



SeaBridge Core Global Strategy

Second Quarter 2014

Commentary

We have consistently made the case that the US economy is in the process of slowly accelerating towards its economic potential of between 3% and 3.5% growth in GDP. One of the key drivers in our analysis is the continued recovery in real estate. Housing starts began 2014 at an annualized level of 897,000 units. Based on demographics, we believe housing starts should improve to a sustainable level of 1.5 million units. Although housing has recovered nicely off of the extremely depressed level following the 2008 credit crunch, it has recovered more slowly in the current economic recovery than in past recoveries. We can rationalize this slow recovery based on several factors. In September of 2013, we noted that a severe shortage of land entitled for development was one such attenuating factor. In December 2013, we commented on higher credit standards as another factor that has slowed the recovery in real estate. Yet another inhibiting factor was a reduction in home ownership among the age cohort 30 to 34, which has historically been the average age of the first time home buyer. In our April 2014 commentary, we said the decline in home ownership among the first time buyer cohort was likely attributable to price competition from institutional investors at the low end of the home price spectrum.

Importantly, in our judgment, none of the factors we have identified as having contributed to a slow recovery in real estate are permanent. We view them as transient factors that both slow and lengthen the real estate recovery in the US. We believe that as time passes these attenuating factors will abate. In fact, recent housing data support this view. In June, the key housing statistics indicate a resumption of growth in housing following the soft patch that we experienced over the past nine months. Housing starts are up 12% at an annualized rate since the level reported in January. Similarly, building permits are up 6%, new home sales are up 10%, and existing home sales are 6% higher. If these data mark the beginning of a trend, housing may be poised to add between 1/4 and 1/3 of 1% to GDP growth for the next few years as new home construction advances towards an annual rate of 1.5 million units.

Another factor, student debt, could also have slowed the growth in housing in recent years, but is a little more complex than the factors cited above. In 2006, which was the year before the housing economy began to hemorrhage, student loan debt was 3.2% of GDP. This jumped to an eye popping 6.5% of GDP in 2014! Clearly, young adults who would normally be buying homes as they entered the 30 to 34 year old cohort would have a tougher time qualifying for mortgages if they were burdened with loans for their education. As we discussed above, the shortage of land entitled for development, price competition for property from vulture funds, and higher credit standards all may have inhibited the recovery in housing, and may now be abating. Like these three factors, student loan debt may also have inhibited the recovery in housing. Unlike the other factors, however, an increase in student loan debt may result in a lasting economic driver as time passes and it ceases to be a growth attenuator.

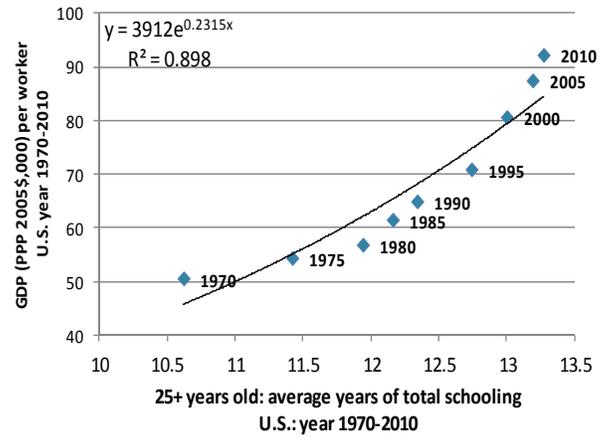
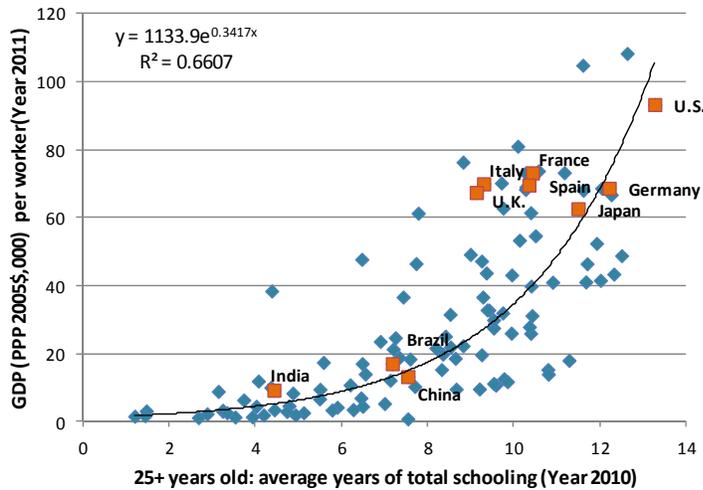
While it would be easy to conclude that an increased student loan burden was the result of rising tuition costs and, therefore, unlikely to diminish over time, the data suggest otherwise. From 1983 to 1994, private college

