

Gold Shares as Rising Phoenix

Authored by Sprott Asset Management USA, Inc.

In our February report, *2019 Top 10 List*, we presented 10 fundamentals supporting a portfolio allocation to gold in 2019. Here we shift our focus to the portfolio utility of gold mining equities. At Sprott, we view the investment merits of gold and gold shares as distinctly different. Gold provides the capacity to remove virtually unlimited amounts of capital from the vagaries of the global financial system at a moment's notice.

Gold shares, on the other hand, introduce two important sweeteners to the gold investment thesis. First, gold mining companies provide well-documented torque to cyclical advances in spot price of gold. In essence, high-quality miners introduce a tangible value-creation process to the secular opportunity of rising gold prices. Second, gold shares represent a tactical allocation capable of generating significant portfolio alpha¹ during periods in which over-ebullience for U.S. financial assets is being recalibrated.

The investment proposition of gold shares is fairly straightforward: **gold equities provide leverage to rising gold prices.**

In Figure 1, we compare the annual performance of spot price of gold², gold mining equities (GDM Index)³ and the S&P 500 Index.⁴ By and large, the interrelationship of these three asset classes has proved roughly as might have been expected—gold shares have (intuitively) outperformed broad equity averages when bullion prices have been especially strong, and underperformed when the momentum of rising bullion prices has stalled or reversed into outright decline.

Figure 1: Performance Comparison: Gold Bullion (Spot) vs. Gold Equities (GDM) vs. S&P 500 Index

(2001-3/15/19)

Year	Spot Price of Gold Delta	GDM Total Return	SPX Total Return
2001	2.46%	39.28%	-11.89%
2002	24.78%	79.69%	-22.10%
2003	19.37%	47.07%	28.66%
2004	5.54%	-9.38%	10.88%
2005	17.92%	30.43%	4.91%
2006	23.16%	22.98%	15.78%
2007	30.98%	17.58%	5.57%
2008	5.78%	-26.34%	-37.00%
2009	24.37%	37.98%	26.45%
2010	29.52%	34.76%	15.06%
2011	10.06%	-15.48%	2.11%
2012	7.14%	-8.46%	15.99%
2013	-28.04%	-53.62%	34.62%
2014	-1.72%	-11.71%	13.68%
2015	-10.42%	-24.55%	1.37%
2016	8.56%	54.57%	11.95%
2017	13.09%	12.45%	21.82%
2018	-1.58%	-8.39%	-4.39%
3/15/2019	1.56%	6.20%	13.11%

Source: Bloomberg. Based on annual total return for Spot Price of Gold, GDM Index and S&P 500 Index as of March 15, 2019.

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Between 2001 and 2012, spot price of gold posted **12 consecutive years** of price gains, an extremely rare occurrence for any investment asset. As exciting as this period was for gold investors (gain of 474.4%), the outperformance of gold shares was extraordinary (up 628.3%).

For gold shares, the inescapable flipside of upside beta⁵-to-bullion leverage through 2011 was subsequent downside gearing which proved every bit as potent. From an intraday high of \$1,855.09 on 9/9/11, the GDM Index declined **81.27%** to a low of \$347.41 on 1/19/16. It is fair to say that any asset class shedding four-fifths of its value over a four-year period is unlikely to breed a broad class of dedicated constituents. On the other hand, it is from such misery that compelling investment propositions are spawned.

Given our evaluation of the current macroeconomic landscape, we suspect gold equities are poised for a span of significant nominal and relative performance.

The Math of Rising Gold Prices

Gold shares' beta-to-bullion relationship is powered by empirically sound fundamentals. Gold mines involve significant fixed costs underpinning highly variable revenues. Therefore, the math of a rising gold price implies profit leverage over both embedded development and construction costs as well as ongoing costs of extraction. Additionally, a rising gold price increases the mineral reserves of most mining companies even in the absence of incremental discoveries.

SEC accounting rules guide gold-miners to include in their reserve statements only the portions of ore bodies which can be mined **profitably** at a reasonably assumed gold price. As the gold price rises, miners can therefore upgrade their mineral resources to the reserve category based on audited assumptions of profitability. Finally, a rising gold price fuels expanding corporate exploration budgets, in turn, enabling the value creation of new discoveries. Because most new gold is found close to existing deposits, a rising gold price reflexively enhances the value of miners' existing land packages.

This beta-to-bullion dynamic suggests that the most important factor in performance of gold equities should always be the direction of the gold price. Nonetheless, a common reservation about gold shares is the perception that their equity component introduces vulnerability to the same type of broad-based equity turbulence against which a gold investment is supposed to provide protection.

