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November 29, 2011

*Copy of letter sent to individual clients of SeaBridge Investment Advisors*

*We have now moved out of the realm of economics and into the realm of social philosophy.*

That thought started the final section of Dr. Woody Brock's luncheon address at a private equity investors meeting last Spring. Woody followed that with two points. First, we are now fighting about who pays the cost of excess spending and promising in the U.S. over the past decade. The battle will be fierce. Second, his audience of well-off investors had little idea of how difficult the economics of the last decade have been for most of the U.S. population. The majority of the population will not have its entitlements cut back without a major fight.

That brings us to Europe, and the highly volatile markets we are experiencing. Europe has plenty of money – average annual per capita purchasing power of more than \$30,000. The idea that Europe would turn to China with an average per capita purchasing power of \$7,500 to get the money to bail itself out would seem laughable. But the “haves” in Europe do not want to pay for the entitlements of the “have-nots” any more than their counterparts in the U.S.

Unfortunately, unless some solution is found in Europe quickly, we are likely going to have a major financial accident – probably in the nature of a run on a major Italian or French bank. Politicians – read Angela Merkel – know what they want to create: a club whose membership demands fiscal reform and oversight and penalties for violators. The associated treaty revisions will take months at best, and the markets are measuring time in days.

The outcome is highly unpredictable but, if I had to guess, it would be that a bank run would force some government to nationalize a bank or inject capital the way our TARP program did. Other governments would have to follow. This would upset the markets but buy time to see if the German “fiscal super club” could be established as the basis for sharing a single currency.

That would not be good, but in the background looms a larger shadow. Europe's banks are undercapitalized for the magnitude of sovereign debt write-offs they are facing. They do not wish to raise capital when their stocks are trading at 40% of book value. So they are shrinking assets, meaning lending slows a lot, and asset sales drive down the price of assets. This could precipitate a severe recession. Estimates of the bank assets to be sold run as high as \$800 billion Euros. The OECD predicted this week that if a severe credit squeeze runs its course, Europe's GDP would shrink 2% in 2012 and 3% in 2013.

One alternative to a credit squeeze would be to nationalize Europe's major banks. As in the U.S., the banks have political clout and they will fight that. In the U.S., our “Super Committee” of Congress could not find common ground for a fiscal fix, and discord will likely fill the election battles next year. So, Woody's prediction of battles of social philosophy is right on target.

In light of all this, what are we doing in your portfolios?

- In our Asian strategy, Dave Descalzi is investing in higher yielding, but slower growing companies. He is focusing on companies which should fare better until China eases credit in response to their slowing economy. Even with a slowdown, we expect China to grow three times as fast as the U.S.
- In Core Global portfolios, John Conti continues to focus on companies with high recovery potential if the market anxieties diminish. Generally these are companies which seem very undervalued in a growing – slower than past recoveries, but growing nonetheless – economy.
- In International portfolios, Denise Clayton-Purvis and I are keeping considerably more cash investments than usual, and focusing on non-cyclical companies which should be able to endure a world recession if one is triggered by Europe's problems.
- In the other strategies – Global Trusts, Yield Growth, Inflation Fighter, and Cautious Core – Howard Chin, Bobby Henebry, Susan Boyd and I are keeping much less in stocks and more in areas such as bonds, energy infrastructure MLPs, and other income producing investments with asset backing. We continue to have a significant position in Gold in these accounts.

I would describe our actions – particularly in the last four of the styles – as “reducing regrets” if Europe blows up and we have a global recession. This does not mean “no regrets,” for, if Europe blows, all assets are likely to fall in price. But it means giving up potential returns if events go well in order hopefully to protect capital better in case events go badly. As we said in our third quarter letter, equities are probably undervalued versus where the world will be in five years. If Europe finds a fix, equities could rally 25% or more without a strain. But if Europe goes badly, another 15% or more decline cannot be ruled out.

Some of the trades you have seen in taxable portfolios recently have occurred to book tax losses and offset, in some cases, gains booked earlier in the year. But other trades were solely to reduce cyclical of the portfolio for reasons cited above.

We hope you will have a wonderful holiday season in spite of the world's uncertainties and financial distress.

Sincerely,  
*Garnett Keith*

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*This letter discusses, in general, client portfolios. SeaBridge manages portfolios for clients in several different styles. Results for individual clients may differ. Results in the future are likely to be different. Please contact Susan Boyd if you wish to see more details on the after-fee returns for any of our investment styles. Please refer to the Form ADV Part II for SeaBridge Advisors LLC (or our website [www.SeaBridge.com](http://www.SeaBridge.com)) for a complete fee schedule. The “actions” mentioned for SeaBridge portfolio strategies may be changed at any time as SeaBridge's outlook and conclusions evolve.*

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