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As portfolio managers, we are continually faced with the challenge of finding good investment ideas for our clients. We are living in challenging times however, and good long-term investment opportunities are hard to come by. These days, investors and Wall Street analysts get excited when a company 'beats estimates' - despite the fact that these estimates incorporate large revenue and earnings declines from previous quarters. In many cases, the 'earnings' are actually losses brought on by falling consumer demand. This leads to a vicious cycle wherein lower revenues lead to layoffs, which in turn lead to less consumer spending and lower revenues. We have written at length about our views on the world economic situation: the fact that governments have been busy bailing out the financial system, have not placed enough attention on fixing the real economy and that economic indicators point to a depression. Please refer to the following Markets at a Glance articles: "[So You Think 2008 Was Bad? Welcome to 2009](#)", January 2009 and "[It's the Real Economy, Stupid](#)", July 2009.

The double impact of the mushrooming U.S. fiscal deficit and the Fed's Quantitative Easing policy is seriously threatening the value of the U.S. dollar. Other countries are also experiencing severe economic slowdowns and government deficits, and are turning to the printing presses in order to cope with their burgeoning liabilities. Foreign investors, such as China, are becoming increasingly alarmed at the potential for their foreign currency reserves to drop in value and are looking to hard assets as an alternative to financial assets. While fiat currencies can be created in unlimited amounts (i.e. printed), gold preserves its value due to supply constraints. For a complete discussion on the reasons to own gold please read John Embry's "[Reasons to Own Gold](#)".

We first invested in gold in 2000. At that time there was little interest in the sector: central banks were sellers of reserves and big mining companies hedged out their gold production. The situation is vastly different today. This year European central bank gold sales are setting a record low since 1999, with only 140 tonnes sold so far out of the 500 tonne maximum.¹ There is new demand from ETF's, such as the SPDR Gold Trust, the iShares COMEX Gold Trust and the Central Fund of Canada. There is also high profile institutional demand. Greenlight Capital Inc.'s David Einhorn, for example, recently stated that the US\$5 billion hedge-fund firm bought shares in the SPDR Gold Trust, making it its biggest holding (he subsequently switched out of the shares into physical bullion).² Northwestern Mutual Life Insurance Co., one of the largest life insurers in the U.S., bought US\$400 million of gold for the first time in the company's 152-year history. Northwestern's CEO was quoted saying that "the downside risk is limited, but the upside is large".³

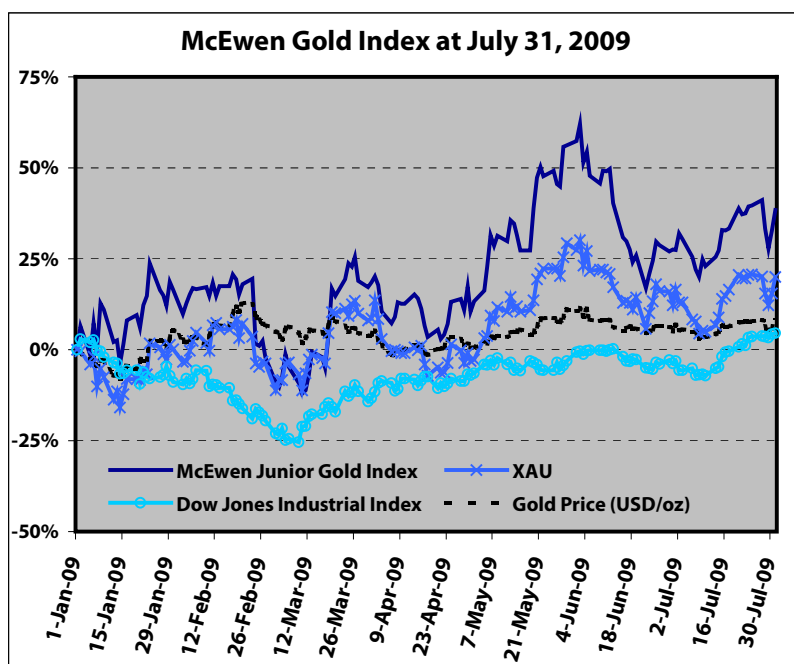
¹ Harvey, John (July 29, 2009). Reuters: Cenbank sales under gold pact well below limit: WGC. Retrieved on July 31, 2009 from: <http://af.reuters.com/article/investingNews/idAFJ0E56S0CJ20090729>

