Europe, 4% p.a. in Asia, and China leading the parade at some 8.5% p.a. This does not bring down unemployment, but it is not a disaster of the 2008-2009 variety.
- While housing remains weak, we are burning off the excess supply at a rate which implies the market will clear in three or four years (600,000 new builds versus family formations of roughly 1.2 million).
- Political processes are grinding away at the problems. Progress is painfully slow, but solutions should eventually be found.
- China remains an engine of growth with foreign exchange reserves exceeding $3 trillion; that should be sufficient to stimulate their economy or bail out their banks if they have loan indigestion follow the investment boom of the past three years.

But those reassurances alone are not enough to direct portfolio policy at the moment. What is stunning is the earnings yield available from a diversified portfolio of high quality companies compared to the yield available from Treasury bonds.

Graph[1]: Stock Earnings Yields vs. Bond Yields



You see the tiny (< 2%) return from owning high quality bonds versus the exceptionally high earnings yields (8-9%) available on the stocks of high quality growing companies, and you do a double-take. This situation occurs only a few times in one's lifetime, when everyone is very frightened. Add to that the recession/inflation tradeoff – bonds generally do better in the former, but only stocks give meaningful protection if we must inflate our way out of all our debt -- and the choice seems pretty clear: To the extent to which one can take a longer view, selling stocks now to get the protection of "risk free bond assets" is a choice about which history has been very unforgiving.

[1] Green line is yield on ten year Treasury bond, currently 1.8%; red line is historical earnings on S&P 500 stocks divided by the price of S&P 500 stocks, currently about 8.4%. Source: Bloomberg data (October 4, 2011)

We are not happy about the fall in portfolio values in the third quarter – it was brutal[2]. Our personal portfolios declined too, and it is painful. We cannot be sure markets will not fall further as we go forward. But our conclusions are:

1. To the extent you can take a longer view, we think this is likely to be seen in retrospect as a big buying opportunity.
2. To the extent you have commitments which will be pressing in the next 15 months, you might consider moving some of your assets to something like our Cautious Core strategy. Those assets decline, too, in a bad market, but should decline much less than the equities in our other strategies. Of course, if you were to change strategies and the market does rebound, Cautious Core will likely rebound much less than more aggressive strategies.

I wish we could promise more, that is how the facts stack up in our review.

With best wishes for the remainder of the year,

Garnett L. Keith, Jr

P.S. for those of you who would like to dig further into the analysis on the economic and market trends, attached is a note by John Conti with some other perspectives on the current environment.

[2] For the quarter, the S&P 500 index returned a negative 13.9%, the Russell 3000® Index was down 15.3%, the MSCI World Index was down 17.3% and the MSCI World Index ex the USA dropped 19.8%. For the nine month period, the S&P 500 index had a negative 8.7% return, the Russell 3000® Index lost 9.9 %, the MSCI World Index was down 13.2% and the MSCI World Index ex the USA dropped 16.5%.

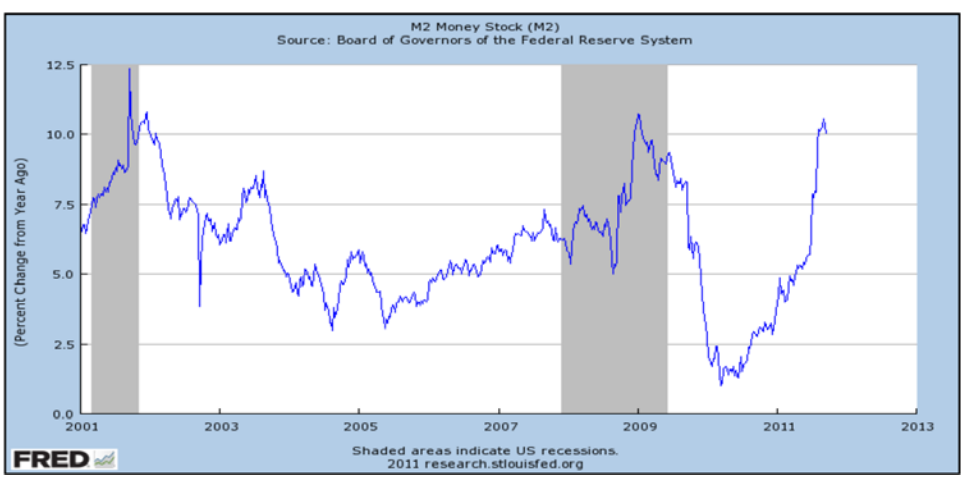
Results for these indices (S&P 500, Russell 3000®, Morgan Stanley Capital International All Country (MSCI) World Index and MSCI World Index ex USA) are quoted as being somewhat representative of the broader equity markets for comparison to SeaBridge U.S., global, and foreign portfolios. The SeaBridge 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.

