Maurice Jackson of Proven and Probable and Rick Rule of Sprott USA discuss the ins and outs of modern investment in the precious metals and commodities markets.

Source: Maurice Jackson for Streetwise Reports

Maurice Jackson: Joining for a conversation is legendary investor Rick Rule of Sprott USA. Mr. Rule, welcome to the show.

Rick Rule: Pleasure, Maurice. Thank you for having me back.

Maurice Jackson: Always the honor to have you join us. Rick, I would like to begin our discussion with the research analysis your team is always conducting, regarding the deep values and discounts for speculators in the natural resource base. I would like to begin with base metals. Which ones have Sprott's attention and why?

Rick Rule: The whole sector has our attention in the sense that, expenditures in exploration and mine development have been constrained for a very long time. And if those aren't addressed, you will begin to see epic supply destruction take place. Supply destruction is a circumstance in a depleting business, like a resource business, where if you don't make significant sustaining capital investments, your ability to produce is constrained.

As an example, in the zinc markets, in the copper markets, in the nickel markets, and certainly in the uranium markets, we have a circumstance where at current prices there's no incentive for new production. Assuming that at least demand holds steady, even if it doesn't increase we're heading into a period where demand exceeds supply and, of course, that traditionally yields higher prices. We are attracted to the whole space.

The only thing that makes us a little cautious about this space is that the economic recovery that we're in is nine years old now. I'm not an economist, I'm a credit analyst. But in my experience, nine years is a relatively long economic recovery. And should the economic recovery begin to fade at the same time that supply concerns emerge, demand might reduce too.

But on balance we're still very attracted to those industries. As you know Maurice, several of those industries, in particular copper and uranium, have treated Sprott extremely well in the last 30 years.

Maurice Jackson: And they certainly have. Correct me if I am wrong: The world will be consuming more copper in the next 25 years than all of recorded history, and that is because copper is projected to grow at compound rate of 3% for the next 25 years.

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Rick Rule: I believe what you say is true. If we head into a period of global economic contraction, those forecasts might not be true, for all of our sakes. I hope it is true, of course.

The big demand driver in the last decade, Maurice, was the urbanization and industrialization of China. Some 30 years ago Deng Xiaoping said to become rich as glorious, and that unleashed an amazing amount of productivity and really an amazing amount of human happiness. And the key to the ongoing base metals boom is the increase in living standards among the two billion people in the world
who are poorest; their urbanization, their industrialization.

There're other themes that are important too, like the electrification of western economies and of course, electric vehicles. But what really drives demand is the bottom of the demographic pyramid. When you and I get more money, we already have too much stuff. We might buy some service, but in other words, our consumption is not commodities-weighted. But when poor people get more money, they're able to feed their families more food, they're able to upgrade all of their material living standards. And it's important that the ascent of man—the ascent of the poorest one third of humanity—continue apace for industrial materials and base metals to do well.

Maurice Jackson: Moving on to physical precious metals: Which precious metals does Sprott view as being most undervalued?

Rick Rule: I think it depends on who you are within Sprott. If you're an old guy like me interested in insurance, you own gold. Gold has done well through a millennium in terms of being a store of value and insurance against the idiocies of the ways that we vote as a collective. Now traditionally, of course, when the gold prices done well, the silver price does even better. It's called poor man's gold for a reason. The unit costs are lower and when gold begins to perform, speculators gravitate to silver because it's a cheaper, more volatile vehicle. At the same time the poor people gravitate toward it, because it is a store of value that they can afford.

At the end of the spectrum, of course, are the platinum group metals, platinum and palladium, which function both as precious metals in stores of value, but also as industrial materials that have lots of utility on their own. I suspect if you looked against historical norms, the most undervalued of the family of precious metals is, of course, platinum.

Maurice Jackson: How about the extraction of precious metals? Does Sprott favor the miners or the junior miners?

Rick Rule: Well, I think, again, that depends on who the customer is. We have customers who general market securities investors, for whom we buy the biggest of the big and the safest of the safe. The Franco-Nevadas (FNV:TSX; FNV:NYSE) of the world. Our reputation has been built on much more speculative names. There's information disequilibrium, meaning that there isn't much information available about companies in the sub-billion or even sub-hundred million market cap space. And traditionally, Sprott has out competed its competitors in that space. That's information that's worthwhile for investors and speculators who can take the risk in the smaller, more volatile names. Certainly, I can say to you without qualification, Maurice, that all of the money I invested in sensibly I made by speculating, and so, at heart, I'm still a speculator.