M&A on the Rise as Gold Miners Consolidate

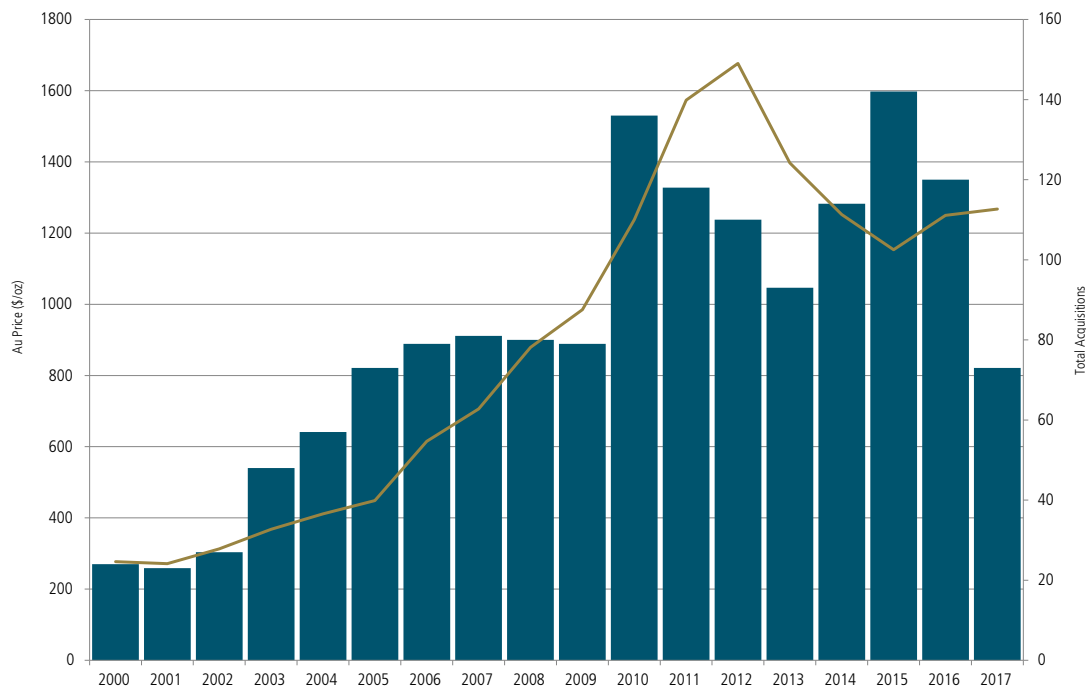
We also believe that we have entered a new mergers and acquisitions (M&A) cycle. Since 2000, there have been nearly 1,500 acquisitions in the precious metals industry. 2019 alone has seen the industry's biggest players making headlines for mergers and new ventures.

Gold mining is one of the only industries we can think of with a "negative survivorship bias." Unlike most industries, the most senior gold miners are not necessarily the competitors with the brightest or safest prospects. It is extremely difficult for gold miners to replace their mined reserves on an annual basis, for the simple fact that gold appears in the earth's crust at only 4-or-so-parts-per-billion. Therefore, in order to avoid being priced as depleting-resource assets, senior gold miners are generally forced to acquire emerging producers to supplement dwindling proprietary discoveries. After 12 straight years of rising gold prices through 2012, gold's 45% decline through December 2018 exposed an inordinate number of poor development and acquisition decisions across the industry. Now that legacy write-offs have been taken and capital discipline has been reinvigorated, the most senior gold miners are on stronger footing to take the next step towards industry rationalization.

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Figure 2: Number of Acquisitions vs. Gold Price (2000-2017)



Source: S&P Global Intelligence, Bloomberg. As of December 31, 2017.

Late last year, industry maverick Mark Bristow engineered what amounts to a reverse-takeover of larger Barrick Gold (4.57% in Sprott Gold Miners Exchange Traded Fund “SGDM” and 0% in Sprott Junior Gold Miners Exchange Traded Fund “SGDJ” as of 3/31/19) by the far more efficiently managed Randgold Resources (0% in SGDM and 0% in SGDJ as of 3/31/19). Given Mr. Bristow’s legendary discipline in converting EBITDA to free cash flow, we expect the Randgold/Barrick merger to catalyze significant reorganization and right-sizing of Barrick’s far-flung assets. Following Mr. Bristow’s lead, Newmont (0% in SGDM and 0% in SGDJ as of 3/31/19) responded within months to Randgold’s throwing of the gauntlet with an equally surprising bid for industry behemoth Goldcorp (0% in SGDM and 0% in SGDJ as of 3/31/19). In recent weeks, Barrick and Newmont have agreed to an innovative and far-reaching joint venture to extract synergies from joint operation of the two companies’ sprawling Nevada assets. While it is still too early to predict how industry dynamics will ultimately shake out, it certainly appears that the starting gun has been fired on long-overdue consolidation in the gold mining space.

