SeaBridge Investment Advisors, LLC

SeaBridge Core Strategy

Second Quarter 2017

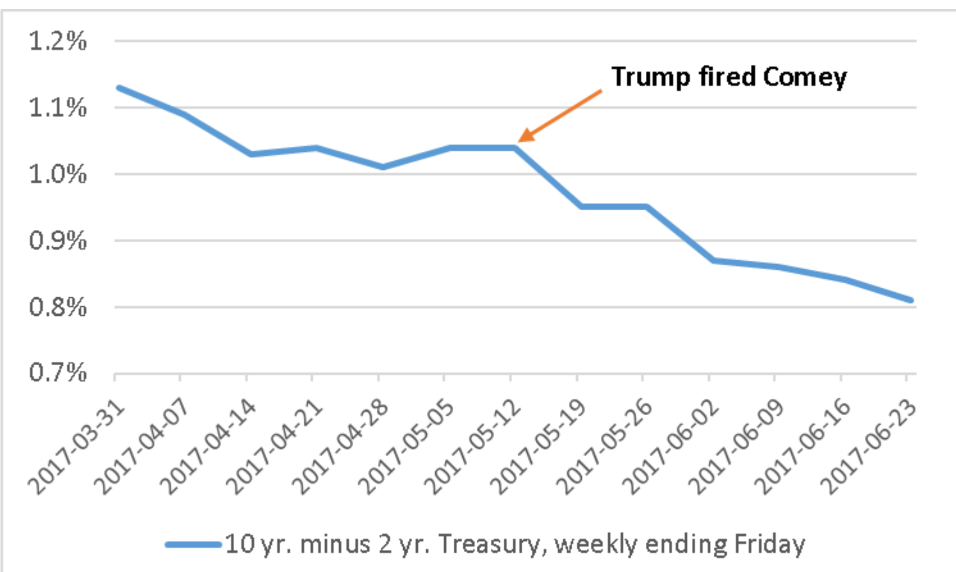
Commentary

We entered 2017 riding a wave of business sentiment that surged sharply higher following the monumental regime change in Washington after the Presidential election. As noted in our January commentary, the perception among business owners was that Mr. Trump would champion a new era of less onerous business regulation, and introduce legislation designed to stimulate both job creation and commerce. This spontaneous optimism following the election was termed “animal spirits” and was supposed to presage an acceleration in the rate of U.S. economic growth.

Although animal spirits remained strong throughout the first quarter of 2017, they appear to have faded in the second quarter. An economy that seemed poised to break out of the 2.2% growth rate experienced in the 7 years subsequent to the Great Recession suddenly began to send mixed signals in the second quarter of 2017. Importantly, the job market remains robust. In contrast, however, retail sales and residential construction stalled a bit, which is odd given that the rate of unemployment has declined substantially and interest rates remain very low. In the corporate sector, anecdotes of increasing requests for proposals and job quoting activity, thus far, have failed to turn into a broad increase in orders and backlogs. Although we want to avoid making a political statement, it seems more than a coincidence that the economy’s failure to turn rising animal spirits into economic activity was coincident with Mr. Trump’s many missteps since becoming President.

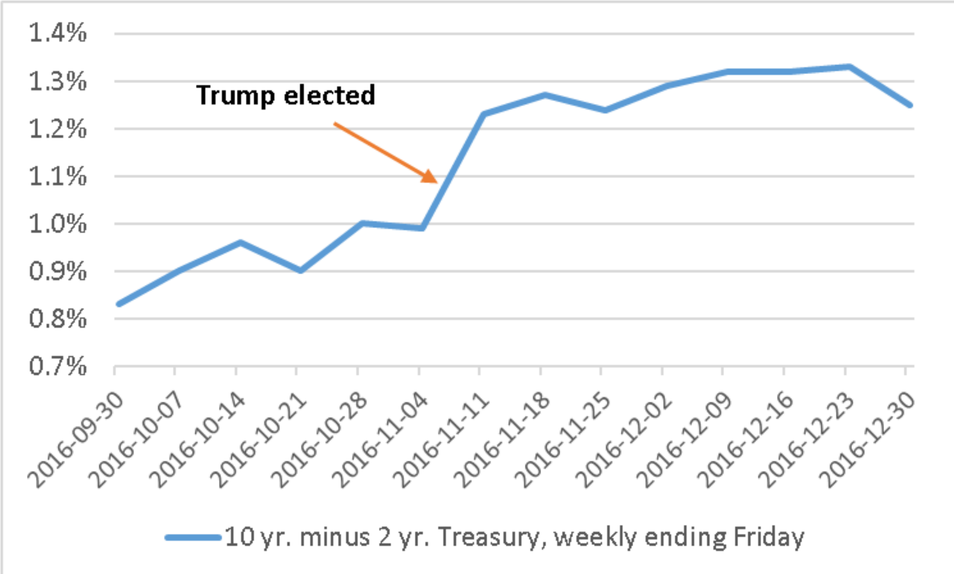
As an objective barometer of the bond market’s opinion of the likely efficacy of the Trump agenda, we can point to long-term interest rates which declined sharply after Trump fired FBI Director Comey. (See Chart 1). As you may recall, after President Trump was elected, long-term interest rates rose sharply in anticipation of an increased demand for money that would likely come from an accelerating economy. (See Chart 2).

