Manager Commentary: On the Gold Market

Gold swings sharply in final trading day, ended month at $1,696.85/ounce

By: Joe Foster, Portfolio Manager

Fund Review

The Fund's Class A shares declined 1.72% for the one-month period ending February 29, 2012 (excluding sales charge), while the NYSE Arca Gold Miners Index (GDM) lost 1.90% for the same period.

Average Annual Total Returns (%) as of February 29, 2012

	1 Mo[1]	1 Yr	5 Yr	10 Yr
Class A: NAV (Inception 2/10/56)	-1.72	-10.36	12.35	21.53
Class A: Maximum 5.75% load	-7.37	-15.51	13.69	22.26
GDM Index	-1.90	-6.64	7.87	--

Average Annual Total Returns (%) as of December 31, 2011

	1 Mo[1]	1 Yr	5 Yr	10 Yr
Class A: NAV (Inception 2/10/56)	-13.30	-21.52	11.90	24.24
Class A: Maximum 5.75% load	-18.27	-26.04	10.58	23.50
GDM Index	-14.37	-15.48	6.36	--

[1]Monthly returns are not annualized.

Expenses: Class A: Gross 1.25%; Net 1.25%. Expenses are capped contractually until 05/01/12 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

The recurring monetary stimulus that has characterized the post-credit crisis economy continued unabated. In February the Bank of England (BoE) announced it is going to continue quantitative easing by buying an additional £50 billion ($79 billion) of securities (gilts). This expands the BoE balance sheet to £325 billion, which is proportionately much larger than the Fed's balance sheet. The Bank of Japan announced increased purchases of government bonds (JGB's) by ¥10 trillion ($125 billion) and for the first time vowed to hit an inflation target of 1%. This caused the Yen to take a 6.4% tumble in February. The granddaddy of the month was the European Central Bank's lending of €529 billion ($712 billion) through the second tranche of its Longer Term Refinancing Operation (LTRO), which brings the total lent through LTRO to €1.02 trillion ($1.38 trillion). The wanton expansion of the supply of paper (or electronic) money globally tends to create additional demand for gold, which cannot be created through fiat.

Gold's second source of support came from the oil market, as Brent Crude traded above $120 per barrel and reached all-time highs in Euro terms. Geopolitical tensions escalated with sanctions on Iran and threats to close the Strait of Hormuz. Emerging Asian markets are particularly exposed to Iranian oil. Higher crude prices feed inflation in places like China and India where fuel is a much higher percentage of budgets than in western households. Continued high oil prices may drive emerging market investors to gold as an inflation hedge.

Gold reached its high for the year of $1790.50 per ounce on February 29 due to currency debasement and tension in the oil markets, but finished the month down $40.75 at $1696.85 per ounce. Beginning at 10:00 am on February 29, gold took a dive, ending the day with an $87.38 loss. Subsequent rumors suggest that the selloff began with a large fund that was taking profits. Five percent daily changes in the gold price are rare. Many analysts attribute the move to the market's interpretation of Federal Reserve Bank Chairman Ben Bernanke's Congressional testimony on the same day. Mr. Bernanke did not make mention of the possibility of any type of quantitative easing as he has in other recent testimonies. The market apparently interpreted what he did not say as an indication that there will be no more quantitative easing (QE), even though he did continue to emphasize "persistent downside risks" to the economy.

Please note that the information herein represents the opinion of the portfolio manager and these opinions may change at any time and from time to time.

We disagree with the market's reaction, believing that for the foreseeable future, there remains the risk of an economic downturn strong enough to prompt another move to QE. The massive stimulus being applied by central banks seems to have masked equally massive problems in the economy. For example, the Obama Administration foresees a higher fiscal deficit in the current fiscal year than the $1.3 trillion deficit in 2011. The January housing data and jobs report are seen as signs of a recovery. However, it looks as if improving housing sales are a function of an unusually mild winter, especially in the Northeast. Average sales prices continued to decline. While the unemployment rate fell to 8.3%, we believe this was mainly due to the number of discouraged workers who dropped out of the labor market. Meanwhile, most of the job gains were in part-time employment. In Europe, no sooner had a fresh Greek bailout been announced when a "debt sustainability analysis" sponsored by the European Central Bank, International Monetary Fund, and European Commission was leaked warning that the austerity measures applied to Greece are so severe, that there is little chance of meeting the targeted 120% debt/GDP ratio by 2020. Spain has already failed to meet its 2011 deficit target and is now asking to raise its 2012 target.

Market Outlook

Anyone who follows gold stocks probably knows that companies have struggled to control costs. In fact, this has been the main reason that gold companies have periodically missed expectations, which has disappointed the market and caused some to underperform the gold price. Many assume that escalating costs reflect poor management. However, cost inflation for mining companies has been no different than inflation at the gas pump or grocery store for consumers. You have to pay the going price for necessities.

