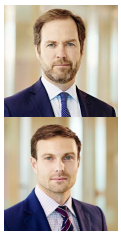
Sprott Enhanced Equity Strategy

December 2017 Commentary

Investment Team



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The bull market in U.S. equities and the related bear market in volatility continued unabated in December with the S&P 500 gaining 1.1% for the month and the VIX closing below 10 once again. In Canada, the continued rise in the price of crude oil (WTI above US$60) surprised most investors (though not us) and it helped push both the equity market (SPTSX up 1.2%) and the Canadian dollar (up 2.4%) higher for the month. The fall in the U.S. dollar more than offset the climb in U.S. equities, equating to a -1.5% drop in the S&P 500 for the month in Canadian dollar terms.

Markets have continued their post-tax reform rally into the New Year after consolidating through the holiday period on light volume. We took profits on the vast majority of our index call position prior to the holiday period. Markets have moved from pricing in much of the primary impacts of tax reform, such as immediate earnings accretion from lower tax rates, to considering some of the second derivative impacts of policy change which we will discuss below. While the market has re-rated from a ~17.5X FWD PE pre-tax reform to ~18.5X as of the end of December, many bottoms up earnings estimates do not currently reflect the recent tax changes leaving tailwinds to estimates revisions in the near term and suggesting markets aren't as expensive as headline valuations indicate. Earnings revisions tend to drive a virtuous cycle for the market all on their own and are a nice tailwind to start the year void of any un-foreseen negative catalysts, with trade disruptions a possible candidate we are keeping an eye on.

Below we consider several key debates among market participants who are currently considering what the impacts of tax changes are likely to be on a go forward basis. We see a possibility that the market is perhaps trading at a lower valuation than the pre-tax reform regime assuming base earnings growth was achievable to begin with. While we expect management teams to guide conservatively on accretion from tax reform due to several unknowns they have little control over (competition as one example), we consider the setup to be generally positive for the first half of 2018 for markets. We present our thoughts on several of these factors below and come out decidedly positive on many of them.

- How much of the tax tailwind will companies be able to retain vs. pass on to end customers as competitive pressures take hold?

After the last major tax reform undertaken by the Reagan administration, operating margins continued to expand for companies on aggregate through the rest of the business cycle suggesting there is some historical precedent for sustainable gains that fall through to the bottom line. Certain sectors are certainly likely to have a more challenging times keeping tax gains than others - retail is a good example. However, relative valuations in this sector are not high vs. history even after considering the strong performance in late 2017. This suggests the market is already discounting

some of the “have” and “have nots” of tax reform. Financials are also an area of the market where investors are starting to question the sustainability of any tax gains. We note that after the Reagan reforms financials were able to drive higher return on assets and growth which argues for higher valuations in general. For a sector which has generally been unable to earn even its cost of capital since 2008, this upside would represent a paradigm shift in earnings power considerations for the group.

- What are the negative impacts of tax reform on levered businesses due to interest expensededuction limitations and the pressure on tax shelters?

This is unquestionably one of the more difficult considerations for investors. That said, our early analysis on several companies that we consider to be challenged under a new tax regime, given their current high leverage and low tax rates has been more positive than we initially expected. Many are “soft guiding” to a neutral to only slightly negative impact indicating, albeit anecdotally, that this is not as significant of a risk to forward estimates as many believe. More details are likely to come forward on Q4 earnings calls.

- Will a virtuous cycle of capital spending and “trickle down” economics push higher capital spending and consumer demand? Who will receive revenue tailwinds indirectly from additional economic activity and is it fully reflected in valuations?

We think the recent move to allow full deductions of certain capital spending will likely drive labour productivity investments and should be stimulative towards automation spending. This should in particular help companies in the technology supply chain. Pre-tax reform, an investment in capital spending came at a hefty after tax cost of ~36% for corporations. Adding an incremental new unit of labour was 100% deductible against your taxes. Tax reform now levels the playing field for investments in capital vs. labour in many sectors. As an example, Fiserv, a technology company owned in the funds, services banks payment technology needs. They not only benefit directly from having a high tax rate (that will go lower), but could see revenue acceleration from increased spending technology by banks who are going to see a historic earnings tailwinds due to the changes in tax policy. The stock has only marginally outperformed post tax reform suggesting this second derivative impact is not well discounted by the market. We’ve seen this dynamic in several other sectors suggesting many stocks are not fully reflecting the possible revenue tailwinds that could lie ahead.

- Are “base” bottoms up earnings estimates for 2018 actually achievable vs. past years given a possible acceleration in GDP growth?

