SeaBridge Investment Advisors, LLC

SeaBridge Core Global Strategy

September 2014 Commentary

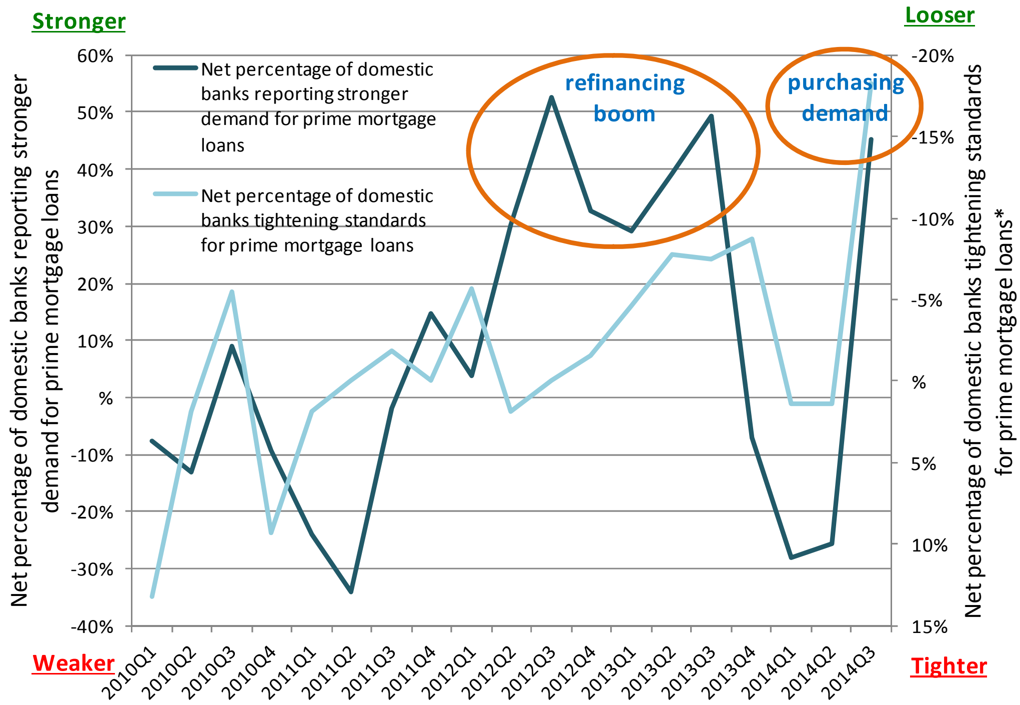
In the second quarter of 2014, the U.S. economy appears to have rebounded strongly from a severe winter weather induced first quarter decline. According to the second report from the Bureau of Economic Analysis, GDP growth accelerated to 4.2%. We continue to believe economic growth at a pace of 3% to 3.5% is a reasonable expectation for the second half of 2014 and into 2015. Recent survey data, such as the ISM indices and the Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices, support our expectation of continued growth. Despite our positive economic outlook, the stock market exhibited some volatility in August owing to concern over the global geopolitical situation. While carefully monitoring the impact of external shocks to the economy, we believe a steady economic growth trajectory driven by the demographically powered housing recovery and shale oil & gas exploitation creates a favorable environment for equities. We believe the Core Global Equity portfolios are well positioned to capitalize on this powerful evolution.

The July Manufacturing and Services ISM indices were both higher than the numbers reported in June indicating acceleration in the economic environment. Encouragingly, the forward-looking components improved significantly. The Manufacturing and Services New Orders Indices registered 63.4 and 64.9, respectively, gaining 4.5 and 3.7 points from their June readings. The Institute for Supply Management reported that the Services New Orders Index is at its highest reading since August 2005. Strong current production and future business outlook were translated into strong hiring trends with both employment indices advancing. Comments from survey respondents were generally positive, although some respondents voiced concern over the global geopolitical situation.

Another July survey, the Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices, showed a broadly based increase in loan demand accompanied by an easing of lending standards and terms for many types of loan categories. A significant proportion of banks reported stronger Commercial and Industrial (C&I) loan demand from firms of all sizes to finance investment in plant or equipment, accounts receivable, inventories, or mergers and acquisitions. Banks also reported stronger demand for all three types of Commercial Real Estate (CRE) loans: construction and development, nonfarm nonresidential and multifamily. Importantly, stronger demand for prime residential mortgages was reported for the first time since one year ago. On the supply side, banks indicated standards for C&I and CRE loans are now easier than or near the midpoints of their ranges over the past decade. However, standards for residential real estate and credit card loans remain somewhat tighter than the midpoints of banks' longer-term ranges.

