

Sprott Investment Fund

2008 Annual report



Forward

The Sprott Investment Funds goal is to make capital gains when the investment risk does not compromise the preservation of capital. Through this process the fund aims to educate its members in the intricacies involved in the modern market place, and expose them to the added stress real capital brings to money management.

While the monetary performance of the fund is important, it is the implicit goal of the fund to provide a healthy learning environment for its members. During the SIN Fund experience, participants will learn valuation techniques, research methods and how to use powerful financial software such as Bloomberg. Analysts will learn quickly how to create formal investment reports, how to back investment rationale in round table discussion, and gain perspective on how macro economics, emotional markets and institutional investors, affect markets. Managers will hone leadership skills with the SIN Funds team based model, and tight deadlines. They will also be given the opportunity to involve others in their personal investment hypotheses, using the work of three to accomplish tasks which are daunting to do alone. As a member from the SIN Fund graduates and moves into the workforce, the knowledge and experience gained from the many investing challenges tackled on the fund, will add greatly to their hire-ability.

Our investment decisions are reviewed before trading by our academic overseeing professor, Howard Nemiroff. His active participation in the fund includes: participation in recruitment, recommendation of companies to report on, and final veto power on all buy recommendations. He and Professor Otchere are continual sources of information for analysts on the fund, and we thank them for investing their time in us.

Detailed in this report is a brief summary of the funds actions and reasoning throughout the year, accompanied with an outlook on expected market direction through to the fall. We hope to involve the student body in our decisions next year with a weekly blog and semiannual open meetings in which we will address interested student and faculty on our investments and rationale.

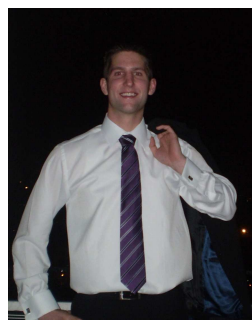
Current Members



James Heard **Background**

Senior Manager
3rd Year Finance,
Bachelor of Commerce

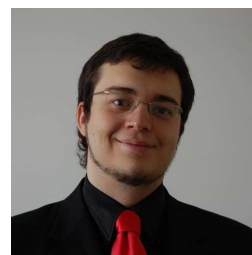
James started with the SIN fund in 2007 as the funds Energy Analyst. He took the role of Senior Manager in September of 2008, which he hopes to hold until Spring 2010. Along with his managerial duties James continued to monitor investment opportunities, and produced recommendations for RIG, GE, and POT this year. He currently holds his IFIC license, is Bloomberg Equity Certified and looks forward to challenging the CFA level 1 test in spring 2010.



Aaron Sapelak **Background**

**Global
Economic
Advisor**
4th Year Bachelor of
International Business –
Foreign Investment,
Finance and Banking

This was Aaron's first year on the fund. Aaron studies International finance and Banking, having completed a year of study abroad at the Solvay Business School in Brussels, Belgium. While away, he completed many courses covering global finance and international business environments. He was previously a teaching assistant for Quantitative Methods in Business I and II, providing the fund with a solid understanding of quantitative modeling as well as global economic issues and their business impacts. He did analysis on Aeon, Entergy, E.ON AG, Fluor Corp, Intel, Iberdrola SA, Jacobs Engineering, SNC Lavalin and all of the BRIC countries for possible ETF investments. He looks forward to working in the international finance arena in the future.



Alexander Bakushchyk **Background**

Analyst
4th Year Finance & IS,
Bachelor of Commerce

Alexander began his career with the SIN fund in the fall of 2008 as the funds IT/Tech Analyst. He has since moved on to other sectors ranging from newsprint media to private education. He hopes to attain a management position in the 2009-2010, while finishing his IS concentration. Alex has produced recommendations for RCI, DV, and the newsprint industry. He is currently in the process of attaining his Bloomberg Equity Certification. His experience includes a VP Finance position at AIESEC Carleton.