Maurice Jackson: You reference Franco-Nevada. Are the royalty and streaming companies trading at a discount or premium?

Rick Rule: They're trading at premium to the rest of the market, but I would argue that they deserve to be trading at a premium. Mining companies through cycles—the good ones—have traded on operating margins in the 12% to 15% range. Well, the better royalty and streaming companies trade at 65% operating margins. They don't have sustaining capital investments like the mining companies do. This combination of better markets and lower sustaining capital investments means that they deserve to trade at a multiple.

They are trading at less multiples than I think they deserve, because many observers—many investors—believe that the period of rapid growth is behind us in particular for the streaming companies. But I disagree with that. Streams, which are prepayments for metal delivered over time, are becoming a really important financing mechanism in new mine construction, and [are] also important financing mechanisms in the mergers and acquisition boom, which is already taking over the precious metals mining business.
We believe a combination of the fact that these are superior businesses, from a capital employed basis and from a return on capital employed basis, combined with the fact that there are billions of dollars’ worth of transactions that will need to be completed in the next five years, which will benefit the streaming companies at the same time that they benefit the companies that sell the stream, means the best five years we’ve seen in the streaming business are ahead of rather than behind us.

Maurice Jackson: Very interesting. Rick, let’s discuss the project generators also known as the prospect generators, which provide speculators exposure to base metals, precious metals and royalties from a valuation prospective. Are they at a discount?

Rick Rule: The prospect generators are trading at a substantial discount. I would suggest maybe even historic discounts. The speculative money in the space doesn’t seem to be able to differentiate between sole risk exploration that is funding exploration projects with your own balance sheet, and knowledge businesses like prospect generators. The truth is—Maurice, you’ve heard me say this statistic before—the probability of success in sole risk exploration is somewhere between one in a thousand and one in three thousand.

By contrast, I have now invested in, I believe, 66 or 67 prospect generators in a 35-year carrier and I’ve enjoyed 22 economic successes and 21 takeovers, meaning that I’ve been successful in about 30% of my outings, where the expectation would be one in a thousand. This incredible superiority of business model has gone completely, completely unnoticed by the market, much to my delight.

Maurice Jackson: Rick, before we leave the natural resource space, introduce us to Sprott Inc. and the merits of being a shareholder.

Rick Rule: Well. I can’t speak to the merits of everyone being a shareholder, because of course, I don’t know all of your audience. I can say from my own perspective, and as you know Maurice, I’m the largest shareholder now of Sprott Inc. The attractiveness, to me, is that Sprott Inc. does only resources—we don’t try to be all things to all people. We have concentrated on an area that’s out of favor—an area that’s out of favor, where every prior time and my life that’s been out of favor, it returned to favor.

Sprott’s market share, offering financial service to investors in natural resources and also to natural resource issuers, grows and grows and grows, even as our competitors shrink or, in some cases, die. We have managed to stay profitable as a firm during a bear market that has seen equity valuations in the small cap resource space followed by more than 80%. In other words, while most of our competitors have died, we have continued to thrive. We have a very strong balance sheet; we manage or administer over $10 billion in assets, which is a lot in the junior resource space.

And importantly, we pay a very healthy dividend. Today, I think the dividend is around 4%. If you were to buy a broad-based natural resources mutual fund, you’d probably be paying 125 basis points. That is a 1.25% management fee. If you buy Sprott, which gives you the same diversification, we pay you a 4% dividend, so it’s pretty compelling arithmetically. Even aside from all of the other benefits that you might see by owning Sprott.

Maurice Jackson: And for the readers, the stock symbol for Sprott Inc. is SII and on the OTC is SPOXF. Let’s transition the focus of the conversation from Sprott to Rick Rule. I’m often asked, Maurice do you know what Rick is buying? This a valid question. But I would be more inclined to find out what you’re buying, when you’re buying it, why you’re buying it, and equally, on the selling side. Is there a way that I may invest with Rick Rule?

Rick Rule: There, in fact, is. I have been asked by investors for years to construct an account product that would buy what I bought and sell what I sold when I bought it and when I sold it. The consequence of that is that there is now a Rick Rule Managed Account, where investors will open an account and their orders will be
placed concurrently with mine. In other words, you won't buy stuff after I bought it, you won't sell it after I sold it. I'm not going to try and worry about what I think you are to do as an investor. You have to buy into the fact that you want to do what I do as an investor. In fact, every on market transaction in resources that I do—that is everything that I do, with the exception of private placements, which I do in private placement partnerships—will take place in the Rick Rule account.

