Investor Insight: Whitney George

Whitney George of Sprott Asset Management describes his affinity for cyclical businesses, what he's finding to be unusual after eight years of a bull market, how he's applying his expertise in precious metals, what he prefers about managing a closed-end fund, and what he thinks the market is missing in Franklin Resources, Pason Systems and Cirrus Logic.

You focused almost exclusively on small caps during your long tenure at Royce & Associates, but one fund you brought with you to Sprott invests in big and small alike. How did that come about?

Whitney George: That particular fund, now called the Sprott Focus Trust, always had a broad mandate, but we didn't really take advantage of it until 2009 when very large, high-quality companies started to trade at absolute valuations that were too attractive to ignore. When you can buy Microsoft, Exxon Mobil or Apple at valuations that you're only accustomed to seeing in ignored and out-of-favor small- and micro-cap stocks, you should do it.

Also, as a long-term investor in smaller stocks, you can often see ideas grow from small, to mid-cap to even large over time. I generally don't want to have to sell the companies I know best and where I have the longest relationships just because of the cap size.

You describe favoring high-quality companies, but don't seem to have any problem with very cyclical businesses. How do you define quality?

WG: High-quality companies have strong balance sheets, earn high returns on capital through the cycle, and have people running them who allocate capital intelligently and whose incentives are fully aligned with shareholders.

But I'm also trying to buy at an attractive absolute valuation, which means a cap rate – our estimate of a company's normalized operating earnings divided by its enterprise value – in the low- to mid-teens. Those moments of weakness aren't always a function of cycles, but basic cyclicality that you can understand is very often a source of mispricing. Cycles are difficult for many investors to deal with because they often create short-term disappointments that people hate. I'm basically doing time arbitrage – finding companies where economic, industry or company-specific disappointments prompt short-term investors to sell me their shares at compelling absolute valuations based on what I consider normal longer-term earnings power.

Two of my larger holdings today are Cal-Maine Foods [CALM] and Sanderson Farms [SAFM], which produce eggs and poultry, respectively. I've known and invested in these companies for a long time and they both have excellent track records, fortress balance sheets and scale advantages. They also fully understand they are in cyclical businesses and manage themselves accordingly, being opportunistic at low points in order to reap the benefits when times are good.

> **ON FINDING BARGAINS:**
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> **Cycles are difficult for many investors, so basic cyclicality that you can understand is often a source of mispricing.**

With respect to their businesses, both companies should benefit as global population growth and higher average income levels increase secular demand for affordable protein like that from chicken and, even more so, eggs. But in terms of the market for the stocks, the sell side hates them because quarterly earnings are impossible to predict, and investors generally dislike the random things that can happen. Just earlier this month Sanderson's stock was off 13% on the day it announced missing earnings estimates by 20 cents a share. The principal reason was due to hurricanes in the U.S. that knocked out production long enough for the birds to get fatter, increasing supply on the market, which knocked down prices. How can you predict something like that?

What we do with companies like this is arrive at what we believe the business is worth, say, on five-year average earnings or some other reasonable estimate of normal. If you keep your head while the quarterly earnings game drives people batty, these types of opportunities can be very attractive over time.

What other types of situations allow you to buy quality on the cheap?

WG: In addition to taking advantage of time arbitrage, there's still something to be said as well for detailed, fundamental research. I've owned the real estate investment company Kennedy-Wilson [KW] on and off for fifteen years and consider it one of the best real estate asset managers in the world, with a track record to back that up. But it's also organized in a complex, not-easy-to-understand way, which exacerbates the difficulty of seeing how good they are unless they're selling things and it becomes obvious. If you peel apart individual projects you can better understand the company's value and take advantage when the market isn't recognizing it. When they start selling more than they buy – which is starting to happen now – the underlying value tends to surface.

You own GameStop [GME], the video-game retailer, which has certainly had its share of naysayers. Has your patience been tested there?

WG: It has. This is also something I've owned on and off for a long time and today there is a well-articulated case that this will be in video games what Blockbuster was in movies, which is kaput as everyone accesses games online.

