LOOKING FOR A SPRING IN GOLD THIS FALL

Gold equities have declined more strongly than bullion

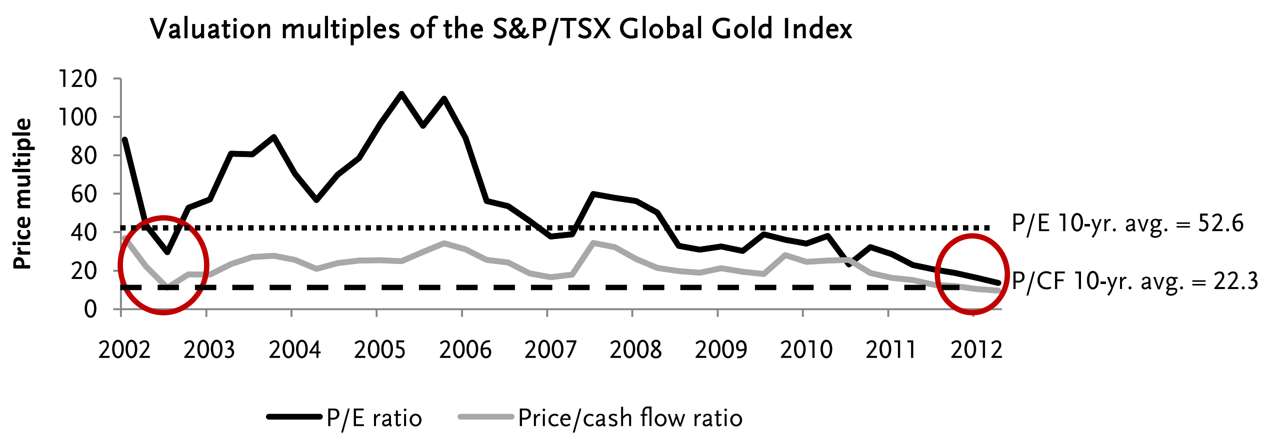
Gold equities have significantly underperformed bullion in recent months amid significant global risk aversion, brought on in part by the debt problems plaguing Europe, a distant political solution and a backdrop of a slowing global economy. This has caused high volatility across global equity markets, in turn causing investors to flee. According to Ani Markova, the portfolio manager of the AGF Precious Metals Fund, nowhere has this flight out of markets or to less-risky assets been more prominent than the resources sector.

The HUI index, a modified equal-dollar-weighted index of major gold mining companies, has experienced a precipitous decline of more than 40% from its high set in September 2011. Contrast this against the 19% decline seen in gold bullion. Equities have declined substantially compared to bullion – by more than double.

	HUI Index (US$)	Gold bullion (US$/oz)
High set in Sept. 2011	635	1,900
Low set in May 2012	376	1,540
Decline from high to low	**40%**	**19%**

Source: Bloomberg as at June 30, 2012.

Although investors are often cautioned to look beyond short-term performance and invest for the long term, this decline should not be ignored. A significant opportunity has been created as a result of the global state of affairs: the divergence between gold bullion and gold equity performance. This has resulted in extremely compelling valuations for the S&P/TSX Global Gold Index, which has not been valued this cheaply for many years, even during the last significant contraction in multiples a decade ago. The price-to-cash-flow multiple is currently 9.6X while its 10-year average is 22.3X, and the price-to-earnings multiple is currently at 13.6X while its 10-year average is 52.6X.



Source: Bloomberg, as of June 30, 2012.

