



## Sprout's Thoughts

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### 19 'Tough' Questions for Eric Sprout on Gold and Silver

By Henry Bonner (hbonner@sproutglobal.com)

Eric Sprout founded Sprout Asset Management LP in 2001. Sprout Asset Management is an independent asset management company headquartered in Toronto, Canada. The company manages the Sprout family of mutual funds, hedge funds, physical bullion funds and specialty products and is dedicated to achieving superior returns for its investors over the long term.

Sprout's US affiliates, Sprout Global Resource Investments Ltd. and Sprout Asset Management USA, offer full-service brokerage services and managed accounts for US and international, non-Canadian investors. Accredited investors who are clients of these companies may be able to invest in Limited Partnerships alongside Rick Rule as they become available.

Eric Sprout recently answered a number of questions on the minds of gold and silver investors, and we hope you'll find his insights valuable.

#### **1. How did we miss the top of the market, in 2011? Why wasn't someone 'pounding the table' to sell precious metals and precious metals equities?**

Eric Sprout: With the benefit of hindsight, anyone can say that we all should have been selling in '11. But we stayed in because the facts at the time seemed indicative of more growth, not a peak and subsequent decline.

Back then, it was suggested that the Fed might exit *QE 2*. Some might have interpreted this as a reason to sell gold, much as suggestions of 'tapering' recently were interpreted in that way. They launched *QE 3* instead, which we expected to be bullish for gold.

So they did not exit *QE*; they added more stimulus instead. In addition, the Chinese entered the market, buying at least 1,000 tons more in 2012 than in 2011. Despite these facts, gold has continued to founder.

Disregarding China and Russia, since that gold is consumed domestically before entering the global market, the yearly mine supply is roughly 2,100 tons of gold. It surprises me how China can enter the market and buy 50% of available mine supply, or an additional 25% of the total supply, and yet the price of gold declines.

Where is the supply of gold coming from? I have publicly claimed that I believe gold ETFs are seeing their physical holdings go to China. In my view, this is where the 700 tons of physical gold that were redeemed during the first six months of '13 ended up.

Meanwhile, the world's largest consumer of physical gold – India – has been stifled. Government has imposed some very draconian measures to stop people from buying imported gold, and this has worked. Officially reported gold import numbers declined very severely, and premiums jumped for domestic gold sales.

So despite this bear market for gold, I view people who are willing to sell gold here as extremely short-sighted. For now, the Chinese demand for gold is (I believe) being supplied by gold draining out of ETFs, and the fact that Indians cannot get their hands on the stuff legally. How much longer can this current situation hold?

All of these factors stopped me from telling investors to sell gold and other precious metals in 2011.

Add to this the fact that *QE* keeps increasing and that ‘tapering’ has been thrown out by the Fed. There is a very solid case for continuing to own gold and other precious metals equities right now.

## **2. What will it take for precious metals and precious metals equities to turn around?**

It has to be the precious metals prices themselves. The stocks are probably 99% correlated to the price of the underlying metals being produced or explored for, and they typically go up two or three times faster than the precious metals prices.

Going forward, I believe we will begin to view the levels we saw this summer – with the lowest low on June 28 – as the bottom for the price of gold. For the stocks, it will all be about metals prices.

## **3. How much of your portfolio is devoted to precious metals stocks and bullion?**

Between shares in mining companies and physical bullion, I have at least 80% of my total portfolio invested in gold and silver. This is similar to the amount in the public accounts I run such as the mutual funds. I have been happy to remain there. It was a wonderful trade since 2000, and, of course, an awful trade since the 2011 peak.

Breaking it down further, the amount of bullion that I hold has been going down – to probably 15 percent of my total portfolio right now. It was as high as 35 or 40 percent.

This year, I am selling bullion to buy stocks because the leverage is so much higher in the equities than in the physical bullion. We decided to move into stocks, and we have participated in a number of private placements in the past 3 or 4 months in companies that are highly leveraged to the price of the metals going up.

I am putting my money down on the price of gold going up, and seeing a quantum increase in the precious metals equities.

## **4. Is this suitable for any investor?**

If this seems high, remember that I am a risk-taker and a very successful investor. I am happy staying the course on this. Whether this allocation is suitable for any specific investor depends entirely on that investor’s financial situation and risk tolerance profile. What I find really interesting is that right now, gold – the metal and the stocks – represent half of one percent of all the assets in the world.

So you have some investors like me with a large allocation to gold. The average person, meanwhile, never owned any gold, even while it was going from \$250 to \$1,900. Gold is still a very under-owned asset, in my opinion.

## **5. How often do you review your portfolio allocation to stocks and the metals?**

This is a constant process. We are doing it all the time. If you move 20 percent of your portfolio into stocks, like we just did, I think that is a pretty significant re-allocation.

My view on precious metals and equities have been the same for a long time, because when I study the data, it seems so obvious to me that we are going to have a shortage of physical metal.

They are just printing money with reckless abandon, so this is a time when people should be buying assets that are going to hold their value, such as gold.