² Kishan, Saijel (July 14, 2009). Bloomberg: Greenlight holds Bullion, Buys reinsurance stocks (Update1). Retrieved on July 31, 2009 from: <http://www.bloomberg.com/apps/news?pid=20601213&sid=arz6MqVbTVBs#>

³ Frye, Andrew (June 1, 2009). Bloomberg: Northwestern Mutual makes first gold buy in 152 years (Update2). Retrieved on July 31, 2009 from: <http://www.bloomberg.com/apps/news?sid=ajf0L9wTPq6Y&pid=20601087>

Investing in gold has worked well over the last eight years – the price of gold has appreciated 17% per year on average, outperforming both silver and oil. It was one of the only investments that generated a positive return in last year's meltdown. Because we believe the gold price is going higher, we have been increasing our exposure to junior mining stocks, which enjoy more leverage to the spot gold price than their large capitalization peers. Indeed, junior mining stocks have performed exceptionally well since the lows they experienced in the Fall of 2008. The Sprott Gold & Precious Minerals Fund (Series A), managed by Charles Oliver and Jamie Horvat, appreciated 49.02% in the seven months to July 31, 2009, driven by small and mid caps (1YR: -8.72%; 3YR: -10.67%; 5YR: 4.79%; Since Inception on Nov. 15, 2001: 17.98%). The Fund significantly outperformed the S&P/TSX Global Gold Index, which was down 1.45% over the same time frame.

Rob McEwen, the founder of Goldcorp and a well-known gold investor, created the McEwen Junior Gold Index to track the performance of the juniors vs. the senior producers and the price of gold. The graph below illustrates the relative outperformance of the small cap sub-sector in 2009:



Source: www.mcewencapital.com

Despite the recent outperformance of the small caps, we still see many opportunities for outsized returns. We look for under-followed companies that we can foresee generating significant earnings in the future at current gold prices. Below we provide some names that we have recently added to our portfolio along with their potential earnings in 2011 using US\$950 gold:

	<u>Price at July 31, 2009</u>	<u>2011 Earnings Estimate⁴</u>	<u>2011 P/E Multiple</u>
CGA Mining Ltd.	\$1.46	\$0.34	4.3 x
Lake Shore Gold Corp.	\$3.24	\$0.35	9.3 x
La Mancha Resources	\$0.93	\$0.22	4.2 x
Medusa Mining Ltd.	A\$2.69	A\$0.57	4.7 x
Norseman Gold Plc	A\$0.70	A\$0.23	3.0 x

⁴ Earnings estimates based on reports from the following securities firms: BMO Capital Markets, Euroz Securities Limited, Northern Securities, Ocean Equities Ltd and Wellington West Capital Markets Inc.

As can be seen from the table above, these juniors are trading at low price-to-earnings multiples. Senior gold producers, on the other hand, are trading at over 20 times their 2011 earnings. Let us now imagine that the price of gold breaks through the \$1,000 level and shoots up to \$1,200. How profitable would our junior producers be then?

	<u>Price at July 31, 2009</u>	<u>2011 Earnings Estimate⁵</u>	<u>2011 P/E Multiple</u>	<u>Increase from \$950</u>
CGA Mining Ltd.	\$1.46	\$0.52	2.8 x	53%
Lake Shore Gold Corp.	\$3.24	\$0.61	5.3 x	74%
La Mancha Resources	\$0.93	\$0.36	2.6 x	64%
Medusa Mining Ltd.	A\$2.69	A\$0.79	3.4 x	39%
Norseman Gold Plc	A\$0.70	A\$0.40	1.8 x	74%

For a 26% rise in the gold price, earnings could potentially increase by 40% to 70%, demonstrating the tremendous leverage available in the junior sector. We are excited about the prospects for these companies and provide a brief discussion of each below:

CGA Mining Limited (TSX: CGA, ASX: CGX): CGA is focused on their Masbate open-pit mine in the Philippines. The company has already defined over 7 million ounces with plenty of exploration potential remaining. After acquiring the project in March 2007, CGA moved quickly to put it into production with the first gold pour taking place in May 2009. The current plan is to produce around 200,000 ounces per year, but an increased production rate can be achieved through an expansion of the processing plant.