Gold equities have outperformed after historical declines in gold bullion prices

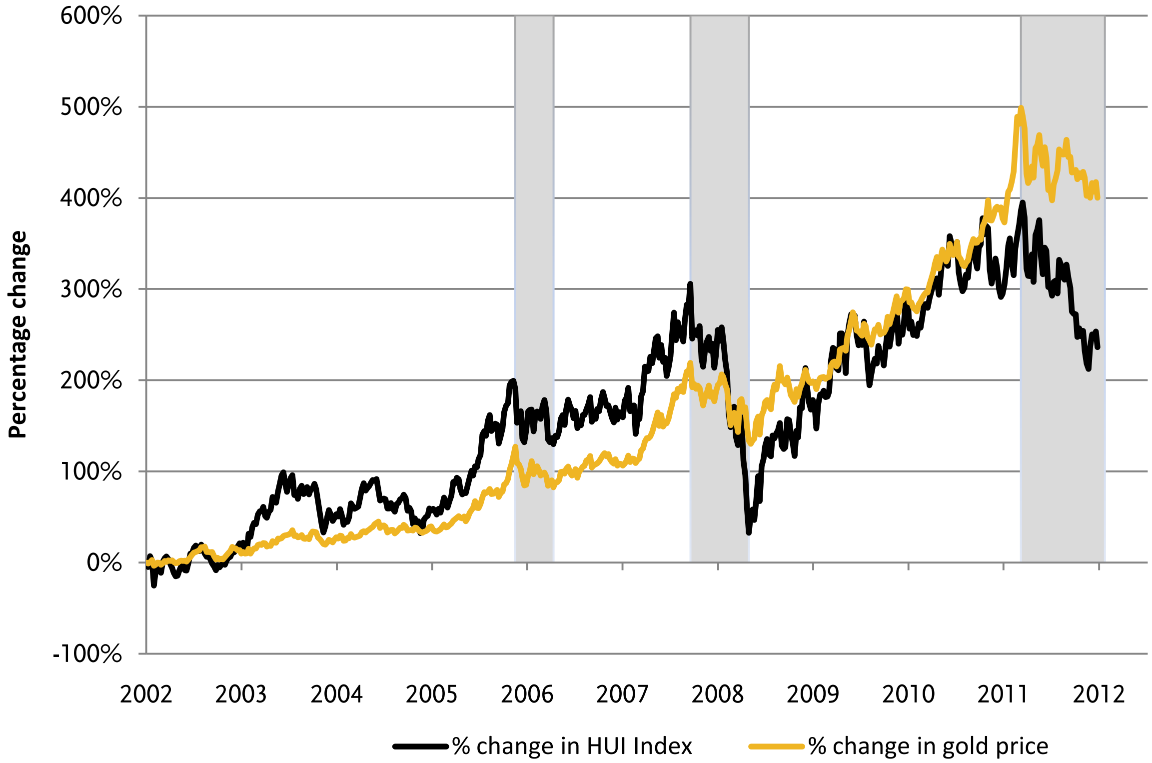
	Select performance from graph below	
	Gold bullion	Gold equities
May 2006-Oct. 2006	-23%	-21%
Oct. 2006-Mar. 2008	**79%**	**76%**
Mar. 2008-Oct. 2008	-29%	-67%
Oct. 2008-Sep. 2011	**163%**	**266%**
Sep. 2011-June 2012	-17%	-31%
June 2012 onwards	**?**	**?**

Source: Bloomberg as of June 30, 2012.

Gold equities have declined considerably during each significant contraction in bullion prices, only to rebound strongly in the period after. As can be seen in this performance table, which identifies the contractionary periods shown in the chart below, gold equity performance was outstanding after significant declines in gold equity prices. While it is possible the decline in gold bullion could continue in the short term, this could eventually set gold equities up for a much stronger rebound.

10-year performance of gold compared to gold equities

Measured by the HUI Index (the NYSE Arca Gold BUGS Index, a modified equal-dollar-weighted index of major gold mining companies.)



Sources: Bloomberg as of June 30, 2012; Dundee Capital Markets as of June 28, 2012.

Gold equities to outperform when bullion catches the bid

Why have gold equities underperformed so significantly? One of the reasons is tied to the risk aversion and flight to liquidity afflicting investors. Furthermore, overall, companies have disappointed with the lack of free cash flow, operational misses and capex overruns. For example, Barrick Gold Corp. and Goldcorp Inc. both disappointed with their recent quarterly results, and Barrick announced a massive capital overrun at its Pascua-Lama development project to about $8 billion, which is about 60% higher than previous estimates.[i] One of the recurring themes affecting these companies as well as the broader industry is the rising cost of production and increased capital needs for growth.

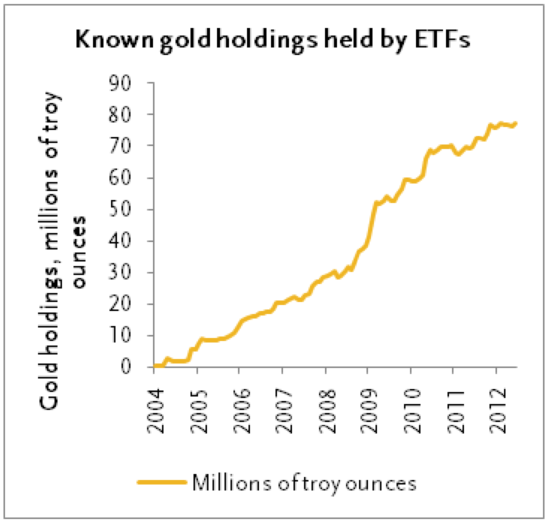
Senior gold producers have seen their average gold cash costs roughly double in the last five years.[ii] However, since gold prices are slightly above US$1,600 per ounce, and marginal cost of production is approximately US$1,550 per ounce, this does not leave significant room to generate excess profits.[iii] This has weighed heavily on junior mining companies that have not yet begun production or are awaiting financing of their capital projects and thus they would not be able to economically profit from mining at current prices.

