Core Strategy Q1 2022

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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:

We ended our commentary in our last quarterly letter by saying that we were not overly pessimistic about markets in the coming year, just rationally cautious. With concerns about inflation and interest rates amplified in the quarter just ended and given the horrific development of Russia's invasion of the Ukraine, we have only become more cautious in the near term. The Federal Reserve is clearly behind the curve in its main mission of achieving price stability. Because of commodity supply chain disruptions, the Russia/Ukraine war further exacerbates the inflation outlook. This encouraged us to become more defensive in positioning the portfolio.

Defining "defensive" is a challenge. It certainly means lightening up on or eliminating positions in cyclical companies such as housing, consumer durables, financials, and certain industrials. We may be at or near peak earnings in these companies as margins may be pressured by rising cost inputs and top lines challenged by the slowing of the economy the Fed seeks to achieve. On the other hand, companies in sectors affected by the Russia/Ukraine war such as energy may thrive even in a downturn. We will not be reluctant to raise cash while in the process of reducing the cyclicality in the portfolio. Until we see more balance between supply and demand for goods and services, and a Fed that catches up with reality, we may err on the side of caution.

Contributors and Detractors:

Some of the largest contributors to our performance during the quarter were CF Industries and Compass Minerals. These are two commodity companies that benefited from the broad-based rally in commodity prices during the quarter. CF has been a top holding for some time in the strategy and the stock increased roughly 45% during Q1 reaching an all-time high. The company produces nitrogen-based fertilizers for use in agricultural applications. Its production includes ammonia and urea fertilizer lines which have seen prices increase sevenfold in the past year as market fundamentals improved. Further, Russia remains one of the largest producers of nitrogen fertilizers in the world and with the Ukrainian conflict unfolding, sanctions levied upon Russia have benefited fertilizer producers outside the region. We have reduced our position in CF as the stock price has increased.

Housing related names such as Simpson Manufacturing and Mohawk were a drag on performance. Simpson produces key connectors used in the construction of residential housing. The company declined more than 20% as markets in general rotated away from construction-related businesses due to the expected slowdown in the housing sector from rapid increases in residential mortgage rates. The 30-year fixed-rate mortgage rate ended Q1 at 4.89% compared to the 3.27% rate at year-end and well above the full-year average in 2021 of 3.09%. Using the average loan as a reference point, the 1.50% rise in the rates translates into a 23% higher monthly mortgage payment on a loan with a 20% down payment. Also, the most rapid rise in home prices since 1981 only aggravates housing affordability further. Over the past 5 years, home prices have risen 55%. Any slowdown in home purchase activity we believe would have meaningful implications for many areas of the economy. We reduced our position in Simpson during the quarter and further reduced it following quarter-end as we maintain a reserved outlook for housing.

Portfolio Activity:

We initiated new positions in secular growth themes including Becton Dickinson, Salesforce, and Stanley Black & Decker. We also increased our positions in Spotify, Comcast, T-Mobile, and TE Connectivity following a period of weakness. Overall, we think our purchase activity has continued to diversify the portfolio's risks by adding exposure to areas like technology, communications, and healthcare, which are areas that historically have had less exposure. Our sales activity included reducing exposure to real estate as interest rates rose and trims to Iron Mountain and Alexander & Baldwin. We believe the portfolio's activity has favored quality and diversification versus our holdings at the end of 2021. Our cash levels remain elevated reflecting our cautious outlook.