



## INSIDE SPROTT

ROB CARRICK

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It's **8:15a.m.** and the day is unfolding as it always does in the **26th**-floor Bay Street offices of Sprott Asset Management. Sitting around a huge boardroom table, analysts and portfolio managers toss out factoids and ideas gleaned from their research, while the CEO of the firm, Eric Sprott, takes notes in a spiral-bound notebook. Declining global oil reserves are discussed, as are gold prices, solar energy, the value of General Motors shares, and milk. Yes, milk. Analyst David Tomljenovic broaches the topic as a result of some reading he's done about a growing milk shortage caused by rising consumption in emerging economies like China and India. "Milk is the new gold," Tomljenovic offers.

Despite the many paintings and sculptures that adorn the premises, a first glance at the dozen or so people around the table suggests that Sprott Asset Management is a fairly informal place to work. There's a mix of suits and office casual attire, and a collegial flow of banter as Eric Sprott guides the session with questions and comments. But there's also a feeling of tension, of wanting to say something that piques the interest of a boss who is good-natured and sociable, and yet intimidates with his obvious grip on market developments. The milk-as-gold idea is the sort of thing that might conceivably appeal to Sprott, manager of the amazingly successful Sprott Canadian Equity Fund and a keen prospector for investing themes with a future. Sprott was buying gold back in **2000**, when it traded below **\$300** (U.S.) per ounce and few people envisioned the **\$800** prices we've seen recently. He took a shine to uranium in **2003**, on the cusp of a gradual 10-fold price increase, with the expectation that nuclear power will have a big future in an era of high oil prices. Lately, his search for the next big score has led him to stocks in commodities like molybdenum, phosphates and silicon. "When looking at a stock, we ask, 'What could happen that would make this thing triple or quadruple or quintuple?'" Sprott says, later, after the meeting. "We're a sucker for big things. If someone says, 'I have something big,' that appeals to us."

There's an outsized aspect to much of Sprott's world: his collection of native Indian and Inuit art, his conviction that the financial system is in big trouble, and his returns as manager of Sprott Canadian Equity. And yet, his success as a fund manager has come from investing in tiny, speculative stocks that rocket higher. Finding these grains of sand with a future requires the sort of work done by Tomljenovic, a **38**-year-old former investment banker and consultant who has studied history at the University of Western Ontario and earned both an MBA (University of Toronto) and a law degree (Osgoode Hall). Sprott Asset Management employs eight analysts like Tomljenovic, and competition is intense to supply the firm's portfolio managers with intelligence they can exploit. Tomljenovic found the "milk-is-the-new-gold" line in a recent article in the *International Herald Tribune* that referred to milk as a new symbol of rising prosperity in some countries. The idea leaves Sprott neither shaken nor stirred, almost as if it's a raw concept that needs further refining. But, no matter. Tomljenovic is coming off the sort of stock pick that helped the Sprott Canadian Equity Fund reach its 10th birthday last September as the No. 1 performer over the previous decade, out of a universe of almost **3,000** funds. The compound average annual return to Sept. 30 was a stunning **27.3%**, compared to the **11.7%** average achieved by Sprott's peer funds in the natural resources category (the fund is classified thusly because it currently has a heavy resource base, but Sprott is willing to go into most any sector). As of the end of **2007**, the fund's average annual **10**-year return was a chart-topping **28.1%**.

Tomljenovic's killer stock pick was Timminco Ltd., a Toronto--based producer of light metals like silicon, which is used in solar panels. He found it about three years ago through a mix of tenacious research and personal contacts that revealed something staggering. Through an acquisition, Timminco had come up with a process to refine silicon that it had previously been selling for **90** cents per kilogram into something purer that could be marketed for **\$35** per kilogram.

The firm started buying Timminco around **40** cents per share, Tomljenovic recalls. The buying continued as the stock exceeded the **\$20** mark in the latter part of last year, making it far and away the top performer on the Toronto Stock Exchange, though it plunged back to the low teens in early **2008**. "Maybe once or twice in your career do you get to be involved with a stock that can potentially do what this one has," Tomljenovic said. "It's the most exciting thing I've ever been involved with."

sprott, 63, is driven enough to wake every day **at 5** a.m. so he can brief himself on what's happening in the

financial world. Three newspapers are on the menu: *The Globe and Mail*, *National Post* and *The Wall Street Journal*, as well as material gleaned from e-mails and websites. When you hear Sprott talk about the markets, the facts and figures spill out like the threads of a grand theory that explains how and why events are unfolding as they are. "There's no element of chance in what goes on here, it's very well orchestrated and it's hard work," said Tomljenovic. "And Eric is the hardest-working one of all. I know that, in the mornings, I better have read everything he's read and know everything about all of my companies because he's going to know just as much as I do, and he never wants that."