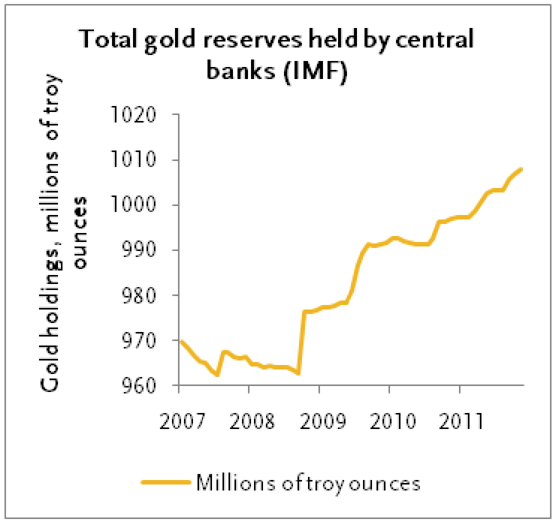
AGF believes that when the gold price resumes its upward momentum, gold companies will finally be able to show the free cash flow leverage, as management teams today are focused on cost controls and deferral of marginal projects. To name a few, BHP Billiton Ltd. announced deferral of its Olympic Dam expansion, Barrick advised it had shelved Cerro Casale and Donlin Gold as they no longer met investment criteria, and Kinross Gold Corp. stated it would defer expansion and consider scaling down Tasiast, its fully-owned gold mine located in Mauritania (in its 2012 second quarter report dated August 8, 2012). With better capital discipline and growing dividends, equity valuation multiples could expand significantly from currently suppressed levels, potentially rewarding investors who are able to take advantage of the current divergence between gold bullion and gold equities.

Other strong reasons for bullion outperformance

The quantitative easing that has occurred in global markets to stave off economic recessions has caused the monetary supply to expand significantly. The U.S. Federal Reserve's M1 money supply, a measure of the U.S. money supply which includes only currency and chequable deposits, has increased dramatically to approximately US$2.3 trillion, from US$1.4 trillion five years ago. This would imply a compounded growth rate exceeding 9% in the M1 alone.[iv] This growth in the money supply is likely to continue as the U.S. economic recovery remains muted amid weaker-than-expected economic data. Manufacturing activity unexpectedly contracted in June, and high unemployment continues to pervade the economy. These indicators likely point to an upcoming QE3, the third round of quantitative easing. AGF believes that the pervasive inflation of the monetary supply will eventually pass through to bullion prices.

The demand for gold has continued to rise as holdings by exchange-traded funds (ETFs) continue to increase from an insignificant level a decade ago to holdings in excess of 70 million troy ounces, and does not look likely to slow anytime soon. Investors clearly believe in gold as a wealth preservation tool. Central bank holdings of gold have also risen strongly in recent years, as the sovereign debt crises continue to place further uncertainty on the true value of government debt and fiat currency deposits (deposits not backed by physical assets). Both are key demand drivers.



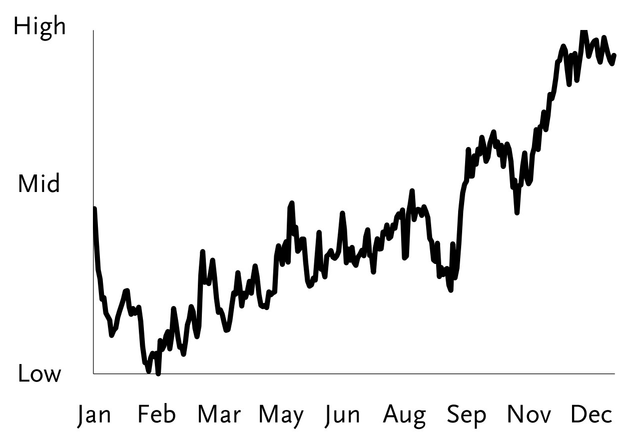


Source: Bloomberg, as at June 30, 2012.

Another key factor to take into account is the outperformance of gold bullion after federal elections in the United States. History shows that despite underperformance prior to and during elections, bullion prices have made strong gains post-election.

