Where's the Beef for Gold Equities?

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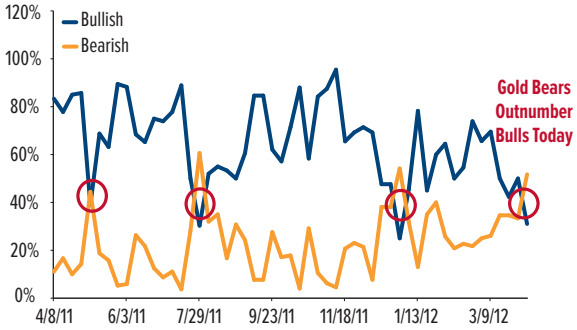
Gold bulls have plenty of room to graze in the stockyard these days as the investing herd migrated to other assets during the market's steep climb in 2012. For the fourth time in the past year, gold bears outnumbered the bulls in Bloomberg's weekly Gold Bull/Bear Sentiment Survey. In fact, the bears had the bulls outnumbered by almost 2-to-1.

Today's growing sloth of gold bears is a "buy" signal for contrarian investors like us at U.S. Global. Research from the gold team at Canaccord Genuity found that gold rallied about 10 percent on average during the month following each of these sentiment "cross-overs." This historical increase means that gold could potentially rally to the "high $1,700's per ounce," which Canaccord believes "would breathe some new life into the gold equities."

After a year of neglect from investors who favored bullion, gold equities need resuscitation. Going back to April of last year, gold stocks have been undervalued compared to bullion. I discussed this disconnect back in June 2011 (***Will Gold Equity Investors Strike Gold?***) and again in August (***Valuation Gap Makes Gold Miners Attractive, but All Miners Aren't Created Equal***).

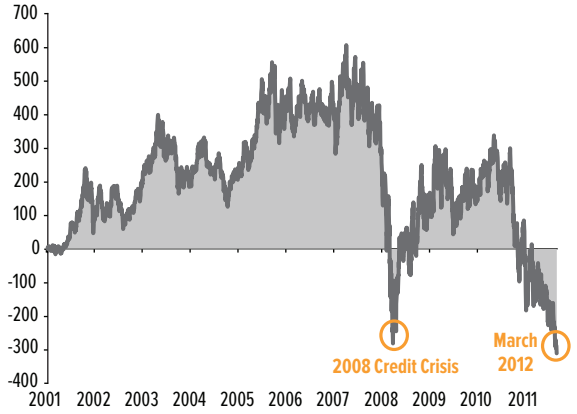
This trend has been accelerating recently: At the end of March, the spread between the NYSE Arca Gold Miners Index and gold bullion was at the same

Contrarian Sign that Gold May Be Headed Higher
The Bloomberg Gold Bull/Bear Sentiment Indicator Weekly Results



