

# *SeaBridge Investment Advisors LLC*

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*Copy of letter sent to individual clients of SeaBridge Investment Advisors for the First Quarter 2008.*

Dear Client:

I ended my January letter with the thought that the markets would be weak early in 2008 and finish the year strong. I have written about lurking problems in past letters, but I certainly did not foresee the tornado which tore up Wall Street in the first quarter. Our portfolios participated in the declines, but considering the crisis in the financial sector, I feel we were lucky to end the quarter as well as we did. The sharp rally in the first week of April has restored values a bit, but the housing and financial problems of the country are not yet behind us.

There were three villains in the script for the first quarter. First, the fall-out from unwise lending in the residential mortgage markets, during the 2003-2006 period of very low interest rates, has been widely reported. It will take several years for the over-built housing markets to stabilize and some sort of government intervention is likely to try to accelerate the return to housing stability.

Second, for a decade American consumers have been buying vigorously, funded by credit card borrowing, and periodically repaying those debts by borrowing against the rising equity values in their homes. With the 10% year-over-year drop in home values, the consumer's piggy bank is broken, and a sharp reduction in consumer spending is upon us. That will reverberate through the economy for several years. There is still a debate about whether we will have a "near recession" or a "near depression." Only history will put the precise label on what we are going through, but even government officials are talking "recession." So rather than arguing about labels, we are focused on how long and how deep the current adjustment will be.

The third and major villain, which devastated Wall Street in the past quarter, was leverage – the borrowing of money to carry investments in a rising market. Everyone knew that leverage in banks, brokers and hedge funds had increased since 2002, but few understood just how great it had become. This was because banks and other financial players had found devious ways to increase "off-balance-sheet" leverage – meaning how to increase borrowings in indirect ways which were not apparent on official statements visible to regulators or general financial reports.

So when asset prices began dropping, capital was destroyed at a rate much faster than anyone anticipated. If a bank is leveraged 10 to 1 (ten dollars of capital are destroyed for every dollar of asset price decline), a 2% drop in asset prices results in a 20% destruction of capital. This increases the leverage from 10 to 1 to 12.2 to 1 and forces more sales of assets, which in a market with no buyers, causes further asset price drops..... The cascading loss of capital, coupled with questionable, unsalable assets, raises doubts about the viability of the leveraged institutions in the financial marketplace. Concerned about their own viability, banks stop making new loans, and the whole economy slows rapidly.

This is the tornado the Fed and Treasury are trying to reverse. (As new information is disclosed, I write analytical notes to myself to try to clarify my own thinking. I wrote three of these during the first quarter as more negative information came in. These notes go into more of the technical details regarding my thoughts about how the economy and markets are interacting. If you would like a copy of these informal notes from February and March, let us know.)

As a result of all this, markets were uniformly weak in the quarter, with the S&P 500 down 9.44%, the broad U.S. market Russell 3000® index off by 9.52 %, the global MSCI World Index down 9.18% and the MSCI World Index ex USA down 9.07%.<sup>1</sup>

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<sup>1</sup> Results for these indices (S&P 500, Russell 3000®, Morgan Stanley Capital International All Country (MSCI) World Index and MSCI World Index ex USA) are quoted as being somewhat representative of the broader equity markets for comparison to SeaBridge U.S., global, and foreign portfolios. The SeaBridge portfolios differ from these indices (in number of securities held, industry, sector and country weightings, etc). Therefore, in any given period, results for SeaBridge portfolios are likely to differ from the results for these market indices.

Fortunately, our predilection starting in 1Q07 for traveling light on housing, consumer and financial stocks served us well. These sectors absorbed the worst of the devastation as the sub-prime mortgage problems froze the financial markets and spread to consumer confidence and spending.

However, two other exposures in our portfolios proved to be subject to big price declines. The first was higher-yielding portfolios of mortgages backed by commercial real estate and government guaranteed mortgages. When we cut back on real estate lenders in 2007, in some portfolios we kept IStar<sup>2</sup> (whom we believe are “best of class” credit underwriters, albeit with a risky new commitment in California,) and Annaly (which owns only government guaranteed mortgages.) While managements at IStar and Annaly did their jobs well during the quarter – in fact both increased dividends in the quarter – they both dropped like stones as hedge funds shorted heavily anything which had to do with leveraged real estate debt. We believe both are extremely attractive at current prices. However, until the markets for real estate debt begin to unfreeze, we are suppressing our instinct to buy substantially larger positions at fire-sale prices. We simply do not know how bad the real estate markets in the US will become before they turn better, and whether leveraged portfolios will be viable in the post-crisis world.

The second area of specific disappointment was Asia, especially stocks listed in Hong Kong. Even though growth in Asia continues undiminished, the Hong Kong market sold off roughly twice as sharply as the U.S. market. If one assumes that China’s growth slows a bit but continues at a pace of eight per cent a year or better, Asian companies look like extraordinary bargains. On a recent trip to Hong Kong, I heard a knowledgeable businessman estimate that China will grow between seven and eleven percent in 2008. He gets there from 5% growth in domestic spending, plus 2% growth from foreign direct investment, plus 2% growth from government infrastructure building. That gets to 9% growth. The swing factor is growth in exports, which can range from plus 2% to minus 2%, depending upon what happens in the U.S. and Western Europe. At worst, we think that China will grow about five times as fast as the most optimistic estimates for the U.S. in 2008-09. Yet the market is down twice as much and trading at very cheap levels.

Stock price declines were not limited to mortgages and Asia, of course, and almost everywhere we look we find stock values to be the best they have been in five years. However, newspaper headlines scream about the liquidity crisis in Wall Street, and until Fed Chairman Bernanke plus Congress find ways to stabilize house price declines, stocks are not likely to recover substantially.

I am still hopeful that, with some U.S. government actions on housing, the markets will stabilize and begin to recover in the second half of the year. The second quarter will probably be choppy as hopes rise and fall regarding a bottom in house prices. Happily, the world continues to grow, with Asia leading the way. As we focus portfolios for the rest of 2008, we are keeping a sharp eye on companies which should benefit from foreign growth and have relatively less exposure to the “recession” in the U.S.

Garnett Keith

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*Note: this is a copy of a quarterly letter sent to clients of SeaBridge Investment Advisors. It is presented in order to illustrate the current thinking of the investment manager. This does not represent an offer to buy or sell securities.*

*This letter discusses, in general, results for 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 views presented here represent the opinion of Garnett Keith of SeaBridge Investment Advisors based on his analysis of publicly available information. The opinions of other analysts based on these data may differ. There are no guarantees that the expectations expressed here will be realized in the future.*

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<sup>2</sup> We sold IStar in some taxable portfolios to realize a tax loss in 2007.