

Manager Commentary: On the Gold Market

Gold declined \$39.45 in December, ended month at \$1,675.35/ounce

By: Joe Foster, Portfolio Manager

Fund Review

The Fund's Class A shares lost 3.87% for the one-month period ending December 31, 2012 (excluding sales charge), while the NYSE Arca Gold Miners Index (GDM) lost 1.55% for the same period.

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

	1 Mo ¹	1 Yr	5 Yr	10 Yr
Class A: NAV (Inception 2/10/56)	-3.87	-9.61	4.47	15.31
Class A: Maximum 5.75% load	-9.38	-14.79	3.24	14.63
GDM Index	-1.55	-8.46	1.17	--

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

	1 Mo ¹	1 Yr	5 Yr	10 Yr
Class A: NAV (Inception 2/10/56)	12.84	-1.50	9.17	18.87
Class A: Maximum 5.75% load	6.34	-7.18	7.88	18.17
GDM Index	12.03	-1.67	4.67	--

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 declined \$39.45 (2.30%) to end the month at \$1675.35 per ounce. Gold stocks declined with gold, as the NYSE Arca Gold Miners Index¹ fell 1.55% and the Market Vectors Junior Gold Miners Index² fell 5.20%. Two of the drivers of the recent gold bull market have been gold purchases by emerging market central banks and extreme monetary policies from the central banks of industrialized nations. Both were in play in December, with news of recent bullion purchases by the central banks of Russia, South Korea, Brazil and Iraq. Meanwhile, the Federal Reserve Bank (the "Fed") announced at its December 12 Federal Open Market Committee ("FOMC") meeting that, in January, it will begin to purchase \$45 billion worth of U.S. Treasury bonds each month. On December 16, Japan effectively elected--by a landslide--a new Prime Minister who ran on policies calling for unlimited monetary easing and increased public work spending. On December 19, the Bank of Japan (BOJ) increased its asset purchase program by over 10% to ¥101 trillion (\$1.18 trillion). Both the Fed and BOJ will create ("print") money to pay for the purchases. The fact that gold failed to perform well on this news leads us to believe that other potentially temporary year-end factors were weighing on the market. The likelihood of capital gains tax increases in the U.S. may have caused some to sell ahead of the yearend to lock in gold profits at the 2012 tax rates. Also, there could be redemption selling among funds with large gold holdings. In addition, the negative December trend in gold could have been exacerbated by thin year-end markets. If there is indeed a year-end effect at play, gold should bounce back early in the new year.

Gold has now risen for twelve consecutive years. Since 2000, the price of gold has increased by \$1403.10 per ounce and generated an annualized return of 16.33%. During that time, many gold stocks and some gold equity funds have outperformed gold. However, gold equity indices have underperformed gold due to their high weightings in the largest gold companies. For example, since 2000 the Financial Times Gold Mines Index³ (FTGMI) had an annualized return of 12.52%. Over the past two years, most gold stocks, from small to large, have underperformed gold. In 2011, gold gained 10.06% and in 2012 it gained 7.14%. The FTGMI fell 14.93% in 2011 and another 13.86% in 2012. The recent poor performance of gold stocks was caused by rising operating and capital cost inflation and missed expectations. This has led some to believe that the correlation between gold stocks and gold has broken down.

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.

The table below shows that this is not true:

FTGMI vs. Gold Bullion (weekly):	Raw Beta ⁴	R Correlation ⁵
Pre-Crisis: 3/30/01 – 12/31/07	1.449	0.739
Post-Crisis: 10/31/08 – 12/31/12	1.599	0.783
Low Mine Cost Inflation: 10/31/08 – 12/31/10	1.844	0.806
High Mine Cost Inflation: 12/31/10 – 12/31/12	1.275	0.764