Chart 1 shows the trend for earnings revisions of the past several years. Bottoms Up investors have consistently entered the year with optimism around both GDP growth and earnings growth only to be disappointed on both as the economy “muddled” along just above stall speed. Historically, this has caused negative estimate revisions as we moved through the calendar year with last year being a slight exception. We wonder “if” GDP growth accelerates to a 3.0% pace for 2018, are base bottoms up earnings estimates (before considering tax reform benefits) possibly more achievable than in the past several years? If so, this would suggest that earnings could grow high double digits in 2018 once we layer on tax gains to this number. We could therefore see high double digit returns in the market if valuation multiples can stay constant.

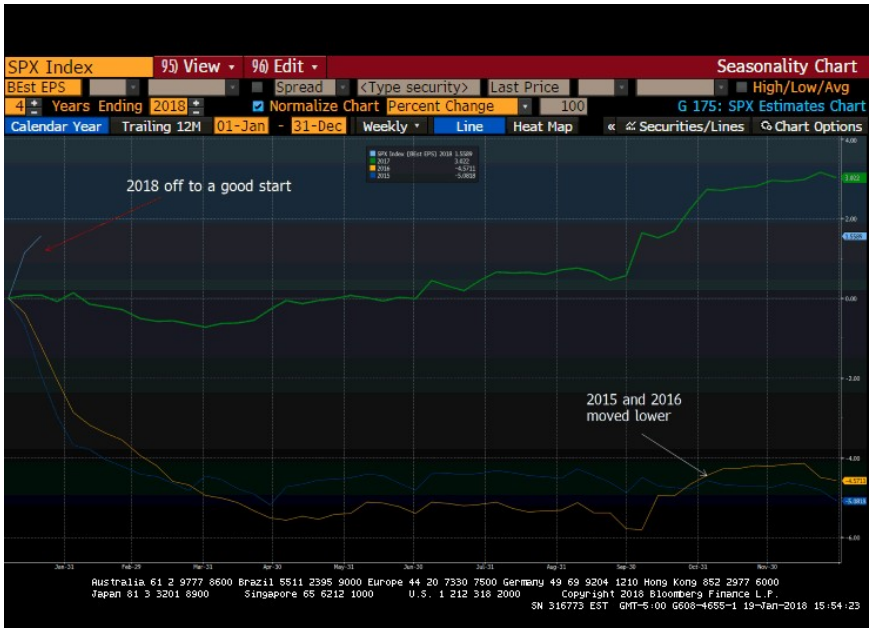
- Which business models look more attractive relative to their peers under a tax regime that

favours capital spending? What do we pay for these companies on a go forward basis and does it add to the PE multiple of the market on aggregate?

We still think this remains an interesting dynamic many investors have not fully considered. We will take U.S. railroads as an example. These companies typically were penalized by markets for having lower free cash flow conversions than many "high quality" industrials. However, with tax reform, they go from one of the highest cash tax payers with lower than average free cash flow conversion to the lowest cash tax payer with the highest free cash flow conversion. There are companies in many other sectors that share similar dynamics. This would indicate, all else constant, that these companies should re-rate to valuations in-line to peers. This dynamic is only starting to play out and could be a valuation catalyst unto itself for the market in 2018.

While we consider all of these positives in our investment decisions, we also think that as the year unfolds that the Federal Reserve is likely to continue to tighten the liquidity spigot somewhat more that the market currently expects. Eventually, this will likely have a negative impact on rate sensitive sectors of the market and eventually spill over into broader equity markets. Furthermore, markets have not experienced a year of synchronized global growth since the financials crisis and so we don't exactly know the impact on inflation but it seems the risks could be the upside. Fixed income markets are not priced for this dynamic currently on the long or short end of the interest rate curve. Given these considerations, we have already constructed an options hedging playbook to try and mitigate these impacts on our clients' portfolios and stand ready to employ it "if" we see the risks are becoming elevated. Fortunately, hedging these risks is unusually cheap given low volatility in fixed income markets. We continue to hedge our broader equity portfolio with equity index puts at relatively low costs relative to history as a way to manage unforeseen events. We have no intention of breaking discipline on this part of the strategy.

Chart 1: S&P 500 Estimate revisions starting the year strong



Source: Bloomberg

Until next month,

The Enhanced Team

[1] All returns and fund details are a) based on Class/Series F shares/units; b) net of fees; c) annualized if period is greater than one year; d) as at December 29, 2017; e) inception date for Ninepoint Enhanced Equity Class is 04/16/12.[2] 50% of S&P/TSX Composite TRI; 50% of S&P 500 TRI CAD and is computed by Ninepoint Partners LP based on available index information.

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