It is our expectation that high-quality producers just below the top-tier of industry capitalization will be the ultimate beneficiaries of intelligent rationalization of the gold mining industry. As seniors shed and trade their non-core assets, **we anticipate subsequent balance sheet liquidity to be deployed in competitive bidding for the most attractive mid-tier and emerging producers—precisely the tranche of the gold-mining industry we favor at Sprott.**

(For more on the industry’s increasing M&A activity, please see our webcast *Gold’s Time to Shine*, featuring Ed Coyne and John Hathaway.)

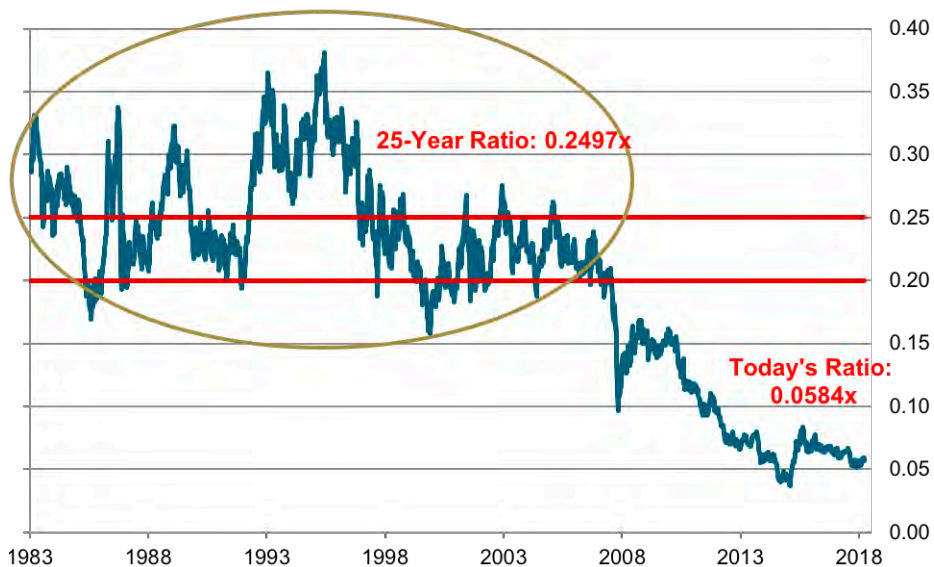
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Outlook for Gold Equities in 2019

Ebullient equity markets and a range-bound gold price have constrained investor enthusiasm for gold equities in recent years. Despite significant gains during 2016, gold shares remain in 2019 near historic lows in many valuation metrics. As shown in Figure 3, during the 25 years through 2008, the ratio of the XAU Index⁶ to spot price of gold averaged 0.2497x but today rests at only 0.0584x. We recognize there are a few legitimate factors weighing on this ratio's decline. Component XAU companies have issued more shares, contemporary mining opportunities are increasingly challenging and gold miners are still disabusing investors of their reputation for poor capital allocation. **Nonetheless, we view the 77% decline in relative valuation between prominent gold-miners and their sole output (bullion) as an investment proposition with highly compelling reversion-to-mean potential.**

Figure 3: Gold Equities Undervalued Relative to Bullion (12/23/83-3/15/19)



Source: Bloomberg. Ratio of XAU Index-to-Spot Price of Gold. As of March 15, 2019.

As we have mentioned, we remain confident in the proven capacity for gold miners to generate portfolio alpha during significant corrections in U.S. equities. As shown in Figure 4, since 1996, there have only been two periods of extended inverse performance between the GDM Index and the S&P 500: 1996-through-2002 and 2012-through-the-present. In the first instance, gold shares were literally left for dead as the internet bubble hit full frenzy through March 2000. Then, as the S&P 500 fell 52%, gold stocks tripled.

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Figure 4: Gold Equities Dislocation from the S&P 500 Index (1/3/95-3/15/19)



Source: Bloomberg. GDM Index versus the S&P 500 Index. As of March 15, 2019.