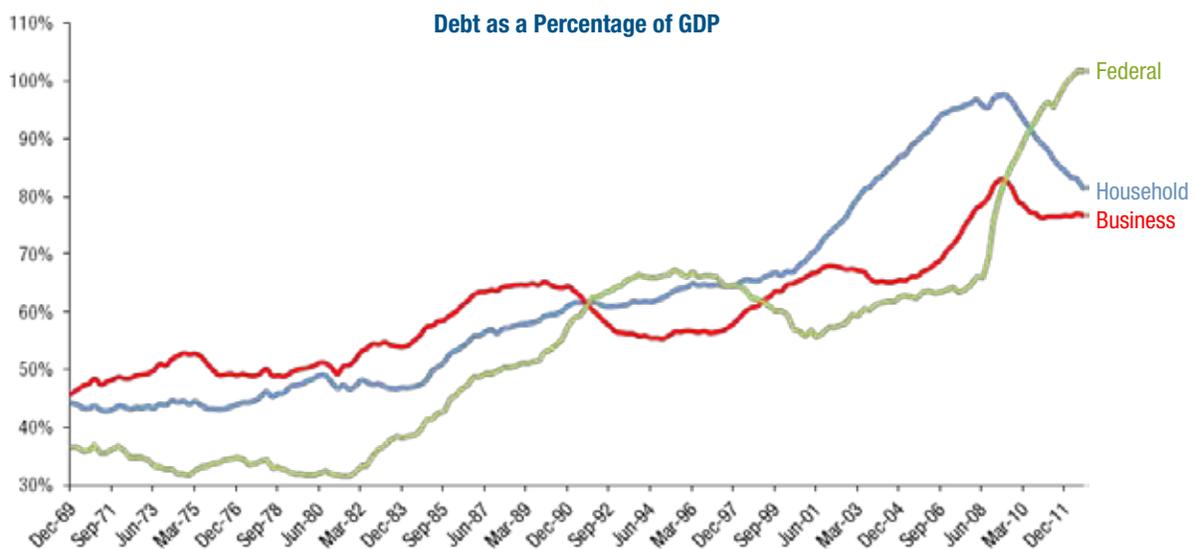
Source: Bloomberg.

The correlation between gold and gold stocks is consistently high throughout the bull market, indicating that on a weekly basis, gold stocks have historically moved in tandem with gold. What has changed is the beta of gold stocks to gold. The beta has been much lower in the past two years than in other periods before or after the financial crisis. This means the stocks are not showing as much leverage to gold. While they are still moving in tandem, they are sometimes falling more than gold in down weeks and underperforming in up weeks. This is important because we believe it suggests that the strong correlation will persist and that once the fundamental reasons for the low beta are removed, the leverage the stocks have shown historically should return. We expect the beta to increase in 2013 as the major companies focus on profits and shareholder returns instead of growth. Also, we believe the escalation in cost inflation will begin to moderate, enabling companies to meet expectations.

Market Outlook

The currency debasement that has been one of the drivers of the gold bull market looks like it will intensify. In September, the Fed decided to purchase \$40 billion per month of mortgage debt, dubbed “QE3” (quantitative easing 3). Now it has added \$45 billion per month of treasury purchases. While the media has not really labeled this as a QE4 event, we will. In fact, we call this “QE4ever”

Source: Federal Reserve



... forever because it appears to be open-ended. The Fed has dropped its time constraints and instead will engage in 0% Fed funds rate targets⁶ until unemployment drops below 6.5% and/or anticipated inflation moves above 2.5%. While unemployment is currently 7.7%, it would be closer to 10% without the decline in the labor participation rate since the credit crisis. Reducing unemployment to 6.5% may take a very long time if some of the 9.7 million people who have dropped out decide to return to the work force. Meanwhile, the Fed’s preferred measure of inflation has rarely been above 2.5% in the past two decades. It is difficult to imagine higher inflation with low wage growth, fiscal austerity, and uncertainty looming over an already weak economy.

Since 2008, the Fed has printed some \$2 trillion in an effort to stimulate the economy, causing its balance sheet to mushroom to \$2.88 trillion. In the coming year, it plans to add another \$1 trillion to its balance sheet through purchases of mortgage debt and U.S. Treasuries. It seems all that extra cash has yet to create much benefit. It is piling up in commercial bank reserves, corporate balance sheets and foreign exchange reserves. It is keeping U.S. Treasury rates low and creating artificial demand for government debt. Cheap and abundant funding weakens incentives for politicians to pursue structural reforms or sound fiscal policies, opting instead for more borrowing and spending, more can-kicking and fiscal cliffs, and more financial uncertainty. The chart below shows how this era of quantitative easing has coincided with an explosion in the federal debt/GDP ratio, while at the same time household balance sheets are returning to health.

