Manager Commentary: On the Gold Market

Gold posted 4.8% gain in August, ended month at $1,692.01/ounce

By: Joe Foster, Portfolio Manager

Fund Review

The Fund's Class A shares gained 12.86% for the one-month period ending August 31, 2012 (excluding sales charge), while the NYSE Arca Gold Miners Index (GDM) rose 11.95% for the same period.

Average Annual Total Returns (%) as of August 31, 2012

	1 Mo[1]	1 Yr	5 Yr	10 Yr
Class A: NAV (Inception 2/10/56)	12.86	-26.97	10.94	17.60
Class A: Maximum 5.75% load	6.39	-31.18	9.64	16.91
GDM Index	11.95	-22.88	6.16	--

Average Annual Total Returns (%) as of June 30, 2012

	1 Mo[1]	1 Yr	5 Yr	10 Yr
Class A: NAV (Inception 2/10/56)	2.19	-27.46	7.44	15.59
Class A: Maximum 5.75% load	-3.69	-31.63	6.17	14.91
GDM Index	2.40	-17.27	4.51	--

[1]Monthly returns are not annualized.

Expenses: Class A: Gross 1.20%; Net 1.20%. Expenses are capped contractually until 05/01/13 at 1.45% for Class A. Caps exclude certain expenses, such as interest.

Please note that precious metals prices may swing sharply in response to cyclical economic conditions, political events or the monetary policies of various countries. Investors should be aware that recent market conditions resulting in high performance for the gold sector may not continue. The tables present past performance which is no guarantee of future results and which may be lower or higher than current performance. Returns reflect applicable fee waivers and/or expense reimbursements. Had the Fund incurred all expenses and fees, investment returns would have been reduced. Investment returns and Fund share values will fluctuate so that investor's shares, when redeemed, may be worth more or less than their original cost. Fund returns assume that dividends and capital gains distributions have been reinvested in the Fund at NAV. Index returns assume that dividends of the Index constituents in the Index have been reinvested.

Market Review

Gold rose $77.71 (4.8%) in August to close at $1692.01 per ounce. Anticipation of another round of economic stimulus from the Federal Reserve Bank (the "Fed") helped drive gold higher, while the U.S. Dollar Index (DXY) fell 1.7%. The release of the minutes of the Fed's August 1 FOMC (Federal Open Market Committee) meeting suggested further action is imminent. Fed Chairman Bernanke's August 31 Jackson Hole speech provided evidence of the benefits of previous large scale asset purchases (some of which are commonly known as quantitative easing or "QE") and reiterated the Fed's willingness to engage in further stimulus if economic conditions warrant. However, lack of action from the Fed has now caused the market to shift QE expectations to the September FOMC meeting.

The technical outlook for gold improved substantially in August. On August 21, gold moved higher to break out of a consolidation pattern established over the past year, since the $1921 per ounce high on September 6, 2011. The timing of the break-out fits with seasonal strength that is common historically in the fall. It will be interesting to see how this develops.

Gold stocks outperformed gold in August, shown by the 11.94% gain in the NYSE Arca Gold Miners Index (GDM). A disappointing second quarter reporting season has passed and markets are now hoping for better results from the sector. If the gold breakout mentioned above develops into a trend, perhaps gold equities can claw back some of the value lost through poor performance over the past year. Year to date, the GDM has underperformed gold by 14.6%.

Junior gold stocks also performed well, as the Market Vectors Junior Gold Miners Index (MVGDXJ) gained 11.21% for the month. The MVGDXJ has underperformed gold by 19.9% this year. When gold first traded to $1692 per ounce on August 8, 2011, the MVGDXJ stood at 2625, which is 41% higher than it is currently. Since then, capital costs have escalated and financing has become more difficult for many companies. However, most companies continue to develop the same projects, many with double-digit rates of return that were attractive then and remain attractive now. Perhaps with continued positive momentum in the gold price, investors might take a friendlier view of these stocks.

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The World Gold Council released their second quarter report which showed central banks buying 254 tonnes of gold in the first half. This came as a surprise and sets the banks on a pace to eclipse last year's 455 tonnes. Most of the buyers are not known and may remain anonymous. Those mentioned include Russia, Kazakhstan, Philippines and Ukraine. The Bank of Korea confirmed it bought 16 tonnes in July. The Central Bank of China does not routinely disclose its gold activity, but shipments of gold through Hong Kong suggest the Chinese are importing more gold than can be accounted for by investment and jewelry demand. While Indian jewelry demand has been weak this year, it seems central banks have stepped in to pick up the slack.

Investment in gold exchange-traded products (ETPs) rose in August, sending total gold held within these funds to a record. Now only the IMF (International Monetary Fund) and the central banks of Germany and the U.S. hold more gold than is held in the gold ETPs.

Widely publicized violence involving striking platinum miners in South Africa has created a tense environment. Gold mines are in a different area of the country and have historically had a friendlier relationship with the unions than the platinum mines. Gold unions are not as fragmented and they have central bargaining agreements. This makes disturbances created by rival unions less likely. Nonetheless, on August 31, Gold Fields Ltd. announced that 12,000 workers at their Kloof-Driefontein mine were illegally on strike. After many years of costly government mandated Black Economic Empowerment programs and improving safety records, it is disheartening to see the type of unrest and violence recently reported. Political risk to the mining industry in South Africa is not moving in the right direction.

