SEABRIDGE
INVESTMENT ADVISORS, LLC

SeaBridge Core Strategy

July 2015
Commentary

For the past 18 months, the portfolio has produced disappointing investment returns. This begs at least two questions:

1) Are we appropriately positioned for the current environment?
2) If so, what will need to occur for the investments in the portfolio to produce reasonable returns?

First, we believe we are well positioned for the economic environment that we see in the United States. Although the strength of the US economy was masked in the first quarter by several transient factors, it is becoming increasingly apparent that the US economy is reverting to a solid, sustainable rate of growth. The rebound has been most evident in the continued strength in the job market, the sharp rise in building permits, and a strong improvement in the Index of Leading Economic Indicators.

Although our investments are chosen on an individual, rather than sector, basis we have five major areas of exposure in the portfolio. Each of these sectors should perform well in the economic environment that we perceive to be developing. The sectors are industrials, consumer discretionary, banking, energy, and real estate.

Earnings for our **industrials** have been hampered by currency translation resulting from the strong dollar, weak energy-related capital spending, and slowing growth in Europe and some emerging economies. We had been trimming these stocks into strong performance one to two years ago, but more recently we have been increasing investment in the industrial stocks. Although counterintuitive, cyclical stocks such as our industrials perform worst into strong earnings and best into weak earnings. This phenomenon is the result of the share price anticipating future results and capitalizing normalized earnings, rather than peak or trough earnings. The earnings visibility of many of these stocks was poor in the second half of last year and coming out of the first quarter 2015 earnings reports. Encouragingly, many of our industrials performed well off of the initial knee-jerk, negative reaction to disappointing earnings in the first quarter. In particular, Caterpillar (CAT) and Deere (DE) have bounced nicely off of their lows. Hopefully, this is the harbinger of change we have been expecting. As U.S. economic growth accelerates and Europe escapes the grip of another recession, the cyclical industrial shares should continue to anticipate an earnings recovery. Meanwhile, the companies in which we are invested have been buying back their shares to leverage the earnings rebound. In addition to CAT and DE, our industrial investments include TE Connectivity (TEL), AirGas (ARG), RPM International (RPM), Hubbell (HUBB), Pentair (PNR), Xylem (XYL), ITT Corp (ITT), SPX Corp (SPW), United Technologies (UTX), Actuant (ATU), and LittleFuse (LFUS).

The **consumer discretionary** investments are mostly special situations. Coach (COH), Urban Outfitters (URBN) and Bed Bath & Beyond (BBBY) each had an internal problem that marred great long-term performance. As each management team implements their plan to address their respective internal problem, the shares should continue to rebound. We are very comfortable with the progress that each of these companies has made and believe the future to be bright for the price of their shares, although it may take some time for the stock market to fully appraise the changes that we believe to be taking place. Our other consumer discretionary investment is

Thor Industries (THO). THO is the largest manufacturer of recreational vehicles. Thor's business should benefit from rising employment and wages, as well as the baby boom generation beginning their retirement.

We have investments in three **banks**, Citigroup (C), Regions Financial (RF) and Bank of America (BAC). Now that the Fed is beginning to raise the amplitude of rhetoric about interest rates rising, the banks are starting to show signs of life. Higher interest rates and a steeper yield curve should each contribute to widening margins for the banks. Also, a more persistently growing economy should lead to greater loan demand. The banks are very well positioned for the current economic environment.

We have written extensively about our **energy** investments: Laredo Petroleum (LPI), Pioneer Natural Resources (PXD), and WPX Energy (WPX). There are two aspects to the investment thesis for our energy companies: 1) the price of oil and 2) the rising return on investment due to the learning curve effect (i.e., declining cost curve). Although the learning curve effect is still improving the returns for these companies, the price of oil has turned sharply lower in recent days. We believe this to be the result of three factors: 1) continued discussions with Iran regarding their nuclear program and the potential relaxation of economic sanctions; 2) anxiety regarding negotiations between Greece and the troika[1]; and, 3) stock market instability in China. We believe all three of these companies are extremely cheap based on the value of their potential oil and natural gas reserves, but it is likely that we will need to be patient to realize these values in the stock market.

