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(Abbreviated) copy of letter sent to individual clients of SeaBridge Investment Advisors for the Third Quarter 2008.

This will be the longest quarterly letter in a while – appropriate, I think, since 3Q08 saw the worst turmoil in the stock market in six years, rivaled only by 2Q02 and 3Q98 in the past decade.

The market averages[1] tell the story: for the **third quarter**, the S&P 500 was down 8.36%, the broad U.S. market Russell 3000®index was off by 8.73%, the global MSCI World Index fell 16.51% and the MSCI World Index ex USA was down 21.84%.

Year-to-date, the S&P 500 was down 19.27%, the broad U.S. market Russell 3000®index fell 18.81%, the global MSCI World Index was down 25.20% and the MSCI World Index ex USA returned a negative 29.54%.

The roots of the problem have been widely reported. In short, two trends crossed. *First*: the growing amount of leverage (borrowing) in the financial world. Leverage has been increasing since 1975 and accelerated in the past few years via hedge funds, derivatives, off-balance-sheet vehicles sponsored by major banks, and especially by a type of derivative called Credit Default Swaps (CDS). A CDS is a contract where one party accepts a fee from a second party to guarantee to the second party the credit of a third party. At the peak, there were reportedly some $62 Trillion of CDS outstanding, and as some of the guaranteed credits started to go bad, the guarantors could not meet the calls for more collateral – with AIG at the head of that list.

The *second* trend was banks shifting their business strategy to originating loans for sale to third parties. The process was made much more complex by packaging thousands of loans in pools called Collateralized Debt Obligations or CDO's, and selling slivers of each package to other banks here and abroad. With thousands of underlying credits involved, each packaged and sold off in hundreds of slivers, when a CDO fails to pay the expected interest to the holder it is almost impossible to sort through all the slivers of a 1000 loans to find the bad mortgage and seize the collateral. In fact, it is almost impossible to analyze the underlying collateral, and who owns what.

This CDO process was used particularly for bundling and selling low grade mortgages, with Bear Stearns, Lehman Brothers and Merrill Lynch being the leading practitioners. As the payments began to fall short of expectations, banks stopped lending money to one another for fear of the magnitude of CDO assets that the borrowing bank might have on its books. Bear, Lehman and Merrill had kept big slivers of the CDO assets on their own books and failed or had to be rescued.

The highly controversial $700 Billion Treasury rescue plan is focused on getting these toxic mortgage and CDO assets off bank balance sheets, so the normal banking channels will start working again. In the meantime, the massive liquidity which the Fed has pumped into the economy is not getting to the companies which need to borrow. In short, the banking system is frozen, and the economy is stalled and falling into a serious recession.

How bad and how deep will the recession be? No one knows at this moment, and that has made the markets very frightened. In an interview with Charlie Rose on October 1st, Warren Buffett likened the economy to a great athlete who has suffered cardiac arrest. If his heart can be started quickly he can be up and performing

[1] 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.

again in a few months or quarters. But with every passing day of a non-functioning financial heart, muscles are dying. A protracted delay will incapacitate the athlete for years. (You can see this interview on www.charlierose.com, and I recommend it for those wanting to understand better what is happening.)

During the last few days of September and the first three days of October, the markets were extremely volatile as passage or non-passage of the Treasury's rescue plan was stalled in the House. On Friday, October 3, the plan passed and was immediately signed into law by President Bush. However, the episode left many questioning whether Government intervention can catch up with the restorative job needed to avoid a long and deep recession. This concern was heightened last week by the failure of the European Central Bank to start cutting rates to head off what appears to be a coming recession in Europe.

Offsetting these concerns somewhat, the Federal Deposit Insurance Corporation (FDIC) has performed beyond expectations in the past month. The FDIC has always ranked below the Treasury and Federal Reserve Bank in the government pecking order. But while the former seemed to be at least a stride behind the problems they were trying to catch, the FDIC grasped and sold two giant failing banks with unexpected ease. Washington Mutual, the country's largest thrift was sold to J P Morgan on September 25, and the banking operations of Wachovia were sold to Citibank on September 29. To ease the transfer, the FDIC gobbled large piles of toxic mortgages and CDO's into the maw of the government. To make it more attractive to big banks to acquire troubled banks, Congress changed the tax law allowing faster tax write-offs of bad mortgages. This caused Wells Fargo Bank to reappear to the bidding on October 3 and try to snatch Wachovia from Citibank. Litigation of that maneuver will likely go on for months.