In the current episode, the S&P 500 and gold shares have (counter-intuitively) moved in opposite directions ever since the Fed's September 2012 announcement of open-ended QE3 (third round of quantitative easing). During the first half of 2016 (yellow ovals), this gaping divergence appeared to be closing with a vengeance. Since the Trump election shock, however, gold shares have essentially moved sideways for two years while the S&P 500 has resumed its blistering upward trajectory. At the risk of talking our own book, it appears the S&P 500 is carving out the mother of all head-and-shoulder tops precisely as the GDM Index is percolating towards its next significant advance (blue ovals).

Especially in context of the post-Trump equity liftoff, we expect the "jaws of life" divergence between the S&P 500 and gold equity averages to close with trademark gusto in the near future. **To us, redeployment of a portion of general U.S. equity exposure to gold shares at this juncture represents a non-consensus portfolio allocation with extremely high probabilities for success.**

If we are correct in sensing an important inflection point for relative valuations of precious metals equities versus general equities, what might be in store for gold shares for the balance of 2019 and beyond?

¹ Alpha gauges the performance of an investment against a market index or benchmark that is considered to represent the market's movement as a whole. The excess return of an investment relative to the return of a benchmark index is the investment's alpha.

² Spot price of gold is measured by the Bloomberg GOLDS Comdty sub-index.

³ NYSE Arca Gold Miners Index (GDM) with dividends reinvested. GDM is a modified market capitalization weighted index comprised of publicly traded companies primarily involved in the mining of gold and silver in locations around the world.

⁴ S&P 500® Index represents 505 stocks issued by 500 large companies with market capitalizations of at least \$6.1 billion. This Index is viewed as a leading indicator of U.S. equities and a reflection of the performance of the large-cap universe. The SPX Index represents price only, and SPXT Index represents total return with dividends reinvested.

⁵ Beta is a measure of the volatility, or systematic risk, of an individual stock in comparison to the unsystematic risk of the entire market.

⁶ XAU is an index of precious metal mining company stocks that are traded on the Philadelphia Stock Exchange.

Two Unique ETFs to Invest in Gold Stocks

Each Index:

- Seeks to outperform purely passive representations of the gold and silver mining industry
- Uses transparent, rules-based methodology designed to overweight gold stocks with attractive investment merits relative to the other stocks in the index
- The stock selection and index weighting criteria were co-developed by Sprott Asset Management, a leading, long-time gold sector investor, and Zacks Index Services

SGDM

NYSE ARCA

Sprott Gold Miners ETF

- Stocks weighted in the index based on quarterly revenue growth and long-term debt to equity
- Reconstituted quarterly

SGDJ

NYSE ARCA

Sprott Junior Gold Miners ETF

- Stocks weighted in the index based on revenue growth and price momentum
- Reconstituted semi-annually

SPROTT ETFs

Sprott ETFs provide investors with access to innovative and unique indexes that are designed to outperform passive market cap-weighted offerings. Each Index is designed using specific **FACTORS that MATTER™** for a particular strategy. These customized factors are selected because they have historically shown correlation to stock performance.

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Sprott Gold Miners Exchange Traded Fund

Monthly Performance as of 02/28/2019

TOTAL RETURNS	Cumulative				Annualized		
	1 Month	3 Month	YTD	Since Inception ²	1 Year	3 Year	Since Inception ²
Sprott Gold Miners ETF (Net Asset Value)	1.30%	28.03%	10.90%	-20.02%	4.81%	4.24%	-4.71%
Sprott Gold Miners ETF (Market Price) ¹	1.94%	28.63%	11.38%	-19.86%	4.53%	4.30%	-4.67%
Sprott Zacks Gold Miners Index (Benchmark) ³	1.42%	28.32%	11.05%	-17.26%	5.58%	5.01%	-4.01%

Quarterly Performance as of 12/31/2018

TOTAL RETURNS	Cumulative				Annualized		
	1 Month	3 Month	YTD	Since Inception ²	1 Year	3 Year	Since Inception ²
Sprott Gold Miners ETF (Net Asset Value)	15.45%	12.79%	-15.01%	-27.88%	-15.01%	11.69%	-7.06%
Sprott Gold Miners ETF (Market Price) ¹	15.49%	12.25%	-15.12%	-28.04%	-15.12%	11.64%	-7.10%
Sprott Zacks Gold Miners Index (Benchmark) ³	15.55%	13.05%	-14.36%	-25.50%	-14.36%	12.50%	-6.38%