I can't make the case that the bears have it all wrong, but I do believe that with the stock trading at 5.4x consensus earnings for this year and at an 8.4% dividend yield, there's quite a bit more optionality on the upside than the downside. Management has been very clever in how they handle real estate and in building out complementary businesses in used games and equipment, in collectibles, and in sales and service outlets for Apple and AT&T products. The company's loyalty program is first-rate, on par with something like Amazon Prime. I also don't believe people understand how much content is in video games, making them a chore to download, and the loyalty that gamers show for traditional gaming platforms and equipment.

One thing that worries me is why management hasn't taken the company private by now. I probably should be buying more, but I'm just finding it too hard to get the level of conviction that would require. This is certainly not something for the faint of heart.

You've long been active in precious metals, probably even more so now that you're at Sprott. Describe why.

WG: I've been using precious metals and mining stocks in the Focus Trust portfolio since 1999, and probably have 10% of my personal net worth in physical gold or related investments. Physical gold in particular I consider a great diversifier over the long term because it moves differently at different times from stocks and other assets. Think of it as a simple, less expensive alternative investment, providing a hedge against things not going as perfectly as everyone expects.

There's also a hard-assets angle to my interest. Developed countries have too much debt to ultimately service or pay back, but rather than default, the likely path will be to debase currencies. Gold is a way to protect against that and profit from it. There are other things going on with cryptocurrencies that are rather scary, but this same phenomenon is expressing itself today in the excitement over them.

Around 13% of Sprott Focus Trust's portfolio today is in miners, spread over nine or 10 stocks. (The fund can't own physical gold.) While I very much believe in having the hard-asset exposure, because of the unpredictability in the sector and the fact that extractive businesses aren't that capital-efficient through the cycle, I generally don't own more than 2% in any one name. I'm also highly unlikely to take the overall portfolio exposure past 15%.

ON GOLD:

Think of it as a less expensive alternative investment providing a hedge against things not going perfectly.

What's your take on the cycle in the gold-mining sector today?

WG: I actually think we're in a bit of a sweet spot. The bear market in gold and precious metals exposed a great deal of malinvestment, resulting in a significant number of management teams being removed and replaced. There is capital discipline in the business now and probably even some underinvestment in development. If interest in precious metals increases, mining companies' leverage to higher prices is far greater than it would have been three years ago.

Most precious-metals investors have scars from ideas gone wrong. One of those for you was Allied Nevada Gold, which went under in 2015. Lessons?

WG: This was a company pursuing difficult but potentially lucrative development, with highly promotional management that seemed quite credible at the time. The problem very often turns out to be deceitful management, compounded by a balance sheet that can't withstand it when the deceit results in too much cost and not enough revenue. That's nothing new – if you've ever invested in gold miners, you know that's what can go wrong. Unfortunately, knowing it doesn't guarantee it can't still happen.

Do any of your gold stocks stand out as particularly compelling today?

WG: Given my approach in holding a basket, I wouldn't put one or two over the rest. I would maybe point out, however, that Franco-Nevada [FNV] and Randgold Resources [GOLD] are unique in that their shares have outperformed the price of gold reasonably significantly going as far back as 2000. That's rare, and would explain why their stocks are somewhat expensive relative to peers at the moment. But that's probably where I'd go first if there were a correction in metals prices.

In general, are you finding enough to do in today's market?

WG: I would normally at this stage in a bull market have to be in the weeds with micro-cap stocks to find attractive-enough valuations. But the market seems more bifurcated, with values still showing up across the capitalization spectrum. The valuation of Apple [AAPL] is not challenging. Western Digital [WDC] trades at 6x this year's earnings. I can't make sense of those valuations any more than I can at the other end with something like Tesla or Amazon.

I mentioned looking to buy when normalized operating-earnings yields are in the low- to mid-teens. On the other side, I'm looking to sell when those cap rates get closer to 8%, which is typically when a stock is attracting the kind of crowd that makes me want to be near the door. One advantage of having done this for a long time is that you already know a lot of companies, know where you'd buy and where you'd sell, and can just wait for Mr. Market to throw you opportunities from time to time. Even with overall valuations stretched, that usually happens often enough to keep me busy.

