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(Abbreviated) copy of letter sent to individual clients of SeaBridge Investment Advisors for the Fourth Quarter 2008.

The year 2008 gave us dreadful markets and a rapidly deteriorating economy. The **economic** prospects for 2009 seem to be for continued misery. Data from almost every country in the world signals falling consumer and business demand and rising unemployment. President-elect Obama will come into office in a few days with plans to create public works jobs and a coordinated attempt to slow the rise in unemployment. Whether and how this will work remains to be seen.

However, the 2009 outlook for **markets** is more encouraging – not great, but not without some opportunities, as well. After drastic cuts in interest rates by the Fed during 4Q08, Treasury securities, including those in money market funds, provide almost no yield. Elsewhere in the fixed income markets, corporate and municipal bonds provide record spreads over treasuries. One clear opportunity (although not without risk) at year-end 2008 is for investors needing income to shift out of Government money market funds into funds holding corporate and municipal bonds and lock in the unprecedented yields.

Lower quality (high yield) bonds are also providing good yields. However, given the prospects for a long and deep recession, reaching for bonds rated below investment grade should be done cautiously and in small size until prospects for the economy look better.

The stock market had one of the worst quarters in history to end 2008. The mid-September failure of Lehman Brothers set off a financial panic, combining public flight from mutual funds and 401-K plans with escalating liquidation sales by hedge funds. The decline in prices hit both stock and bond markets hard, with foreign markets generally falling more than the U.S.

To quantify the declines for the indices[1] we use as a reference for our investment styles: for the **fourth quarter**, the S&P 500 was down 21.95%, the broad U.S. market Russell 3000® Index was off by 22.78%, the global MSCI World Index fell 22.25% and the MSCI World Index ex USA was also down 22.25%.

For the full year, the S&P 500 was down 36.99%, the broad U.S. market Russell 3000® Index fell 37.31%, the global MSCI World Index was down 41.85% and the MSCI World Index ex USA returned a negative 45.24%.

The markets made two lows in October and November which resemble past bear market bottoms. However, with more bad economic news to come in 2009, and some $400 billion of hedge fund liquidations pushed over from 2008 to 2009, it will be a while before we know whether the stock market has hit bottom. We still have a major liquidity squeeze, hedge fund deleveraging, continuing housing erosion, and other recession problems to come. So it takes an optimistic turn of mind to conclude the worst is behind us.

[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.

Past recessions ended when cheap money sent the consumer back into the markets on a buying spree. This cycle, both the consumer and the Government are overextended. Since the consumer cannot be counted on, the Government will print money to spend. In the short run, that will help. Whether it will be sufficient for a mid-year recovery is unknown. And whether the dollar will slide faster or inflation will rise following the Government spending are imponderables on the horizon. Concerns about the future purchasing power of assets argue for keeping a significant stock weighting, as well as using bonds for less short term uncertainty in some strategies.

In an effort to capture some of the opportunities offered by adversity, our strategies are somewhat different by investment style:

