



Whitney George
President, Sprott Inc.

A Paradigm Shift

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President, Sprott Inc.; Chief Investment Officer, Sprott Asset Management; Chairman, Sprott U.S. Holdings; Portfolio Manager of Sprott Focus Trust

Gold continues to deliver strong relative performance and was up 2.37% on a year-to-date basis through yesterday's close. This compares to -33.74% for the S&P 500 Index.¹

Asset	YTD	1 YR	3 YR*	5 YR*
Gold Bullion	2.37%	18.15%	7.62%	5.46%
S&P 500 Index	-33.74%	-18.45%	4.00%	3.20%

*Average annual total returns. Bloomberg. Data as of 3/23/2020.

How do you view what is happening in the market right now?

Whitney George (WG): I keep thinking about Ray Dalio's predictions in his essay last July, "Paradigm Shifts." He talked about how markets change, usually every 10 years and he predicted that we were in a changing environment. He finished his essay by recommending this to investors: "I believe that it would be both risk-reducing and return-enhancing to consider adding gold to one's portfolio." We are in a paradigm shift right now, one that may have taken us all a bit by surprise. I expect that central banks will shortly provide the liquidity required to settle the markets, an accomplishment that will be very favorable to gold.

"I have observed there to be relatively long of periods (about 10 years) in which the markets and market relationships operate in a certain way (which I call "paradigms") that most people adapt to and eventually extrapolate so they become overdone, which leads to shifts to new paradigms in which the markets operate more opposite than similar to how they operated during the prior paradigm."

– Ray Dalio, Co-Chief Investment Officer & Co-Chairman of Bridgewater Associates

Next will come the consequences of this war against the COVID-19 coronavirus (which feels more like a terrorist attack response). As the world stays locked down for the next two weeks, I think two things will occur. This war, like all wars, will become increasingly unpopular as people begin to weigh the financial consequences and isolation against the need to protect a small part of society with such a massive response. We are now forced to reflect on our financial futures. We may discover that we have too much invested in financial products that we don't understand; we have not invested enough time or money in seeking sound advice; and we have no idea what to do with a massive hoard of toilet paper (it too has taken on currency status). In a world of limitless paper, the inflation that central banks so desperately seek will arrive faster and more dramatically than imagined. Hard assets will once again play an essential part in wealth preservation during the inevitable period of stagflation required to restore balance.

Insights: Interview

March 24, 2020

Did we experience this kind of paradigm shift at the end of the last decade, 2010?

WG: The global financial crisis (GFC) came in 2008-2009, and many things changed, but mostly we went back to what we had done before. For the past 10 years since the GFC, we have seen that value investing hasn't worked as well as growth investing; passive investing is now how most investors own stocks, as opposed to active management; and private equity investments have become incredibly popular with huge sums committed.

These things may be changing. Private equity enjoys the benefit of marking portfolios at will in the hidden corners of financial institutions. We first started to see the private equity breakdown last year with the unsuccessful IPOs of several well known unicorns, and ultimately WeWork, which was presumed to come public at \$50 billion but was discovered to be almost bankrupt.

The coronavirus crisis has unveiled the tremendous leverage in the global financial system. Yesterday morning, the U.S. Federal Reserve ("Fed") announced unlimited quantitative easing (QE) to financial markets, which is unprecedented. This translates into flooding the system with enough cash so that it stabilizes and provides enough liquidity for people to get in and out. In the past couple of weeks, we have basically experienced a global margin call, in which there was too much leverage. Some things that had worked well for the past 10 years — trading strategies, correlations, stocks go up, bonds go down, etc. — some of these patterns that had become persistent and which were now assumed to be permanent have been disrupted and have broken down. You might have thought you were hedged, and you might have used a lot of leverage to capture small incremental returns, but it turned out that you were not hedged and nothing worked. Not even gold. But one could argue that gold has held its own, and its purchasing power is up nearly 30% if you are interested in buying equities right now.

What is Sprott telling clients right now?

WG: Sprott is focused on hard assets investments, specifically gold and precious metals. Hard assets have two key advantages. They represent ownership of something finite and tangible. When the paper you use to purchase it is infinite, hard assets like gold can help to preserve real wealth. And while the earnings potential of hard assets can be deferred, and these assets may not be earning as much as you would like today, their earnings potential never goes away, unlike empty airline seats. The coronavirus slowdown may slow the rate of mining gold, but that gold is still there in the ground and can be recovered and exploited in the future. If you are running an airline with vacant seats, those are lost revenue dollars that can never be recovered.

Right now, we are recommending to clients to own some physical gold, along with physical silver. These are proven safe haven investments. Silver has both precious and industrial metals utility, and it has lagged gold. The gold-to-silver ratio currently stands at 117:1, its highest on record, compared to its average of 65:1 since 2000 (see Figure 2). The ratio measures how many ounces of silver it takes to buy an ounce of gold; the higher the number, the more silver is underperforming gold. Mining equities would be another place to look for those who are more opportunistic, and possibly even farmland.

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March 24, 2020

Figure 1. Gold/Silver Ratio is Highest on Record



Source: Bloomberg. Data as of 3/23/2020.

I believe we are entering an era of stagflation like the 1970s. Other things that fare well in this type of environment are brands, which can retain their purchasing power, and for a true contrarian, I can't imagine the news in the energy patch getting any worse. Oil at \$20 a barrel is an unsustainable price. As many have said, the best cure for low prices in commodities is low prices. I suspect that this will work itself out. During downturns like this, people need food and raw materials, no matter what else is happening. Other new themes may emerge. Millennials have preferred to move to urban areas, but this trend may shift, and they choose to migrate toward non-urban areas because of newly discovered inconveniences like pandemics.

