

Manager Commentary: On the Gold Market

News out of Europe lifted gold in July, ended month at \$1,614.30/ounce

By: Joe Foster, Portfolio Manager

Fund Review

The Fund's Class A shares gained 0.25% for the one-month period ending July 31, 2012 (excluding sales charge), while the NYSE Arca Gold Miners Index (GDM) fell 4.25% for the same period.

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

| | 1 Mo ¹ | 1 Yr | 5 Yr | 10 Yr |
|----------------------------------|-------------------|--------|------|-------|
| Class A: NAV (Inception 2/10/56) | 0.25 | -30.91 | 6.62 | 18.04 |
| Class A: Maximum 5.75% load | -5.51 | -34.88 | 5.37 | 17.34 |
| GDM Index | -4.25 | -23.97 | 2.46 | -- |

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 | -- |

¹Monthly 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 gained \$16.90 (1.06%) to finish the month at \$1614.30 per ounce. Events in Europe were supportive. A recently planned €100 billion bailout of Spanish banks was not enough to keep Spanish sovereign debt rates from rising through 7% that many economists regard as an insolvency threshold. Some regional Spanish governments are asking for aid and the Bank of Spain is now forecasting recession until 2014. Triple A sovereigns may be going the way of the dinosaur, as Moody's lowered its outlook for German, Dutch and Luxembourg bonds to negative from stable. This would reduce the pool of AAA-stable sovereigns by half. As we have indicated in past reports, we believe that when faced with austerity or monetization, governments usually opt for monetization of burdensome debt. As financial conditions worsen, statements by European Central Bank President Mario Draghi suggest Europe is moving further down the road to monetization. In what we would describe as a "helicopter moment", Mr. Draghi said monetary policies would be used to do whatever it takes to preserve the euro, emphasizing "believe me, it will be enough". This supported gold's modest gain for the month of July and may have helped established a firm summertime base for further advance.

U.S. banking regulatory agencies released proposed changes to capital rules that align the U.S. with Basel 3 standards. In it, gold bullion is named along with cash and U.S. Treasuries as 0% risk weighted assets. Gold currently carries a 50% risk weighting, which implies the new standard should improve a bank's capital ratios if they hold gold. These changes further integrate gold into the financial system. What this means for the gold price is unclear, as it may create more demand for gold as a banking asset, but gold supply through lending might also rise.

Many of the senior gold producers have now reported second quarter results, and it has not been pretty. In a refrain that has become much too common in this sector, escalating costs and operating issues caused most earnings to fall short of expectations. During July, the NYSE Arca Gold Miners Index (GDM) fell 4.25%. Declining reserve quality, skilled labor shortages, high energy prices, and geopolitical risks have caused costs to escalate.

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While we expect these issues to periodically create pressure on share prices, it has been made much worse by industry leaders' failure to recognize negative trends within their companies and adjust their outlook and market expectations accordingly. We believe the entire sector has been under pressure this year largely due to a loss of faith in management. Lately, we have seen signs that companies are making necessary adjustments to cope with persistently negative issues. The most dramatic has been the recent firings of the Chief Executives of both Barrick and Kinross. In a July 31 meeting of the Melbourne Mining Club, Goldfields Limited CEO Nick Holland gave a surprisingly and refreshingly candid assessment of the issues in a speech entitled "What Do Investors Want from a Gold Mining Stock?". Senior gold company Boards are finally realizing that many of the large high capex gold projects in planning will not generate a sufficient return to shareholders at current gold prices. Also, the common practice of expanding operations to capture marginal ounces may end up losing money. We believe we are seeing the beginning of a shift in emphasis from production growth to cash flow and profitability among the large producers. Managing expectations and meeting guidance is receiving a new priority. Companies that grow production profitably should outperform their ex-growth peers. Companies who are not able to grow production must show growth in profits in order to outperform the price of gold. We have said before that we expect companies to meet guidance going forward, only to be disappointed. With the management changes and awareness we are now seeing, we feel the industry stands a very good chance of regaining investor trust in 2013, if not sooner.

Junior gold stocks outperformed gold and the larger producers in July, as the Market Vectors Junior Gold Miners Index (MVGDXJ) gained 1.26%. While valuations are low across the sector, we believe juniors represent the best value in the group. We found evidence of this in the July 13 acquisition of La Mancha Resources. Based in Canada, La Mancha has a market cap of nearly \$500 million and has operations in some countries that we view as politically risky. Nonetheless, Weather Investments II S.a.r.l. agreed to purchase La Mancha in an all cash deal at a 55.6% premium to the July 12 stock price. Weather Investments II is an Egyptian family conglomerate that obviously also shares our views on value in the gold sector. This is a rare deal in an environment where there has been little mergers and acquisitions (M&A) due to low valuations of both acquisition targets and acquirers. Importantly, it gives us a glimpse into how an outside company views the sector. We are encouraged by a company that is unencumbered by its own low valuations, who sees this as a good entry point to gold mining.

