SeaBridge Investment Advisors, LLC

Global Diversified Q2 2022

Investment Style: Global Equities & Fixed Income

SeaBridge Global Diversified Strategy seeks to achieve risk-adjusted investment returns over the medium to long-term by investing in high-quality companies and fixed income investments at attractive prices, while exercising a deep understanding of the macroeconomic environment to manage investment risk. Companies are selected based on our fundamental research, utilizing a long-term horizon and seeking to invest in quality and value. Depending on the client's objective and risk tolerance, the strategy seeks to provide capital growth, current income, and preservation of capital through a portfolio of stocks and fixed income investments.

Outlook and Positioning:
Both equities and bond returns were challenged in the second quarter as the markets priced in higher interest rates and the risks of a recession. In response to increasingly stubborn inflation rates, the Federal Reserve ramped up its tightening efforts which caused markets to swoon. On a brighter note, the private sector continues to be strong. We believe the household sector is benefiting from a strong job market, high wage growth, and unprecedented levels of savings, which accumulated during the years of the pandemic and remained unspent by consumers. Businesses are in a position of similar strength with record levels of earnings and margins while balance sheets remain healthy. However, a weaker earnings outlook is a risk for the second half of 2022.

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. Currently, the markets are likely pricing in rate cuts in the second half of 2023. 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 favor our "growth at a reasonable price" holdings while looking to reduce our exposure to companies dependent on consumption, especially discretionary spending.

Contributors and Detractors:
Some of the largest contributors to our performance in Q2 were Merck and Post Holdings. 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. Post Holdings was also relatively strong following the recent spin-off of its majority stake in Bellring Holdings to shareholders in Q1. This appears to have driven a re-rating in the remaining company assets as the operations became easier for the market to value. We used the relative strength to exit our position. We expect the cost of capital to continue to rise across the world; this will likely impact those that rely on capital markets for funding of their balance sheets the most in the short term.

Some of the largest detractors of performance during the second quarter were Apple and Alphabet (Google). In general, value stocks continued their outperformance over growth stocks in the quarter. The stocks fundamentally remain some of the higher quality, large cap investments available in the world. Each of their quarterly earnings reports showed businesses operating at record levels in terms of revenue generation, profitability, and free cash flow generation. Further, both companies continue to return unprecedented levels of capital to shareholders. We believe the weakness can be largely attributed to a repricing in the cost of capital. While Apple remains at a premium valuation to the market, Google no longer commands a valuation premium versus the S&P 500. We believe both companies should earn premiums to the market due to their better than average business quality, pricing power, and higher growth prospects. We view our allocations to these names as sensible given the outlook for the stock market.

Portfolio Activity:
During the quarter, we used the significant market volatility to rebalance the portfolio to reflect a higher inflationary and slowing economic environment. We intended the cumulative impact of our buying and selling to leave us with a more defensive and higher quality portfolio. This included higher allocations to franchise companies with demonstrated pricing power and secular demand growth profiles of end markets. We reduced our allocation to industrials, financials, consumer, and international related equities. We increased our exposure to technology, communications, healthcare, defense, and commodities. The addition of a higher mix of commodity investments was a function of seeing an extended period of inflation on a wide band of commodity assets. This was due to a multi-year period of under-investment on the supply-side which we believe will have a longer than normal impact on prices. Finally, during our review of the portfolio, we specifically searched for leveraged balance sheets among our holdings due to the expected negative impact from higher rates and widening credit spreads.