Sprott Enhanced Equity Strategy

September 2017 Commentary

Investment Team

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The month of September saw the broader U.S. market grind to new highs amid historically low volatility. The grind higher masked meaningful shifts below the surface as heavy sector rotation marked changes in investors' relative positioning. Equity market leadership was driven by strength in energy, financials and small caps based on stabilization in crude oil prices and rising expectations for passage of some sort of U.S. tax reform. Sectors that funded this rotation included staples and utilities as well as the leadership group in tech (Facebook, Amazon, Apple, Netflix and Google).

Our funds benefited from this rally as we have rotated from pipelines to more producer focused positioning in energy and had increased our positioning in companies which we felt would benefit from U.S. tax reform and better overall growth. We had started to develop a more optimistic view in August on the likelihood of tax reform and the potential implications it had on many sectors of the market and our holdings. Our discussions with several Washington consultancy groups and former U.S. politicians over the summer lead to us to consider that the probability of reform was moving above 50/50 vs. the market expectation at the time of essentially 0% (see chart 1). The nature of the reform also looked to be less hostile to several sectors of the market (technology and retail) than the previous proposal, largely due to the dropping of the Border Adjustment Tax (BAT).

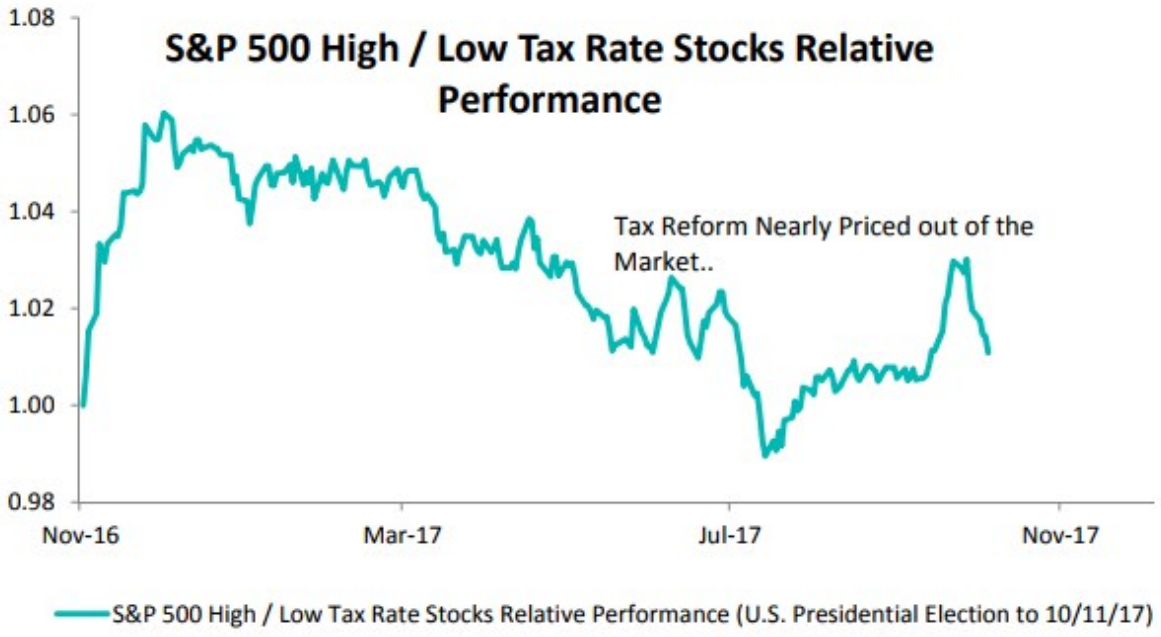

Chart 1 | Source: Evercore ISI

The current proposal is taking the form of a “tax cut” instead of “tax reform” with the tax shortfall funded through deficit spending instead of tariff-like tax increases. This is bullish for growth sensitive domestically oriented sectors of the economy, value stocks and specifically financials (see chart 2). Our change of view lead us to re-enter positions in U.S. large cap financials such as Bank of America (BAC) and Citigroup (C). As a reminder, we exited U.S. bank stocks at the beginning of 2017, on the premise that too much of the upside optionality of tax reform had already been priced in at a time when we were concerned with the potential for weaker credit trends. While we still see 2018 credit growth estimates as potentially too high, better economic growth, expense control, exposure to potentially higher net interest margins and upside from tax reform more than offset those concerns. We like Citi for its ability to return significant amounts of capital to shareholders in the form of buybacks after overcoming years of significant balance sheet and regulatory hurdles. Meanwhile, BAC has more tax optionality and expense control potential.