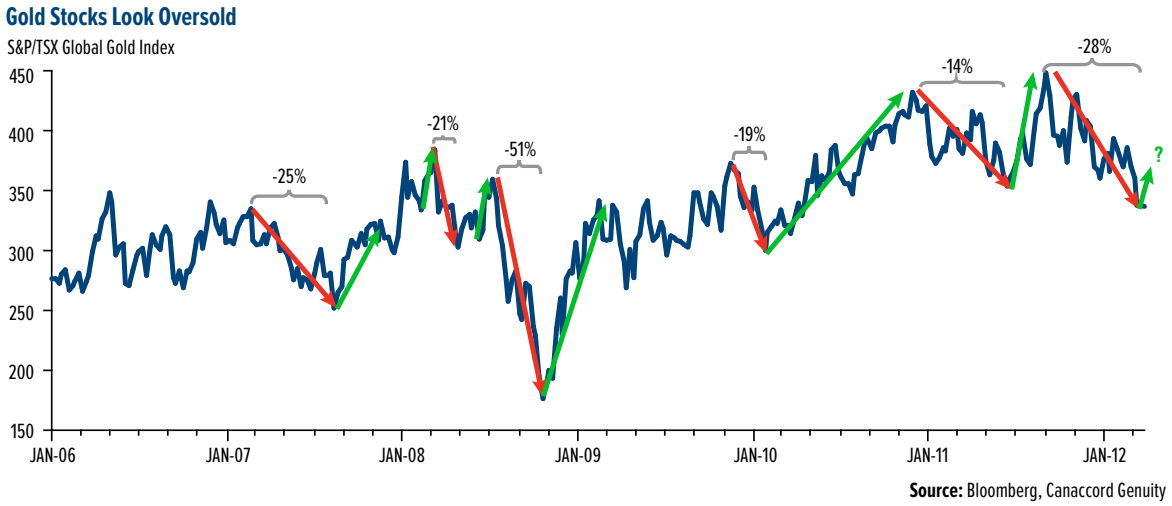
Source: Bloomberg

Spread Between NYSE Arca Gold Miners Index and Spot Gold



Source: Bloomberg

Gold investors must be quick to "buy on the dips" since these sharp V-shaped corrections have been frequent.



Source: Bloomberg, Canaccord Genuity

extreme level it was during the 2008 credit crisis despite a much rosier global economic outlook. Going back the full decade of gold's bull run, this is quite a rare event.

It hasn't been a complete drought for gold equity investors though, as there have been occasional spurts of relief over the past year. From the beginning of 2011 through the middle of the year, the S&P/TSX Global Gold Index declined by 14 percent. The index then quickly reversed course upward during the market's volatile period last fall. Now, the index has been declining for four months now, dropping 28 percent, while gold bullion has only fallen 9 percent over that same time period, says Canaccord.

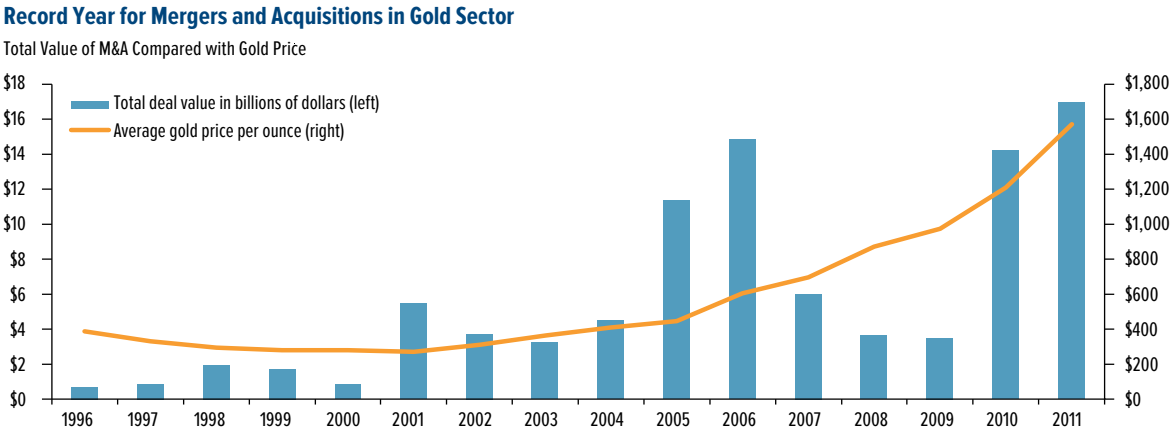
Believe it or not, the four-month selloff is a bullish sign for gold stocks. If you expand your time horizon, you'll see each dip has been a turning point for gold stocks. Canaccord says that, "sector weakness (less than one year) in the gold equities over the last six years has typically ended with "V" shaped corrections to the upside." Gold investors must be quick to "buy on the dips" since these sharp V-shaped corrections have been frequent.

The Stampede to Buy Undervalued Gold Miners

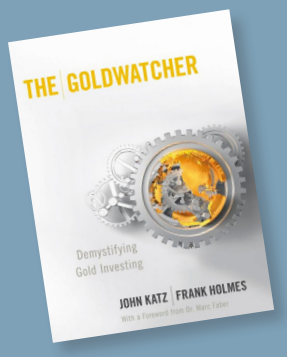
If you plan on shopping for bargains in the gold miner department, you're going to have to fight a crowd. Numerous global investors have been pounding the table for gold stocks, including Dr. Marc Faber who said "gold shares have become extremely oversold and could rebound in the next few days" in his April market commentary and Global Portfolio Strategist Don Coxe, who reiterated that gold equities are undervalued compared to the precious metal on his weekly conference call last Friday.