Despite strong second quarter growth in the overall economy, the new residential construction market did not catch up until July. Unusually harsh weather took its toll on first quarter housing starts. After a brief recovery in April, housing starts slid below 1 million units in both May and June. In the July report, starts jumped to an annualized pace of 1.093 million units, the second best reading since its post recession peak of 1.105 million registered in November 2013. Many observers have suggested that higher mortgage rates were to blame for weak earlier performance. The Fed's Loan Officer Survey suggests that loan demand, indeed, responds to interest rates. Chart 1 depicts loan demand and credit availability in the U.S. prime residential mortgage markets. On balance, if more banks were to report higher loan demand, the dark blue line (left axis) would stay above zero. The scale for lending standards is plotted inversely. Therefore, if more banks, on balance, were to report looser standards, the light blue line (right axis) would rise, thus going below zero. Between the second half of 2012 and the first half of 2013, prime mortgage demand rose significantly to coincide with a substantial decline in mortgage rates. In the fourth quarter of 2013, as rates climbed, mortgage demand fell sharply.

<u>Chart 1</u>



*Note, the right axis is graphed in reverse.

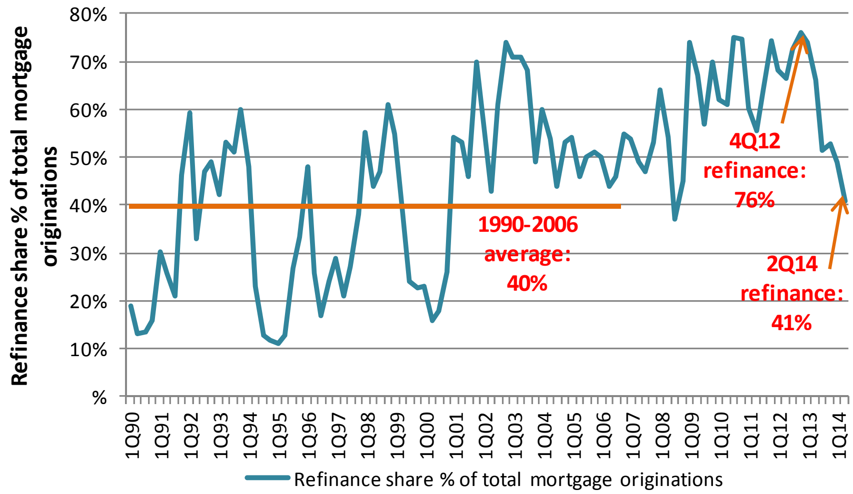
	1Q12	2Q12	3Q12	4Q12	1Q13	2Q13	3Q13	4Q13	1Q14
30y mortgage rate %	3.92	3.8	3.55	3.36	3.5	3.69	4.44	4.3	4.36

Source: Federal Reserve

A closer look, however, suggests that the surge in loan demand during the late 2012-early 2013 period can largely be attributed to refinancing rather than purchasing activity. During the second quarter of 2014, purchases represented 59% of total mortgage originations, a significant rise from merely 24% in the fourth quarter of 2012. On average, refinancing represented 40% of total originations from 1990 to 2006 (see chart below). With the dissipation of above normal refinancing volume, we expect to see mortgage demand driven by home purchase activity. Higher mortgage demand accompanied by loosening of lending standards indicated in the July Loan Officer Survey perhaps suggests housing reacceleration ahead despite moderately higher rates.

However, recognizing the outsized government footprint in the mortgage market, we expect a slow normalization of bank lending standards. This could constrain growth and introduce volatility. As of the first quarter of 2014, the Federal Housing Administration's (FHA) share of purchased mortgages was 16.9%, well above its 6.1% share in 2003. The FHA provides credit access to predominantly low and moderate income home buyers purchasing their first home. The average FICO credit score for FHA-insured loans compared with conventional loans was lower at 684 vs. 755 respectively, in the first quarter. Other requirements such as debt-to-income and loan-to-value ratios are more lenient albeit at the cost of mortgage insurance premiums. Even if banks are generally loosening, the retreat of government insurance as normalization takes place could be perceived as a tightening of lending standards because of the reduced share of lower quality loans that would be originated in such an environment.