Real estate has been an important part of the portfolio for many years. We have both direct and indirect exposure to real estate. In addition, our real estate investments are exposed to both residential and non-residential construction. Earlier in the business cycle, our real estate investments performed well. More recently, however, they have stalled. As the job market continues to improve, both residential and non-residential real estate should also improve. We have written extensively about the strengthening employment environment that is developing in the US. This should lead to wage growth and, perhaps more importantly, increasing consumer confidence. This is an ideal environment for real estate. Our investments that have either direct or indirect exposure to real estate are: The Howard Hughes Corporation (HHC), Alexander & Baldwin (ALEX), Plum Creek Timber (PCL), CoreLogic (CLGX), RPM Corp (RPM), Hubbell (HUBB), Pentair (PNR), Bed Bath & Beyond (BBBY), Senior Housing Properties Trust (SNH), Simpson Manufacturing (SSD), and all three of our banks.

We believe our analysis of the US economy, the job market, and energy market dynamics are generally on target. Consequently, we believe the portfolio is appropriately positioned to capitalize on the major economic drivers. Hopefully, that answers the first question noted above. The second question is harder to answer. The main problem that continues to vex our portfolio is the speculative nature of many of the stocks that are producing superior returns at present. We believe this to be the result of an unnaturally low interest rate environment. The best example of this dilemma is Pall Corp. We had a position in Pall in the portfolios for many years. It performed well for us, but we sold the shares, after trimming repeatedly, when they became too expensive in our opinion. Just two months after we sold our last shares, Pall agreed to be acquired by Danaher at a 25% premium. This equated to a price to EBITDA (operating cash flow) multiple of 20, which is an absurd valuation for Pall. Therein lies our problem. **Good companies without some sort of current blemish are trading at ridiculous valuations due to the extended period of abnormally low interest rates that we've experienced since the last recession.** Our choice is to try to chase current performance by investing in over-valued companies, or invest in cheap stocks that are working through some manner of problem, either internal or cyclical. We believe the path that will lead to the

[1] Troika is the tripartite committee led by the European Commission with the European Central Bank and the International Monetary Fund that organized loans to the governments of Greece, Ireland, Portugal, and Cyprus.

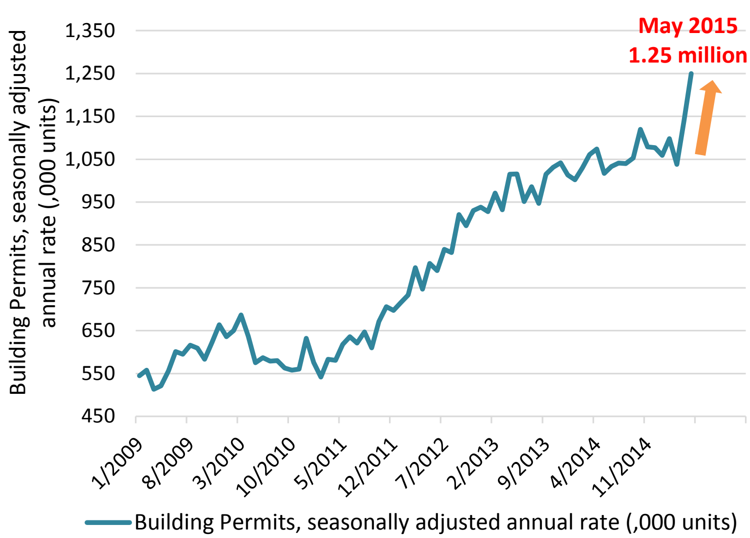
greatest reward with the least risk is the latter, which we have chosen but, admittedly, the wait can be and has been painful. From our perspective, however, it is always easier to measure reward than risk.

From our perspective, the biggest potential risk to the portfolio is the Fed. As we have noted in the past, U.S. monetary policy is being held captive by the unsettled situation in Europe. We believe the Fed is already late in allowing interest rates to seek their normal level. It has become very clear that the Fed's Federal Open Market Committee (FOMC) is refraining from allowing interest rates to rise due to the currency implications of tightening monetary policy while the European Central Bank (ECB) is easing monetary policy. If the FOMC continues on this tack for too long, then the U.S. economy could overheat. This would result in the bond market jumping ahead of the Fed in raising rates thus crushing equity valuations. We don't believe this to be the most likely scenario, but it is a growing concern.