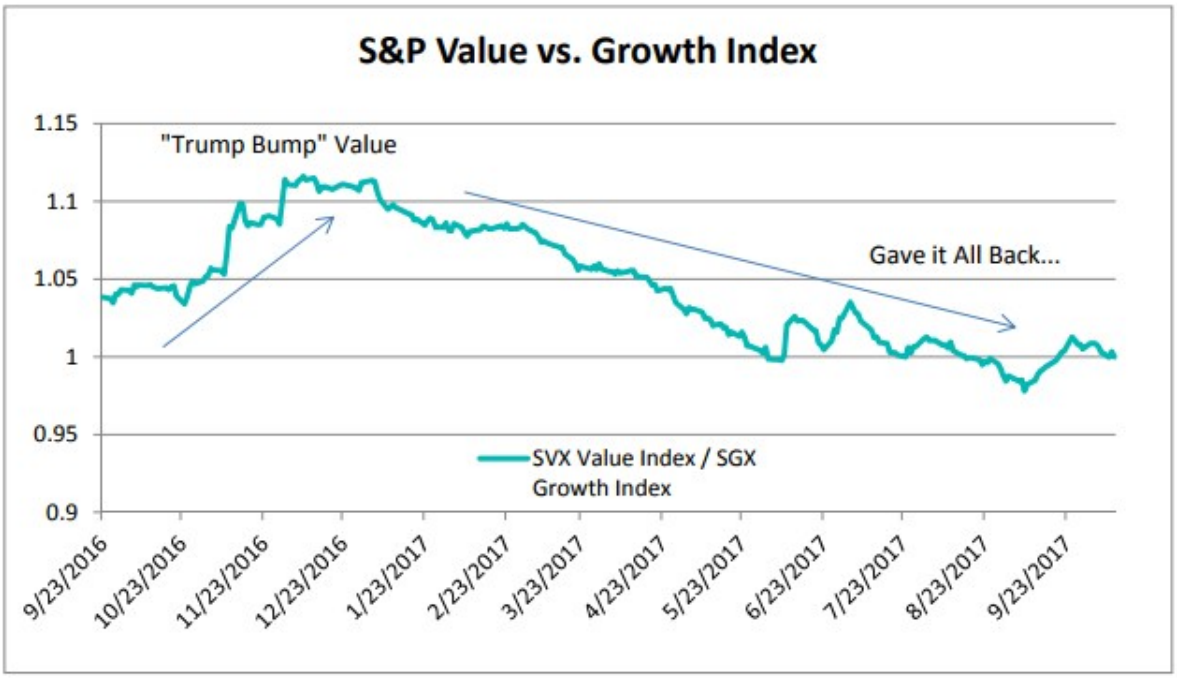

Chart 2 | Source: Bloomberg

On the other side of the coin, tax reform is likely to be negative for treasuries as higher deficit spending and inflation acceleration concerns start to seep into market expectations. This will in turn be bearish for defensive “bond proxy” sectors such as staples. We’ve watched for several years the revenue trends broadly in staples become increasingly lower quality at a time when the desire for yield and stability pushed many investors to value these companies at 40-50% PE multiple premiums to the market. With this as the backdrop, we decided to exit our position in Pepsi. We’ve held the position based on the thesis that the company could trade from a discount to a premium relative to its peer group as it became more apparent that the business had stronger than peer earnings visibility driven by stable revenue growth and continued execution on cost reduction. Pepsi in our opinion also had a miss-understood beverage business that operated in an attractive global oligopoly as well as underappreciated growth in the snacking category. Pepsi recently achieved our expectations and now trades at a premium valuation to the peer group and therefore motivating our decision to sell.

