SEABRIDGE
INVESTMENT ADVISORS, LLC
Garnett Keith, John Conti, David Descalzi, Susan Boyd
450 Springfield Avenue, Suite 301 • Summit, NJ 07901-2610
Tel: (908) 273-5085 • Fax: (908) 273-6297

August 4, 2015

Copy of interim client letter August 2015

In our quarterly letter last month, I used a riverboat analogy and suggested "we are out of the known channel and trying to assess the risks of various courses, speeds and economic sandbars." Events in July have borne out that assessment: we are in unknown waters. Weakness in China, the greater than expected impact China is having on oil and other commodities, investor focus on individual tech companies at the expense of other sectors, and other developments have generated significant volatility in the stock market, particularly in some individual stocks.

These factors make us expect more volatility as the Fed begins to tighten, as the magnitude of China's slowing become clear, and as Europe tries to sort out Greece - it is not over yet by any means. Together these call for a more conservative posture in the hope of having a real buying opportunity between now and year-end.

In our Yield Growth, Cautious Core, Inflation Fighter, and Global Trust styles we like the stocks in the portfolios, but have used part of the cash position to put in hedges -ETF shorts on the Russell 2000 and S&P 500. In our International strategy, we raised some cash and examined shorts on the Shanghai market, but found the borrowing costs for ETFs shorting that market to be too high.

In our Asia strategy, while Dave Descalzi acknowledges that China, its economy and its stock market are of some concern now, he believes China has the time and the resources to work through issues before they get out of hand and he has been focusing on the long-term prospects for the individual companies in the portfolio. He also believes that some parts of Asia, particularly South East Asia, will be net beneficiaries of the turmoil in China as companies increasingly look to expand in the region outside China.

In our Core Global style, we raised cash levels by selling individual securities. John Conti's detailed review of what he sees going on in the world and how he is responding to those developments in the Core Global Equity strategy is attached.

Please contact us if you would like to discuss your portfolio and how it is positioned relative to your goals and risk tolerance.

Garnett L. Keith, Jr.

SeaBridge Investment Advisors, LLC

SeaBridge Core Strategy

August 2015
Commentary

Subsequent to the distribution of our last commentary, we made several changes to SeaBridge Core Strategy portfolios in response to recent events. Most notably, the extreme volatility of stocks in China, the 20% decline in the price of oil in just one month, the price action of some US stocks in the early weeks of earnings reporting season, and the continued strength of the US economy caught our attention. In response to these events, we eliminated our position in Coach, trimmed our direct exposure to oil & gas exploration & production companies, and increased our cash reserves. It is our intention, at the present time, to re-deploy our reserves into volatility that may occur in US equity markets in the final months of 2015.

The Chinese stock market more than doubled over the past year. It peaked in mid-June and then began to plummet. By the end of the first week in July, the Chinese market was more than 30% below its high for the year. Moreover, the day-to-day volatility towards the end of the decline was breathtaking. The wealth effect of changes in equity prices in China is likely considerably less than in the US because stock ownership among the population in China is very low. However, in response to the extreme volatility, the Chinese government implemented some very aggressive measures to stabilize the market. In particular, they halted trading in 1,400 stock issues and promulgated rules aimed at inhibiting large scale selling of equities. Our concern is that these measures could cause consumers to feel as though they can't get access to their money and, therefore, reduce spending to conserve capital.

In response to this thought process regarding China, we eliminated our position in Coach (COH). Although Coach only derives about 15% of its business from China, it is an important contributor to growth at Coach. Continued growth in China is all the more important to Coach at present as the Company is in the middle of a very complex, multi-year restructuring process designed to change its merchandising, marketing and promotional strategy with a goal of building a platform that can support their next stage of growth in the United States. We fully intend to re-establish our position in Coach after we have had the opportunity to evaluate the situation in China as we believe the intrinsic value of Coach's shares to be twice the current price, and the business re-engineering plan in place is the key to unlocking the value.

Subsequent to the sharp decline in the price of oil since last November, we published several notes examining the prospective supply and demand dynamics of the oil market. Our conclusion had been that the oil market would likely come into balance late in 2015 or early 2016. The important elements of our analysis were a decline in production in the US, and an increase in demand in both the US and Europe. Prior to June, we were seeing support for each of the three dimensions of our case for the price of oil to stabilize and drift higher. In June, however, the price of oil dropped 20% from $60 per bbl. to $47 per bbl. (West Texas Intermediate). Initially, we surmised the price decline in oil was likely attributable to an unexpected increase in supply from OPEC. In the short-run, increased supply from OPEC can put downward pressure on the price of oil. In the long-run, however, we believe Saudi Arabia's (OPEC's largest producer) rate of production is unprecedented and likely to damage their oil fields if production were to be maintained at the current pace for too long. Indeed, Saudi Arabia more or less confirmed this perspective in late July when they announced that they expect to curtail production by the end of the summer.