Expenses as of 03/31/2017

Management Fee	0.57%
Other Expenses	0.00%
Total Operating Expenses	0.57%

Sprott Junior Gold Miners Exchange Traded Fund

Monthly Performance as of 02/28/2019

TOTAL RETURNS	Cumulative				Annualized	
	1 Month	3 Month	YTD	Since Inception ⁵	1 Year	Since Inception ⁵
Sprott Junior Gold Miners ETF (Net Asset Value)	2.83%	31.16%	14.03%	20.48%	-3.63%	4.87%
Sprott Junior Gold Miners ETF (Market Price) ¹	2.98%	31.42%	13.90%	20.44%	-3.93%	4.86%
Sprott Zacks Junior Gold Miners Index (Benchmark) ⁶	2.85%	31.26%	14.08%	24.39%	-3.06%	5.73%

Quarterly Performance as of 12/31/2018

TOTAL RETURNS	Cumulative				Annualized	
	1 Month	3 Month	YTD	Since Inception ⁵	1 Year	Since Inception ⁵
Sprott Junior Gold Miners ETF (Net Asset Value)	15.03%	3.80%	-25.66%	5.66%	-25.66%	1.48%
Sprott Junior Gold Miners ETF (Market Price) ¹	15.38%	3.75%	-25.67%	5.74%	-25.67%	1.50%
Sprott Zacks Junior Gold Miners Index (Benchmark) ⁶	15.06%	3.98%	-25.20%	9.04%	-25.20%	2.33%

Expenses as of 03/31/2017

Management Fee	0.57%
Other Expenses	0.00%
Total Operating Expenses	0.57%

Performance data quoted represents past performance. Past performance is no guarantee of future results so that shares, when redeemed may be worth more or less than their original cost. The investment return and principal value will fluctuate. Current performance may be higher or lower than the performance quoted. Call 866.675.2639 for current month end performance.

¹ Market Price is based on the midpoint of the bid/ask spread at 4 p.m. ET and does not represent the returns an investor would receive if shares were traded at other times.

² Inception date of 07/15/2014.

³ The Underlying Index was created by Zacks Index Services ("Index Provider") to provide a means of generally tracking the performance of gold and silver mining companies whose stocks are traded on major U.S. exchanges. An investor cannot invest directly in an index.

⁴ Other expenses are based on estimated amounts for the current fiscal year and are calculated as a percentage of the Fund's net assets.

⁵ Inception date of 03/31/2015.

⁶ This factor-based Index aims to track the performance of small-capitalization gold companies whose stocks are listed on major U.S. and Canadian exchanges.

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IMPORTANT DISCLOSURES & DEFINITIONS

An investor should consider the investment objectives, risks, charges and expenses carefully before investing. To obtain a Statutory Prospectus, which contains this and other information please contact your financial professional or call 1.855.215.1425. Read the Statutory Prospectus carefully before investing.

Sprott Gold Miners ETF and Sprott Junior Gold Miners ETF shares are not individually redeemable. Investors buy and sell shares of the Sprott Gold Miners ETF on a secondary market. Only market makers or “authorized participants” may trade directly with the Fund, typically in blocks of 50,000 shares.

The Funds are not suitable for all investors. There are risks involved with investing in ETFs including the loss of money. The Funds are considered nondiversified and can invest a greater portion of assets in securities of individual issuers than diversified funds. As a result, changes in the market value of a single investment could cause greater fluctuations in share price than would occur in diversified funds.

Micro-cap stocks involve substantially greater risks of loss and price fluctuations because their earnings and revenues tend to be less predictable. These companies may be newly formed or in the early stages of development, with limited product lines, markets or financial resources and may lack management depth.

The Funds will be concentrated in the gold and silver mining industry. As a result, the Funds will be sensitive to changes in, and its performance will depend to a greater extent on, the overall condition of the gold and silver mining industry. Also, gold and silver mining companies are highly dependent on the price of gold and silver bullion. These prices may fluctuate substantially over short periods of time so the Fund’s Share price may be more volatile than other types of investments.

Funds that emphasize investments in small/mid cap companies will generally experience greater price volatility.

Funds investing in foreign and emerging markets will also generally experience greater price volatility.

There are risks involved with investing in ETFs including the loss of money.

Diversification does not eliminate the risk of experiencing investment losses.

ETFs are considered to have continuous liquidity because they allow for an individual to trade throughout the day.

ALPS Portfolio Solutions Distributor, Inc. is the Distributor for the Sprott Gold Miners ETF and the Sprott Junior Gold Miners ETF.

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