SeaBridge Investment Advisors, LLC

# Global Growth Q1 2022

**Portfolio Manager: Adrian Morffi**
**Investment Style: Global Equities**

*The Global Growth Strategy seeks to invest in a diversified portfolio. We prioritize investments first by their end market prospects (demand) and secondly by their position in the marketplace (supply-side). Once comfortable with end markets and the company's position, we consider the business quality and the merits of the management team. If it is the right business with the right partners, then we know we want to own the stock and the price should signal the right entry point. Valuation determines when we make investments and not the type of investments we make.*

**Outlook and Positioning:**

During the first quarter, portfolios had a higher than usual level of turnover compared with the recent history. Given the bottom-up research associated with our stock selection, SeaBridge as a firm tends to experience low turnover across strategies. The last three months of activity eclipsing all of 2021 can be directly attributed to markets experiencing some of the highest volatility since the onset of the pandemic in early 2020. We believe we were able to use these price swings as an opportunity to improve the portfolio's quality, increase its growth rate, and reduce its cyclicality. We ended the period with an increased allocation to secular growth themes such as the digitization of services. Many competitively advantaged businesses saw multiples contract while relative valuation premiums substantially narrowed providing us an opportunity to increase exposure to these areas. We became increasingly aggressive in names like Block (formerly Square) as premiums were wiped out in a matter of weeks for what we believe to be high-quality growth stories. We used the strength in other areas of the portfolio, such as those tied to the U.S. consumer, as an opportunity to reduce exposure to retail, including Kroger & Dollar-Tree, and other pro-cyclical investments like Expedia.

**Contributors and Detractors:**

Some of the largest contributors to our performance YTD in Global Growth were Dollar Tree, Kroger, and Cal-Maine. These are defensive, U.S. consumer-centric businesses that benefited from the accelerating rate of inflation which pushed share prices to all-time highs. They demonstrated an ability to pass on increases in product costs to customers which generated wider net margins as higher gross profits could more easily absorb fixed costs like rent expenses. This dynamic is referred to as operating leverage and it can have meaningful effects on low net margin businesses like Kroger. For instance, in the last quarterly earnings update, the company reported 12% earnings growth on just 4% sales growth.

The largest detractor of performance during the first quarter was Spotify. The company declined more than 30% as markets, in general, rotated away from growth to value. The weakness was further compounded by the company's fourth-quarter earnings report which signaled a move away from volume growth to a strategy prioritizing higher average revenue earned per subscriber. The company has priced its service below fair value in order to rapidly amass customers and achieve a #1 global market share which provides scale benefits over competitors like Apple Music. Netflix experienced a similar scenario in the mid-2010s. We believe this marks the next natural chapter of our investment thesis and we used the weakness to add to our position.

NVR & Mohawk were also two large detractors as sentiment reversed most likely 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. The 55% increase in home prices over the last five years is the fastest rate since 1981. We believe this spike in borrowing rates will almost certainly begin to test the limits of affordability for buyers. Any slowdown in home purchase activity would have meaningful implications for many areas of the economy. We will likely reduce our exposure to the sector as we balance these developing risks within the portfolio.

**Portfolio Activity:**

We initiated new positions in secular growth themes including Netflix, Block (formerly named Square), and Salesforce.com. We acquired each after they fell between roughly one-third to one-half of the highs reached within just the past 6 months. We think the economy will increasingly be moving online and it is still only the early innings of disruption in many areas like those of cable TV, cash-based purchases, and mainframe on-site computing. In a sense, these growth themes like online streaming or digitization of payments are all just specific parts of the same wave, global digitization. We eliminated our position in Expedia, PayPal, Cimpress, Angie's List, Axalta, and Kennedy Wilson from the portfolios as we aimed to increase overall portfolio quality and capture relative value opportunities seen during the period's volatility.

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