SEABRIDGE
INVESTMENT ADVISORS, LLC

Core Strategy Q2 2022

Portfolio Managers: Dave Descalzi and Adrian Morffi, CFA

Investment Style: U.S. Equities

In the SeaBridge Core Strategy, we seek investments primarily in U.S. equities and, opportunistically, international equities. We have a particular interest in the changes to consumer behavior induced by the pandemic related to e-commerce, remote work, and a focus on home improvement. We believe these trends are secular and will generate investment opportunities post-pandemic in U.S. companies. Core is a style agnostic strategy that may hold value as well as growth equities so long as there is a path evident for value to be realized and growth is reasonably priced.

Outlook and Positioning:

It has been a difficult first half for both the equities and fixed income markets as they digest high inflation, less accommodation from the Federal Reserve, and a consensus expectation that the economy will slow, with a recession highly probable. Furthermore, energy is its own category of worry as there does not seem to be an easy solution to meeting world needs at reasonable prices. This is a witch's brew of poor conditions that may not ameliorate soon and thus further pressure markets in the second half. On the brighter side, valuations may be at a level that already accounts for poor expectations. From Main Street to Wall Street, we believe the U.S. economy is in much better shape for a recession. Savings are high, unemployment low, and corporations are cashed up. All major banks have passed their stress tests and have met the Fed's stringent capital requirements.

Despite the stated intention of the Federal Reserve to raise the Fed Funds rate and shrink its balance sheet, the market may pivot to lower interest rate expectations. This transition may put a floor to the downside of equity markets even in an economic downturn. For equities, this change in mindset would likely favor growth over value. Among our portfolio companies, we will be inclined to target our "growth at a reasonable price" holdings while looking to reduce our exposure to companies dependent on consumption, especially discretionary spending. We are also wary of commodities as they will likely feel the brunt of waning aggregate demand. Oil and gas are excepted from this assessment as we believe that strained supply may struggle to keep pace with demand even in a slowing economy.

In the first half of the year, we were aggressive net sellers of holdings and produced significant capital gains. We will work down these gains with losses as best we can before the end of the year.

Contributors and Detractors:

The most significant contributors to performance in Q2 were Kimberly-Clark and Merck. Kimberly-Clark primarily produces tissues and paper towels under branded names like Kleenex. The stock's positive quarterly return resulted from a better-than-expected earnings report. The company saw strength in its top and bottom lines that exceeded analyst expectations, while full-year guidance was increased by management. The recent earnings report indicated the company should benefit from the inflationary environment as it demonstrates pricing power in key product categories enabling higher prices to be passed on to customers. Merck substantially benefited from its new Covid antiviral medication. Lagevrio produced $3B in sales in a single quarter after coming to market during Q1. Merck's flagship oncological drug, Keytruda, continues to contribute meaningfully to fundamentals as the list of cancers it is approved to treat expands.

Spotify and Howard Hughes were the largest detractors during the second quarter. Shares in each company declined more than 30% as markets generally rotated away from growth and real estate-related investments as interest rates rose. We added to our investment in Spotify on the weakness following the selloff. We believe the recent earnings report was evidence of improving fundamentals and find the valuation cheap for a company with a strong growth profile. Howard Hughes' stock price suffered as sentiment continued its sharp reversal for commercial and residential real estate assets. With its master-planned communities located primarily in Houston, TX and Las Vegas, NV, this diversified real estate development and operating company holds vast swaths of undeveloped land. We have been reducing real estate exposure in the portfolio for much of the past 18 months, including Howard Hughes. During the quarter, we also fully exited our position in the Hawaiian real estate company Alexander & Baldwin.

Portfolio Activity:

We continued to diversify our overall investment allocation during the quarter by increasing our exposure to technology, energy, and communication assets. This included purchases in Diamondback Energy, Salesforce, and Verizon. We also reduced our allocations to consumer-related, cyclical assets, including Polaris, Newell Brands, and Hanesbrands.