Another thing I've noticed that's different at this stage in the bull market is that the companies I own have tended to be investing rather than hoarding capital. At the margin they're looking to enhance their businesses while others have been more focused on paying dividends and buying back stock. I don't know exactly how to read that, but I generally take it as a positive sign when well-run companies are investing rather than retreating.

You've said you typically average in and average out of positions. Why?

WG: It reflects the fact that I generally don't believe I have enough clarity to make whole-position decisions all at once. For example, Westlake Chemical [WLK] is a long-term holding that has done very well and has been hitting valuation targets. I'll acknowledge when that happens and start selling in 5-10% intervals, but I will also go back and revisit if I'm missing something the market seems to think it knows. I don't kid myself that I can reliably bottom-tick or top-tick anything.

Explain your broader investment thesis for asset manager Franklin Resources [BEN].

WG: Asset management is an industry I understand well and have invested in throughout my career. I like that you get operating leverage without the financial leverage that's typical of other businesses in the financial services industry such as banks and insurance companies. A well-managed company like Franklin generates high operating margins and high returns on capital because it requires little capital to operate.

The firm manages about $750 billion in mostly actively managed stock, bond and alternative-asset strategies. The Johnson family owns nearly 40% of the shares and manages the business responsibly for all owners, returning much of the company's cash flow to shareholders through stock repurchases, quarterly dividends and the occasional special dividend.

The shares are cheap in my opinion because assets under management have declined more than 15% since 2014, mostly due to the current popularity of competing passive strategies but also the result of underperformance in some of its large funds. This trend has stabilized, and with the company enjoying strong performance across much of its product line, flows have held steady through the fiscal year ending in September.

Is this mostly a bet that active money management has a brighter future than many expect?

WG: The passive story has been quite well told and has become a bit of a momentum trade. Growth of passively managed assets becomes self-fulfilling. Assets flowing into ETFs and index funds inflates stock prices and reinforces the perceived efficacy of passive vehicles, which begets more passive flows.

I do believe, however, that the pendulum will swing back in favor of active strategies. The objective of most active managers is to reduce risk, and in bull markets reduced risk means reduced returns. The underperformance compounds with the length of the bull market, especially when stocks are highly correlated as they have been in recent years. It's a toxic recipe that has led to the most pronounced backlash against active managers in history. The latest backlash has been particularly acute, but this is not the first time active managers have come under fire. In the late 1990s when tech stocks were all

INVESTMENT SNAPSHOT

Franklin Resources
(NYSE: BEN)

Business: One of the world's largest investment managers, with around $750 billion in assets invested primarily in actively managed stock, bond and alternative-asset funds.

Share Information (@12/29/17):

Price	**43.33**
52-Week Range	39.32 – 47.65
Dividend Yield	2.1%
Market Cap	$24.00 billion

Financials (TTM):

Revenue	$6.39 billion
Operating Profit Margin	35.4%
Net Profit Margin	26.5%

Valuation Metrics
(@12/29/17):

	BEN	S&P 500
P/E (TTM)	14.4	21.8
Forward P/E (Est.)	14.3	20.0

Largest Institutional Owners
(@9/30/17):

Company	% Owned
Vanguard Group	4.8%
State Street	3.3%
Massachusetts Fin Services	3.2%
BlackRock	2.6%
Highfields Capital	2.0%

Short Interest (as of 12/15/17):

Shares Short/Float	2.8%

BEN PRICE HISTORY

THE BOTTOM LINE

Whitney George believes the market is assuming the company's mostly actively managed assets "will be flat or down forever." If he's right that active managers return to favor and the company's diverse portfolio of funds again shows solid growth, the shares at an 8% cap rate on estimated operating earnings, plus net cash, would be worth around $68.

Sources: Company reports, other publicly available information

the rage and the market was very risky, active managers were similarly unpopular. Redemption ultimately came with a bear market, as I believe it will again this time. When stock prices begin to decline, the poor performance of passive strategies will also become self-fulfilling. Investors will pile out of indexes the same way they piled in, but probably twice as fast.