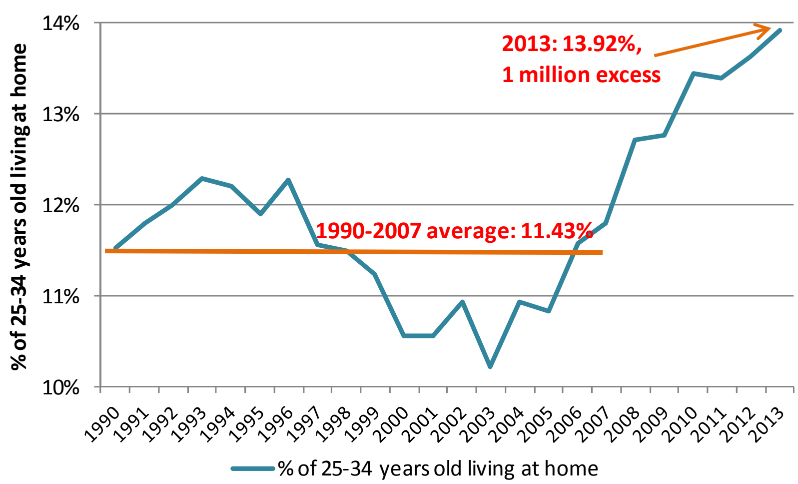
Chart 2



Source: Mortgage Bankers Association

Importantly, as the economy and labor market continue to improve, household formations are expected to strengthen significantly as pent-up demand is unleashed. Among the nation's young adults, weak labor markets, high student loan debt balances and high rents have dampened household growth in the wake of the Great Recession. Based on Census data, we estimate 1 million excess young adults age 25-34 could leave their parents' homes, giving a strong boost to the housing market. The housing recovery remains a compelling investment thesis. Despite a likely moderate increase in long-term interest rates, a recovering housing sector would foster land development and home building, which in turn should accelerate job growth, household formations and housing demand. This virtuous circle should allow the US economy to achieve its full potential, over time.

Chart 3



Source: U.S. Census Bureau

Thus far in 2014, real estate related equities have performed inconsistently. In the portfolio, The Howard Hughes Company (HHC $158.00) has been an outstanding performer, while Brookfield Residential Properties (BRP $20.00) has declined in price. Although both companies are real estate developers, HHC has a mix of commercial and residential properties under development. BRP, on the other hand, is a pure-play on residential development. We believe the residential real estate recovery is solidly proceeding at a modest, but persistent, pace. In this long, but slowly accelerating environment, BRP has an excellent backdrop for implementing its business plan.

BRP is primarily a real estate developer. Although the Company builds and sells finished homes on 20% of its real estate, its main business activity is the entitlement of raw land that is intended to be sold to other home builders. The entitlement process includes obtaining permits as well as building the infrastructure, such as streets, water, sewer, etc. BRP presently owns 91,895 building lots. Slightly more than half of those lots are in Canada, which has proven to be a very steady real estate market. The remainder are in the United States, primarily in California, Colorado and Texas, all of which we believe to be desirable markets. The Canadian development activities provide stability to cash flow, while the US properties will likely provide the upside potential.

BRP has an equity market capitalization of approximately $2.36 billion. In addition, the Company has debt of approximately $1.36 billion. Thus, the total enterprise value is $3.7 billion. This means that the stock market is capitalizing BRP's 91,895 lots at an average value of approximately $40 thousand per lot. In recent years, BRP has been selling land to home builders at prices ranging from $72 thousand to $169 thousand per lot. The average selling price per lot was $138 thousand in the first six months of 2014. Of course, in order to prepare the lots for sale, some costs would be incurred. They would also have to pay taxes. The exact net value of the land won't be known with certainty but, in order to achieve our 50% three year target return, the intrinsic net value of BRPs lots only needs to be $53 thousand, which seems to be a reasonable figure given recent sale price trends. To incorporate a margin of safety into our analysis, we have not ascribed any value to the Company's 9,481 lots that are not consolidated on their financial statements because they are owned in partnerships. Also, we have not ascribed any value to the home building operation, which generated nearly $1 billion in revenue last year, and currently has $343 million in its inventory of finished homes. Needless to say, Brookfield Residential Properties appears to be an exceptionally cheap stock in a stock market in which cheap stocks are increasingly scarce. As the real estate market continues to recover, we believe our investment in BRP will prove to be rewarding. However, there are no guarantees.

8/28/14
Angell Xia
John Conti

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There are differences among portfolios managed by SeaBridge in the Core Global Equity strategy based on client-specific factors. Not all portfolios hold the same securities. Not all stocks held in the portfolio perform similarly. Some stocks held in the portfolio historically performed much worse than the examples presented. Performance differs among accounts. SeaBridge also manages portfolios in other styles. These portfolios differ from the Core Global Equity strategy portfolios.

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