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

Dear Client:

The markets ended 2007 on a downbeat note as data came in reinforcing anxieties. For the year, most of our portfolios performed acceptably, but almost all the gains came in the first half of the year. Actually, instead of being happy about the year, our emotion is relief about performance in the second half - in that we avoided major value collapses in most portfolios while the market absorbed some of the disturbing realities which have been ignored for years.

For the quarter, the S&P 500 was down 3.33%, the broad U.S. market Russell 3000® index returned -3.35%, the global MSCI World Index was down 1.7 % and the MSCI World Index ex USA was down 0.62%.* For the full year 2007, the S&P 500 was up 5.49%, the broad U.S. market Russell 3000® index returned 5.14%, the global MSCI World Index was up 12.18% and the MSCI World Index ex USA was up 17.12%.

Certainly the political unrest in Pakistan, oil prices at \$100/barrel, and the rapid rise of Mike Huckabee, a Republican candidate not liked by financial interests, were factors in December's weakness. However, in our minds, there were three other realities which weigh more heavily on the market outlook:

1. The housing problems continue to grow. The government is searching (probably frantically) for some mechanism to slow the decline in house prices because each drop in home value leaves another layer of mortgages greater than the value of the underlying homes. This indicates more problems with mortgage defaults and more stresses on already strained bank capital. The eventual solution to falling house values is either a sharp drop in interest rates or a sharp rise in incomes. The inflation outlook makes the former difficult to effect in the short term, and the economic slowdown and rising unemployment make the latter also unlikely in the early part of 2008.
2. Consumer spending is weakening as widely predicted, with discretionary purchases being particularly hard hit. This is not surprising because consumers, in the aggregate, have been spending far beyond their incomes, and the withdrawal of equity from homes to support spending is generally now much less available. A former Fed Chairman recently estimated that the overspending has been on the order of 6% of GDP. If that is to be the magnitude of the needed cut back, even spread over several years, it probably ordains a recession followed by a period of slower growth in the U.S. domestic economy. Wall Street has long felt that the U.S. consumer would always find a means to "keep spending." The possibility that cut-backs are now upon us weighs heavily on the large consumer-driven part of our economy, and on those holding the credit obligations of over-borrowed consumers.

* 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.

3. The country is still assessing the leverage that “the shadow financial system” has introduced to our markets. The shadow system includes: the structured investment vehicles (SIV’s) and other off-balance-sheet vehicles of banks; the leverage through foreign borrowing of hedge funds; the use of derivatives which can multiply the exposure of any financial instrument; and the greater leverage used by the trading desks of banks in their intense quest for quarterly profits as spreads have narrowed. The spreads on inter-bank borrowing in both the U.S. and Europe and the price action of securities held by leveraged portfolios both indicate that the strains on the shadow financial system are not yet fully unwound.

So where does that leave the strategy of someone who remains “cautiously optimistic?” Or perhaps why is anyone “cautiously optimistic” in the face of this? There are several reasons:

- There is still a lot of liquidity in the U.S. and in the world. The buoyancy of markets in the past six months testifies to the fact that financial markets look pretty good relative to other places to put savings. In fact, the move to put savings into real estate over the past four years appears to have come to an abrupt end.
- Much of the world’s growing liquidity has accumulated in the hands of sovereign wealth funds (SWF’s). This occurs due to our trade deficits on oil and Asian purchases. So far the preferred destination for the growing capital of the SWF’s has been U.S. Treasury bonds and strategic investments in troubled financial institutions in the U.S. This recycling supports our markets in the same way that LBO buying did in the prior two years.
- The dollar is cheap relative to the Euro, Latin and Canadian currencies. Not only is the U.S. export sector prospering, but foreign buyers are seeing U.S. equity assets trading at a big discount via the exchange rate.
- Asia, the Middle East, and emerging markets (EM’s) supplying the materials for infrastructure growth in Asia and the Middle East, are enjoying a boom (and having a large impact on the world economy). There is a question about whether this boom can continue if U.S. growth slows sharply. Our assessment is that the EM boom probably would slow, but given lead times in infrastructure, that slowing would probably occur in 2010 and afterwards.
- Finally, U.S. stocks are not expensive relative to interest rates and even less expensive compared to where interest rates are likely headed in the hunt to support housing.

So this puts sharp focus on what to own to try to take advantage of the plusses and avoid the problem sectors. Since the stock prices of involved companies have dropped sharply reflecting bank, mortgage, and retail spending problems, the real question is whether the current outlook is already reflected in stock prices. The answer is “*We do not know.*” However, with leverage in the system still unwinding, it seems wise to assume there are still some price adjustments left to come.

Our own views on that are influenced by our past work experiences in financial institutions. It takes a lot longer than one would think for the full impact of portfolio positions to drive decisions to do things differently. In the meantime, career protection leads the players to understate the problems caused by their past decisions. Moreover, commercial real estate, which had become significantly over-valued as of last Spring, is just beginning to unwind values and surface credit problems. Commercial real estate lending is a big asset component for many regional and local banks and indigestion in the regional banks could follow the stresses seen in big money-center banks in the last six months.

So our instincts are to try to find some companies at least a few steps removed from the current problems. We may miss a rebound, but we may also miss a final wicked down-shot in some names (although we may not miss them all!). The risk we prefer to take is betting on Asian growth companies - particularly if Asian markets swoon in sympathy with New York. (Smaller Asian companies working in the food and infrastructure sectors had painful price declines in 4Q07, but we remain positive about their future prospects and like their valuations relative to U.S. companies.) We also want to keep some spare cash so if the markets fall very hard in 1Q08; we have some currency for buying at distressed prices.

Finally, our guess is that 2008 will be the mirror image of 2007. Problems in the first quarter are obvious, but as the year goes on, we hope that some things will be resolved and, with low interest rates, the stock market can work higher.

Happy New Year,

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.