Shareholder Report

2011 Vol. 2

Moving at the Speed of China

Inside: Asian Tiger Sinks Teeth Into Gold | Where Wealth Lives

Dear Shareholder,

We are experiencing China's true Great Leap Forward…American style.




At an incredibly fast pace, China has been linking the country by high speed rail. The inaugural line between Beijing and Tianjin made its first trip only three years ago, in 2008. Since then, the country has set more than 4,600 miles of new tracks, three times longer than the railways in Japan, the birthplace of the bullet train.

The millions of residents and tourists expected to climb aboard this high-tech transportation system will travel at speeds that exceed 250 miles per hour, shortening their trips considerably.

China Pushes the Pedal to the Metal

Another rapid development has been the automobile market. In recent years, China's middle class has fueled a booming demand for cars. Motor vehicle ownership across China increased from less than 1 percent to 13 percent over the past 10 years.

Hold on to your seats as the car ownership rate is set to accelerate even more quickly. Take a look at the S-Curve plotting considerable differences in vehicle penetration across several emerging and developed countries. Whereas U.S. car ownership has peaked, the progression for China is only just beginning and even lagging other similarly populated countries, such as Thailand. Currently, there are only about 3.5 vehicles for every 100 Chinese citizens.

China's total vehicle sales reached 18 million in 2010—up nearly 900 percent since 2000—and research group ISI expects 30 million cars will be sold by 2015. Many of these will most likely be made by U.S.-based companies. According to *Time*, the Buick Excelle is the most popular car sold in China today. The U.S. appears to be exporting the "American Dream."

A dream-come-true for China's richest residents may be their own private jets, complete with karaoke equipment. Since the government relaxed airspace restrictions, private jet sales in the country have soared. According to the *Wall Street Journal*, 90 private jets were registered in China during the first four months of 2011, up "from essentially none a decade ago."

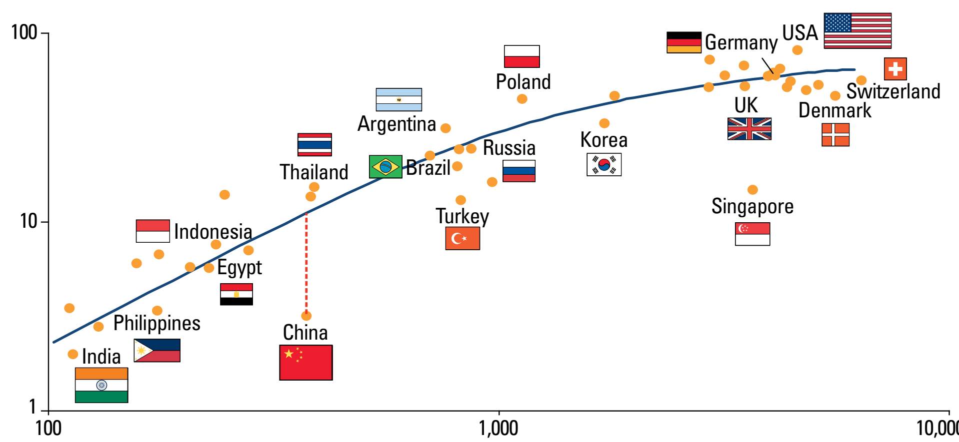
The True Great Leap Forward

We believe this growing infrastructure and the accompanying consumption of planes, trains and automobiles has already lapped America's growth following the construction of the Interstate Highway System.

During the time the boomers were babies and McDonald's had only a dozen restaurants, President Dwight D. Eisenhower signed the 1956 Federal-Aid Highway Act. The "great road program" was said to be the most intense road construction period in U.S. history, altering where Americans lived, how they vacationed and where they chose to work. A 62-day trip in 1919 from Washington D.C. to San Francisco was reduced to two days due to the U.S. interstate system.