I've allocated $1 million to it personally. When that money has been fully invested— I'm about 55% invested now—I'll allocate another $1 million, and then a further $1 million. I intend to have $3 million invested in this account. And, as I say, everything that I do in the small-cap natural resource space, I will do in this account. And everybody who opens this Rick Rule managed account, will invest simultaneously alongside me.

Maurice Jackson: And what are the investment themes here?

Rick Rule: There're three investment themes currently, but I need to say, Maurice, this is what I do with my own money. As the ideas that I think are attractive will change, the account will change too. The themes that I find attractive right now—and the three themes that I'm pursuing aggressively as we speak—are in the first instance mergers and acquisitions. We're seeing a really unprecedented wave of mergers and acquisition in the mining and gold mining business. The Barrick Randgold merger, the Newmont Goldcorp merger, the takeover of Tahoe by Pan American, the very recent acquisition by St. Barbara of Atlantic Gold.

Trying to determine companies that are strategic to other companies and sell at a valuation discount, I think is going to be a wonderful way to make money in the next 18 months. And this mergers-and-acquisition boom really benefits everybody. It benefits the people who buy the companies that are acquired, because of course, they get the normal premium and the takeover. But a strategic acquisition benefits the buyer as well as the seller, which is important to know. Larger companies with larger market capitalizations and more trading liquidity, trade at higher share prices. In other words, they enjoy a lower cost of capital. In a circumstance where you're in a capital-intensive business, that's a definable competitive advantage.

Also, the general and administrative expense in large companies tends to be lower relative to the assets under administration than in smaller companies. They become more management efficient. For every reason, we are paying attention to mergers and acquisition business, right now focusing on the companies that are likely to be acquired by other companies, [and] in a year or two focusing on smaller companies that will be able to buy redundant assets that are sold as a consequence of the earlier merger-and-acquisition activity. You will recall, I think, Maurice, in the last acquisition cycle, several wonderful companies, but particularly Lumina Copper, were put together as a consequence of buying assets that were redundant to larger companies, but made the acquiring company an absolute fortune.

In the case of Lumina, our good friend Ross Beaty spent about $100 million over six or seven years and built a company that he was able to sell for $1.6 billion. Truly spectacular performance and we're looking to be able to repeat that somewhere, somehow.

I'm also interested in royalty and streaming for the reasons I talked about before. The royalty and streaming businesses offer great margins and they're headed into a sweet spot, in terms of their ability to grow, by financing small companies in both mergers and acquisition and mine construction.

We think as many as $5 billion a years' worth of transactions could take place over the last five years. The knock against these companies, that they can't grow, we think is a very, very unfounded knock. We're owning the royalty and streaming companies and looking to increase our positions there. Not merely in mining, but also, by the way, in the oil and gas space.

And finally, I'm extremely interested in the more speculative parts of my speculative
accounts, in generative exploration—in particular the prospect-generating companies that we talked about earlier in this interview.

Those are the three areas that I'm currently concentrating on. But I'll give you an exclusive, Maurice, I'm looking very closely at a fourth area activity. You know that I actually grew up in the oil and gas business. I'm very comfortable with it and I'm very fond of it. Right now, we see incredible opportunities in the small-cap Canadian oil and gas space. We see that because oil and gas commodities in Canada are underpriced relative to the U.S. as a consequence of politically inspired pipeline capacity constraints outside of Alberta.

The Canadians have done a very odd thing in the context of voting for increased poverty in Canada. Of course, the socialists in place in Alberta, the New Democratic Party, mercifully for everybody, were thrown out of office. The last political obstacle to the oil and gas business in Canada, is, of course, federally in Ottawa, where Justin Trudeau, who is notoriously anti-energy, is Prime Minister. I believe that there's a 60% chance that Mr. Trudeau will be allowed to pursue other employment activities in October. And if that happens, it wouldn't surprise me to see the small-cap oil and gas equities up by 30% or 35% just as a consequence of Mr. Trudeau being thanked and excused.

I see a situation where the industry is well run, hated, undervalued, with a possibility—in fact the probability—of a circumstance in place [that] could cause it to revalue upwards. We're looking at 15 different names, hoping to find the best five to populate a Canadian oil and gas lead in the Rick Rule Managed Account.

Maurice Jackson: Rick, you have a way with words that I don't know will ever be matched, but what a unique value proposition that this Sprott Rule managed account presents to our speculators.