You view this period as a repeat of the 1970s and not the 1930s?

WG: Today's response from the Fed is nothing like what happened back in the 1930s. We did learn some lessons from the Great Depression. The response back then to the speculation and the excess was to contract the money supply, which just exacerbated the situation. Today, we are clearly throwing everything at the problem at this point to stop a depression.

Is this lock-down period likely to last for several months?

WG: I don't think that our society can tolerate being in lock-down for more than a few weeks. People are already getting a bit angry. The media, in my view, has been causing unnecessary panic by focusing on the daily increase in the cumulative numbers, but the full impact remains to be seen. We are trying to flatten the curve, and we are making progress. This year being an election year, everything will move faster and change faster. At some point, popular opinion will shift as people wonder why we are destroying our economy and will start making a cost-benefit analysis.

More information will come out daily and more virus testing will be done. People right now are extrapolating out crazy numbers and panicking. As we get better statistics of how many people are genuinely infected, things will improve. With better understanding, this challenge will be put into better perspective. Since September of last year, 36 million Americans have gotten the flu, and we've had approximately 22,000 deaths. Most of this has gone unreported, and it did not halt the U.S. economy. We have come to accept this as part of daily life. I think new information on the coronavirus will emerge rapidly and we will better understand how to handle it.

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How have you been managing the portfolio of Sprott Focus Trust (FUND)?

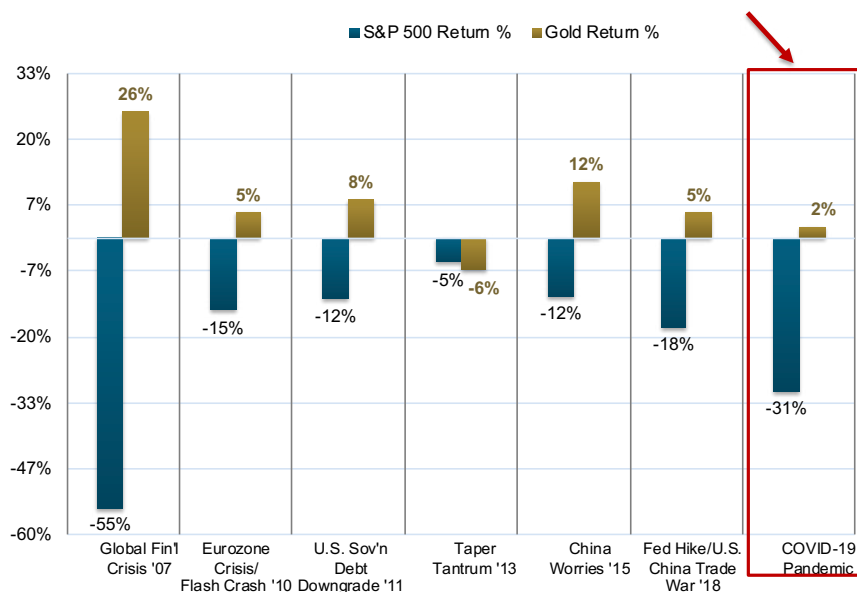
WG: We had cash going into this period, and I have been investing it as the market has been going down. These investments include precious metals mining companies, which now represent more than 15% of FUND, the most significant weighting I have had in my tenure as portfolio manager. I have been investing in high-quality energy companies, which I was doing before this crisis, and before the price war between Saudi Arabia and Russia. I have been adding to active asset managers, which are often punished the hardest in a market decline because of their exposure to the markets. Still, they have some of the strongest balance sheets and operational leverage to a recovery. I have also been adding to my positions in protein stocks, chicken and egg producers, because we need to eat, and these are among the cheapest sources of protein.

Have you ever gone through a crisis like this in your career?

WG: I was under the desk on October 22, 1987, when the market crashed 22%. That was when Chuck Royce, my former partner, reached out and put in this order: "buy 10,000 shares of your five favorite stocks, every eighth-of-a-point down² until they stop". When the market turned, my choices all turned out to be big winners. This period right now has allowed me to cash in on some winners and to rebalance my portfolios. I have been reinvesting the proceeds incrementally as the market keeps dropping. Looking ahead, I am confident that markets and the economy will bounce back as they have had in the past.

Figure 2. How Gold Can Provide Proven Portfolio Protection

Gold has outperformed the S&P 500 Index during the six most recent market crises and is poised to do so during the COVID-19 crisis. YTD 2020, gold is up 2.37% versus -33.74% for the S&P 500.



Source: Sprott Asset Management. Dates used: Global Financial Crisis: 10/11/2007-3/6/2009; Eurozone Crisis: 4/20/2010-7/1/2010; U.S. Sovereign Debt Downgrade: 7/25/2011-8/9/2011; Taper Tantrum: 5/22/2013-6/24/2013; China Worries: 8/18/2015-2/11/2016; Fed Rate Hike & China Trade War: 9/20/2018-12/24/2018; COVID-19 Pandemic: 1/1/2020-3/23/2020.

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¹ The S&P 500 Index is a stock market index that tracks the stocks of 500 large-cap U.S. companies.

² This translates to 1/8 of a dollar or 12.5 cents, and was the spread or the smallest amount a stock could change in value back in the 1980s.

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