Manager Commentary: On the Gold Market

Gold suffered collapse after Fed comments, ended June at $1234.57 per ounce

By: Joe Foster, Portfolio Manager

Fund Review

The International Investors Gold Fund's Class A shares lost 17.45% for the one-month period ending June 30, 2013 (excluding sales charge), while the NYSE Arca Gold Miners Index[1] (GDM) declined 17.07% for the same period. The Fund is actively managed and invests mainly in gold-mining equities. Geologist Joe Foster has been part of Van Eck's gold investment team since 1996. The Fund is managed by a specialized investment team that conducts continuous on- and under-the-ground research to access mining efficiencies and opportunities.

Average Annual Total Returns (%) as of June 30, 2013

	1 Mo*	1 Yr	5 Yr	10 Yr
Class A: NAV (Inception 2/10/56)	-17.45	-40.77	-8.92	9.07
Class A: Maximum 5.75% load	-22.20	-44.17	-10.00	8.42
GDM Index	-17.07	-44.39	-11.86	--

Average Annual Total Returns (%) as of March 31, 2013

	1 Mo*	1 Yr	5 Yr	10 Yr
Class A: NAV (Inception 2/10/56)	2.15	-23.78	-1.01	15.01
Class A: Maximum 5.75% load	-3.70	-28.15	-2.17	14.33
GDM Index	1.32	-22.22	-3.61	--

*Monthly returns are not annualized.

Expenses: Class A: Gross 1.29%; Net 1.29%. Expenses are capped contractually until 05/01/14 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 markets suffered a synchronized collapse following comments made by Federal Reserve Bank (the "Fed") Chairman Ben Bernanke on June 19. Stocks, bonds, currencies and commodities all traded down when Mr. Bernanke suggested that an end to the Fed's monthly purchase of mortgage-backed securities and treasuries could come as early as mid-2014. Without the Fed's assistance, markets fear that interest rates could rise, snuffing out anemic economic growth.

Since April gold had found support around the $1400 per ounce level; however, it could not withstand the spike in real interest rates or the firming of the U.S. dollar that the Fed's comments created. Gold fell to its lowest level in nearly three years at $1180 per ounce. In hindsight, we believe the markets overreacted to the Fed and it has since made efforts to mitigate the damage. Follow-on comments by several Fed governors are typified by Jeremy Stein's on June 29: "I think it is a mistake to infer from these [market] movements that there must have been an equivalently big change in monetary policy fundamentals." Despite the Fed's backtracking, the damage was done and gold lost $153.35 or 11.0% for the month to close at $1234.57 per ounce.

The Indian government's effort to effectively drive the country's gold trade underground continues. India raised taxes on bullion imports by another 2% (to 8%) and is asking dealers to suspend sales of coins and bars to retail investors in an effort to improve India's trade deficit. We expect this to dampen demand in the second half as consumers adjust to higher transaction costs.

With gold under intense pressure, it should be no surprise that gold stocks were even weaker. The NYSE Arca Gold Miners Index[1] (GDM) fell 17.1%, while the Market Vectors Junior Gold Miners Index[2] (MVGDXJTR) declined 25.7%.

Market Outlook

This is the second time this year gold has failed to hold key support levels. We thought it would hold $1525 per ounce, then we thought it would hold $1350 per ounce. We were wrong on both counts. The gold market seems to be pricing in an outlook that calls for real interest rates rising to normal levels, a firm U.S. dollar, improving economic growth and falling fiscal deficits. This is not our outlook, but if it persists, then we acknowledge gold could trade towards $1000 per ounce.

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.

It is hard to imagine even lower gold prices when the average all-in sustaining cost for the gold industry is around $1050 per ounce. A couple of junior producers have already announced mine closures based on a $1400 price and we expect to see more such announcements. As the price falls, more supply will remain in the ground.

We began the year with a cautious outlook on gold. As the price deteriorated, the portfolio has been refined to reduce exposure to companies that might struggle financially if gold fell below our targets. The average all-in operating cost for the portfolio is around $900 per ounce. The Fund is also overweight in royalty companies, who have no exposure to operating costs. Debt ratios are low, with most of the companies in the portfolio having negative net debt/equity (i.e., net cash positive). We continue to overweight the junior gold stocks, although we have rotated a higher allocation to junior producers with favorable cost profiles. Exposure to junior developers have declined to now include projects that provide adequate returns at current gold prices. While these measures are little comfort in a sector that has seen indiscriminant selling pressure, we believe it positions the Fund favorably once the gold market reestablishes a positive trend.