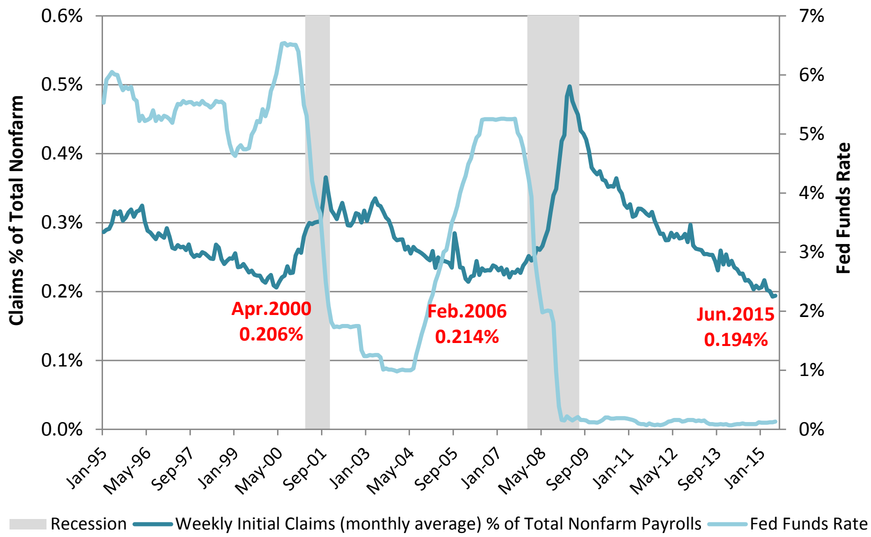
By the third week of July, US companies began to report their second quarter earnings. It quickly became apparent that an unexpected reason for the sharp decline in the price of oil since June could be related to a slowing in the growth of demand from China. Several companies in our portfolio, as well as others, reported a sharp decline in economic activity in China late in the second quarter. In particular, United Technologies (UTX) said that elevator orders declined sharply in China. Similarly, TE Connectivity (TEL) reported that its sales of electrical connectors to the auto market in China softened. Although our initial reaction to extreme volatility in the Chinese stock market was to conclude that consumer caution could lead to some softness in economic activity in China, as companies began to provide updates on business conditions in China, it was suddenly apparent that we may have had the causal arrow pointing in the wrong direction. Instead of stock market volatility in China leading to a pause in economic activity, perhaps the volatility in the stock market was, in fact, the result of an unexpected softening of business conditions in China.

As it became more apparent that China was experiencing an economic pause, the price of commodities continued to drop. Most notably, copper declined by more than 12% since the beginning of June. This supports the notion that the sharp decline in the price of oil since June was partly the result of less demand from China rather than simply more OPEC supply. As a result of this conclusion, we reduced our position in oil & gas Exploration & Production (E&P) companies. We view this as a temporary development and will look for opportunities to increase our exposure to E&P as we develop a better understanding of the magnitude and duration of the economic pause in China. Although the E&P stocks swing wildly in the short-term in reaction to changes in the price of oil, longer-term we believe the learning curve effect that these companies are experiencing in the United States is accreting tremendous value.

The sharp decline in business activity in China was not the only surprise revealed in second quarter earnings reports. Price action of specific companies, as opposed to the stock market as a whole, was stunning. We have lamented for some time that our performance problem over the past 18 months was likely the result of an extended period of a zero risk free interest rate (i.e. US Treasury Bills) causing excess valuation in equities of high growth companies and a near abandonment of the shares of companies that we believe incorporate a more reasonable reward potential vs. the risk of longer-term value destruction. This phenomenon became all the more extreme as companies reported earnings. The poster child for extreme valuation is Netflix (NFLX), the shares of which jumped 15% following the release of their second quarter earnings. Netflix shares now trade for more than 500 times estimates of this year’s earnings and nearly 350 times next year’s estimates. While Netflix has certainly been at the vanguard of disrupting the conventional TV program distribution model, we are concerned that valuation models that justify such an extreme valuation may not incorporate realistic long-term discount factors. A discount factor should incorporate two variables, the risk free rate of return and a risk adjustment factor designed to take into consideration that long-term success of any business model contains a degree of uncertainty. The latter component of the discount factor as it applies to companies such as Netflix is beyond the scope of this commentary. The former, however, is something we have written about many times, and will touch on briefly yet again.