Franklin's diversity of assets, the de-risking nature of active management, and the relative outperformance of active strategies in our envisioned scenario should protect and ultimately enhance its business. We don't believe the stock today adequately reflects that.

How inexpensive do you consider the stock at a recent $43.30?

WG: The shares currently trade at about 14.5x the $3 per share the company earned in its 2017 fiscal year, but if you net out $18 per share of cash on the balance sheet, that earnings multiple falls to 8.4x. We think at these levels investors are ascribing a value to assets under management that they think will be flat or down forever. We don't think that's going to be the case and if we're right, the company will grow again and investors will eventually value it differently.

Franklin in rosier times has traded at an 8% cap rate on operating earnings, which is not far from where many peers that don't have all the excess cash trade today. At an 8% cap rate, plus the cash, the shares would be worth closer to $68. It won't be a straight line, especially if there's a market break of some kind, but we believe the value will be there.

Oilfield specialist Pason Systems [Toronto: PSI] is certainly not a household name. What attracted you to it?

WG: As a contrarian, I'm interested in the energy sector when it has just underperformed. That is the case now, as it was in 2003 when I first invested in Pason. In energy, I prefer the far better balance sheets of service companies over exploration and production firms. As I mentioned with Franklin, Pason has operating leverage without the financial leverage.

The company isn't that well known, trading in Canada with a market cap of about C$1.5 billion. But it's the dominant market leader in what it does, which is provide technology and electronics that collect, manage and analyze oil and gas drilling data that is used to help optimize performance of drilling operations. For example, their primary product is an electronic recorder that monitors wear and tear on drills and pumps, collecting and transmitting data via satellite back to geophysicists who can monitor and manage multiple projects from their air-conditioned offices. Another product monitors gas levels from the drill bit in order to keep it in the sweet spot of long, horizontal resource formations. The company even installs electronics at the drill site so workers can e-mail their spouses and watch Netflix when they aren't working.

Pason has roughly 90% market share in Canada and has captured 65% of the U.S. market since entering it ten years ago. The hardware is installed on the rig by the original equipment manufacturer and generally remains in use over the rig's life, providing a strong barrier to competi-

INVESTMENT SNAPSHOT

Pason Systems
(Toronto: PSI)

Business: Develops and services technology systems that collect, manage and analyze oil and gas drilling data that is used to help optimize performance of drilling operations.

Share Information (@12/29/17):

Price	**C$18.19**
52-Week Range	C$16.65 – C$22.36
Dividend Yield	3.7%
Market Cap	C$1.55 billion

Financials (TTM):

Revenue	C$228.2 million
Operating Profit Margin	14.5%
Net Profit Margin	5.0%

Valuation Metrics
(@12/29/17):

	PSI	S&P 500
P/E (TTM)	133.7	21.8
Forward P/E (Est.)	33.1	20.0

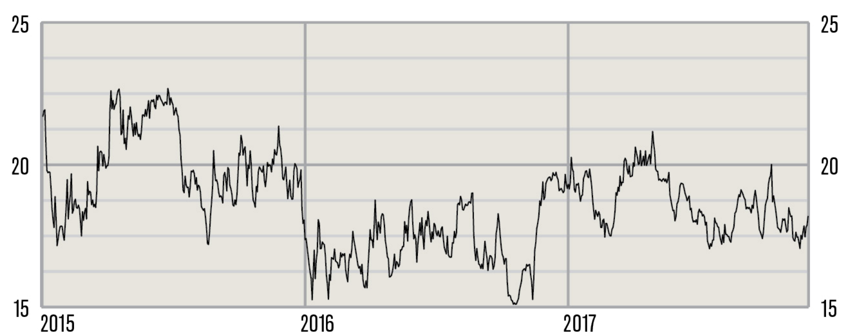
Largest Institutional Owners
(@9/30/17 or latest filing):

Company	% Owned
Burgundy Asset Mgmt	10.0%
Caisse de Depot du Quebec	8.4%
Royce & Assoc	7.4%
Neuberger Berman Inv Mgmt	6.3%
Fidelity Mgmt & Research	4.2%

Short Interest (as of 12/15/17):

Shares Short/Float	n/a

PSI PRICE HISTORY



THE BOTTOM LINE

A dominant market leader in a niche energy-services sector, the company should prosper as North American rig counts continue to rebound after a precipitous fall since 2014, says Whitney George. If the shares earn what he considers a warranted 8% cap rate on operating income that is 80% of its prior peak, the stock would trade at around C$30.