Government Policies are in Place to Capture the American Dream

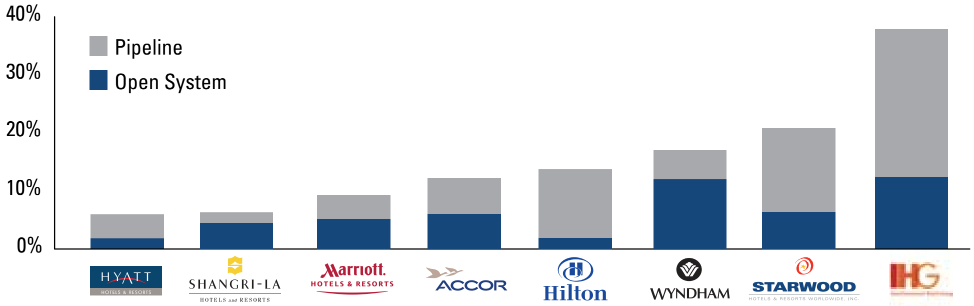
Motor vehicles per 100 people against GDP per capita



Source: World Bank

Race to Participate in China's Epic Build-Out

Hotels' Current Market Share and Pipeline



Source: Morgan Stanley Research

Paved roads stretched from coast to coast and throughout America's Heartland, helping to sustain a more than tenfold increase in the U.S. GDP, according to the Department of Transportation.

But America's experience is a leisure Sunday drive compared to China. The U.S. connected 160 million people with nearly 47,000 miles of freeways; by 2020, China will connect 700 million people across 250 cities, spanning more than 47,000 miles of interstate and 18,000 miles of rail.

The effect this infrastructure investment has on world commodities is substantial. China will need an enormous amount of material for thousands of miles of new tracks and highways, hundreds of new stations, and dozens of new trains and automobiles. But there's also an important corollary effect that seems to be transforming China's economy. More people with more money who will be traveling across the country means there will need to be more places for them to eat, sleep and shop.

Companies Compete for China Share

Currently, the U.S. has just fewer than 5 million hotel rooms spread across the country; China has about half that amount. Morgan Stanley forecasts that the two countries are set to switch places near 2025 as China pushes to offer more than 9 million hotel rooms by 2039. Familiar names to Americans, including Wyndham, Starwood and Hilton, are planning major additions to their pipelines in China.

Morgan Stanley says that the high speed rail expansion presents opportunities in areas such as consumer staples, car rentals and tourism. The latter is especially important because the average Chinese citizen is going to be able to explore culturally rich areas of the country that were previously too difficult or expensive to visit. A poll from CLSA's China Reality Research last year showed that travel remained a top aspiration for many citizens.

Rail passenger traffic has a strong correlation with instant noodle consumption (79 percent positive correlation) and soft drink volume (86 percent positive correlation), according to Morgan Stanley. This means that American chains such as McDonald's (1,300 stores in China) and KFC (4,000 stores in China), both of which are largely concentrated in the eastern third of the country, will likely follow the high speed tracks into Central and Western China. According to Bloomberg News, to compete with KFC, McDonald's plans to open as many as 200 additional stores in China in 2011 alone.

China's desire for luxury products is growing as well. Cartier, Gucci, Louis Vuitton and Hermes are not only available in Shanghai, Beijing, Guangzhou and Shenzhen—all key financial, political and manufacturing centers in the eastern part of the country—but the demand extends to second- and third-tier cities in the Chinese hinterlands. Chinese residents who live as far west as Urumqi in the oil-producing Xinjiang region, south to industrial Kunming in Yunnan province and up to the trading center of Harbin in the northeast corner have access to these luxury goods.

Your Behind-the-Scenes Access

Our investment team follows these dynamics and their effects on the world through our research and several on-site trips each year. In 2011, these worldwide trips have spanned thousands of miles across 18 countries and 10 U.S. states. As investors, it's important to combine on-the-ground tacit knowledge to what we already know from balance sheets, cash flow statements and valuations against peers. We believe this is what differentiates U.S. Global and has allowed us to create alpha for shareholders.

Sincerely,

Frank Holmes

CEO and Chief Investment Officer
U.S. Global Investors, Inc.

The security mentioned, Shangri-La Asia, was held by one or more of U.S. Global Investors Funds as of 3/31/11. A fund's alpha is the excess return of the fund relative to the return of the benchmark index. The S-Curve is a type of curve that shows a rapid, exponential increase in growth for a period of time, followed by a tapering or leveling off.