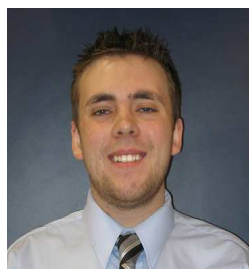


HanYang **Background**

Analyst
4th Year Finance,
Bachelor of Commerce

Han began with the SIN fund in 2008 as the funds Basic Material Analyst, and he is looking forward to becoming one of the fund managers for next year. During the year with SIN find, he had learned a lot of strategies of investment and made many recommendations including MOS, NUE, MON, RYN, etc. He is currently interested in fix income and derivatives and looking forward to explore these fields in his last academic year. Also, he is planning to receive a Bloomberg Equity Certificate by this year and start his CFA exam after graduation in 2010.

Tyler McKendry **Background**



Analyst
3rd Year Finance,
Bachelor of Commerce

Tyler joined the SIN fund in 2008 as a financial sector analyst. After analyzing the Canadian banking industry, he recommended BNS to outperform the industry. Tyler also contributed insight to investment opportunities with his conservative, value investing approach. He currently works at CIBC, is a treasurer of a local organization, and will be interning with Grameen bank in the summer of 2009. Tyler intends to return to the SIN fund as a manager in his 4th year.

Matt Fines **Background**



Analyst
3rd Year Finance,
Bachelor of Commerce

Matt began his first year with the SIN Fund as a Technology Analyst and aspires to gain a management position with the fund next year. He examined and maintained recommendations for WMI, LMT, GOOG, and AAPL. Also, Matt is currently completing Bloomberg Certification and preparing to write the CFA level 1 test in the following school year.

Lisa Fulford **Background**



Analyst
3rd Year Finance,
Bachelor of Commerce

Lisa began with the fund in 2008 as a financial sector analyst. She was responsible for extensive research in both US and Canadian banking industries before she branched out into other industries including consumer non-cyclical. Lisa successfully pitched McDonalds to the fund in 2009, as the best firm within the consumer non-cyclical sector with a reasonable dividend and impressive recession resilience model.

