Sprott Canadian Equity's structural challenges

Sprott Canadian Equity Fund (SCEF) is the flagship of Sprott Asset Management (SAM). Eric Sprott's macro view of the world drives the firm's investment strategy and the stock selection of its flagship fund. We quite like Sprott's high conviction investing style, independent thinking, and contrarian views. We also admire the huge success that Sprott and his investors have enjoyed over the past decade. But recent inquiries from our advisor-clients on the merits of the SCEF prompted us to take a closer look at this popular top performer. We found that SCEF now faces size-related challenges that did not exist a couple of years ago, and that should be top of mind for any would-be SCEF investor.

It's important to highlight that we've not had in-depth discussions with SAM. At the time of writing, we have received neither an acknowledgement nor a response to our two recent inquiries with SAM. Hence, what follows is our independent analysis, without any input from SAM despite our efforts to obtain their input.

Number of stocks

A rising asset base is often associated with an increasing number of stocks held. We have observed over the years how bulging assets change the way firms execute their investment processes. The trend at SCEF, however, is perhaps the most striking we've ever seen. The chart on the next page provides a historical illustration of the number of stocks held by SCEF versus its rising asset base.

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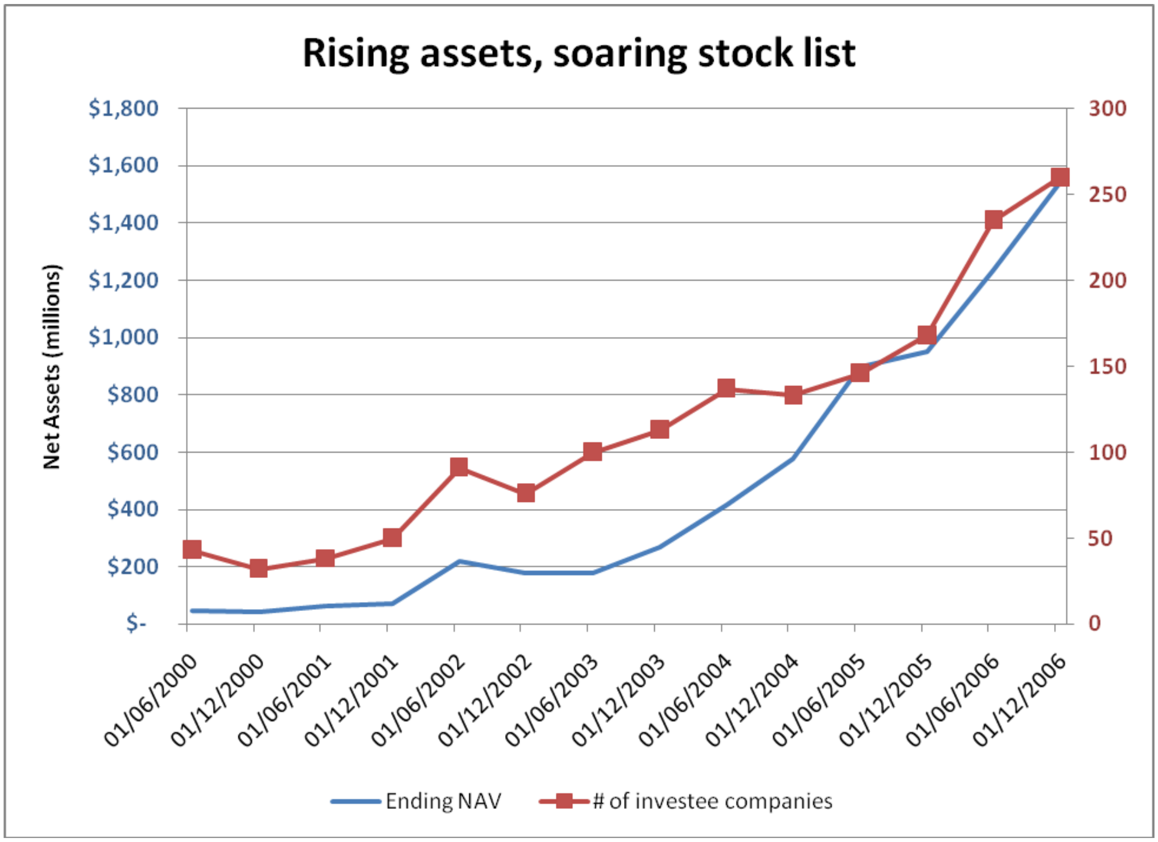