Market Outlook

The gold bull market has been running for 11 years now, during which gold has gained 505% and the XAU gained 226%. Over the past decade we have not wavered in our conviction and our base case continues to be positive. We believe the global economy is in the grips of a deflationary collapse in credit that presents financial risks to banks, sovereigns, and the economy that are very supportive of gold as a safe haven. The economy probably continues to limp along until the housing sector finishes carving out a bottom and private sector inertia finally kicks in again. Once credit markets begin to function normally and the economy begins a cycle of sustained growth, we believe there is a huge risk that the massive liquidity created by central banks to fight deflation and monetize debt will eventually enter the financial system, creating a cycle of price inflation in goods or financial assets that propels gold to new heights as a store of wealth and inflation hedge. Central Bankers demonstrated no skill in forecasting the devastation caused by the asset price inflations of the tech and housing bubbles. We see no reason to believe they will have the foresight to raise rates or sell off enough assets to head off another unwanted cycle of inflation, especially with one of the worst economies in history in fresh memory.

Like all bulls, this one will end one day, perhaps with a parabolic rise, perhaps not. As investors, we must also consider possibilities that might end the gold bull. The upcoming U.S. presidential election could be the first credible threat to the bull market. Since the January 20, 2009 inauguration of Barack Obama, gold has gained 88%, the GDM 43%, and the MVGDXJ 105%. Policies that have resulted in an expansion of entitlement spending, huge fiscal deficits, increased regulations and uncertain future tax burden have made gold an asset to own during the Obama presidency. Nearly half of American households receive some form of government aid. About half of Americans pay no federal income taxes. As a believer in big government, social spending and redistribution of wealth, President Obama has a formidable natural constituency. If he gets reelected, his past record suggests gold should perform well.

However, many analysts would agree there is a 50/50 chance that Mitt Romney becomes the next president. Some regard Mr. Romney as a weak candidate. In a recent Wall Street Journal editorial, Peggy Noonan described both candidates as lacking in the political genius that America needs right now. Nonetheless, Mr. Romney has a strong background in business and politics, along with sound family values and character. While it is difficult to discern details on how a Romney administration would act, given his background, he has as much potential to do the right things as a Hollywood actor turned governor did in 1980. Few expected Ronald Reagan to end the cold war and usher in policies that set off one of the greatest economic expansions in history.

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So what are the right things? In our opinion, the basics are not too complicated: 1) A credible plan to reduce and maintain fiscal deficits at much lower levels; 2) Since debt is so massive and austerity is not politically popular, a one-time monetization of a large chunk of government debt may be needed in combination with a change in Fed mandate towards sound currency policies that inhibit excessive credit creation; 3) Reduce the size of government and government regulation to a more manageable, less wasteful, and more business friendly level; 4) Design a much simpler and fairer tax code for both individuals and businesses; 5) Maintain a social safety net for those who need it most. These are the most important items that come to mind.

Given Mr. Romney's background and campaign rhetoric, we suspect he may believe in many of these items. He has said he would replace the Federal Reserve Chairman. The June 5 rejection of the recall for Governor Scott Walker for his anti-union budget policies suggests voters may be ready to make difficult choices and endure some near-term pain, even in a liberal state like Wisconsin. Similar austerity votes were also cast in San Diego and San Jose, California. Cheap energy provided by the boom in unconventional gas in the U.S. could provide a timely boost to the economy.

We hope that the winner of the November 2012 election implements policies that successfully reduces investors' desire to use gold as a store of wealth and hedge against currency debasement or inflation. However, it is difficult to be optimistic. It seems that if anything is consistent in Washington, it is gridlock. Opposing parties and special interests habitually block attempts at progress, common ground is seldom found, and the "can gets kicked" further down the road. Europe, Japan and now many emerging economies have serious problems of their own that may inhibit growth globally. Gillian Tett's July 10 commentary in the Financial Times about the G-20 nations says "Rarely has politics seemed so crucial for investors and yet so impotent. The craft of government has become defensive, reactive, small-minded and profoundly frustrating to watch." One could probably apply such statements about government to any point in history, however, they now seem to have added relevance.

The Congressional Budget Office estimates that federal debt held by the public is on trend to reach 90% of GDP by 2022. A recent Bank for International Settlements study estimates that advanced economies would need 20 years of budget surpluses exceeding two percent of GDP just to bring the debt-to-GDP ratio back to its pre-crisis levels. Is the debt problem even solvable given the political realities? Will a cure be worse than the disease? Will attempts to reduce debt and balance budgets throw the economy into another tailspin? Will it create extraordinary levels of social unrest or another banking crisis? We believe the risks outweigh the chances of a successful outcome in the coming presidential term, regardless of who wins. Nonetheless, we will be watching, waiting, and hoping for the next administration to do the right things.

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All company weightings as of July 31, 2012.

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