Tony Kim **Background**

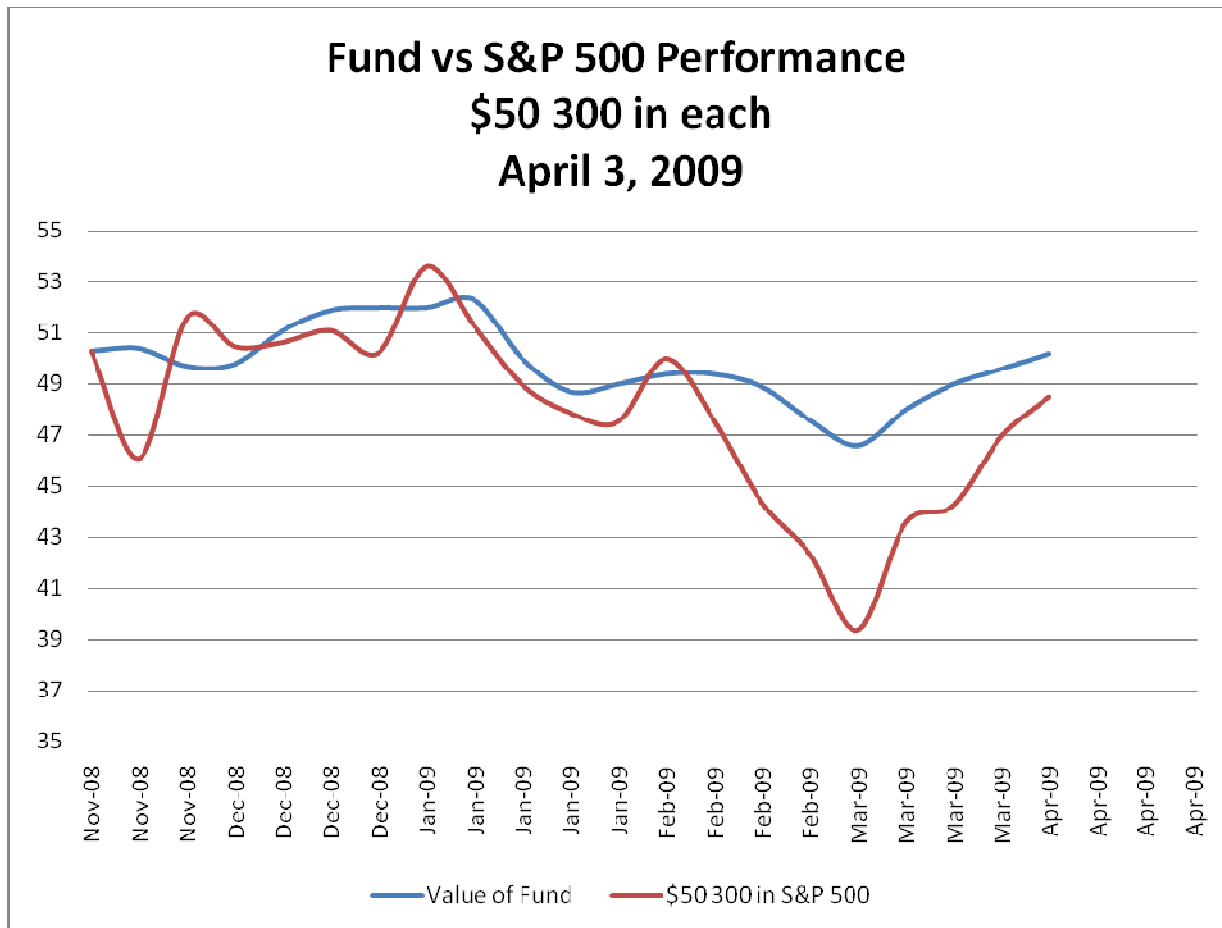


Analyst
4th Year
Accounting/ Finance,
Bachelor of Commerce

Tony started with the SIN fund in 2008 as the funds Basic Materials Analyst. He looks to take the role of Manager in September of 2009, where he will bring value to the investment fund. Tony prepared recommendations primarily for companies within the basic materials sector, but looks to research the retail sector when the industry is more favorable as a whole.

Performance Summary

The fund was engaged with an extremely exciting time in the investment world this winter with the greatest market correction in living memory for all of the funds participants. During this time, caveats to the funds guidelines were incorporated to ensure that the fund would be able to operate appropriately and safely in such a turbulent market. The fund was in cash until November 14, where it made its first trade of the semester, purchasing Waste Management, beginning a challenging and rewarding relationships with the markets at home and abroad. Below we see the capital performance of the fund from its first trading day November 14th matched with a hypothetical investment in the S&P 500 of equal value to the funds initial capital base, started on the same day. We feel that the S&P 500 is an appropriate benchmark to measure from because the fund was entirely US invested until the 6th of March, and the majority of its positions continue to be US firms.



The fund was able to stay relatively unscathed throughout the February downturn, however this market wide downturn stole away from the gains made in 2008 and we find the fund with a closing capital balance on April 5, 2009 of approximately \$50 200, one hundred dollars less than what it started with.

