

A Message from the CEO

June 27, 2019



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My Lessons in Gold Investing

Peter Grosskopf

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Gold moved above the critical \$1,400 an ounce mark for the first time in nearly six years, following the Fed's June 19 FOMC (Federal Open Market Committee) meeting. Although the Fed left interest rates unchanged, it opened the door for future rate cuts and took a more "accommodative" stance. **We believe that gold may be decisively breaking out of a six year cycle and that this may be the beginning of a powerful multi-year rally.** It's an opportune moment for CEO Peter Grosskopf to share his lessons on gold investing.

The Beginning of a New Multi-Year Rally for Gold?



Source: Bloomberg. Data as of 6/26/2019.

Over my 32 year career in financial services, I have always enjoyed working closely with gold mining investors and executives. I started as a futures trader in an era when a COMEX gold contract cost \$90 to transact, compared to today's roughly \$1 fee. Throughout this span, I have worked with many notable portfolio managers, investors and executives in the precious metals space. I have never stopped learning from them, with the added benefit that many are colorful, ever optimistic risk takers.

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When I joined Sprott nearly 10 years ago, the firm was already one of the world's largest and highest-profile gold investors. I was fortunate to sit each morning beside Eric Sprott, one of my mentors and a precious metals legend. I saw first hand the investing techniques which had powered his amazing three-decade track record, much of which was focused on gold and resources. I was fortunate to bring together a brilliant team of renowned mining sector investors, including John Embry, Rick Rule, Paul Stephens, Whitney George, Trey Reik and most recently John Hathaway [through our recent joint venture](#). Given that it was late 2010 when I joined Sprott, my timing could not have been worse — I set myself up to manage the firm within the difficult business environment of the last 9 years.

A reasonable question might be, "What have you learned about the gold sector to benefit investors?"

Lesson #1. Gold Investments Have a Cycle

After decades of observation, I view gold largely as a thermometer of confidence in traditional markets — economies, equities, interest rates and foreign exchange (i.e., fiat currencies and their government printers). Being tremendously liquid, gold is a legitimate alternative to fiat (government-backed) currencies as a store of value. Yes, at various junctures gold's positive or inverse correlations with long-standing relationships — the U.S. dollar and global inflation expectations/real rates, and commodity prices — can vary. But at any given time, there are investors using gold to protect against deflation as well as those buying it for inflation protection. While this appears confusing — and potentially explains why consensus gold price forecasts are frequently inversely correlated to gold's performance — in the end, it always comes back to confidence levels and investor psychology. As I wrote in my last post, [Why We Need Gold](#), we need gold despite (or because of) a financial industry which is hugely incented against it.

Gold mining equities introduce a further variable to the gold cycle, namely the degree of their over- or under-valuation compared to their underlying fundamentals. Gold equities, due to the leverage of in-ground reserves and operating margins, generally move with roughly 3X the torque of the gold price. When they are over-extended due to the inevitable performance-chasing capital allocators, the relatively tiny size of the gold equities market exaggerates these movements substantially. As evidenced over the past few years, with little interest in the sector, valuations can become quite depressed. This boom-and-bust gold equity cycle leads to poor capital allocation and management behavior, leading to inevitable hangovers, the recoveries from which can last for years.

Lesson #2. Allocations to Gold Should be Gradual

Similar to administering powerful drugs to a patient all in one shot, allocating to gold in one instant is a move fraught with peril. The best strategy is to move slowly and as a contrarian, picking bullion and other investments inversely with one's confidence in the overall markets. One of the most reliable contrarian indicators that I have encountered is the Bernstein Sentiment Indicator — beware readings over 75 and pay attention to those below 25. Those making gold equity allocations need to pay particular heed to the valuations and fund flow metrics of the sector.

I recall Eric's call-to-arms was always "if it's up 20% from the bottom, the game is on". At Sprott, we have more of our balance sheet capital committed to lending against the assets of established or developing mining projects because we know that this keeps us protected and invested throughout the cycle and provides valuable information on projects which may become interesting equity opportunities. Nonetheless, there are times when the cardinal rules of contrarian investing need to be employed, including when the shift to equities is justified by fundamentally low valuations.

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Lesson #3. There's Money to be Made, and Lost, in Gold Equities

This is true even in the best of times. There are two basic approaches to investing in gold equities, which are the index approach or the stock selection approach. Gold equity index investing offers the advantages of liquidity, low costs and the default logic that most public mining sector equity funds are index funds in *drag* (mostly due to the liquidity requirements thrust upon them by regulators in the name of protecting small investors). Index funds in the mining sector have dominated the investment flows for so long that the cost of capital for quality large producers is now 1/3 to 1/2 that of quality small-cap producers. To me, it seems like an opportunity for stock selection is currently brewing.

