SPROTT
ASSET MANAGEMENT

SPROTT ENHANCED EQUITY STRATEGY

July 2016 Commentary

Despite the surprising vote by the UK to leave the European Union, we have seen an uncanny alignment of factors supporting risk assets, particularly U.S. equities. First, there was the realization that those who had campaigned for Brexit were not expecting (hoping) to win, which created doubt in the market that they would even move forward with the separation. Additionally, the Bank of England, the ECB and the G20 all reacted quite quickly to stem any potential financial contagion. Finally, there was a realization that the economic impacts of Brexit will most likely be felt over a long period of time and would remain, for the most part, localized, with any potential uncertainty created from the event a catalyst for additional central bank easing (or at least no tightening). In other words, the Federal Reserve will not move on rates, the U.S. economy is OK; creating a potential "goldilocks" environment once again for risk assets. Very quickly, the S&P 500 recouped its ~5% Brexit related downdraft and U.S. equity markets are now breaking to new highs.

Helping support equity markets is the fact that we are now emerging from that earnings recession that started about a year ago. Back then, a strong US dollar had dented multinational foreign revenues and earnings, while the precipitous decline in oil prices had annihilated earnings for the Oil and Gas sector. The second quarter earnings season is now officially over, with more than 85% of the S&P 500 having reported. The tone was definitely better. On aggregate, sales surprised to the upside by about 60bps, whereas earnings beat analyst estimates by about 4%. Most importantly, management commentary was good enough that people now have confidence in the full year EPS estimate for the market (perhaps even see some upside).

While our anecdotal observations suggest some of this is just lowering the accounting quality bar a bit, we see how markets could get temporarily excited about the potential for EPS beats and estimate revisions driven by even a slight re-acceleration in revenue growth. This acceleration is occurring into a backdrop where positioning is fairly defensive among investors, creating pressure to participate in the equity market "melt-up" currently underway. To us this represents the most likely upside scenario for the rest of 2016.

In our funds, the Q2 earnings season was relatively good; there were no thesis changing results and most of our companies are on track to deliver solid years. On average, our portfolio companies are expected to realize approximately 10% EBITDA growth this year, accelerating to 14% next year.[†]

Earnings reports are a great opportunity for management to address any lingering overhang on their story. For example, following press reports that they had lost three large PBM contracts to UNH's Optum Rx; CVS had been a relative underperformer for a few months. Careful examination of those contracts and information we could gather on the overall selling season led us to believe that the loss of those contracts was normal part of business (they have had >97% retention rates for the past few years) and that the fundamentals of the business were still solid. Indeed, CVS reported a nice beat to their own guidance and consensus, raising guidance for the full year (they expect 12.5-14.25% EPS growth) and reported a net win of $4.6bn in new contracts. The stock rerated by approximately 5% following the report. We believe that CVS's earnings multiple should trade at least at par with the overall market, given their above market EPS growth profile and lower revenue and earnings volatility (CVS trades at a 2 point discount right now).

Danaher, a multi-industrial held in our funds, recently announced the completion of a spin-off of their more cyclical industrial portfolio. The remain-co Danaher will now constitute core environmental, dental and life sciences businesses that have a high consumables mix and low cyclicality. On the most recent quarter, management reiterated FY2016 EPS and organic growth projections that imply almost 20% growth for this year. The company also saw a re-acceleration in organic

Continued on next page >

growth in the dental business, an area of concern for us. With the most recent move in the stock, we are less compelled by valuation. However, we continue to see the potential for 3-4% organic growth and 75bps of margin expansion per annum as the new Danaher focuses on closing some of the margin gap versus peers in several segments.

Given the dovish central bank backdrop mentioned above, we remain cautiously positive on gold, with our positioning expressed through two high quality large cap names. In energy, we continue to collar (sell a call to finance the purchase of a put spread) most of our positions. High implied volatility has allowed us to set up what we consider prudent risk-reward outcomes in some of Canada's leading integrated oil producers and infrastructure companies.