## **6. How do you know when to exit a particular stock?**

This is a function of a particular company meeting its guidelines. You need to reassess the position if they fail to meet these guidelines.

## **7. Are you selling some stocks in order to enter 'cheaper' or more leveraged stocks?**

Well, right now for instance, we are buying producers. If the price goes to 2,000 dollars, they will see a lot of cash flow. And those will probably be the first stocks to go up. The exploration stocks will go up as a function of those guys now having more money to spend.

I am looking for producers today rather than exploration, even if certain explorers may have some good deposits. We still have not opened up our capital to those kinds of capital raises yet. When we choose to finance them, it will come as a function of investors getting more convinced that we are in a sustained rally.

## **8. Rick Rule, the second largest shareholder of Sprott Inc., says he is actively seeking opportunities to put money in exploration companies. Why is he willing to finance the exploration juniors, whereas you prefer the producers right now?**

Rick has a very long view that I cannot take because I run open-ended funds, whereas Rick runs partnerships with a long-term capital base, full-service brokerage accounts, and investment advisory accounts. These give him the ability to take a more long-term stance. Running open-ended mutual funds generally requires that we acquire shares of companies that have a good chance of performing well within a time frame of a few months rather than years.

## **9. Are you prepared to take losses if a stock was a mistake? Should a smaller investor with fewer assets be prepared to take losses also?**

Yes, you are always prepared to take losses. That is just the nature of our business. Lots of stocks will lose money – in fact, I might lose money on half of the stocks I choose. Of course, the other half can go up by hundreds of a percent if I am right. This is the nature of investing in small to mid-sized businesses. Some of them run afoul due to problems with their projects, and some run afoul due to the market. They can also fail due to government interference or environmental problems. So there have been lots of situations where we have taken losses on stocks.

When you talk about taking losses, you mean that you would be selling one thing to buy something else. Either way, I certainly would not recommend, if somebody had seen a decline in their portfolio of 50 percent, that they sell their positions right away. They may want to sell a stock to buy another, but I certainly would not be selling everything and getting out of the sector here.

## **10. What do you think could really turn this market around?**

It has to be something to do with the physical markets. When the physical shortage becomes apparent – in an extreme case there could be a failure to deliver – is when gold and other precious metals should really get going.

Traders in the gold markets have their views that we are in deflation or in some kind of economic recovery where the dollar is going to strengthen. I think that what will break this perception is the recognition by the market that there is a gold shortage.

Of course, a kind of recognition has already occurred. The GOFO (Gold Forward Offered) rate has recently gone negative, as it was at the June low in the price of gold. It has only been negative 5 times in the past 15 years, and is generally linked to strain on the physical gold supply.

## **11. Do you expect, like Sprott Inc. board member Marc Faber has stated, that there will be a repeat of a 2008-style stock market crash?**

I think there is going to be a point where QE will become ineffective. There will be a point when countries with a more sane approach, like China, stop buying US bonds and instead start selling them. That would lead to higher interest rates and have a negative impact on stocks. We have already seen the effects of the rise in interest rates on home and auto sales – the two biggest motors of the US economy since the beginning of QE3.

On top of that, I believe that the US government is insolvent. In fact, everybody knows the US is broke but people will stand by and let it happen.

An analogy for the Federal government is the city of Detroit. Five years ago, they already knew that they were broke. But it is not until they finally had to write a check that they could not write that they declared bankruptcy.

Even though the bankruptcy was inevitable, it shocked people. The City of Detroit recently announced that pensioners would get 16 cents on the dollar. Had Detroit faced its budget problems five years earlier, pensioners may have gotten 60 cents on the dollar. Allowing the situation to get worse led to great disappointment and damage.

The Federal government looks about as bad as Detroit five years ago. In financial year 2013 it brought in \$2.8 trillion in revenues and spent 3.5 trillion, as reported by the Treasury department.<sup>1</sup> Their current liabilities are something like 87 trillion with a national debt of 17 trillion.<sup>2</sup> The situation is hopeless.

It is propped up by the Fed. When the Fed does an open-market operation, the stocks go up. When they are not doing any such operations, overall, they go down.

## **12. Will precious metals stocks fare any better than the rest of the market?**

I think that gold and silver stocks are more correlated to gold and silver prices than to the overall stock market. If gold and silver go up, the stocks will most likely go up.

An analogy is that during the 30's, when everything dropped, gold and silver stocks went up.

Another point is that off the low in 2000, gold stocks went up by about 1,800 percent. Meanwhile, the market has gone nowhere since then in real terms. So that is what I expect: gold stocks go up; the rest of the market does nothing.

## **13. Is gold still a safe-haven against risk?**

Investors who are dumping gold have short memories. Gold is a very wanted commodity – so wanted that India had to stop its people from buying it.

Analysts like to say there is no interest in gold. There may be none in the Western world because the Western banks are the ones who promulgate this nonsense that gold is not the appropriate asset to have. We will wait to see what happens for the next few years – gold versus the stock market. The beauty of a stock market is that it can go on for a long time while being completely wrong.