As of the end of 2006, SCEF's more than $1.5 billion in net assets was spread across holdings in 260 unique companies. Six years earlier, the fund boasted just $43 million in assets and just 32 stocks. The above chart shows clearly the tight (and almost perfect) link between assets and the number of companies. Holding a longer or shorter list of stocks depends on assets but also on the nature and breadth of available opportunities. Legg Mason's Bill Miller succinctly described why in his Q4 2006 commentary:

> If I am considering buying three $10 stocks, two of which I think are worth $15, and the third worth $50, then I will buy the one worth $50, since my expected return would be diminished by splitting the money among the three. But if I think all are worth $15, then I should buy all three, since my risk is then lowered by spreading it around.

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Since we consider SAM to be a 'high conviction' investment manager (i.e. making big sector or stock bets), it's safe to assume that they'd give a big weight to a stock that clearly offered upside potential that is superior to other available stocks. Indeed, SCEF previously held nearly 20% in a single stock about which SAM was very bullish. Today's lower stock weightings and longer list of names has one of two likely explanations.

If no outstanding bargains exist, SCEF may be diversifying as a sign of their reduced confidence in each stock held. Alternately, maybe so many stocks are held because it cannot invest 10% of its assets in such small companies without owning too much of a company's shares or float. While both factors are valid, we suspect that size is impacting today's portfolio structure much more so than the general availability of good bargains.

Analyst coverage capacity

As a firm, SAM's roughly $4 billion in assets under management are invested in 362 unique companies[1]. We wonder how SAM's team of 13 investment professionals can have in-depth knowledge of so many small companies. The *362 companies* figure does not include short positions or other stocks kept on a watch list (i.e. not in the fund).

In our experience, stock watch lists are typically half as long as the number of investment portfolio holdings. Estimating the number of stocks on SAM's watch list implies that each investment professional covers between 30 and 40 stocks at any one time.

This sounds high but not unfeasible. But when you consider that many of SAM's investee companies are commodity firms (many of which have overseas properties), you realize that more work is required to know each company very well. This is particularly important for a high conviction manager like SAM. Compounding this is the fact that most of SAM's stocks are issued by small companies, which we would argue require more (time-intensive) qualitative analysis than larger firms.

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[1] In total, the four Sprott funds sold by prospectus hold positions in 469 companies. But SCEF has 107 of these in common with the other three funds. Hence, the firm has long positions in 362 unique firms.