It's not unusual for money managers who play in Sprott's league to have a high-strung, slightly condescending, master-of-the-universe quality to them. But Sprott seems to be so relaxed in his daily routine that he's genuinely enjoying himself. Secure in his stature, he's quick to share the credit for Sprott Canadian Equity's success with analysts like Tomljenovic. "I've always had lots of analysts around," he says. "Analysts pay for themselves, right? If a guy can find one idea. Take the fact that we're in Timminco. Oh my god, the stock's up 5,000%."

The Sprott team lives for the Timmincos of the world, and has close to zero interest in everything else. Sprott won't touch the bank stocks that are stacked up like cordwood in most Canadian equity funds, because he's a confirmed stock market bear who thinks the financial sector's problems only began with the liquidity crunch of 2007 and stand to get much worse. There are plenty of blue-chip names in the resource sectors he favours, but he avoids them because their size precludes those giant share-price gains. "My favourite investment is to own 0.1% of something and have it become 30% of my portfolio," Sprott says. "We have a lot of those stocks that were really, really little and became winners."

Sprott Asset Management offers a dozen or so mutual funds and hedge funds that are run by an accomplished team of portfolio managers. Among them are Allan Jacobs, who built a sterling reputation running a Canadian equity fund for Sceptre Investment Counsel; gold bug John Embry, formerly of the Royal Bank of Canada fund family; and Peter Hodson, a growth-investing specialist who established his name at the Synergy fund family, and then moved to CI Funds after its purchase of Synergy. Hodson says Sprott Asset Management is unlike either of those firms: At CI, for example, he managed or co-managed five funds, and yet had no analysts assigned to help him. "Here, I have one fund and I have eight analysts who are specialists in their field, and their job is to find good stocks to buy, or short."

Hodson notes some cultural differences, as well. Sprott Asset Management, for example, has only a small, three-person team of wholesalers whose job it is to persuade investment advisers to use the firm's products for clients. The firm also doesn't do much marketing, although it has attempted to get some attention for Sprott Canadian Equity's 10-year numbers. "Eric's viewpoint is that if the performance numbers are there, the money will show up," Hodson says. "When I arrived at Sprott, we started up a new fund, and I asked, when do we go on the road show, when do we send out the baseball caps? Eric just looked at me like I was from another planet. He's like, 'We don't really do that here.' "

The \$2-billion Sprott Canadian Equity Fund is the oldest and largest product offered by Sprott Asset Management, and it's run solely by Sprott. The fund has roughly 300 different positions, most of which can be categorized as penny stocks (or "low-priced," as Sprott puts it). This style of investing has fed a widespread belief that the fund is too risky for mainstream purposes like, say, registered retirement savings plans. "The returns for this fund are like we've never seen before," said David Paterson, an independent analyst who helps more than 600 investment advisers across the country select funds for their clients. "But, from a volatility standpoint, it kind of scares me. This is a fund that I could never, in good conscience, recommend as a core holding."

The argument from analysts such as Paterson goes like this: Any fund that is capable of producing larger-than-life gains is vulnerable to staggering losses as well. In fact, Sprott Canadian Equity has been downright nasty at times. In the 12 months ending October 1998, for example, the fund lost 38.97%. Last August, near the peak of a liquidity crunch that rocked global markets, the fund plunged 12%, yet still ended the year up 14%. Sprott Canadian has shown a resilience that makes it almost machine-like in its excellence. At its 10th birthday, the fund's return for the preceding 12 months was 33.7%, while its three- and five-year compound average annual returns were 26.9% and 26.7%, respectively (the 10-year return, remember, was 27.3%).

"We go where we think we can make the safest and best return for our customers," Sprott says in explaining how his company's funds balance risk and return. "Lots of people look at what we own and they say it's risky. I seriously challenge that." As an example, he uses his 2003 call on uranium, then trading around \$14 per pound. "We realized there was going to be a shortage of uranium, which has obviously evolved. Two years later, the stocks are up 500 or 800%, and the price goes to \$125. The

question is, Was it a risky bet? We'd done the work; we had a pretty good idea of what should happen." Ultimately, Sprott argues that his fund is simply misunderstood. "The reason we've outperformed is that our style is different," he says. "We don't buy the mean stock. That's the last thing we want to do. We want to buy things where the opportunities are outsized, where it looks like we're taking a big risk, but the reality is that we're not. It's just perceived risk."

Even Sprott's fans are wary of the fund's potential downside, however. Peter Loach, vice-president and managing director of mutual fund research at BMO Nesbitt Burns, says Sprott Canadian Equity is too racy to be on the firm's core recommended list, but it is suggested for sophisticated clients who understand the volatility and can hold on for, say, five years. "Eric Sprott is in a class of his own," Loach said. "But if you invest in this type of fund, the mandate has to be no whining in the short term. With a fund like this, there can be swings to the downside as well as the upside."