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Check out the video of Portfolio Manager Evan Smith's visit to China.

China's Luxury Market is Expected to Become the World's Largest by 2020

Source: CLSA, James Lang LaSalle Research

Where Wealth Lives

Most middle-class households today live in developed countries, but a growing number of people in the emerging world are enjoying a lifestyle with discretionary income.

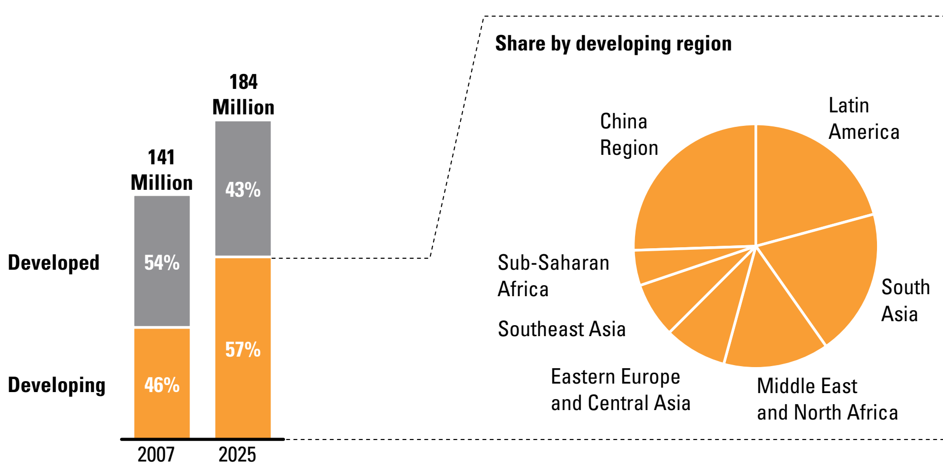
Middle-class, affluent, bourgeois, white-collar ... they all describe a group of people who enjoy a comfortable life, have access to healthcare and, most importantly, have a purchasing power beyond necessity, which we believe is essential for consumption, growth and the development of many cities.

Across 600 of the largest cities in the world, nearly 140 million more households will be considered middle class between 2007 and 2025, according to McKinsey Global Institute. Of these, 120 million will call a developing country their home. This number is larger than the combined middle class in the U.S., Canada and Western Europe today.

The future global youth will be raised primarily in these emerging markets. As shown below, by 2025, the developing region will likely account for almost 60 percent of middle-class children under the age of 15.

These families, living in places such as China, Latin America and South Asia, should be the driving force behind demand for goods and services, housing and transportation that extend beyond the basic necessities of life. Their extra spending cash might be used to buy their first vehicle or upgrade their home, furnishing it with new appliances and the latest technology. For years to come, these middle and affluent classes should be contributing members of the ongoing and expected substantial economic growth in emerging markets.

Middle-Class Global Youth of Tomorrow



Assumes population distribution across income segments is identical to household distribution across segments. Total population aged <15 in households with annual income above $20,000 at purchasing power parity across the 600 largest cities. **Source:** McKinsey Global Institute Cityscope 1.0

Millionaire Row Just Got Longer

More than half of the newest billionaires reside in a BRIC nation, according to *Forbes'* 2011 list of billionaires. Out of 214 added this year, 108 billionaires live in Brazil, Russia, India and China. China now ranks second only to the U.S. in having the most billionaires in the world, but the richest person of all lives just south of the U.S. border. Mexican telecom tycoon and entrepreneur Carlos Slim Helú is worth $74 billion, far ahead of Bill Gates and Warren Buffett, according to *Forbes*.

The trend of growing wealth in emerging markets is set to continue at an accelerated pace. Deloitte estimates that the number of millionaire households in emerging nations should grow at a rate of 260 percent versus 107 percent in developed countries over the next nine years. Among emerging markets that Deloitte studied, the number of millionaire households in Brazil, South Korea and Malaysia is estimated to grow the fastest.

In terms of the highest proportion of millionaire households among an entire developing country population, Hong Kong and Singapore are expected to take the lead by 2020.