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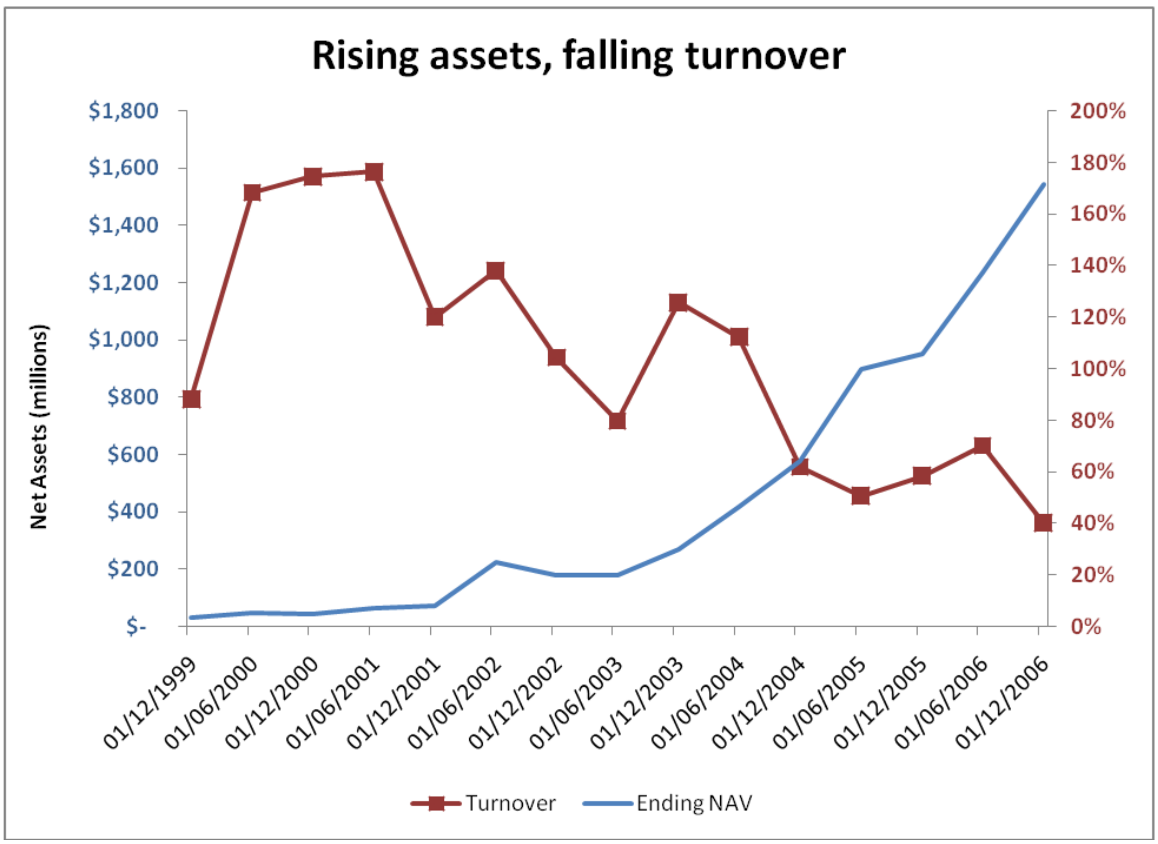
Turnover

Another classic sign of assets impacting process is found in trading frequency or turnover rates. SCEF's turnover had routinely been in the range of 100% to 180% per year. However, as assets marched north of $500 million, turnover began its strong descent. Indeed, SCEF's turnover has fallen rather consistently to less than half of the above range – and most recently to 40% for 2006. The chart below illustrates historical annualized turnover for each six-month period starting January 1, 2000 and ending December 31, 2006. Turnover is charted against assets under management for SCEF.



To a certain extent, SAM has still been able to make significant sector shifts. For instance, SCEF's exposure to mining, metals, oil & gas, and other energy stocks has varied fairly significantly in the past 3-4 years. However, these sorts of portfolio shifts become increasingly difficult to execute as assets pile up.

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Stock concentration

We've also noticed a markedly reduced concentration of SCEF's stock investments. It should come as no surprise that a fund increasing its list of stocks from 32 to 260 would also become less concentrated. And while we still consider SAM's style to be "high conviction" on a sector basis, they display much less conviction on an individual stock basis compared to just a few years ago. The table below shows how the weighting of SCEF's 15 largest stock positions has changed over the years.

End Date	% of assets in top 15 stocks	Net Assets ($ millions)
31-Dec-2000	83.2%	$44
31-Dec-2001	72.4%	$72
31-Dec-2002	50.3%	$180
31-Dec-2003	44.5%	$269
31-Dec-2004	44.0%	$577
30-Sep-2005	47.1%	$961
30-Sep-2006	35.4%	$1,250
31-Mar-2007	36.8%	$1,749

The above table shows a clear trend toward lower individual stock concentration as assets have risen. Given that the first chart (see page 2) showed a big increase in the number of stocks held in SCEF, the diluted concentration is not surprising. Conversely, when we investigated similar issues with Canadian Equity mandates run by Kim Shannon of Sionna Investment Managers, we found that her portfolios became tighter and more concentrated despite a ten-fold increase in assets[2].

[2] A reduction of investments in small cap stocks explains part of Shannon's tighter list, but it's not a significant factor. She continues to hold a concentrated portfolio of mid- and large- cap stocks despite working with a tiny asset base compared to what she ran at CI Financial.

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Liquidity risk

While we've not gone through the portfolio of all 260 companies, we looked at the liquidity of selected SCEF top holdings. The table below shows the shares owned as of March 30, 2007 of some top holdings and each respective stock's trailing 200-day share trading volume (as of May 16, 2007). We also looked at trading volume from 1998 and 1999 to view liquidity in a more bearish context.