The US economy has been growing at a slowly accelerating rate in recent years. Earlier this year, we published Chart 1 below that depicts the level of initial unemployment claims as a percentage of the total number of jobs in the US economy. We then overlay the Fed Funds rate, and make two observations from this chart: 1) the level of initial unemployment claims is as low as it has been in modern economic history, 2) in the past, when the level of initial unemployment claims has been nearly as low as it is at present, the Fed Funds rate was already rising for quite some time to get ahead of an increasing probability of inflation rising. Our conclusion is that the Fed is very late in taking the first step in allowing interest rates to seek a normal level. While it can’t be known with certainty when the Federal Open Market Committee (FOMC) will take the first step in lifting the Fed Funds rate, Chairperson Yellen has indicated in Congressional testimony that she believed the FOMC is likely to take at least one step in 2015. Although the FOMC will auger its actions based on future data points, it is distinctly possible that they will raise the Fed Funds rate in September, and then possibly again in December.

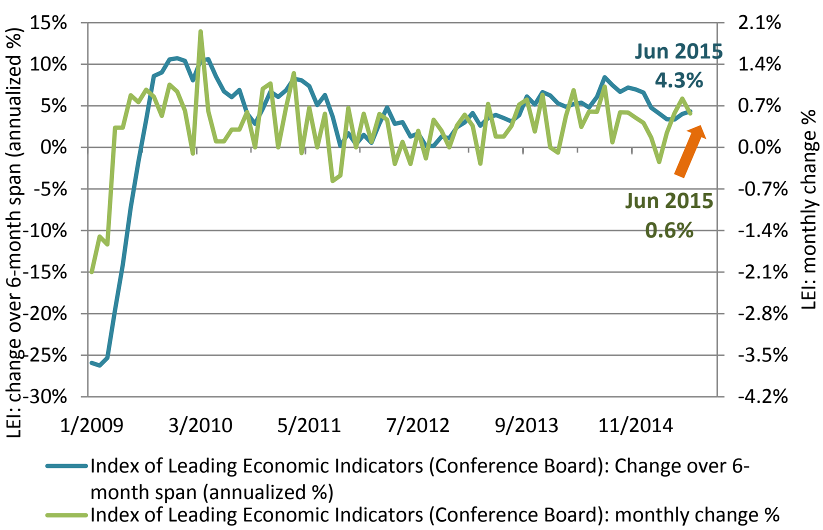
Chart 1:



Source: St. Louis Federal Reserve

Furthermore, the Index of Leading Economic indicators (Chart 2) is pointing to continued moderate acceleration in the US economy, which is likely to further tighten an already tight job market. The market for college educated and skilled labor has been tight for some time but, now that both residential and non-residential construction are in the process of mounting a second leg of their upturn, the market for unskilled labor may tighten as well.

Chart 2:



Source: The Conference Board

Although we are of the belief that a modest increase in interest rates will actually stimulate the economy as banks will see margin improvement and, therefore, have a greater incentive to lend money, we are concerned that the high valuation stocks that have led the stock market in 2014 and 2015 may not be prepared for the end of an era of free money and could stumble as interest rates rise. Any revaluation of the market leaders may also cause extreme volatility in the price of equities in general. Consequently, we have taken the precaution of increasing our cash reserves to prepare for opportunities that may emerge in the stock market as investors reconsider the relative valuation equation.

Clients are reminded that the strategy employed in the management of these portfolios is index agnostic. Neither the composition of the S&P 500 nor its performance has any bearing on the structure of our portfolios. The structure of industries and valuation of equities are two of the more important characteristics that we consider in making our investment decisions. Moreover, we consider the reward potential of specific equity investments within the context of the risk that we perceive through our appraisal of macro considerations. At the present time, stocks, such as Netflix, that are driving returns in the marketplace lack the industry structure characteristics and or valuation that attracts our attention. Although Netflix has done yeoman's work in disintermediating the conventional television program distribution model, the competitors they will have to contend with are formidable, and include the likes of Amazon (AMZN), Apple (AAPL), Google (GOOG), Facebook (FB), Time Warner (TWX), Disney (DIS) CBS (CBS), Verizon (VZ), and Comcast (CMCSA) just to name a few. We view this industry structure as unfavorable as it contains many powerful, aggressive new entrants that have the tools to disrupt the established players, and in the process reduce the profitability of all participants. This scenario hardly warrants a P/E multiple of 500 times current earnings for Netflix, in our opinion. Moreover, as we prepare for the beginning of the end of an extended period of extraordinary monetary measures, the potential valuation adjustment of market leading equities, and possibly the market as a whole may present us with a more favorable risk/reward potential and enable us to put our cash reserves to work.

8/3/15
John Conti