In Canada, we exited our position in Enbridge, favoring instead a risk reversal in the XEG energy ETF. In this options position, we sold a downside put spread, which limited our downside and used

the proceeds to purchase upside calls that were trading with implied volatilities near all-time lows. We put this position on for virtually no cost. If the energy sector just trades back to where it was in January, our position could generate ~75% of the upside of an equivalent position in the ETF. Meanwhile, on a 15-20% sell-off the position generates only ~1/3rd of the losses of an equivalent position in the index. Given our mandate to control downside risks while providing reasonable upside, we feel this position offers a strong risk/reward in a volatile sector. We also initiated a position in the Bank of Commerce which has lagged the rest of the Canadian banks. With a yield approaching 5% and the cheapest valuation in the group we believe concerns regarding its recent U.S. acquisition are overdone.

While we expect the market can continue to grind higher, our strategy dictates that we hedge market risk in our portfolio and we continue to do that using S&P put options. Monthly volatility in September reached all-time lows, cheapening the cost of that protection which we currently have in place out to the end of the current year (chart 3).

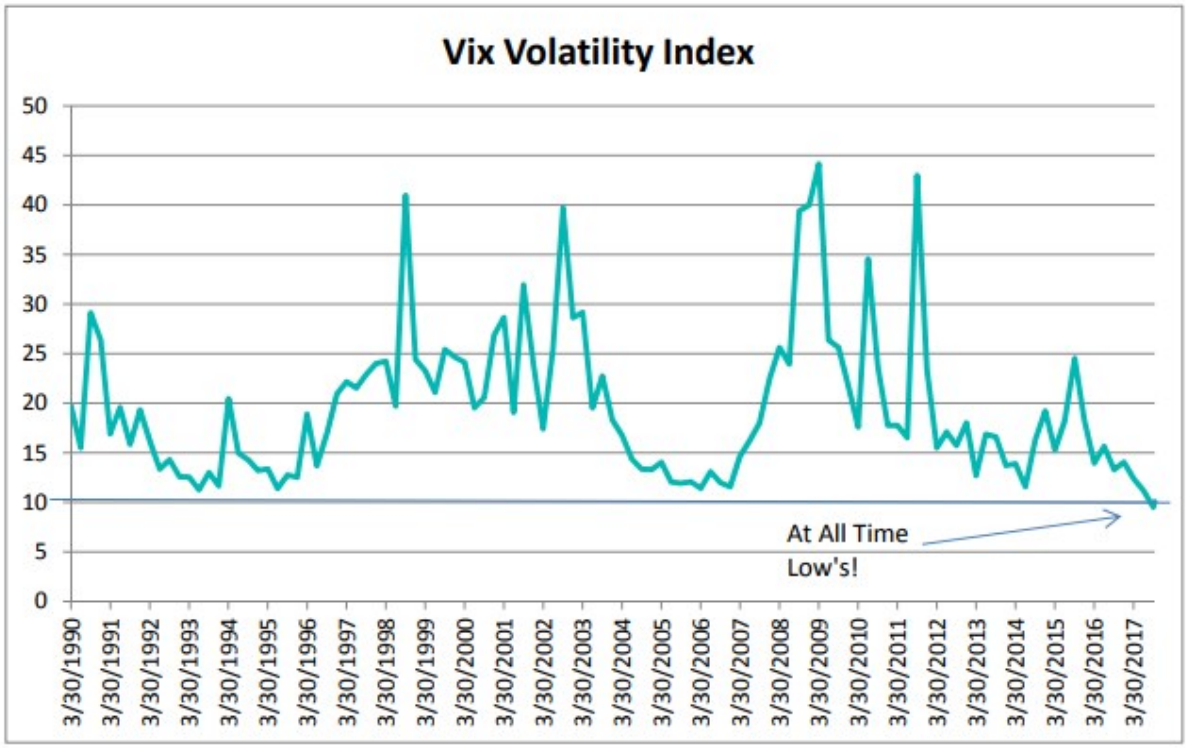

Chart 3 | Source: Bloomberg

Overall, we remain relatively optimistic on both near term global growth as well as the prospects for the U.S. Administration and Congress to deliver some version of a tax cut. We expect both of these factors to underpin better earnings expectations going forward, likely driving markets to new highs as we enter the late stages of the current bull market.

The Enhanced Strategy 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 September 30, 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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