Also in the supportive category, stock prices relative to earnings have fallen to levels usually seen only at recession bottoms. However, that assumes the athlete gets liquidity in time to recover during the first half of 2009. Central Bank intervention – applying the cardiac defibrillator in the form of low interest rates and lots of credit availability – has worked in every recession post WWII. However, there is a real possibility that this recession will be longer and deeper due to falling house prices and falling consumer spending, which got overblown by borrowing in the past six years.

We are looking at our portfolios with a cautious perspective. With regard to our more conservative investment styles (Cautious Core and Yield Growth), we are moving in the direction of bonds and other (hopefully) secure income streams as well as cash. This will not totally protect prices if the recession is long and deep, but will hopefully protect assets somewhat better and provide a higher current income in the meantime. The fearful markets are now providing yields on bonds which have in the past been available only as a total return for owners of equities.

In our Core portfolios we have higher-than-usual cash levels and are looking carefully at our equity holdings to try to keep risk under control.

This leaves our more aggressive styles – International and Asia, which are also holding much higher than normal cash levels until we think we see liquidity returning to the market. As the signs mentioned below appear, we expect to be buying stocks at what we hope will be bargain prices, post recovery.

The losses in portfolio values in the third quarter have been painful. It is small consolation that most of our portfolios have done somewhat better than the markets. Our past concerns about housing, financial and consumer stocks have somewhat protected us this year. However, many of our other holdings – especially smaller faster-growing companies overseas - have been hard hit as money has returned from smaller markets back to Treasury bills in New York and Sterling deposits in London.

The affairs of most of the companies in the portfolios are running about as expected – which is what makes the sharply reduced prices seem cheap. However, cheap is based on an assumption that the "U.S. economy athlete" will be up and moving about in 2009 after a huge liquidity injection in 4Q08.

There have been studies on the different ways that governments intervene in banking crises, and how economies respond afterward. The Treasury plan is designed to fix the economy for the longer term and, if the economy recovers, the cost to the U.S. taxpayers will probably be minimal. This is because the government buys distressed high yielding mortgages or CDO's with low cost government money and holds them for improved borrower performance as the economy and house prices recover. The high yields and improved performance should give the Government a profit over time.

Other countries have responded by the Government investing cash or bonds directly in banks and taking some form of preferred stock in return. This second approach leaves the Government as a major owner of the banking industry – an outcome which the free-market Bush Administration finds displeasing. Each dollar injected into bank capital carries several times its amount in assets, so the stated amount of the plan is smaller. Moreover, the direct injection works faster because the Government does not have to set up machinery for pricing the purchase of troubled assets, and liquidity goes immediately into the banks. Some of the delay in the House last week was due to a debate about whether the Government had chosen the right plan.

To deal with the urgency of the situation, we expect to see the Treasury or Fed taking other major action to inject liquidity directly into the banks while the asset purchase plan is being put into place. If this happens we will be encouraged, and conversely no action will make us more concerned.

Our Presidential election is in a month, and we expect whichever candidate is elected to come forward with new plans to "help Main Street." As this is written, Senator Obama is leading in the polls. We are somewhat comforted regarding the programs which might come from a new Democratic Administration by the persons Senator Obama has gathered around him for advice on the crisis – Paul Volcker, Warren Buffett, and Robert Rubin. Before the last two weeks there were forecasts of a strong fourth quarter rally, post election. That would be welcome, but I will settle for fast action to get liquidity into the markets and calmer markets for the rest of the year.

We know that you're concerned about the decline in your portfolio values. We are trying to limit losses within the parameters of the strategies, which are still primarily equity strategies and subject to equity market risk. Please take the time to review your risk tolerance and investment objectives. If you would like to discuss those with us, please call or email us. If you want to move to a more cautious strategy, please let us know. These are not good markets to be selling into, but even after the fear abates we are likely facing a severe recession. You need to make sure you have liquidity to go through that.

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) for a complete fee schedule. The views presented here represent the opinion of Garnett Keith, Dave Descalzi, John Conti and Susan Boyd of SeaBridge Investment Advisors based on their 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.