Global investors pay attention to those on "Millionaire Row" for good reason: As *Forbes* puts it, "these moguls have the power to shape our world."

These ultra-rich are investing in businesses or exerting their monetary power on government policies. Others are promoting social change, such as The Giving Pledge, created by Gates and Buffett, to encourage philanthropy among the well-heeled.

Asian Tiger Sinks Teeth Into Gold

The allure of gold drew China to consume a record level in 2010. China's demand for gold jewelry, bars and coins was so strong it outpaced the combined jewelry, bar and coin demand from France, Germany, Italy, Switzerland, the U.K., the U.S. and other European countries. That's despite triple-digit increases in demand from France, Germany and Switzerland, according to the World Gold Council (WGC).

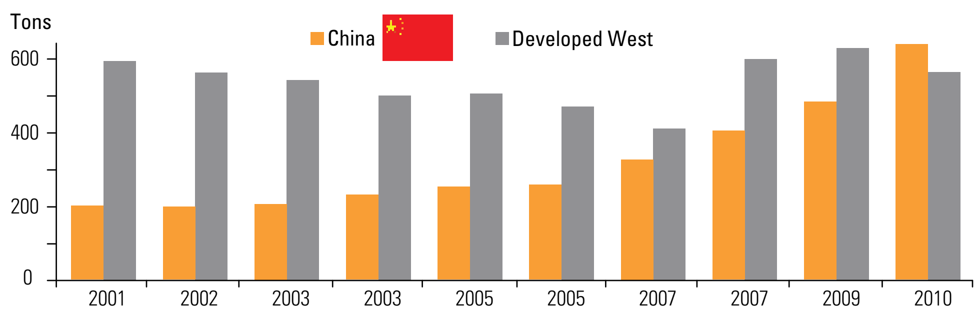
China's attraction to gold is neither a new phenomenon nor a one-time occurrence. Jewelry demand from the country has doubled in the last seven years according to the WGC. Also, from 2007 to 2010, investment demand grew at a compounded annual growth rate of 68 percent, according to commodities researcher CPM Group. The firm had forecasted Chinese investment demand to increase 34.7 percent during 2011 but it may need to adjust its forecast based on the recent growth rate.

The rise in consumption along with higher gold prices coincided with increasing income levels in China. On average, Chinese citizens have doubled their incomes since 2000 on a per capita basis. This growth in income has been so substantial that, today, China is second only to the U.S. with a middle class population of 157 million people, according to the Organization for Economic Co-operation and Development.

We expect this "Asian Tiger's" appetite for the yellow metal to continue. Song Qing, director of Shanghai-based Lion Fund Management, captured this same sentiment when he told Bloomberg News that, "Gold has taken on a new role in China amid concern about inflation...Just imagine the total wealth in China and even a small percentage of that choosing to buy gold. This demand is going to be enormous."

China's gold demand is only part of our long-term story on the future of gold. In the U.S., negative real interest rates and increased deficit spending drive the Fear Trade. In China, India and other emerging markets, a combination of rising incomes and a cultural affinity drives the Love Trade.

China's Gold Demand Surpasses Developed World



Note: Gold jewelry and bar and coin demand included only.
Developed West includes U.S., France, Germany, Italy, Switzerland, U.K. and other Europe
Source: GFMS World Gold Council

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Download your copy of our special report, Two Key Drivers of Gold Demand.

China's Gold Market

China's gold market can be traced to the late 1980s when the government began lifting restrictions on gold ownership, says the CPM Group. The Shanghai Gold Exchange was established and Chinese citizens were allowed to put their wealth in gold. Since 2001, when the government lifted its final controls on the gold market, the country has seen one of the greatest booms in gold demand history.

- From 2001 to 2010, China's annual consumption of gold grew at an annual rate of 7.5 percent.
- The Chinese owned only 500,000 ounces of gold in the late 1980s; by the end of 2010, they owned more than 12 million ounces.
- On a per capita basis, consumption of gold in China has more than doubled since 2005.
- The total amount of household savings invested in gold has grown from about $200 billion in the late 1990s to $1.2 trillion in 2010.
- During the first quarter of 2011, Chinese citizens invested in nearly 91 tons of gold bars and coins, more than double the amount of a year ago.
- Recently, the government and state banks have encouraged citizens to purchase gold through gold purchasing programs. The "Only Gold Gift Bar" program offers bars in 10, 20, 50, 100 and 1,000 grams. During the program's first three months, it generated orders totaling 1.8 tons, according to the WGC.