tuition increased at an average annual rate of 4.1%. Public institutions increased their tuition at a rate of 4.3% over the same period. From 1994 to 2004, the rate of tuition increase was 3.1% private and 3.7% public. From 2004 to 2014, private colleges increased tuition 2.3% per year, whereas public institutions increased tuition at 4.2%. We, therefore, conclude that recent increases in the cost of education have been roughly in line with the historical rate of increase. This means that the increase in student loan debt as a percentage of GDP is not the result of the rising cost of education but, more likely, the result of a greater volume of people going to school during the period from 2006 until present. In fact, the enrollment data are supportive of the notion that people enroll in college in greater numbers when the economy is soft than in periods of economic strength. From 1980 through 2007, college enrollment increased at an average annual rate of 1.5%. During the period 2007 through 2010 (i.e., the recession and first two years of the recovery), the rate of increase in enrollment jumps to 4.8% per year! While this increase in the portion of the US population seeking higher education has left us with a temporary increase in student debt burden, we also have more people equipped to compete in an economy that increasingly places a premium on higher education.

In the remainder of this commentary, we analyze the relationship between labor productivity and education from a cross-country and cross-time period perspective and find a strong positive contribution of education to productivity. Better educated workers, on average, have more employment opportunities and higher labor force participation rates throughout their careers. Even at older ages, they tend to have better health and continue to participate at relatively higher rates. During and post the 2008 recession, unemployment among the nation's young adults has been particularly pronounced, which accelerated the long-term trend of decline in labor force participation among the 16-19 and 20-24 years old cohort. Keeping more young adults in school could temporarily suppress labor force and output growth. Fortunately, more baby boomers, with higher education attainment and experience, are more likely to stay in the workforce longer. Given the significant and positive effect of education on output, the changing workforce composition bodes well for productivity growth in the near term and beyond, perhaps keeping a lid on inflation and aiding the Fed in engineering a slow and smooth return to normal monetary policy.

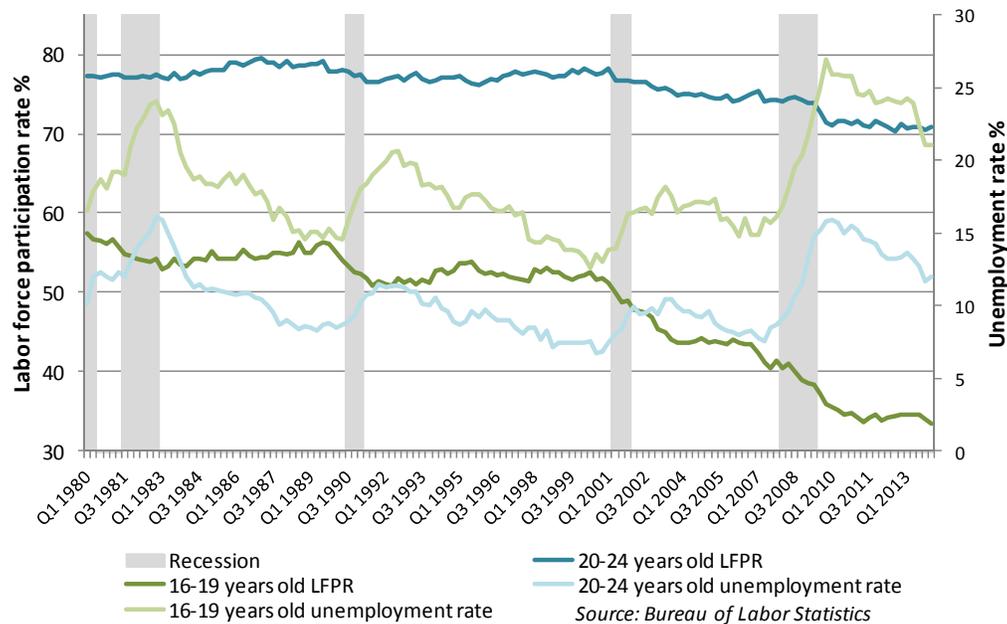
In economic growth theory, the level of productivity (output per worker) that can be achieved in the long run could be attributed to the rate of investment in physical and human capital, augmented by a term known as total factor productivity (TFP), which drives the productivity of physical and human inputs. It explicitly emphasizes the role of education in increasing the innovative capacity of the economy through developing new ideas and technologies. Indeed many product innovations have been closely tied to university-level research. Though it is difficult to predict where the next wave of innovation will come from, a strong research base and well-educated labor force clearly will facilitate idea origination and technology development and diffusion within the economy.