We continue to find a few attractive risk/rewards in large cap companies adding positions in Comcast and Danaher on the most recent correction. Both positions have been wrapped with put spreads collars that offer 6-10% upside into October while limiting our downside risks to ~3% on a 10% correction in either stock. We are positive on both companies' ability to generate above market EPS growth for the next few years on relatively stable revenue bases while generating significant free cash flow growth. Our hedges manage some of the stock and market specific risks we see going forward while offering the upside of the companies' EPS growth algorithm.

Finally, in our Canadian funds with U.S. dollar exposure we remain hedged on over two thirds of our U.S. dollar exposure, leaving our unhedged USD exposure in the 10-15% range depending on the fund.

Until next month,

The Enhanced Strategy Team:
John, Colin and Etienne

COMPOUNDED RETURNS (%) AS AT JULY 29, 2016*

	1 MTH	YTD	3 MTH	6 MTH	1 YR	3 YR	5 YR	10 YR	ANNUALIZED INCEPTION
SPROTT ENHANCED BALANCED FUND, SERIES A	2.0	-0.7	3.7	1.4	-4.9	3.2	-	-	4.2
BLENDED INDEX[1]	3.2	7.7	6.3	9.3	5.1	11.4	-	-	10.8
SPROTT ENHANCED BALANCED CLASS, SERIES A	1.9	-1.1	3.5	1.1	-5.3	-	-	-	2.0
BLENDED INDEX[1]	3.2	7.7	6.3	9.3	5.1	-	-	-	11.6
SPROTT ENHANCED EQUITY CLASS, SERIES A	2.6	-2.5	5.2	0.8	-7.0	3.1	-	-	5.4
TSX/S&P 500 BLENDED INDEX[2]	4.4	7.9	7.7	10.6	5.0	14.5	-	-	14.2
SPROTT ENHANCED LONG-SHORT EQUITY FUND L.P., CLASS A	2.0	-8.9	2.3	-5.0	-15.3	0.7	-1.1	2.9	9.0
TSX/S&P 500 BLENDED INDEX[2]	4.4	7.9	7.7	10.6	5.0	14.5	13.0	7.3	7.6
SPROTT ENHANCED LONG-SHORT EQUITY RSP FUND, CLASS A	2.0	-9.1	2.2	-5.2	-15.0	0.3	-1.4	2.6	4.1
TSX/S&P 500 BLENDED INDEX[2]	4.4	7.9	7.7	10.6	5.0	14.5	13.0	7.3	7.5
SPROTT ENHANCED US EQUITY CLASS[3]	-	-	-	-	-	-	-	-	-

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† Simple average of Bloomberg consensus EBITDA growth estimates for 2016 and 2017 for the companies we own in the Enhanced Equity fund. We use EBITDA instead of EPS or free cash flow per share to make companies more comparable and eliminate the impact of buybacks.

* All returns and fund details are a) based on Class/Series A shares/units; b) net of fees; c) annualized if period is greater than one year; d) as at July 29, 2016; e) inception date for Sprott Enhanced Equity Class is 04/16/12; f) inception date for Sprott Enhanced Balanced Class is 09/13/13; g) inception date for Sprott Enhanced Balanced Fund is 04/16/12; h) inception date for Sprott Enhanced Long-Short Equity Fund L.P. is 04/07/04; i) inception date for Sprott Enhanced Long-Short Equity RSP Fund is 09/30/05.

[1] 40% S&P/TSX Composite TRI; 30% S&P 500 TRI CAD; 30% FTSE TMX Canada Universe Bond Index™ and is computed by Sprott Asset Management LP based on available index information.

[2] 50% of S&P/TSX Composite TRI; 50% of S&P 500 TRI CAD and is computed by Sprott Asset Management LP based on available index information.

[3] In accordance with NI 81-102, we will not publish returns for this Fund until it is one year old.

The risks associated with investing in a Fund depend on the securities and assets in which the Fund invests, based upon the Fund's particular objectives. There is no assurance that any Fund will achieve its investment objective, and its net asset value, yield and investment return will fluctuate from time to time with market conditions. There is no guarantee that the full amount of your original investment in a Fund will be returned to you. The Funds are not insured by the Canada Deposit Insurance Corporation or any other government deposit insurer. Please read a Fund's prospectus or offering memorandum before investing.

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