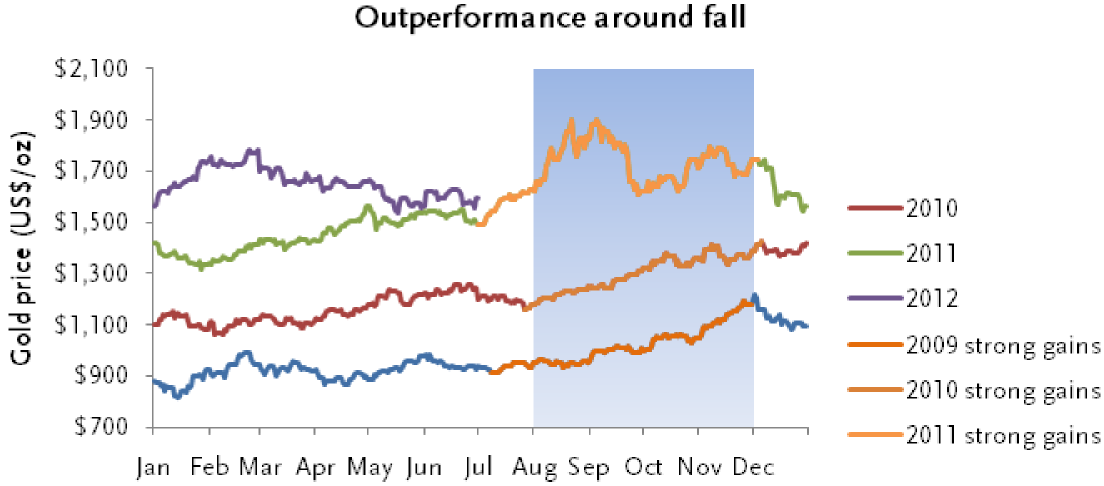
Gold bullion performance in U.S. federal election years (1984-2008)

Gold bullion performance in post U.S. federal election years (1985-2009)



Sources: CIBC World Markets, Bloomberg as at January 2010. (Average of seven elections since 1984)
High, mid and low prices illustrate the relative change in prices each year, averaged over the seven elections.

Traditionally, roughly around the fall season there has been a period of outperformance in bullion prices, as can be seen from the chart below. If history repeats itself, it could well be the case that bullion prices could spring back this fall, and if they do, gold equities could strongly outperform.



Source: Bloomberg, as at June 30, 2012.

In addition to all these factors supporting a positive rebound in gold bullion prices, there is one more key factor that may increase the relevance of this opportunity. India, one of the world's largest consumers of gold (for jewellery), has been out of the bullion market for the better part of this year, especially with the advent of the jewellers' strike on the back of tax increases for gold imports. Discretionary spending in the country has deteriorated because of inflation eating into real wages and currency depreciation making gold less affordable.[v] In the meantime, China has picked up some of the slack in demand. When demand resumes from India, bullion prices could surge even further.

Outlook

The portfolio manager will be keeping an eye out this fall for a large spring in bullion prices. History has shown us that fall has been the best time for gold bullion outperformance, as valuation multiples are at all-time lows and after strong bullion price declines come the most pronounced periods of gold equity outperformance. This is also complemented by the historical track record of bullion performance after U.S. federal elections, which could translate into an even greater showing for gold equities into 2013.

Compelling fundamental factors look positive for bullion, including the increase in demand for gold from ETFs and central banks. As we can see from the continued growth in ETF holdings of bullion, wealth preservation is an important goal for investors in these unsettled times. Because of shifting global markets, this environment creates opportunities in precious metals. The fundamentals, which include the European crisis, instability in the Middle East, consumer de-leveraging, continued government stimulus and money supply expansion in pursuit of economic growth, lead us to believe that this sector will perform well in an environment of low or negative real interest rates, and will help protect investors' wealth in the face of these factors.

While we are aware that negativity is a source of depressed valuations in the equity space, the manager will attempt to mitigate risk by remaining focused on companies that can generate cash flow and have strong balance sheets and capable management. Among the junior mining companies, we are focused on companies that are close to the production stage or have assets that could become producing mines. The industry needs strong prices for the supply to continue to at least maintain current production levels at the time when demand outstrips supply driven by investors and central bankers.

We believe that there is a significant opportunity to capitalize in the precious metals space if a rally in bullion prices takes place this fall. The historical overreaction of gold equities to a decline in bullion prices lends to our optimism that it is just a matter of time before history repeats itself, and astute investors would do well to take advantage of the opportunity presented to them.

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[i] Sources: Bloomberg, as at July 26, 2012; Credit Suisse; Scotiabank.

[ii] Source: Bloomberg, as at July 26, 2012.

[iii] Source: AGF analyst estimates, July 31, 2012.

[iv] Source: Bloomberg, as at July 25, 2012.

[v] Source: Reuters India, as at August 6, 2012.