Each dollar created gets borrowed, spent, saved and borrowed again. This turnover of dollars through the financial system is monetary “velocity”. The trillions of dollars being printed have few consequences so long as households are paying down debt and increasing savings. Consumer spending remains subdued and businesses are reluctant to invest capital.

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In this environment, the following chart shows the current M2 velocity⁷ is at extremely low levels.

M2 Velocity (M2/GDP)



Source: Federal Reserve

Eventually, hopefully within the next several years, if oil and gas prices remain at current levels, the housing market improves, consumer spending picks up and businesses regain confidence; perhaps the economy will enter a sustainable period of healthy growth. At that point, the Fed will sense a need to raise rates and begin withdrawing money from the system. Will the Fed have the courage to raise rates on an economy that has been starved of meaningful growth for so long? If and when the Fed raises rates, will politicians acquiesce to escalating interest payments that drive the deficit higher? Will there be a sufficient market for Treasuries without the Fed's buying?

When growth returns and credit markets start functioning normally again, the velocity of money will likely pick up. This can be seen in the M2 Velocity chart during the economic expansions in the early/mid nineties and the period from 2003 to 2008. Each of these expansions were accompanied by accommodative monetary policies. Each ended in historic asset bubbles in tech stocks and housing. Given its record, there is the risk that the Fed again maintains accommodative policies during the next expansion.

Layer upon this the trillions of recently created dollars that are now pent-up in the system. The effect this money has on the economy gets magnified as velocity increases. We are afraid there is too much money in the system and too few goods, too few assets, too few good investments relative to the amount of money available. This is a recipe for inflation in asset prices, consumer prices, or both on a scale that might make the housing bubble look tame. While this is a hypothetical scenario, we believe it nonetheless has a probability that is high enough for investors to diversify their portfolios with an allocation to gold and gold shares as hedges against inflation, financial stress and currency turmoil.

A Note from Joe Foster, January 9, 2013: We continue to promote gold stocks as radically undervalued, however, Q3 2012 reporting season and early Q4 2012 reporting and guidance indicates the gold mining industry continues to struggle to meet expectations.

As we believe it could take another six months for the industry to align with expectations, we have established an 8% position in physical gold in the International Investors Gold Fund.

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Any indices listed are unmanaged indices and include the reinvestment of all dividends, but do not reflect the payment of transaction costs, advisory fees or expenses that are associated with an investment in the Fund. An index's performance is not illustrative of the Fund's performance. Indices are not securities in which investments can be made.

¹NYSE 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 capitalization-weighted index comprised of publicly traded companies

²Market Vectors Junior Gold Miners Index (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.

³Financial Times Gold Mines Index (FTGMI) is a market capitalization-weighted global index of gold-mining shares.

⁴Raw beta: volatility measure of the percentage price change of the security given a one percent change in a representative market index. The beta value is determined by comparing the price movements of the security and the representative market index for the past two years of weekly data. Actual Beta = Raw Beta +/- the standard error.

⁵R Correlation: correlation coefficient measures the relationship between two variables for the historical period you select. A correlation's measure is always between -1 and 1. A positive correlation indicates that the two securities move in tandem with each other. A negative correlation indicates that the two securities move inversely of each other. A correlation of zero indicates that the two variables have no correlation.

⁶Federal funds rate is the interest rate at which depository institutions actively trade balances held at the Federal Reserve, called federal funds, with each other, usually overnight, on an uncollateralized basis. Institutions with surplus balances in their accounts lend those balances to institutions in need of larger balances. The Federal funds target rate is determined by a meeting of the members of the Federal Open Market Committee which normally occurs eight times a year about seven weeks apart.

⁷M2 Velocity: M2 is currency in circulation plus savings accounts and non-interest bearing bank accounts. The turnover of dollars through the financial system is monetary "velocity".

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