Back in 2003 we invested in a company called DRC Resources. We remember meeting the company's CEO and veteran geologist, John Kruzick, at the Prospectors and Developers Convention in Toronto. Pouring over maps of the Afton copper/gold project located in British Columbia, we shared John's vision for the property. Afton had already been mined as an open pit in the '80s, but DRC had identified an extension at depth with the potential to support a new operation. Recognizing the need for the company to expand corporately to support a large copper/gold project, John relinquished the CEO position in 2004. In 2005, the company changed its name to New Gold. In 2008, New Gold merged with two other junior companies with producing mines and, in 2009, another mine acquisition was added. The company had reached the critical mass needed to finance and develop Afton. Recently, we had the opportunity to visit the New Afton mine and we were impressed with what we saw. New Afton is a block cave underground operation, which is rare in the gold mining industry. The company recruited experienced block caving engineers and designed an efficient underground conveyor and mill facility.

After two years of construction, start-up is going very well and the mill is now at full capacity. This is an example of the time and patience that is often required when investing in mining projects and building gold companies. New Gold expects New Afton to generate $240 million of cash per year at current gold and copper prices. It is now a solid mid-tier gold company with growth projects, and one of only a handful of companies that have outperformed gold so far this year.

Market Outlook

There is an ongoing uncertainty among investors about their financial future. Individuals are concerned about taxes, entitlements and employment opportunities. Businesses have issues with changing tax and regulatory codes. Central banks fret over the value of paper reserve assets—currencies and sovereign debt. Banks lend less than before the credit crisis, having raised credit standards to compensate for the uncertainty. It seems everyone shares a tentative economic outlook. As a result, we believe that wealth preservation has become a prominent theme and debt markets are hot. According to Bloomberg, banks have already bought more U.S. Treasury and government agency debt than in all of 2011. In July, Spanish banks purchased sovereign debt with over €400 billion borrowed from the European Central Bank. Some investors are now willing to pay for safety, as near-term yields recently turned negative on the sovereign debt of Switzerland, Denmark and Germany. High demand for high-quality sovereign debt has coincided with limited supply, as credit ratings and outlooks have declined. The IMF estimates that worries about governments' fiscal health could remove one-sixth of the world's supply of "safe" government debt by 2016. Some investors have moved to riskier issues, shown by the yield on U.S. municipal bonds, corporate debt and junk bonds that are now at or near historic lows. Some companies are offering debt not because they need it, but because demand is high and rates are low.

In our opinion, the uncertain outlook that is driving the bond markets is also driving investors to gold. Gold's value as a safe haven stems from its history, monetary properties and limited supply. Similar to bonds, gold may face supply constraints although for different reasons. Historically, there have been three sources of supply: central bank selling, scrap recycling and gold mines. Central banks became net buyers two years ago, which leaves only two supply sources. More people are motivated to redeem their jewelry as the gold price rises. Indeed, scrap sales have risen through the gold bull market, but peaked in 2009. Since then, scrap supply has declined, including a 7.7% fall in the second quarter. While scrap sales remain at relatively high levels, it seems that higher gold prices and tough times are not encouraging more people to redeem their gold for cash. The scrap market seems to have met its limit.

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The supply from gold mines also has its limits. Gold production went into decline from 2001 to 2008 as mines aged in the prominent producing regions of South Africa, United States and Australia. Since 2008, production has risen as record gold prices have enabled expansions of existing operations and development of new mines around the world. However, we do not believe this trend will last and recent developments suggest major gold producers could have difficulty maintaining current production levels for two reasons. First, there simply have not been enough discoveries of large gold deposits over the current bull cycle. Companies are spending record amounts on exploration, but the low-hanging fruit has been picked. Metals Economics Group (MEG) found that 99 gold deposits each containing at least two million ounces had been discovered from 1997 to 2011. Majors hold 39% of the gold in these 99 discoveries, but this covers just 46% of the gold needed to replace their bull market production from 2002 to 2011. This suggests the past discovery rate would have needed to roughly double just to replace production.

The second reason for a possible production decline is a significant shift in strategy among the major gold producers brought on by poor share price performance over the past year. Many discoveries and new developments are in places with no infrastructure or trained labor. The cost of developing many such projects on a scale that is meaningful to a major has become prohibitive and rates of returns are no longer attractive. Gold Fields Ltd. estimates that all production, capital and other costs (all-in costs) across the group rose to $1380 per ounce in the first quarter. As a result, the majors have begun to rationalize assets, downsize or shelve large projects, and focus on profitability rather than growth. MEG figures the majors currently have enough gold in reserve to last an aggregate 21 years at 2011 production levels. However, the dearth of discoveries and a more disciplined strategy suggest it may now take longer for the gold in the ground to reach the market.

Finally, we believe a flat or falling gold supply would be bullish for the price. However, falling supply is not as critical as it is for other commodities. Gold coins and bars are used as a financial asset and saved. Gold jewelry is also saved as a store of wealth. It is not consumed like other commodities. Nobody keeps barrels of oil or copper tubing in their safe deposit box. Investment demand drives gold rather than commercial or industrial demand. While we have identified serious supply constraints, investors nonetheless hold a lot of gold that may come into the market with changes in economic conditions or price.

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All company weightings as of August 31, 2012.

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The S&P® 500 Index consists of 500 widely held common stocks covering industrial, utility, financial and transportation sectors. U.S. Dollar Index (DXY) indicates the general international value of the U.S. dollar. It does this by averaging the exchange rates between the U.S. dollar and six major world currencies. NYSE Arca Gold Miners Index (GDM) is a modified market capitalization-weighted index comprised of publicly traded companies involved primarily in the mining for gold. Market Vectors Junior Gold Miners Index is (MVGDXJTR) is a rules-based, modified capitalization-weighted, float-adjusted index comprised of a global universe of publicly traded small- and medium-capitalization companies that generate at least 50% of their revenues from gold and/or silver mining, hold real property that has the potential to produce at least 50% of the company's revenue from gold or silver mining when developed, or primarily invest in gold or silver. Philadelphia Stock Exchange Gold and Silver (XAU) Index is capitalization-weighted and includes the leading companies involved in the mining of gold and silver.

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