Market reactions to the Fed's June 19 comments give us a peek into what to expect if and when interest rates trend to normal levels. The resulting sell-off was global and it encompassed every major asset class. The U.S. dollar was the one of the few things that gained on the news. Rising rates would likely restrict the flow of capital to emerging markets. They would hamper the housing market, one of the cornerstones of the U.S. recovery. A May 22 op-ed Wall Street Journal piece by Phil Gramm and Steve McMillin calculates that if rates return to the post-World War II average of 5.9% on the 5-year U.S. Treasury note, the interest cost of federal debt will approach $590 billion, becoming the second largest expenditure behind social security.

The markets are sending contradictory signals. On one hand, gold has collapsed this year on the belief that the Fed can successfully remove years of extraordinary stimulus and restore normal growth. On the other hand, global markets went into a panic in June when the Fed merely suggested that it might scale back its quantitative easing[3] (QE). These opposing outlooks cannot both be correct. In our opinion, we believe the gold market has it wrong. Here's why:

Unfortunately, historically normal economic growth of over 3% and unemployment levels of under 5% may now be unachievable. So many have left the labor force and so many now take government assistance that the level of unemployed could be structural higher than in the past. The 2012 Federal Register[4] (the "bible of regulation") has 78,961 pages. There are 4,062 new regulations at various stages of implementation, of which 224 are deemed "economically significant". Pile on state and local regulations and legal impediments and it is easy to conclude that the regulatory and legal burden has grown to such an extent to materially deter new business development and entrepreneurship.

Meantime, Dodd-Frank financial legislation and Health Care Reform ("Obamacare") will not lessen the burden. We are afraid that 2% might be the new structural limit to GDP growth. Are the Fed's employment and growth targets illusions that enable it to continue current policies indefinitely? Is this why last year's discussion of "exit strategies" have morphed into talk of "tapering" or "dialing back" QE?

While quantitative easing and zero rates have become accepted tools of monetary policy, we don't believe a handful of highly educated economists, or anyone else, have the skills to "fine-tune" the "dials" of the economy as the Fed has implied. The free market system does not work properly unless markets are allowed to clear based on fundamental financial, economic and business criteria. The fundamentals become distorted when the Fed becomes the largest purchaser of mortgage debt and buys enough U.S. Treasuries to equal nearly 70% of the new issuance. Mispricing risk runs high when interest rates are held at artificially low levels for a prolonged period. The government has become such an omnipotent force in the economy that any hint of withdrawal of stimulus wreaks havoc in the markets, while continuation creates further imbalances with unknown consequences. The Fed's market activities have created shortages of relatively safe fixed-income paper and thereby induced investors to take on more risk than they would otherwise. Issuance of high-yield ("junk") bonds hit records in the U.S. and Europe in 2012 with the pace continuing into 2013. Loans with little or no covenants have made a post-crisis comeback. Margin debt reached an all time record in May with new highs in the stock market. The Bank for International Settlements[5] (BIS) recently warned that the most dangerous side effect of the stimulus efforts of central banks is that it takes pressure off governments to overhaul their economies and reduce debt, while delaying necessary reduction of debt in the private sector as well. The Japanese and U.S. governments continue to spend billions more than they take in, while European governments continue to miss deficit targets.

There remain abundant risks to the financial system, but these have failed to drive gold since last December. We believe the gold market is radically oversold, however, it will probably take a catalyst to reestablish a positive trend. It is difficult to speculate on what might catalyze the market and the timing. Possibly the largest driver of the selloff has been redemptions from the gold bullion exchange-traded products (ETP) that began in February and have continued into July. Gold will probably struggle until redemptions subside. That will be a sign that the weak hands, short speculators and reborn gold bears have left the sector, leaving gold to again trade on fundamentals.

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[1]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. [2]Market Vectors Junior Gold Miners Index (MVGDXJTR) is a rules-based, modified market 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. [3]Quantitative easing (QE) is an unconventional monetary policy used by central banks to stimulate the national economy when standard monetary policy has become ineffective. [4]The Federal Register (since March 14, 1936) is the official journal of the federal government of the United States that contains most routine publications and public notices of government agencies. [5]The Bank for International Settlements (BIS) is an international organization of central banks which "fosters international monetary and financial cooperation and serves as a bank for central banks".

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