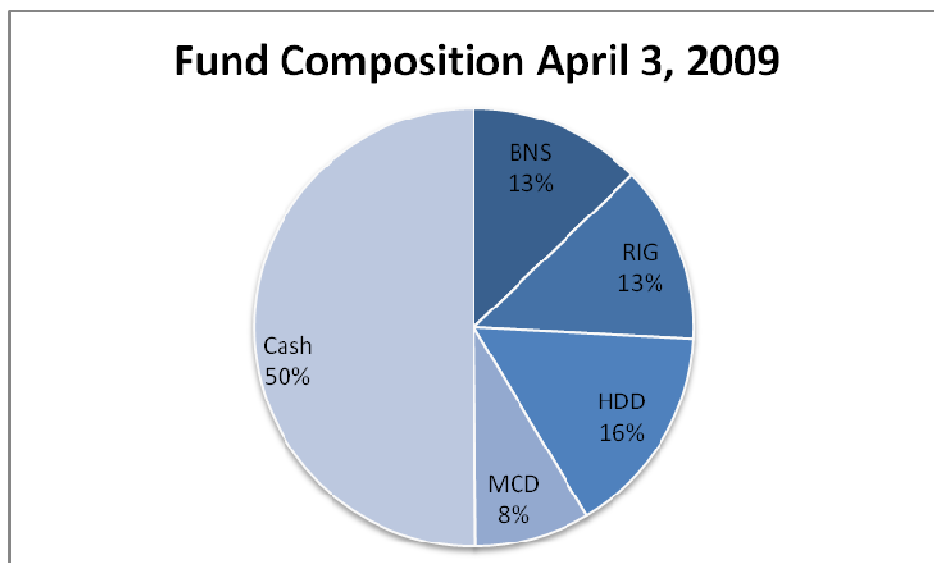
We also see that as the market rallied in March it begins to eat into the substantial earning gap the fund was able to establish in February. The fund hopes to minimize this by buying into both Canadian and American index funds during the summer months.

The fund as a whole provided a much smoother ride for its stakeholders providing a variance statistic of 2.24 based on weekly closing values compared to the S&P 500's variance of 12.64 for the same reporting periods. However we do find that the SIN Fund returns a correlation coefficient of 84% between itself and the S&P 500, suggesting that the portfolio is both appropriately diversified, and unable to shelter itself from broad market swings.

Trading practices of the fund changed dramatically throughout the year as the perceived macroeconomic climate evolved. During the first months of trading every long position was matched with a short on its corresponding benchmark. This strategy provides profit if the firm purchased outperforms its benchmark, which can occur even if the firm shares are losing value providing the benchmark is falling faster. This strategy proved effective but was abandoned coming into 2009 as the risk of a market rally grew.

During the downtrend position turnover remained high, averaging 15 days per firm. This was due primarily to positions hitting stop loss limits set in accordance to the SIN Funds guidelines of a maximum 20% loss. However some positions were able to stand firm, and the funds current positions have been held for an average of 51 days with Transocean being in the fund since late January.

Current fund composition can be seen below with all positions well below their overweight limit of 20%. HDD the currency hedging mechanism for all US stocks and is exempt from weighting limits. It should be noted that half of the cash holdings will soon be replaced with index funds to provide benchmark tracking over the summer.



Trading Summary

Trade	Company	Date Bought	Date Sold	Price	Profit / Loss
1	WMI (Waste Management)	14 - November		160 @ \$31.47	
2	WMI		24 - November	160 @ \$29.00	-\$395.20
3	HSD (S&P Hedge)	14 - November		70 @ \$34.67	
4	HSD		20 - November	70 @ \$43.15	\$593.60
5	HSD	21 - November		70 @ \$46.84	
6	HSD		18 - December	70 @ \$30.59	-\$1137.5
7	HDD (Dollar Hedge)	14 - November		180 @ \$13.68	
8	HDD	21 - November		200 @ \$12.39	
9	HDD		25 - November	200 @ \$13.62	\$123.79 ^{WA}
10	HDD		1 - December	180 @ \$13.21	\$37.61 ^{WA}
11	HDD	2 - December		200 @ \$13.24	
12	HDD	9 - January		200 @ \$14.26	
13	HDD		16 - January	200 @ \$12.87	-\$176 ^{WA}
14	HDD	23 - January		200 @ 13.62	
15	HDD	12 - February		200 @ 12.88	
16	HDD		April 5 (Held)	600 @ \$13.06	-\$214 ^{WA}
17	WMT (Wal-Mart)	21 - November		100 @ 50.87	
18	WMT		21 - November	100 @ 50.53	-\$34
19	MOS (Mosaic)	2 - December		200 @ 25.69	
20	MOS		15 - January	200 @ 32.00	\$1262
21	JEC (Jacobs Engineering)	9 - January		100 @ 51.81	
22	JEC		22 - January	100 @ 40	-\$1181
23	LTM (Lockheed Martin)	23 - January		60 @81.35	
24	LTM		26 - February	DIVIDEND	\$34.20
25	LTM		27 - February	60 @ 63.40	-\$1100
26	RIG (Transocean)	23 - January		100 @ 52.55	
27	RIG		April 5 (Held)	100 @ 65.52	\$1297
28	MCD (McDonalds)	12 - February		75 @ 56.96	
29	MCD		26 - February	DIVIDEND	\$37.50
30	MCD		April 5 (Held)	75 @ 56.64	-\$24
31	BNS (Bank of Nova Scotia)	06 - March		200 @ 25.92	
32	BNS		3 - April DIV X	DIVIDEND	\$98
33	BNS		April 5 (Held)	200 @ 32.13	\$1242