Lake Shore Gold Corp. (TSX: LSG): Lake Shore is an emerging producer based in the prolific Timmins mining camp of northern Ontario and Quebec. The company is run by an experienced management team and is ramping up production to 200,000 ounces per year by 2011 from two 100%-owned mines. Lake Shore also has great exploration potential at their Thunder Creek joint venture with West Timmins Mining, where the partners have reported multiple high grade intercepts, including 83.4 meters of 12.75 g/t.

La Mancha Resources (TSX: LMA): La Mancha was created in 2006 from the fusion of the gold assets of AREVA with exploration properties of La Mancha Resources Inc. We are expecting La Mancha's attributable production in Australia and Africa to increase to 150,000 ounces in 2011. The greatest exploration potential for La Mancha lies at the Hassai property in Sudan, where drilling is beginning to outline what could become a major gold-copper VMS deposit.

Medusa Mining Limited (ASX: MML, AIM: MML): Like CGA, Medusa is based in the Philippines and is operating the high grade Co-O mine. The mine is on track to increase production to 100,000 ounces per annum with very low cash costs of US\$200/ounce. Medusa is aggressively drilling on the property and has recently announced a doubling of reserves.

Norseman Gold Plc (ASX: NGX, AIM: NGL): Norseman operates Australia's longest continually operated gold mine called the Norseman Gold Project. After undergoing operational restructuring in late 2008, the company has been successful at reducing costs and increasing production. Norseman has been producing gold at a rate of around 80,000 ounces per annum, but the company's goal is to increase production to over 100,000 ounces by filling capacity at their underutilized mill.

⁵ Earnings estimates based on reports from the following securities firms: BMO Capital Markets, Euroz Securities Limited, Northern Securities, Ocean Equities Ltd. and Wellington West Capital Markets Inc.

These five names represent a small sample of the undervalued gold companies we currently see in the market. They are trading at a fraction of the multiples attributed to the large gold producers. In some cases it is partly due to their status as 'one trick ponies', or is a reflection of modest production levels or projects that are just starting production. But in most cases their cheap valuation is simply due to the fact that they are unknown to the generalist investor. We do not believe they will remain so for much longer.

In addition to low fundamental valuations, we also have M&A activity in the junior gold sector heating up. There have been a number of instances recently where shareholders of one gold company benefitted from other companies bidding up the value of their shares.

Take Moto Goldmines Ltd. for example. Moto has a large deposit in the Democratic Republic of Congo. Due to the country's political risk and the fact that the company has no production, an astute investor could have bought an ounce of gold in the ground for around C\$20 of Moto's market capitalization. In June 2009, however, Moto agreed to an all-stock business combination with Red Back Mining, and a month and a half later Randgold (in partnership with AngloGold Ashanti Limited) stepped into the ring by making a cash and stock offer for the company. As we write this article, it appears that Randgold will succeed in acquiring Moto and Moto's shareholders may realize a 60% premium on their shares.

Another example of a 'bun fight' for a gold deposit is the story of Kinbauri Gold Corp., whose primary asset is the El Valle gold-copper deposit in Spain. In May, Orvana Minerals Corp. announced a hostile all-cash C\$0.55 offer for Kinbauri, representing a 39.2% premium at the time (the offer was contingent on Kinbauri backing out of a partial sale of El Valle to Glen Eagle Resources Inc. announced in April). Enter ATW Gold Corp., announcing in July a letter of agreement to combine with Kinbauri. The proposal was a stock transaction, implying a value of C\$0.85 per share at the time of the announcement. Orvana promptly countered with a C\$0.75 all-cash offer, essentially forcing ATW out of the game. The bottom line? If you bought Kinbauri stock at the beginning of May, you could have realized a close to 90% return on your investment in three months.

We could also discuss how competing offers for Dioro Exploration from Avoca Resources Ltd. in April and from Ramelius Resources at the end of July have doubled Dioro's share price, but we trust that our readers understand our point: quality gold deposits are scarce. It is therefore easier and cheaper to buy growth rather than to find and develop it.

In summary, we believe in gold. It has worked as a wealth creation strategy and we believe it will continue to do so. There is new investment demand from investors wanting to diversify away from paper assets. While some stocks remain cheap, the sector is being brought into the limelight by growing M&A activity. Our strategy is to buy bullion and undervalued producers and explorers with leverage to the gold price.

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