Another big buyer has been the miners themselves. Mergers and acquisitions in the mining sector have been at an all-time high over the past two years. Large gold miners such as Barrick, Goldcorp and Kinross have been taking advantage of these cheap valuations by snatching up small miners with proven deposits.

And they've been willing to pay a premium too. According to Desjardins Capital Markets, over 2010 and 2011, a total of 26 mergers and acquisitions have taken place to the tune of more than $30 billion. In this time period, the buyout or purchasing premium has averaged more than 40 percent.



Source: Desjardins Capital Markets, Bloomberg, company reports



If you're curious about this phenomenon and want to learn more, check out my book ***The Goldwatcher: Demystifying Gold Investing*** where I go into greater detail.

Desjardins says the M&A trend in the gold sector should continue, given "growing cash hoards and a lack of new discoveries" of the precious metal. As one example of this ongoing worldwide trend, Bloomberg News reported that, "Chinese gold producers are vying for domestic and overseas mining resources," with two companies competing for two different gold mining companies located in the eastern province of Shandong.

Big miners have historically purchased the known assets of their rivals as a way to increase reserves rather than deal with the heartache and headache of drilling core samples and filling out permit applications. Large-scale gold production is a complex and costly process involving digging, transporting, crushing and chemically treating massive quantities of rock to get at small amounts of gold. In fact, a commercially viable deposit could contain just a tiny fraction of an ounce of gold for every ton of mined rock. If you're curious about this phenomenon and want to learn more, check out my book ***The Goldwatcher: Demystifying Gold Investing*** where I go into greater detail.

With the signals there for a bounce and stocks undervalued, what's stopping investors from buying gold equities? One reason could be margin pressure. Rising energy costs, reduced supply and currency swings can quickly erase a gold company's margin.

It takes a great deal of diesel fuel to run the shovels and dump trucks that haul ore to the mill for processing and rising energy costs can affect the profitability of a mine substantially. These variables are the project's cash costs, or how much capital must be spent to pull an ounce of gold out of the ground.

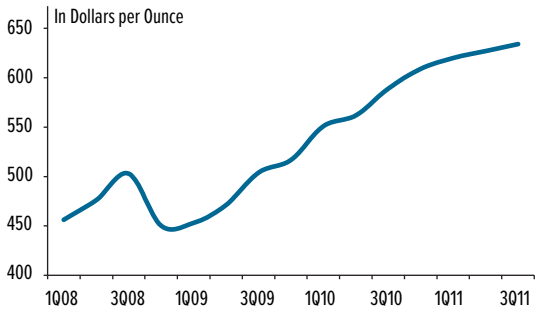
From the first quarter of 2008 through the third quarter of 2011, the global average cash cost has been rising for miners at a rate of about 8 percent year-over-year. Desjardins says costs will "likely remain under pressure, especially on the energy and labor fronts."

However, as Desjardins points out, at the level that gold is at now, "most producers will be generating significant cash flow and earnings," using this cash to fund takeovers, build out development pipelines and pay higher dividends.

Another barrier for investors could be perceived volatility. On Bloomberg Radio, I explained to host Kathleen Hays how gold's 12-month rolling volatility is very different from the way it's perceived. While the normal volatility for the S&P 500 Index is up or down 19 percent over a 12-month period, it's only 13 percent for gold bullion.

My friend and CIBC analyst, Barry Cooper heard my Bloomberg interview and emailed me the chart below showing how the TSX Global Gold Index ETF/Gold Price Ratio has historically been negatively correlated with gold's volatility. Two times over the past four years, when gold price volatility was falling, it was generally associated with rising valuations of the TSX Global Gold Index ETF. Today it's a different story: Gold's volatility and value are both going down. According to Barry, "either we are in a totally new regime for gold shares or something has to give."