WA – Weighted Average

(Held) – This is an unrealized gain as the fund currently still holds this position

*All values are denoted in currency domestic to the firm and gains or losses from currency are excluded

Investment Recommendation Development

All companies considered for investment go through a series of stages which are designed to test the suitability of the company for fund investment. This methodology allows members to produce reports that cover all the key company factors, and reports that allow for easy comparison between companies. Detailed below is a summary of the steps necessary for investment in a firm by the fund.

- ❖ **Investment Sectors:** Professor Nemiroff and the Senior Manager will discuss suitable business sectors to invest in with respect to the current business climate. After the fund produces reports for each sector selected for investment, individual firm or ETF selections are made for Analyst assignment, based hypotheses of favorable companies.
- ❖ **Assignment:** Analysts will receive company assignments from a variety of sources, including the Senior Manager, Professor Nemiroff, and most often their own Manager. On assignment the Analyst will typically have 14 days before the final recommendation needs to be presented and discussed. Analysts are expected to have an output of 5 reports a semester in addition to an industry report for their assigned sector.
- ❖ **Guideline Conformance:** The analyst first needs to check to see if the company resides within the funds guidelines. The Sprott Investment Fund is limited to companies with: market cap above 300 million, beta less than 2 with an appropriate benchmark, share price above 3 dollars, and debt rating above BBB+ if applicable. Companies must also be listed on a North American stock exchange, with ADR's used for international exposure.
- ❖ **Macroeconomic Analysis:** The Analyst will need to find the specific exposure their company has with respect to the macroeconomic environment it resides in. This will form the basis of the firms' specific, and systematic, risk that the company's share price will be most sensitive to.
- ❖ **Company Specific Analysis:** A full company description is also needed to understand the firms' history, giving the analyst perspective on its business model and how future decisions may be made. This is where the Analyst can employ the corporate governance, and qualitative research methods they have learned in Professor Otcheres' Applied Corporate Finance course. The Analyst should use these skills to evaluate the firms' distribution of ownership, managerial performance, and corporate governance practices.
- ❖ **Valuation and Peer Comparison:** We use several different valuation techniques for companies considered for investment, most of which are learned in Applied Corporate Finance with Professor Otchere. Each report should contain a Free Cash Flow to Equity (FCFE) model, and should also comment on valuation based off of peer comparison, and the average professional Analysts 12 month valuation expectation found on Bloomberg. At this point of the research Analysts should thoroughly compare their assigned company against peer competitors with the

focus on finding the most attractive firm for investment. If the assigned firm is not the most attractive firm in its peer group then the Analyst will regroup with their Manager, and a switch may be made to pick up the most attractive firm for recommendation instead.