On a typical day for Sprott, the morning confab is followed by as many as four or five meetings with executives from companies, most of them in the junior mining and oil and gas sectors that figure so prominently in Sprott Asset Management portfolios. "Toronto is the mining finance capital of the world, and our foyer is among the busiest in Toronto," Sprott says. "We might very well spend more money on junior mining and oil and gas companies than anybody, because that's what our focus is."

Although they may not do the roadshows, when it comes to selling their funds the people at Sprott Asset Management know how to put the good word out about a stock. Sprott demurs on this topic, but Tomljenovic lays it out plainly. "We tell our stories," he says. "The portfolio managers get on TV, and they're not shy about taking positions in the marketplace and telling people about it, even if it's controversial."

Often, company executives will visit Sprott's offices to encourage the firm's participation in new share issues that are intended to raise funds. A positive response is not unusual. In early November, for example, the firm put in an order for a very large slice of a share issue by PhosCan Chemical Corp., which is working to bring a phosphate mine in Northern Ontario into production. PhosCan's a good example of how Sprott's personal connections, research and investment philosophies come together to make money for investors.

PhosCan, a tiny company that is listed on the TSX Venture Exchange, was trading late last year at just under \$1 per share. Part of the reason Sprott initially bought into the company was to help out the firm's president, Stephen Case, whom he knew from previous dealings. But PhosCan also fit into one of those investing themes that Sprott uses to guide his investing. In a word--fertilizer. "We're great believers that the world is going to run out of fertilizers, and that we have limited resources in that area," he says. It's a bit of a Malthusian theme--too many mouths to feed."

Thomas Malthus was a 19th-century English political economist who believed that global population growth would outstrip increases in the food supply. Using Malthus's theory to support an investment in the 21st-century fertilizer sector seems sound, but it doesn't explain why Sprott Asset Management chose PhosCan, an obscure stock, as the basis for its small position in fertilizer stocks, rather than a more established company. "Yes, you can buy Potash Corp. of Saskatchewan," Sprott remarks. "But we don't like buying the big guy. We like buying the little guy that no one else is buying."

The identification of promising themes plays a big role in Sprott's stock-picking, but so does a kind of analysis he calls "prospectivity." He neatly summarizes this selection process in a single sentence: "What could happen?" For example, seven years ago, Sprott recalled looking for gold stocks when the metal was around \$325 (U.S.) per ounce--that's less than half the price it would reach at the end of 2007. One name he came up with was Seabridge Gold, whose ore deposits would only become economical when gold prices reached at least \$400 (U.S.). "I said, that's perfect, that's exactly what I want. The stock's gone from, like, \$1.60 to \$30 in seven years."

Self-evident in the periodic downdrafts experienced by owners of Sprott Canadian Equity is the fact that not all of Sprott's bets work out so well as Timminco, PhosCan and Seabridge. One of his recent duds was Falcon Oil, a company that is trying to exploit a process for removing natural gas from underground rock formations. Sprott Asset Management bought into that one around \$1 per share, and, while the stock subsequently rose as high as \$7, it ended 2007 at around 50 cents. With the air of an athlete who knows perfection is impossible, Sprott simply writes the stock off as not having done what the firm expected of it.

Tomljenovic admits to misfires in areas such as environmental technology and clean coal, but suggests that such mistakes are part of the process of finding tomorrow's big winners. "The classic mistake that

retail investors make is to sell their winners and hold their losers," he said. "Here, you cut your losers and buy your winners."

As impressive as the numbers are for Sprott Canadian Equity, a savvy investor has to wonder if this tall poppy will, at some point, be scythed down to size. One who suggests this is possible is Moshe Milevsky, associate professor of finance at the Schulich School of Business at York University and an independent-minded observer of the investing scene. "Statistically, this fund is pretty impressive," says Milevsky. "But to say that this is going to persist and that somehow this is the winning portfolio, I'd be very reluctant to do that." Sprott seems a bit annoyed at the suggestion that his fund will eventually falter or, as they say in fund analysis, regress to the mean. "All I know, is we've been incredibly successful, historically," he says. "We think we know how to pick stocks. We're cautious. The funny thing is, we're more bearish than anybody."

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## BEHIND THE LEGEND

**BORN** 1944 in Ottawa / **FAMILY** Wife, Vizma; daughters, Julijana and Larisa / **HOME** Oakville, Ont. / **EDUCATION** Bachelor of commerce from Carleton University; chartered accountant designation / **HOBBIES** Collecting paintings, Inuit art and sculpture and medieval weapons; golf and gambling / **CHARITABLE WORK** Donated \$10 million to the business school at Carleton (which now bears his name); \$7 million for stem cell research at the Ottawa Hospital / **INVESTING: THE SPROTT WAY** "One of the things I like to compare our stock-picking to is going into a garbage dump. There's a diamond covered with garbage, and you say, 'Oh my god, look at this thing.' You bring it out, you buff it off, and it's a diamond, and it always was a diamond. It was just tarnished."

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