There are three flavors of costs – operating, project capital and ongoing capital. Before looking at these, we must consider a hidden factor that creates cost pressure in a bull market: declining gold grades. This is the gold grade in the rock that is mined and processed. For example, let us say a gold mine has a grade of 2 grams/tonne (0.058 ounces per ton). Hypothetically, if that same mine had a lower grade of 1 gram/tonne (0.029 ounces per ton), then the cost of recovering the gold would double because the company would have to mine and process twice as much rock to get the same amount of gold. Most gold orebodies have halos and satellites of low-grade rock that is uneconomic to mine. As the gold price rises, these areas can become profitable to mine. Leaving such areas of rock behind or discarding it on a waste dump does not make economic sense. With higher gold prices, the mine is able to process this low-grade rock along with the rest because it makes money and extends the life of the mine. The "downside" is that it dilutes the overall grade and increases unit costs (cost per ounce). CIBC (Canadian Imperial Bank of Commerce) World Markets estimates that since 2005 average grades have declined 21%. It is difficult to calculate how much this has increased costs, but we estimate it accounts for 10% to 20% of the rise in operating costs over this gold cycle.

Operating costs or "cash" costs are the direct costs of mining and extracting the gold. The beginning of cost escalation dates to 2003, when WTI Crude crossed the $40 per barrel threshold. Operating cost increases have averaged 15.8% annually since 2003 (using GFMS annual data). According to RBC (Royal Bank of Canada) Capital Markets, fuel and energy make up 40% of operating cost. Labor is the second large component, which also comprises 40% of costs. There is a labor shortage due to 1) overwhelming demand driven by the global mining boom across all metals and 2) not enough skilled labor and professionals have pursued careers in mining. Even though there is high unemployment at the national level, most people are not willing to work in remote locations. Mining schools still have difficulty attracting students. In addition, mining suffered a depression in the '90s when gold fell to $250/oz and copper to $0.60/lb. Many of those who would have held senior positions today left the industry to establish new careers in other fields. Labor is paid in local wages, so when currencies are strong in places such as Canada, Australia, and Brazil, then labor costs rise that much more. The remaining 20% of costs are spread across chemicals, tires, explosives, and steel, for example -- all of which have been increasing as well. When royalties are added, we use the term "total cash costs". High metals prices have given governments room to tweak royalty rates higher. Most royalties are simply a percentage of the gold price, which is paid for each ounce produced. Five years ago, a 3% royalty was typical across the gold industry. Today, 5% is considered normal and some countries have pushed it to 8%.

Building mines is a capital intensive endeavor. RBC Capital Markets estimates that project capital costs have increased by 25% per year since 2003. These large and complex projects are updated every year or two when in the planning stages. With such cost inflation, budgets quickly become obsolete and the market is surprised when new estimates are so much more than the last. Fuel and energy are only 10% of capital costs, while steel is 10% and labor is 35%. The rest is a myriad of equipment, materials, contractors, and engineering consultants. Engineering firms and EPCM (engineering, procurement, and construction management) contractors are used extensively, but they are also impacted by the labor shortage. Despite charging higher rates, the quality of work has suffered for some projects due to lack of experience. Manufacturers such as Caterpillar and Komatsu are enjoying unprecedented demand for mining equipment.

Ongoing capital is required to replace equipment and maintain production at existing mines. It involves most of the same items as project capital and is subject to similar cost pressures. Without it, a mine would quickly become dysfunctional. For most companies, ongoing capital amounts to between $250 and $350 per ounce produced.

In 2011, total cash costs averaged $665 per ounce. We expect operating costs to increase around 15% in 2012, so when we add ongoing capital and other miscellaneous costs, it takes about $1200 per ounce to sustain the average gold mine. Ten percent of production comes from mines that have total cash costs that average $1100. These are clearly marginal at current gold prices. As we write, Brent Crude has crossed $127 per barrel, which is higher than the price gold companies used in their 2012 fuel cost estimates. This already leads us to believe that cash costs will come in at the high end of guidance for 2012.

It is difficult to see an end to the cost pressures across the mining industry. The labor shortage has no near-term solution. Educating and training people and allowing them to gain experience takes time, as does developing new mechanized or remote control technologies. The global mining boom was brought on by the industrial revolution in China, India and Brazil, which is a secular trend that appears to be at least as powerful as the industrial revolution was for the United States. We believe, on a five year outlook, the combination of emerging market demand for oil coupled with supply uncertainty in the Middle East makes $200 crude seem like a reasonable ball-park target.

While costs are a huge issue in the gold mining industry, anyone who focuses solely on costs risks missing the larger picture, which is the profitability of this sector. Operating costs have risen 15.8% annually since 2003, but the gold price has risen 19.8% annually over the same period. Profit margins have expanded, dividend yields have increased substantially, and companies are able to fund all of their capital needs internally. Bank of America Merrill Lynch sees cash flow doubling in 2012 for the North American producers. The gold price must increase in order to keep up with cost escalation, but many of the things that are driving costs are also driving the gold price. These include emerging market demand, the inflationary impact of high oil prices, and supply constraints across many commodities. When we layer in gold's role as a safe haven, currency hedge, and central bank reserve asset, it seems reasonable to forecast a gold price that stays ahead of mining costs.