- ❖ **Thesis, Risk, Recommendation, Target Price:** Using the above research the Analyst and their Manager develop a recommendation detailing the theme of the investment decision (value buy, growth buy, upcoming event), the risks involved in the investment, and a target price if it is a buy, or hold, recommendation.
- ❖ **Discussion:** Two weeks after the initial assignment the Analyst and their Manager pitch the company to the fund as a whole. At this point all fund Analysts, Managers and Senior Manager, will participate in a round table discussion pertaining to the investment of the firm. The presenting Analyst and Manager will be questioned, and new Analysts quickly learn that the fund is very critical of rationale based on opinion rather than fact.
- ❖ **Hedging, Portfolio Effect, Weighting:** The Senior Manager will make a buy decision based on the report presented, the ensuing discussion, and their own research applicable to the firm. If the company is appropriate for inclusion in the fund, the Senior Manager will then need to study the firms affect on the portfolio upon inclusion. Decisions based on sector weighting, currency or market hedging, and inter-firm correlation are all taken into account before a target price and share quantity are prepared for recommendation to the academic overseer.
- ❖ **Defense:** To include the firm in the fund the Senior Manager then takes the wealth of knowledge and research accumulated in the above steps and pitches the firm to the academic overseer, Howard Nemiroff. If Howard is convinced that the company has an appropriate risk profile for the fund, and the timing is right he will place the trade.
- ❖ **Monitoring:** After a firm is included in the fund, the Analyst who made the recommendation, their Manager, and the fund Senior Manager, follow the firm and adjust their outlook periodically. The Senior Manager is responsible for adjusting stop loss limits as share value grows, or selling if outlook changes.

Equity Capital Management

Managing the fund through the Fall of 2008 and into Winter 2009 was a very challenging experience that involved careful strategy and allocation of funds. For much of the trading year the fund considered cash as the most valuable position as the market fundamentals crumbled, and irrational swings were daily occurrences. Our hedging strategy and very tight downside protection resulted in many quick trades and a high equity turnover ratio before the fund found its stride in Mosaic. A summary of the rationale for the chosen positions is as follows.

WMI - Waste Management was considered by the fund to be a king of the non-cyclical firms we felt that we could easily beat the benchmark with this blue collar stock. Matched appropriately with HSD the package did return positive returns until the stock met its 10% downside stop at \$29. This success encouraged in our package strategy shaping and we sought out more stocks that we felt would fall less than the market as a whole.

WMT – Wal-Mart was the second package attempt the fund invested in. Unfortunately the fund fell victim to its own cautiousness as it was stopped out of the stock during a massive intraday price swing from \$53 to \$50.50.

HSD¹ - Horizon BetaPro S&P 500 Bear Fund was the funds downside protection to broad market sell-off. It was paired to the beta equivalent of Waste Management and Wal-Mart, and at a 60% beta² equivalent of Mosaic. The fund felt that the general market had bottomed by mid December and so HSD was sold at a loss that would be immediately covered by the unrealized gains in the positions it hedged.

HDD¹ – Horizon BetaPro US Dollar Bear Fund is used to neutralize currency valuation changes in stocks held in the US. This allows the fund to invest in US listed companies without risk of US dollar devaluation verses the Canadian Dollar.

MOS – Mosaic is the funds bread winner of 2008. It was a result of firm valuation and bottom timing tactics and was sold with over a \$1200 profit. Rationale being the initial purchase of MOS includes its long term inelastic demand market, and institutional dumping creating undervaluation opportunities.

JEC – Jacobs Engineering was a play on stimulus package money. It was felt that with the impending recession the government would try to boost the economy with infrastructure spending. JEC is one of

¹ Horizon's ETF products have an important characteristic that needs to be adjusted for. HDD and HSD both aim to mimic their respective markets by a factor of 200% on the previous days close. This means that overtime there can be significant tracking error due to magnitude differences in change. Eg. If a company losses 5% in two consecutive days and then gains 10% on the third it will be 0.7% short of its starting point. $\{1 * (1-.05) = 0.95, 0.95 * (1-.05) = 0.9025, 0.9025 * (1+.1) = 0.99275\}$. Because of 200% exposure this effect is magnified.