I have closely observed the best long-term stock pickers in the precious metals business, including Eric Sprott, Rick Rule, Lukas Lundin, Robert Friedland, Ross Beattie and others. Despite strikingly different views and approaches to mining investing, they all stick with systems that share one common principle: They are early to the punch, and pay no attention to market experts, particularly the research of sell-side analysts, whose recommendations are biased by investment banking fee generation. The other commonality among these proven investors is that most rely on exceptional technical specialists, who can range from proven exploration geologists and production engineers, to solid undercover work with the purpose to determine when "value can be stolen" (from the market) or "value can be found" (in the ground).

A nettlesome difficulty in gold equity investing lies in assessing management credibility and transparency with regard to a company's mining assets. While company managements are by nature biased, this is the only industry that I am aware of that reverses the usual dynamic of managers sandbagging their CEOs, who in turn sandbag their public estimates. It's not uncommon for crucial project variables to be insufficiently researched or developed in the most positive light, while the reality in mining "what can go wrong, does go wrong."

On the other hand, there are very qualified management teams that can improve shareholder chances for success on a repeatable basis. These teams know that there is no other industry in which assets can be purchased for a million dollars that can be worth a billion dollars if properly nurtured. I have learned that a good asset will eventually find good management and vice versa. Investors should aim to back one or the other, and hopefully both.

Our goal at Sprott is to construct a concentrated portfolio of exceptional assets with exceptional management, in the context of an investment time horizon at least as long as one cycle.

Lesson #4. Experts are Required

To level the playing field in this specialized sector, most industry outsiders can benefit from an independent expert manager with technical expertise and a global view. Unfortunately, among the few remaining globally, many are perma-bulls whose rose-colored lenses are distorted by favorable predispositions to management and street guidance regarding crucial variables. Case in point: the consistent use of an equity discount rate of 5%-7% regardless of political jurisdictions! Making matters worse, these portfolio managers are generally pressed to deploy capital at the wrong time by the performance chasers.

In my contrarian opinion, experts should be raising and deploying funds when it is hardest to do so. *Be Brave* (one of our Sprott mottos). Further, investment managers in our sector should strive (a) to know more about their concentrated investments than the "street" does, (b) to achieve absolute returns from the value-creating activities of their companies, even with a flat gold price and (c) to generate significant alpha in down markets. Finally, any manager should be invested alongside their clients, both personally and corporately.

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Another strategy that can produce excellent returns, especially given the current dislocation in the junior mining equity market, is private lending or private equity style control investments. Private lending involves senior loans with participation features. Much due diligence and industry knowledge are needed in structuring these loans, given the strict repayment and coupon obligations. Private equity adds value through turnarounds, resource development or improving a good long-life mineral asset, usually over at least one cycle. Investors must be prepared to select one of only a few truly experienced teams, commit to the long run and then realize the combined benefits of no mark-to-market and the ability to strategically steer the business or loans.

The good news is that those who get gold investments right can get them very right. Billions are made from the right stock picks (I've seen this first hand). And that's before calculating the protection value of gold in the case of a serious dislocation in credit markets or fiat currencies.

As for my obvious bias, I'll state it plainly. At Sprott, we believe we have built the best global expertise at investing in gold and the mining sector. And no, it's not easy and we are always improving. Our funds are invested alongside our clients; we are committed to doing our best; and will always tell it like it is.

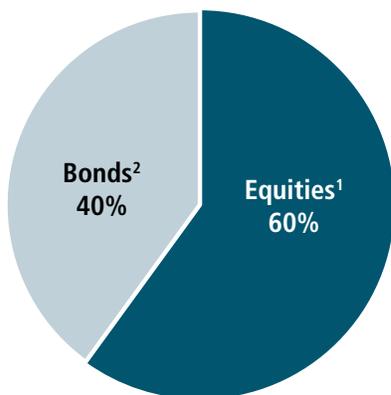


Peter Grosskopf, CEO

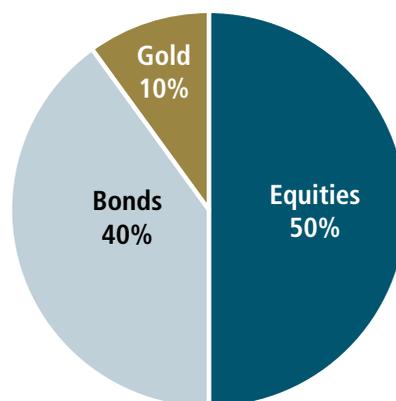
The Optimal Allocation to Gold

Sprott Recommends a 5%-10% Allocation to Gold

With a traditional 60/40 portfolio, equities¹ represents **98%** of the total portfolio risk.



Adding 10% gold to the portfolio, reduces the equity risk contribution from **98%** to **83%**.



¹ International Equities Benchmark: The MSCI ACWI Index is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world.

² Bonds Benchmark: The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market.

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