Sources: Company reports, other publicly available information

tion. I also believe Pason's risk of technological obsolescence is limited because of their commitment to R&D, on which they spend C$30 million annually and which occupies 25% of the workforce.

How has the company weathered the energy recession?

WG: It's actually quite resilient. Revenues fell nearly 70% from peak to trough in the latest cycle, but it has maintained positive cash flow due both to a flexible operating model and the cushion of operating margins that in good times are as high as 50%. The balance sheet is also rock solid, with nearly C$160 million in net cash.

What do you think the shares, now C$18.20, are more reasonably worth?

WG: Revenues here are a function of the rig count and of the number of products per rig that clients use. The North American rig count fell from about 2,300 in 2014 to less than 500 last year, and has recovered to just over 1,100. That rebound in the rig count has had a nicely positive effect on Pason's revenues and operating profits, but the shares have only modestly recovered.

If operating income gets back to 80% of the C$260 million the company earned at the peak of the last cycle, at an 8% cap rate that implies a per-share value of around C$30. I don't think that valuation would be unreasonable at all, given the company's market share, profitability and potential to grow in markets outside North America and by continuing to provide additional services that increase revenue per rig.

Is this eventually an attractive takeover candidate?

WG: I think the size of the market – Pason's revenues peaked at C$500 million – has kept it from attracting much competition and allowed it to gain a big head start. If its market does attract the interest of other big energy services firms, I would expect Pason to be acquired in pretty short order. That would very likely have to be done at a premium to my C$30 price target.

What do you think investors are missing in Apple supplier Cirrus Logic [CRUS]?

WG: Cirrus develops semiconductors that convert sound from analog to digital, and their chips have long been found in the highest-fidelity sound systems. The driver of their business in recent years has been Apple, which uses what's called sound-vectoring technology developed by Cirrus that allows a microphone to capture a person's voice while canceling out surrounding noise. For Apple to let the company earn 50% gross margins, it must be doing something special. Real estate in these phones comes at a premium and Cirrus has proved very good at adding capability while reducing power used and the space required.

We think the shares are discounted because Apple accounts for about 75% of revenues and it doesn't allow Cirrus to discuss the product or business pipeline, leaving analysts more or less in the dark about future earnings. As a result, the stock typically reflects little more than the

INVESTMENT SNAPSHOT

Cirrus Logic
(Nasdaq: CRUS)

Business: Develops and sells semiconductors for audio applications used in smartphones, automotive entertainment systems, security devices and digital-assistant devices.

Share Information (@12/29/17):

Price	**51.86**
52-Week Range	48.61 – 71.97
Dividend Yield	0.0%
Market Cap	$3.30 billion

Financials (TTM):

Revenue	$1.60 billion
Operating Profit Margin	20.8%
Net Profit Margin	17.1%

Valuation Metrics
(@12/29/17):

	CRUS	S&P 500
P/E (TTM)	12.7	21.8
Forward P/E (Est.)	10.7	20.0

Largest Institutional Owners
(@9/30/17):

Company	% Owned
Vanguard Group	10.4%
BlackRock	9.8%
Fidelity Mgmt & Research	5.4%
LSV Asset Mgmt	5.0%
AQR Capital	4.3%

Short Interest (as of 12/15/17):

Shares Short/Float	8.7%

CRUS PRICE HISTORY

THE BOTTOM LINE

The market's apparent concern about overreliance on large-customer Apple gives the company little credit for either continuing to expand its Apple business or for broadening the market for its technology, says Whitney George. Applying a 12.5x multiple to estimated forward operating income, plus net cash, he values the shares at around $82.