We use the 2013 Barro-Lee Dataset from the World Bank for educational attainment, which includes 146 countries from 1970 to 2010 at 5 year intervals, and the Penn World Table for the productivity measure, which is defined as real GDP per worker. The figures below display the two components from a cross-country view (left) and a cross-period view for the U.S. (right). Both indicate a relatively strong association between education and productivity. Barro and Lee suggest that the return attributable to human capital varies across different levels of education and is increasingly positive in the secondary and tertiary levels. Specifically, the rate of return on every additional year of schooling is 10% at the secondary level and 18% at the tertiary level.



Source: SeaBridge Investment Advisors, Penn World Table 8.0 (www.gdc.net/pwt/), Barro-Lee Dataset (2013), The World Bank

Unsurprisingly, our examination of the U.S. Census Bureau data reveals that better educated and more experienced workers tend to accrue a lifelong benefit. These workers are typically more productive, earn higher hourly wages, and enjoy greater employment opportunities. During the prime working ages from 30 to 49, the labor force participation rate gap between workers with Bachelor’s degree or higher and those with High School diplomas averages around 10%. The gap widens to 13-14% as workers approach retirement from 50 to 69. Even into their 70s, they tend to have better health and continue to participate in the labor force at relatively higher rates, maintaining about 10% gap. On the other end of the spectrum, the young, less educated and less experienced workers have experienced economic hardship during and post the 2008 recession due to significantly higher unemployment rates than in and following prior recessions. In late 2009 and early 2010, unemployment rates reached 27% and 16% for the 16-19 and 20-24 years old cohorts, respectively, and continue to remain high at 21% and 12% for the first quarter of 2014. Correspondingly, labor force participation rates hit historical lows for young adults and perhaps will not rebound based on past observations.



The 2008 recession appears to have accelerated the long-term trend of decline in labor force participation among young adults in the U.S. Secondary and tertiary education is becoming a necessity as the country gets further along the path of development from the agriculture economy to the industrial economy and then onto the learning economy, in which the capacity of people to utilize the full potential of new technologies is vital to economic growth. In the near term, as more young adults are kept in school, baby boomers, currently 50-69 years old, could fill the void of labor demand. Baby boomers are different from their earlier generation (70-79 years old) by education attainment with 7% more Bachelor's and above degree and 7% fewer less than a high school diploma. Better educated and more productive boomers will likely remain in the workforce way past the typical retirement age. Beyond the near term, despite the costs of education (tuition and foregone wages), more young adults are obtaining the knowledge and capacity necessary to contribute to growth. The accelerated change in work force composition bodes well for a more productive society ahead, perhaps keeping inflation in check. Or, in the words of that great 17th/18th century investment strategist, Sir Isaac Newton, every action has an equal and opposite reaction. Within the context of the subject of this note, today's high student debt burden may lead to tomorrow's productivity boom.

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 June 27, 2014

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