² Beta calculated with Bloomberg using weekly data points over a two year period and adjusting for outliers. 'Beta Equivalent' relates to weighting. For example a \$5000 position with a Beta of 1.5 which the fund wants to hedge 60% for market risk requires inverse market exposure by a factor of 1.5 multiplied by 60%. Because HSD is double inversed we would need to purchase \$2250 in HSD $((5000 * 1.5 * .6) / 2)$ to hedge our position.

two engineering firms expected to win the majority of the government contracts with Fluor being the second. Unfortunately the Obama administration was increasingly unclear as to where and when funds would flow and JEC was dropped on a stop loss restriction. However we do continue to feel bullish on the infrastructure sector as a whole and JEC may make a second appearance in the fund during the months ahead.

LTM – Lockheed Martin was an investment play similar to JEC which was dropped for the same reasons. It was felt that as the US army transitioned from Iraq to Afghanistan and the worlds international relations were tested by the global recession, defense would be an obvious sector for additional stimulus spending. Unfortunately ambiguity surrounding the financing of an upcoming F-15 contract and general non-communication surrounding the allocation of stimulus money dropped LTM below the stop loss limit and it was sold.

RIG – Transocean has thus far been one of the SIN Funds most profitable positions and is expected to be held for the foreseeable future. Rationale behind the purchase lies in RIG's impressive 3 year backlog, with 98% of customers' investment grade. As production costs drop with demand RIG will find its projects cheaper to fulfill and still receive the pre-negotiated day rate. It is felt that a 3 year window is long enough for the commodity market to re-establish growing demand, allowing RIG to sign new contracts for cash flow into 2012.

MCD – Seeking stability McDonalds was picked up for its steady 4% dividend and proven business model. When times are tough inexpensive food alternatives should thrive and MCD should be able to establish growth opportunities sooner than most during the recovery period.

BNS – Bank of Nova Scotia was bought on valuation after a lengthy risk analysis. It was felt the Canadian banking system was being unduly punished by the downfall in the US banking system. However it is recognized that BNS continues to be on the high end of the Funds risk tolerance and tighter stops have been placed accordingly. BNS currently pays a 7% dividend yield and the fund hopes to enjoy this return into the long term.

Looking Ahead

We feel that the market is establishing the beginnings of a bottom; however we are of the opinion that 2009 will be dominated by markets trading sideways, with the strong possibility of a new bottom in the fall, providing the effects of the stimulus package have more lag than anticipated. As such we are leaving 25% of our capital in cash during the summer to allow for the opportunity for more bottom buying if the downturn continues.

The 08/09 trading period taught the fund some very valuable lessons which we hope to carry into the 09/10 trading period where the fund will need to learn how to navigate a recovery that is expected to be choppy and heavily government aided. One lesson we feel we learned the hard way is the virtue of patience. The temptation to coax the evidence into showing buy signals becomes overwhelming as the market passes through new historical lows quarterly but this lesson, hard learned with JEC, LMT, and WMT was applied to careful buying decisions in BNS, RIG, and MCD.

With perspective on our past follies we set a goal of full fund investment in equity markets to be achieved next year, expanding on this year's 50% investment accomplishment. We do acknowledge that our most valuable position this year was cash, and if adverse climates persist it may continue to be the relative breadwinner between the fund and the benchmark.

The SIN Fund team this year produced insightful, high quality work, at a speed that far outpaced the previous year's performance. It has succeeded in beating the market benchmark, and has participated in one of the darkest investment periods in history without experiencing major losses in capital. Currently all acting members expect to participate in some form next year, and we wish the graduating members Aaron Sapelak and Simon Foucault all the best in their forays into the private sector. Personally I have been honored to debate investments with such a high caliber group of individuals and I look forward to working with these individuals in the years to come, inside the fund, class, and eventually in the private sector.

If you wish to know more about the fund, how to participate, how to donate, or wish to obtain a research report for one of the companies covered, please contact James Heard at heard.james@gmail.com

James Heard
Senior Manager