Stock Name	# of days volume	# of days 1998/99 volume	SCEF Ownership	Firm Ownership*
Blue Pearl Mining**	4.7	1,338.3	6.0%	6.4%
Delta Petroleum	3.2	217.7	5.3%	6.2%
Corridor Resources Inc.	54.3	632.2	8.7%	8.7%
Energy Metals Corporation	5.2	2,305.6	4.0%	5.1%
Falcon Oil & Gas Ltd	6.1	N/A	2.6%	3.3%
Quadra Mining Ltd	9.9	N/A	9.8%	16.4%
Golden Star Resources Ltd	8.1	334.9	3.3%	3.3%
High River Gold Mines Ltd	27.5	481.8	6.8%	6.8%

Source of raw data: http://finance.yahoo.com and Public filings of SAM funds and investee companies.

* Figures include shares owned by SCEF and the three other prospectus-sold Sprott mutual funds; but exclude those that may be owned by the firm's proprietary portfolio, its hedge funds, and other accounts.

** Blue Pearl Mining recently changed its name to Thompson Creek Metals Company Inc.

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The above eight stocks make up about ¼ of SCEF's net assets as of March 31, 2007. While SCEF holds large volume in a couple of stocks, the results are less striking than we initially expected. However, there are two noteworthy liquidity risks we can glean from the above table.

- *Disappearing bids* – We show current holdings relative to average trading volume through 1998 and 1999 to demonstrate the liquidity risk that would exist if liquidity dried up in these (and other similar) stocks; and if SCEF was still holding them. In other words, when stocks are out of favour, liquidity dries up, volume tanks, and bids (i.e. the price at which investors are offering to buy) disappear. If this occurs and the problem is compounded by unitholder redemptions, the consequences will be very painful.

- *Future Dilution* – SAM owns significant stakes in many of its investee companies. Since the fund continues to enjoy strong inflows, this may force the firm to invest in yet more new stocks to keep cash invested and not run afoul of mutual fund ownership limits.

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Tying it all together

Sprott Canadian Equity Fund has generated tremendous returns for its unitholders and its sponsor, Sprott Asset Management. Five months shy of its tenth birthday, the fund boasts a compounded return of 29.3% per year through April 30, 2007. But advisors thinking of investing their own or their clients' money in this fund must focus less on its successful track record and more on some structural issues that have current and future implications.

We're concerned that the bulging asset base of SCEF (and SAM) is negatively impacting the execution of SAM's investment process. Specifically, SCEF now holds an unwieldy number of stocks, trades at less than 1/3rd of its previous frequency, and holds a much less concentrated portfolio than in the past. Adding to these concerns is our dislike of SCEF's performance fee[3]. Liquidity does not appear to be the huge immediate risk it first seemed to be but this remains an important factor to watch if heavily weighted SCEF stocks begin to turn down. Keeping tabs on prepared commentaries and public media appearances can help in monitoring this liquidity issue (to see what they've sold).

Liquidity, while a very real risk, is the lesser of our concerns at this time. We're more concerned that SAM's execution differs markedly from that seen in earlier years when this fund began racking up huge returns for unitholders. This may be exacerbated by continued net sales into the fund and the likely further dilution as new money pours in. As long as the fund does not suffer a decline similar to (or worse than) its 39% drop in 1998, redemptions are unlikely to be a problem – particularly since the fund remains open to new money. Ironically, that the fund still accepts new money is both part of the problem and a potential saviour if commodity stocks sink.

[3] SCEF charges a base fee of 2.5% of net assets, plus a performance bonus equal to 10% of its performance in excess of the performance of the S&P/TSX Composite Index. Given SCEF's near exclusive focus on small and micro cap stocks, it makes little sense to reward management when part of its outperformance can be obtained by getting passive exposure to small cap stocks. A better benchmark is the BMO Small Cap Weighted Index.

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SCEF's returns have lured so much money that it now faces structural risks that didn't exist a couple of years ago. We don't have a formal opinion of the fund at this time but even if SAM is skilled (which they appear to be), investors must be aware of these structural risks, be comfortable with negative scenarios that can materialize, and limit the fund to a relatively smaller percentage of their overall portfolios. Based on the information we have at this time, SCEF is not a fund we'd buy today.

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