For instance, we will probably end this quarter up just 1 percent. Every year, the market believes that we will see a recovery. Every year, they end up disappointed. How much longer will the market believe a recovery is around the corner?

#### **14. What will happen to the US dollar?**

It will be weak. The US dollar will eventually become valueless, as all paper currencies eventually become.

But it is tough to say when people will turn their backs on the dollar. The best things that ever happened to the US dollar were the Yen, the Euro, and the Pound. They are all basket cases.

I am not confident at all with regards to the value of these currencies.

#### **15. What are you doing to protect investors from the risk of a US dollar collapse?**

The one thing I am trying to do is provide vehicles to participate in precious metals, whether it is through our funds or through our physical trusts. I would like to be a spokesperson for both gold and silver. I think that is where you will find the most protection. I am boldly recommending that people stay the course, and I hope in the long run that it will have been the better choice to make. That is all we can do.

#### **16. Gold was rising along with higher interest rates during the 70s. Do you see the same type of correlation today?**

Higher interest rates would bring stress on the banking system, which could potentially wreak havoc on stocks.

When it comes to gold, however, I believe the current demand should already have propelled the price higher. Demand is taking gold off the shelves; that is why I am so comfortable sitting on our positions here.

So I do not draw a unique linkage between higher interest rates and gold going up.

#### **17. What makes Sprott Inc. any different from the rest of the financial industry?**

We have been pretty straight shooters. We tell it like we see it. Most of the things that we predicted to happen did come about. That includes the housing crisis, the '08 financial crisis, and the NASDAQ top.

We stand by our performance in difficult times, which was exemplary. And if the broader markets go through difficult times again, I think it will be exemplary again.

#### **18. What would make you sell gold and silver?**

I would be looking for one of three things. First, I would expect to see a blow-off peak -- an irrational buying frenzy -- where valuations get to ridiculous levels. Another signal would be that government is displaying some fiscal sanity. Finally, if they made the dollar convertible into gold I would no longer need to own physical gold.

#### **19. Will you be 'pounding the table' to sell the next time around?**

I think that we would demonstrate that in our funds. We did that at the NASDAQ peak in 2000 and I shorted a lot of stocks at the time. We will be watching for it.

## 20. What does Sprott offer for US investors?

My colleague Rick Rule runs closed-ended funds for US investors under the Sprott banner. Our US affiliate Sprott Global Resource Investments Ltd. offers full-service brokerage services for investing in natural resources and precious metals, and Sprott Asset Management USA Ltd. offer segregated, managed accounts. We also offer three physical bullion trusts that trade on the NYSE ARCA.

We believe that our experience, outstanding service, and exclusive focus on the natural resource sector make us the best available option for creating and managing a portfolio in this volatile sector.

### *About Eric Sprott*

*Eric Sprott has more than 40 years of experience in the investment industry. After earning his designation as a chartered accountant, Eric entered the investment industry as a research analyst at Merrill Lynch. In 1981, he founded Sprott Securities (now called Cormark Securities Inc.), which today is one of Canada's largest independently owned securities firms. In 2001, Eric established Sprott Asset Management Inc.*

*Eric's has managed the Sprott Hedge Fund L.P., Sprott Hedge Fund L.P. II, Sprott Bull/Bear RSP Fund, Sprott Offshore Funds, Sprott Canadian Equity Fund, Sprott Silver Equities Class and Sprott Managed Accounts. His extensive list of accolades include: HFM Week's Best Long/Short Hedge Fund Globally (Sprott Offshore Fund Ltd., 2008); Winner of Absolute Return's Hedge Fund of the Year (Sprott Capital LP, 2010). Over the years, Eric has personally been the recipient of numerous awards and honours, including one of Investor Digest's Canada's Best Investors (2004); Ernst & Young's Entrepreneur of the Year (2006); Investment Executive's Fund Manager of the Year (2007); Advisor.ca's Top Financial Visionary (2011); Terrapinn's Most Influential Hedge Fund Manager (2012); and the 2012 Murray Pezim Award for Perseverance and Success in Financing Mineral Exploration (2013).*

*More recently, Eric has been elected Fellow of the Institute of Chartered Accountants of Ontario (FCA), a designation reserved for those who demonstrate outstanding career achievements and service to the community and profession.*

*Over the years, Eric has also been recognized for his considerable philanthropic endeavors and community contributions. Eric and his family established the Sprott Foundation in 1988 to address urgent human need, hunger and homelessness. He has provided generous endowments to Carleton University, the Ottawa Hospital Foundation, Daily Bread Food Bank and United Way, among others. More recently, Eric donated \$1.4 million to CanFund in support of Canadian athletes for every gold medal won at the 2010 Vancouver Olympics. In April 2011, along with Sprott Inc., Eric sponsored a 24-year old Canadian driver James Hinchcliffe, getting him a seat with the prestigious Newman/Haas Racing. In June 2012, the Sprott Foundation donated \$25 million in support of the Department of Surgery at the University Health Network.*