Chart 1: Interest Rates Second Quarter 2017



Source: St. Louis Fed

Chart 2: Interest Rates Fourth Quarter 2016



Source: St. Louis Fed

This sudden decline in long-term interest rates that was seemingly the result of a diminished probability of passing the Trump growth agenda restrained the performance of the SeaBridge Core Global strategy from both a relative and an absolute perspective. Keep in mind that the Core Global strategy is managed in a strong value style. In recent years, as well as at present, our value orientation has led us to populate the portfolios managed in this style with investments in companies that are economically sensitive since those are the shares that we believe represent the greatest value in today's market. Stocks in companies that are less economically sensitive as well as high revenue growth companies have been and remain too expensive for this strategy. Given the economic sensitivity of our portfolio, as long-term interest rates deflated along with hopes for the success of the Trump agenda, the valuation of some of our investments also deflated and portfolio performance stalled in the second quarter of 2017. At the same time, high revenue growth equities, that are largely outside of our valuation parameters, got a boost from lower rates and drove the market indices to new, lofty levels. This is classic price-to-earnings ratio expansion that comes from using a lower discount factor to value any given stream of earnings. In other words, the second quarter of 2017 was very similar to 2015; a disappointing period in which our performance fell well short of our historical performance.

Two of our three retailer investments, Bed Bath & Beyond (BBBY) and Urban Outfitters (URBN), were particularly disappointing in recent months. In contrast, our third retailer, Coach (COH), is performing quite well. Our challenge in the coming months will be to determine if BBBY and URBN are structurally challenged or if their woes are transient. As noted earlier, retail sales in aggregate were one of the economic indicators that softened during the second quarter. If this proves to have been the problem, then BBBY and URBN are now extraordinarily cheap and could represent great investment opportunities as the economy reverts back to trend levels of activity or, perhaps, accelerates if Trump can get his agenda back on track. If the problems being experienced by these two companies are more structural, rather than economic, then these two investments could remain permanently impaired. For the moment, we have all three of our retail investments under close scrutiny and will likely make some decisions regarding these investments in the near future. At a minimum, we expect to book losses in our taxable portfolios to offset the gains we have already booked this year.

The economic tremors that deflated some of our investments also created an opportunity for us to put some of our cash reserves to work. During the second quarter, we initiated a position in WPX Energy Preferred (WPXP) and Steelcase, Inc. (SCS). The shares of both companies declined in response to macro factors and now appear to be very attractive to us on the basis of perceived reward potential vs. risk.

WPX is an oil and gas exploration and production company with leases in Texas and New Mexico in the Delaware Basin, as well as choice acreage in North Dakota's Williston Basin. The Delaware Basin is one of two sub-basins within the larger Permian Basin. We are already well exposed to the Midland Basin, which is the other sub-basin in the Permian, through our position in Pioneer Natural Resources (PXD). The economics of producing oil and gas in the Permian Basin are competitive with the best oil fields around the world and should be able to produce attractive returns on investment even in the currently depressed hydrocarbon price environment. Our investment in WPX is in the form of their 6.25% Mandatory Convertible Preferred Stock, which will convert into common shares in July 2018. Between now and the conversion date, we should collect $3.90 in dividends, which effectively lowers our cost to acquire WPX common stock by 8.5%. In exchange for this cushion, we give up the some of the upside potential in the common stock under certain price scenarios through the July 2018 conversion date. In our judgment, the WPX common shares are trading at less than half of their intrinsic value. Within the context of this opportunity, giving up a portion of the potential return to get some downside protection seems reasonable.

SCS is the largest manufacturer of office furniture in the world. In April and May, Steelcase experienced a drop-off in orders from large U.S. corporate customers. Business remains strong among smaller clients in the U.S., and Asia Pacific overall. Also, there are signs of improvement in orders in France and Germany as the political situation in Europe stabilizes and those economies seem poised to accelerate. Company management can't offer a definitive explanation for the recent softness in orders, but believe it may be a function of a hesitation on the part of large clients as the drama over health care and tax policy plays out in Washington. This seems plausible as office furniture is a capital expenditure and tax policy is a factor in capital investment decisions. Longer-term, Steelcase is poised to grow at a modest pace based on expansion in Asia Pacific and by capitalizing on previous investments in new office furniture designs to serve the demands of a changing office environment. The valuation is attractive at 12X earnings. In addition, the management is very shareholder friendly and returns most of the earnings to stock holders in the form of dividends and share repurchase.

As we move into the second half of 2017, we'll continue to look for opportunities to put our cash reserves to work in companies that fit our valuation parameters. In addition, we will also closely monitor developments in Washington. Although the Trump agenda has been mired in controversy thus far, the Republican controlled Congress can hear the drum beat of the upcoming mid-term elections. They will likely jump through hoops to get some legislation passed in 2017. Although we can't predict the future, it seems likely that the party in charge will trim back the scope of its tax reform ambitions and push through a limited tax cut for corporations. If successful, that may be enough to change capital markets' perceptions of the potential strength of the U.S. economy and reverse the decline in long-term interest rates. If past is prologue, a better outlook for the economy and higher long-term interest rates could prompt the stock market to rotate back to value from the current growth/momentum stocks that had the upper hand in the second quarter. We remain patient and disciplined as we search for investment opportunities for your assets.

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