Fulfilling the World's Oil Needs

Global engines revved up last year as oil consumption surpassed 2007 pre-recession levels. Worldwide crude oil and liquid fuel consumption grew to nearly 87 million barrels per day, its second-fastest pace in over three decades, according to the U.S. Energy Information Administration (EIA). For 2011 and 2012, the EIA forecasts world oil consumption will grow by about 1.5 million barrels of oil per day.

Emerging markets, particularly Asia, appear to be the epicenter of oil demand. Based on consumption per capita, Malaysia's use has nearly quadrupled since the 1960s, and oil use in Thailand has more than doubled to roughly 5.7 barrels per year. China's oil consumption per capita has risen nearly 100 percent in just the past decade alone.

Developing nations' hunger for oil has had a hand in rising oil prices, but supply constraints, particularly in the Middle East, are also a major factor. One reason is that a large portion of the world's oil production is supplied from politically unstable areas, such as Nigeria, Iraq, Iran and Libya.

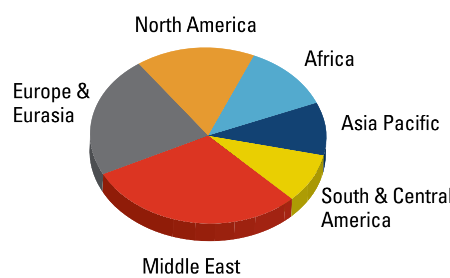
Civil wars and attacks on oil facilities generally create production slowdowns or can even shut down production entirely. Earlier in 2011, the conflict in Libya reduced the country's oil production by more than half, showing just how quickly this can affect global oil markets.

Over the years, the proximity of unrest to oil reserves has led to a reduction in global spare capacity or the excess amount of oil that can be produced, if needed. When the turmoil broke out in Libya, the general consensus was that Saudi Arabia's spare capacity would be more than enough to meet market demand. This hasn't been the case as Saudi Arabia has focused on placating its population to avoid unrest within its own borders.

But it's not just geopolitics that threatens production. Natural decline rates from mature fields such as Mexico's Cantarell oil field are starting to make a dent in global production. Reuters reported that Norway, the world's twelfth-largest oil producer, is experiencing a significant slowdown in production from the Oseberg oil field in the North Sea. Production was expected to be cut by 26 percent in May to only 118,000 barrels per day.

A Third of Global Oil Comes from the Middle East

2010 Oil production as a percent of world total



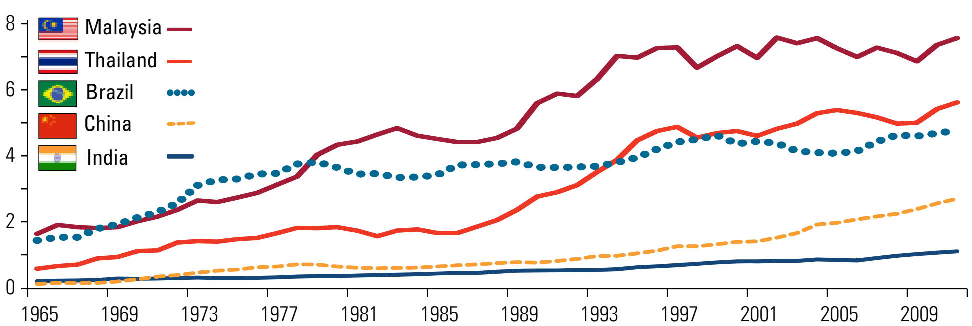
Source: BP (Statistical Review of World Energy, 2011), Barclays Capital

Iraq is another example of the difficulties inherent in production expansion. Recently, the country's former oil minister said it would only be able to meet half of its stated production goal by 2017. The original forecast, clearly a lofty one, called for roughly 12 million barrels per day in oil production.