Earlier in this note, we highlighted the strength in the job market, resurgence of growth in building permits, and strength in the Index of Leading Economic Indicators as reasons for our renewed optimism in the economic scenario that underpins our investment strategy. Several previous commentaries have presented charts regarding the job market so we won't reprint them here. The charts regarding building permits and the Index of Leading Economic Indicators are included to display the recent resurgence in both economic series.

As can be seen in Chart 1, building permits grew sharply beginning in 2012 off of an extremely depressed level following the Great Recession. For a myriad of reasons, about which we've written many times in recent years, building permits grew at a more modest pace in 2013 and 2014. In recent months, however, building permits, which are a leading indicator of housing starts, appear to have begun the next leg up in what will likely be a multi-year journey to a normal housing environment. We continue to believe that housing will be an important driver of growth in the US economy for the remainder of 2015 and, likely, for the next several years.

Chart 1:

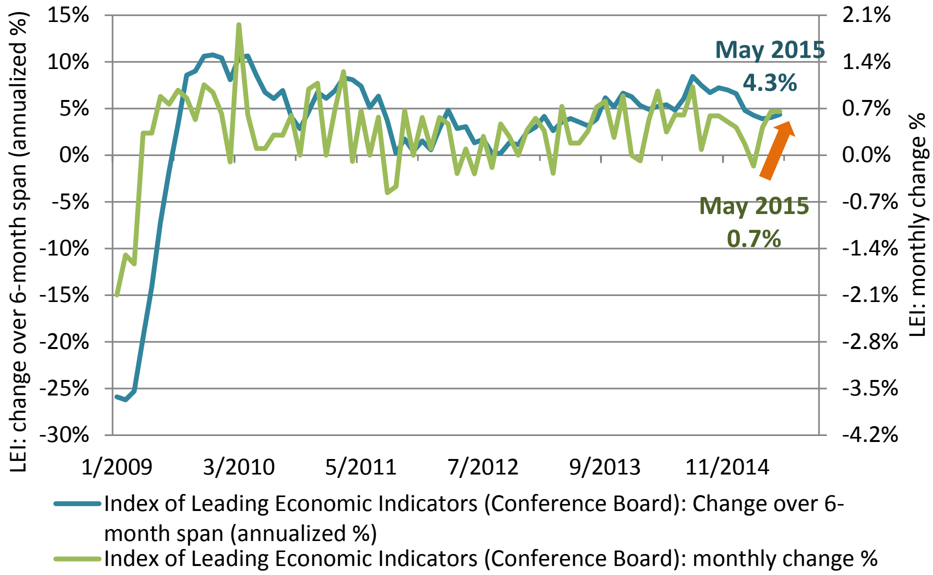


Source: Bloomberg

As can be seen in Chart 2, the Index of Leading Economic Indicators (LEI) has rebounded in recent months. The one month LEI has grown by 0.7% in each of the last two months. In addition, the six month LEI appears to have bottomed over the 4th quarter of 2014 and the first quarter of 2015 and is now back in a rising trend. Part of this upturn in the LEI is attributable to building permits as that is one of the 10 economic data series that comprise the

LEI. Other components of the LEI that are driving the upturn are: average weekly unemployment insurance claims, the leading credit index, and the interest rate spread.

Chart 2:



Source: The Conference Board

In summary, we believe the US economy is recovering from several transient factors that hampered growth in the first quarter of 2015. The employment market for skilled labor is tight and will likely drive growth in wages and consumer spending. The housing market is strengthening and should be an important driver of US economic growth. Given the tightness in the employment market, The FOMC should soon begin the process of allowing interest rates to seek a level more reflective of the strength in the economy. All of these factors should represent a reasonable environment for the major investments in our portfolio to prosper. The biggest visible risk to our base case scenario is a timid FOMC that keeps interest rates too low for too long thus allowing the US economy to overheat.

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6/30/15

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