- In Cautious Core portfolios, we are searching for funds of good quality bonds to improve the yield from Government money funds while maintaining longer term protection of principal for most of the assets. You will see in Cautious Core portfolios several of the closed end funds and mutual funds we have chosen. Money fund assets remain a large portion of the portfolios, and so the search for safe alternatives continues.
- In Yield-Growth portfolios we have reduced money fund positions significantly in the past six weeks. Our goal is to lock in the high yields available in the bond, preferred stock, and MLP markets for the future. We have selected well managed bond funds with a large portion of their holdings rated investment grade. We have also chosen preferred stock and some funds owning senior secured bank loans as well and a few funds holding small portions in high yield bonds.
- In Global Trust portfolios, which are all tax deferred accounts, our strategy was similar to Yield-Growth. We bought closed-end funds to capture the record discounts from Net Asset Value and to also lock in high fixed income and preferred stock yields.
- In Core portfolios we have focused more on the potential for positive developments in the **U.S.** market in the wake of massive public policy response to the credit crunch. For this **global equity** strategy, we moved more aggressively to reduce cash to maintain our clients' equity exposure, with an eye towards preserving future purchasing power. Taking advantage of the low prices created by the public flight from equity securities, we have bought stocks which we feel are undervalued by the market in the coming economic climate.
- In International portfolios, we have kept high levels of cash and made only a few purchases of global bond funds or funds focused on preferred stock or risk arbitrage. Most foreign Governments have been less aggressive than the Fed in addressing the collapse in global demand and we are even more cautious about foreign economies in 2009 than we are the U.S. Following greater declines, stock valuations outside the U.S. are very cheap, which is appealing. We are reviewing large numbers of stocks and closed-end funds, searching for high quality companies with non-cyclical franchises or strong growth prospects which can make progress as the slowdown accelerates overseas.
- In our Asian portfolios, we retain an above-normal level of cash, and are seeking companies at cheap prices operating in non-cyclical areas or areas which will benefit in infrastructure building. Because both consumers and governments in Asia are less stretched than in the U.S. the cheap prices there seem like extraordinary bargains for the long term. However, that long term has to await some return of confidence in New York and London.

It would be nice to start 2009 with a stock strong rally to match the rallying bond markets. That may come about, but we are not counting on it. Our goal is to fit assets which we think are attractive relative to their risk to each of our styles, believing they will provide a good return over the long run.

Note on Closed End Funds

As noted above, in the past six weeks we have added a significant number of closed end funds (CEFs) to portfolios in several styles. A few words on them may be helpful. CEFs are like mutual funds, managed by major institutions, which trade on an exchange, mostly the NYSE. Unlike mutual funds where the fund itself issues new shares to buyers and redeems shares from sellers, CEF shares trade in the market. When a fund is in high demand, its shares move to a premium relative to the underlying Net Asset Value (NAV) per share and, when everyone wants out of a fund, the market price falls to a discount to the underlying NAV.

CEFs usually trade at something like a 5% discount to their NAV. In times like October and November, when the public is fleeing all funds, CEFs fall to large discounts to NAV as everyone wants out at once. Discounts of 20 to 30% relative to NAV are common. For those taking a longer view, this provides an attractive buying opportunity – you can buy $1.00 of assets for $.75, with the prospect of hopefully selling it later for something like $.95.

CEFs have two other unusual characteristics. Many of them use borrowed money to enhance the returns. This magnifies performance in both directions, and one does not want to buy them until you are reasonably confident you are approaching the bottom of a bear market. Second, to keep the discount to NAV small, CEFs adopt a distribution rate which assumes that some capital gains will be earned. When there are no capital gains, the fund's distributions return some of the NAV to the shareholders in lieu of capital gains. When CEF market prices fall to a large discount to NAV, this "over-distribution" is attractive to the shareholders, because you are paying $.75 at market for NAV and the distribution amount in excess of income is paid back at $1.00 NAV.

Fixed income CEFs are particularly attractive because we can examine the underlying bonds held and buy a diversified portfolio at a discount. Because bonds trade in higher amounts, it would be impossible to duplicate the diversification by buying individual bonds in portfolios below $10 million in size. Due to the current depressed market prices, the CEFs sometimes provide "distributions" in excess of 20%, including both the earned income and the "over-distribution." Eliminating the "over-distribution", the normal yield on these funds is typically in the low to mid teens, which we believe is very attractive for solid quality bonds in an uncertain world. Of course, there are still risks that investments in these funds will decline in value.

We started buying CEFs in the summer as the discounts to NAV opened and continued buying in October and November in the face of a falling market and huge discounts. When the Fed announced its "Zero Interest Rate Policy" on December 15, the bond markets started to rally with CEFs leading the way. Happily, by year-end we have a small gain on most of our bond CEFs as well as very attractive yields. (Of course, there are no guarantees that these returns will persist in the future).

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, 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, Dave Descalzi, John Conti and Susan Boyd of SeaBridge Investment Advisors based on their 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.