Switching gears, [from] July 29 through August 2, the Sprott Natural Resource Symposium will be held at the historic Fairmont Hotel in beautiful downtown Vancouver, British Columbia. Rick, you couldn't pick a better time or place for this world-class event that brings the biggest names in mines in the space all together at once. Rick, who will be some of the feature speakers at this symposium?

Rick Rule: Well, Maurice, you have a way with words too. We're very fond of our speakers. People get invited back to speak, that have wowed the crowd at earlier conferences. The conference is run really by the attendees. We have some new guests this year. Nomi Prins, who I'm a huge fan of personally, will be speaking on the big picture of politics and economics as well, Danielle DiMartino Booth; our old friend Jim Rickards is coming back; Doug Casey will be there, of course. But the speakers that really, really carry the show for me are not the gurus, they're not the big-picture thinkers.

The speakers that I like the best are entrepreneurs who have built billion-dollar companies in natural resource space, and talk about the lessons they learned building those companies, how those lessons drive their own investing and how they can improve you as an investor.

To sit and listen to Ross Beaty describe how he built Pan American Silver, how he built Lumina Copper; to hear Bob Quartermain describe how he built Silver Standard, how he built Pretium; to hear Rob McEwen talk about his successes; to hear Robert Friedland the most successful mining financier of my generation, is really an opportunity that you only come across at this Sprott conference. I would say that the real defining characteristic of this Sprott conference is a plethora of people who have built billion-dollar companies from scratch telling you how they did it and why those lessons are important to you.

Maurice Jackson: All of that I can't discredit, but equally important, I find, as well from a personal experience, Rick, has to be the attendees. I find that the intellectual and experiences they bring is of equal value. Talk to us about that.

Rick Rule: Well. That's a wonderful comment, Maurice, and you're improving as a
value investor, I might say. There are going to be 700 high net-worth people who are contrarian enough to want to come to a resource conference with all of their competition. This isn't the cannabis business on the corner. This is a high-quality group of people. The idea that all of the knowledge in the conference emanates from the dais to the crowd is silly. There's going to be 700, hard-working, rich people there, following them around, listening to their questions, comparing notes with them. Very, very important.

As I said, the conference is actually for us governed by the attendees. Every good idea I've heard in the conference business, and a couple of bad ones too, have come to me from the attendees. They're a really special lot of people.

Maurice Jackson: Ladies and gentlemen, this is truly a world-class event. To purchase admission to the Sprott Natural Resource Symposium, visit Proven and Probable and simply click on the icon and you'll be forwarded directly to the registration page. Rick, before we close, in previous interviews I've referenced how you can listen to an interview like this and apply this buckshot approach to adding companies into my portfolio, and that is not a prudent way to speculate. Does Sprott still offer a free grading of one's natural resource portfolio?

Rick Rule: We absolutely do. All somebody has to do is e-mail me personally at rrule@Sprottglobal.com. It's important because I'm an old guy, not technically sophisticated, that you put in the body of the e-mail, the name and symbol of every company in your resource portfolio and I will grade those on a 1-to-10 scale, 1 being best, 10 being worst.

I'll also make comments where it's appropriate, and send it back by return mail. This is, of course, an inducement to get you to talk to me, so that I can talk you into coming to this Sprott Vancouver natural resource investment symposium. But notice that I'm like other advertisers, I'm giving value for your attention.

Maurice Jackson: And to assist in streamlining those e-mails, we ask that you please put Proven and Probable in the subject line. Last question, Rick: What did I forget to ask?

Rick Rule: I think that was a pretty thorough discussion. In subsequent interviews—I don't think we have time today—I think we should revisit the thing that we talked about five years ago, which is Pareto's Law and the unequal distribution of management talent and investment talent in the population. The fact that if 80% of utility is generated by 20% of the population, then arithmetically, 64% or something, is generated by 4% and 40% is generated by 1%—and also the importance of aligning yourself as an investor with the 1% of population that have the best outcome in any given activity. I think that's an extremely important topic and I look forward to discussing it with you in the future.

Maurice Jackson: Certainly will. And I remember that discussion in 2015 at the Oxford Club Investment conference.

For additional inquiries about today's discussion on Sprott USA, and for all their products and services, please visit www.Sprottusa.com or call (800) 477-7853. Finally, we invite you to visit us at Proven and Probable, we deliver mining insights and bullion sales. Rick Rule of Sprott USA, thank you for joining us today on Proven and Probable.

Rick Rule: Always a pleasure. Thank you Maurice.

Maurice Jackson is the founder of Proven and Probable, a site that aims to enrich its subscribers through education in precious metals and junior mining companies that will enrich the world.

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