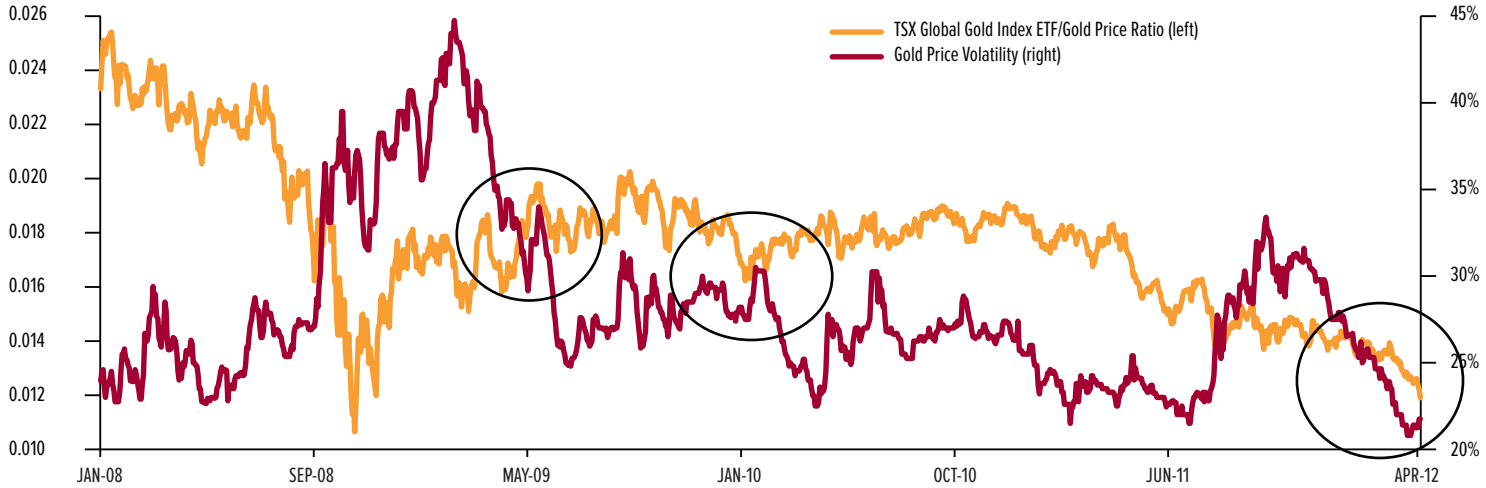
Average Cash Cost for Gold Miners Increasing Around the Globe



Source: VM Group, Halliburton Mineral Services, GFMS

Falling Volatility Generally Associated with Rising Valuations

Volatility of Gold Compared with TSX Global Gold Index ETF



Source: CIBC

To read more of Frank's insights, follow his blog **"Frank Talk"** at **www.usfunds.com/franktalk**. You can also sign up to be notified when a new entry has been posted at **http://www.usfunds.com/subscribe/FTSubscribe.cfm.**

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The cold shoulder from investors has also given way to a promising trend in the gold space—growing dividend payouts. We believe this is one can't-miss trend. We've been paying close attention to this as it has developed over the past few years, because through monthly or quarterly dividends, investors can receive income while they wait for share prices to appreciate. To capture the income potential, we've adjusted the portfolios of ***USERX*** and ***UNWPX*** to hold some of these dividend-payers. Many of these holdings pay a monthly dividend that is higher than the two-year government note, have rich balance sheets and receive royalties from all over the world on their gold mines.

We encourage investors to think contrarian: Eat up all you can while the pasture is wide open, because as the chart above shows, when gold equities reverse, it happens quickly.

Watch Frank Holmes' "Can Gold Continue to Glitter?" interview on CNBC now.

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The Bloomberg Gold Bear/Bull Sentiment Indicator charts the percent of respondents in a weekly Bloomberg News survey of traders, investors, and analysts predicting gold prices will rise the following week. The number of participants in the survey, which is completed every Friday, may vary. The NYSE Arca Gold Miners Index is a modified market capitalization weighted index comprised of publicly traded companies involved primarily in the mining for gold and silver. The S&P/TSX Global Gold Index is an international benchmark tracking the world's leading gold companies with the intent to provide an investable representative index of publicly-traded international gold companies.

Holdings as a percentage of net assets as of 03/31/12: Barrick Gold Corp (Gold and Precious Metals Fund, 3.89%; World Precious Minerals Fund, 0.81%); Goldcorp (Gold and Precious Metals Fund, 4.89%; World Precious Minerals Fund, 2.19%); Kinross Gold Corp (Gold and Precious Metals Fund, 1.27%; World Precious Minerals Fund, 1.05%; Global Resources Fund, 1.59%); TSX Global Gold Index ETF: 0.0%. 12-274