Considering these factors, we expect oil prices to remain historically high for the next several years. For global investors, we believe the opportunities lie in companies focused on the exploration and production of oil to fill the ever-growing need and replace lost supply.

Rising Oil Consumption in the Emerging World

Oil consumption per capita (b/y)



Source: Carnegie Research

A Minute with the Manager: Global Resources Fund (PSPFX)

Evan Smith is the co-manager of the Global Resources Fund.

Evan recently returned from China, where he spent a week in Beijing, Qingdao and Shanghai. He shares his experience with us.

Q. You've been a commodities bull for a while now. How did your trip affect your long-term stance?

My time in China only reaffirmed that viewpoint as it relates to the supply and demand fundamentals of commodities. China's growth has slowed somewhat due to the country's tightening monetary policy, including raising rates to control inflation. This has caused the underperformance we have been seeing in commodity-related equities. However, as the government eases its tightening, I believe growth will ramp up. We anticipate demand for commodities, particularly copper and inputs for making steel, including iron ore and coking coal, will pick up during the second half of 2011.

Q. What is driving that demand for copper and steel inputs?

Industrialization and urbanization require building more power plants to supply the country with energy, cargo rail to transport various goods, high speed rail to connect urban and rural areas, highway systems to transport people, and social housing to provide much-needed homes. Their commodity needs affect the entire world. Here's one example: Right now, China imports 40 percent of its iron ore from countries that naturally have better, higher grades, such as Australia and Brazil. To supply the remainder of the iron ore, the country depends on domestic steel mills which must process their iron ore to upgrade it from about 15 percent to a standard grade of 65 percent commonly used in blast furnaces.

One facility I visited while I was in China excavates low grade iron ore, crushes it and uses magnets to separate the magnetite and boost the material to 65 percent grade. This, of course, adds capital costs, but temporarily satisfies the incredible steel appetite. As the cost of this process rises, China should look to import more of its iron ore needs, which benefits steel exporters.

Q. Oil prices have been hovering around $100 per barrel. What's your long-term outlook?

Currently, demand is greater than supply, and we don't see that changing in the foreseeable future. A major driver is rapidly growing demand for automobiles in emerging markets. There's also rising demand for oil due to urbanization and rising per capita incomes in emerging economies. As countries grow and their populations become more prosperous, they want and can afford to upgrade infrastructure and other construction projects.

However, it is important to manage expectations. As the price of gasoline rises and inflation fears grow, countries such as India are forced to lower government fuel subsidies. This will cause some demand destruction as consumers adjust to paying more at the pump, a situation similar to what we've seen recently in the U.S.

On the supply side, it's getting more difficult to find new supply and even when large reserves are discovered, they lie deep beneath the ocean floor or in parts of the world where it's dangerous to operate. These trends appear to be firmly intact and are why we remain constructive on crude oil prices over the next several years.

Q. For the Global Resources Fund, what specific area of opportunity will you be watching?

Right now, I see a growth trend in the oil services area, including oil service contractors and equipment suppliers. It's a $400 billion per year industry that is still trying to catch up from the downturn that occurred in 2008 and 2009. We see demand for labor and equipment outstripping supply, capex budgets increasing, and increased drilling activity taking place. Meanwhile, with a barrel of oil near $100, operators' margins are strong enough to afford to pay higher prices. I look for this trend to continue.

Foreign and emerging market investing involves special risks such as currency fluctuation and less public disclosure, as well as economic and political risk. Because the Global Resources Fund concentrates its investments in a specific industry, the fund may be subject to greater risks and fluctuations than a portfolio representing a broader range of industries.

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On the cover: *China high speed train*

Frank Talk Turns Four!

Four years ago Frank Holmes started his blog to communicate our investment themes and share our team's observations as we travel the world searching for opportunities. He believed the blog was a great tool to help our shareholders understand the nuances of global investing and help them make better investment decisions.

We invite you to tune in:

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Catch Us at an Upcoming Event

FreedomFest, Las Vegas
July 14-17

Agora Financial Investment Conference, Vancouver
July 26-29

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