Another slant on the economic and market trends and possibilities

The general tenor of economic data reported in the U.S. in recent weeks seems to have improved. For example, the final report of second quarter GDP was revised from 1% to 1.3%. While this is a very low rate of growth for an economic recovery, we remain of the belief that the second quarter was depressed by several transient factors. Most notably, an oil price shock and a natural disaster induced disruption of the manufacturing supply chain from Japan. Now that the price of oil has begun to decline, and the Japanese supply chain has returned to normal, the recent improvement in economic data seems consistent with our assumption that the economy will likely strengthen into the end of 2011. Some of the more salient data points supporting the recovery scenario are: existing home sales, which improved from 4.67 million units to 5.03 million; the Chicago PMI, which improved from 56.4 to 60.4; and the ISM Manufacturing Index, which improved slightly from 50.6 to 51.6. Perhaps most important, however, was the Index of Leading Economic Indicators (LEI), which advanced by 0.3%. Moreover, the 6 month LEI increased at an annualized rate of 4.8%. It is important to note that the U.S. has not gone into economic recession unless the growth rate in the 6 month LEI has gone below zero (observation period beginning 1959).

Despite the improvement in economic data, the stock market is clearly pre-occupied with events beyond the shores of America. Clearly, the continued festering of the sovereign debt problem has weighed heavily on European banks and sparked fears of contagion. Fears of another post-Lehman credit crunch have wreaked havoc on the price of risky assets, such as stocks and commodities. In our judgment, the operative word is fear, which can turn into reality when allowed to persist for too long.

As a part of our analysis of the Leading Economic Indicators noted above, we observed that the largest component of the continued increase in the LEI was a sudden acceleration in the rate of growth in the money supply. Throughout 2011, the money supply, as measured by M2, had been growing on a year over year basis at a moderately accelerating rate to a level around 5% in June. In July, the rate of growth in M2 increased to 8%. By the end of August, M2 growth spiked to a rate above 10%.



Since an M2 spike such as this has only occurred three times since 2000, we view it as significant. Normally, we would think of growth in the money supply as a measure of economic activity. We have been monitoring the growth in M2 closely all year to confirm the acceleration in growth in Commercial & Industrial loans and consumer loans that we have observed. When M2 growth spiked in August, we concluded that M2 changed from being a measure of economic growth to a measure of fear as investors dumped stocks and commodities, and sought refuge in bank deposits and money market funds.

The first spike in M2 in our reference period occurred in September 2001. The horrific terrorist attack in that month roiled the stock market. The second spike in M2 occurred in December 2008/January 2009, which was the post-Lehman panic. The third spike began in August 2011 and continued through September. After the breathtaking market decline in September 2001, the stock market snapped back shortly after the peak in M2. In 2008, the market continued to decline sharply for 6 weeks past the M2 peak. Inclusive of the down-leg, however, 2009 was one of the strongest bull markets in history. Our conclusion is that the stock market may now be a coiled spring. The catalyst for a sharp reversal will probably need to come from Europe. In 2008, the market didn't start moving higher until the Fed's TALF program and the Treasury Department's TARP program were actually implemented. Thus far, however, European leaders have kept the market waiting for a sustainable solution to the sovereign debt/banking problem.

In light of recent economic data, we continue to believe that U.S. economic growth will likely continue to accelerate, albeit modestly, into the end of 2011 as the supply chain disruption fades into history, and the price of oil pushes the price of gasoline into the lower end of our $3 to $4 per gallon danger zone. If the Eurozone governments can stabilize the banking system before the credit markets seize-up, stock market investors have the potential to be justly rewarded for the volatility they have suffered in recent months. Of course, our hopes and expectations may not be realized, and there could be a much more negative outcome than implied by our analysis.

John Conti
October 4, 2011