Sources: Company reports, other publicly available information

quarter just reported and the concern that the company's dramatic increase in earnings power over the last couple of years isn't sustainable.

We disagree with that consensus view. Apple used around $5 of Cirrus' content in the latest iPhone cycle, up from $2 in the previous one, and used another $1 of content in the latest AirPods. So it's not pre-ordained that the Apple business is going to decline. At the same time, Cirrus continues to broaden its market beyond Apple. Through an acquisition, it now provides similar technology for Android-based phones, giving it content today in all of the top-five mobile devices. The company's technology also enables voice interaction used in Internet of Things applications that will increasingly be found in things like automobiles, security systems and smart-home systems. Artificial intelligence should be another growth market – sound technology is necessary for Apple's Siri and Amazon's Alexa to recognize voices, and Cirrus's chips are a premium option.

Walk through how you're assessing fair value for the stock, which now trades around $51.90.

WG: It's quite straightforward. Excluding $5 per share in net cash, the stock trades at a 13% cap rate on the $400 million of operating income the company should earn in its fiscal year ending next March. Again, we'd argue both based on history and on the quality and prospects of the business that the stock will deserve an 8% cap rate, which after adding the net cash would value the shares at around $82.

ON PERMANENT CAPITAL:

The closed-end fund is a great platform to manage money; the crowd doesn't have to affect your investing.

I'd add here that Cirrus, especially given the current valuation, would also make an attractive acquisition candidate. The engineering talent to develop this type of technology is a scarce commodity, so it would likely be cheaper and more effective for a competitor or customer to buy Cirrus outright than to try to develop the same technology on its own.

Sprott Focus Trust [FUND] trades at a 12% discount to net asset value. Why, and are you trying to do anything about it?

WG: The premium or discount of the typical closed-end fund, for better or worse, at least partly reflects the popularity of the underlying concept. When we acquired Focus Trust in 1996 it traded at a 20% discount. In June 2007 it was at a 12.5% premium. After I left Royce, it traded back down to an 18% discount. That's come in a bit, but as you say, it's still around 12%.

The closed-end fund is a great platform to manage money because the crowd doesn't have to affect your investing. You have a stable capital base, so you're not flooded with capital when you don't need it or losing capital when you do. That's a tremendous advantage over an open-end mutual fund, with which I also have significant experience.

That said, I don't intend to sit here with a large discount to NAV. Nearly 25% of the capital in the fund is my own, and it wouldn't make sense to leave it chronically undervalued. We can tell our story better, but in the end to shrink the discount I'm going to have to perform. That tends to heal all wounds in this business. VII

Investor Insight: Tom Olsen

Tom Olsen of European money manager Mensarius explains the three types of situations that tend to attract his interest, his detailed research process meant "to identify and avoid the risks we are able to avoid," his general view on the opportunity set in Europe and the U.K., and why he sees mispriced value in Salvatore Ferragamo, Ericsson and Landis + Gyr.

You've said that your investments typically fall into three general categories. Describe what they are and maybe provide a current example.

Tom Olsen: The first would be a company that earns high returns on invested capital that we're able to buy at an attractive valuation relative to its own history. These may be in somewhat shorter supply today, but for a number of reasons even these companies can find their shares out of favor.

Not so long ago, for example, we bought Viscofan [Madrid: VIS], which is a Spanish company that is the world's largest producer of artificial casings for processed meat production – in other words, sausage making. It also makes the machinery to process meat. The company over a long period of time has consistently built its global franchise, exploiting its scale and expertise in a way that competitors have been unable to do. It also benefits from growth in meat consumption as wealth levels increase in emerging markets. But starting in 2015 and accelerating in 2016 the shares took a hit for more macro reasons, including economic concerns in emerging markets and some foreign-currency issues. We saw that as a wonderful time to buy an interesting long-term franchise. [*Note*: As high as €60 in April 2015, Viscofan shares fell below €43 a year ago. They currently trade at €55.]

The second category of company we find interesting is the quality cyclical company with a competitive edge that we try to buy close to the trough of the cycle.