U.S. Global Investors

Shareholder Report

2011 Vol. 4

The Growing Appeal of Gold

Inside: Poland's Power Play for Energy | "Smart Money" Finds Oil and Gold Reserves

Dear Shareholder,

I have seen many emerging countries create policies to emulate America.

The American Dream Trade

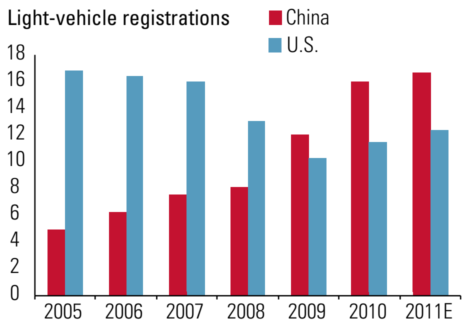
In my global travels over the past several years, I have been very fortunate to have witnessed China during its economic transformation. During earlier visits, China was a rural land with more bicycles on the roads than cars. Around that time, the country only used about 10 percent of the world's energy, about half the energy used by the U.S.

When I visited places such as Shanghai and Beijing this fall, China's development and escalating use of global resources was evident. The country now boasts the largest automobile market, surpassing even the U.S. By 2025, 350 million people will be added to the urban population, which is a trend McKinsey Global Institute believes "will be one of this century's biggest drivers of global economic growth." The International Energy Agency expects China to consume nearly 70 percent more energy than the U.S. by 2035, even though the per-capita energy consumption will be "still less than half the level of the U.S."

Emerging markets' use of natural resources and consumer goods has grown so dramatically that in 2012, *The Economist* reports that more than half of the world's imports will likely be purchased by emerging countries. This should "keep many Western firms busy for years to come," says the magazine.

Years ago, several of America's largest and oldest companies outgrew the U.S. border

China Is Now the World's Largest Car Market



Source: Credit Suisse auto research team

and recognized emerging markets' rising incomes and urbanization rate as an opportunity to export the American Dream. From automobile manufacturers to consumer products, U.S. companies shipped capital overseas, riding the wave of China's growth all the way to the bank.

General Motors, for example, sold a record 2.3 million vehicles in China in 2010, the first global automaker to sell this many cars in a year. The company expects global sales to continue, expanding by as much as 10 percent in 2012, says Bloomberg.

GM in Shanghai topped October's list of the top-ten largest automakers in China with more than 100,000 cars sold in this city alone, according to data from the China Passenger Car Association. With the help of a joint venture with China's SGM Wuling, GM is expanding its operations into emerging markets such as China and India.

I read in *The New York Times* that "American carmaker General Motors has found the Chinese market to be a life-saving opportunity for the reinvention of the Buick brand." Buick, once called a "damaged brand" by a GM executive, leads China in luxury and subcompact car sales and the Buick Excelle is the country's top-selling sedan.

Car companies from the U.S. aren't the only businesses seeking growth in China: this fall, industrial bellwether Caterpillar reported a "record-breaking third quarter," with sales and revenues jumping 38 percent in the Asia-Pacific region.

Beverage companies such as Starbucks, Coca-Cola and PepsiCo have sought to appeal to a nation of traditional tea drinkers. Starbucks recently reported a total of 800 stores in Greater China, and its strategy to sell cappuccinos and lattes appears to be successful: *The Financial Times* indicated that sales in China grew between 30 and 40 percent during the third quarter alone.

Coca-Cola and PepsiCo together have more than 90 percent market share in China, says CLSA. Over the past 10 years, the volume of carbonated drinks in China has increased an average of 8 percent per year, and Coca-Cola still experiences growth in volume. Over the third quarter, the company reported that worldwide volumes grew by 5 percent primarily driven by operations in India and China. In a very fragmented fruit and vegetable juice market,

Anticipate Before You Participate

	Number of +10% Moves	Number of -10% Moves	Frequency of +/-10% Moves
WTI Crude Oil	465	325	30%
MSCI Emerging Markets	137	170	12%
S&P 500 Index	41	93	6%

Calculated over rolling 20-trading day periods. Based on approximately 2,600 total occurrences over the past 10 years as of September 30, 2011. **Source:** Bloomberg

CLSA shows that Coca-Cola has grown from virtually no market share in China's fruit and vegetable juice category, to a 10 percent market share, over the past 10 years.

Likewise, Coca-Cola announced that the company was investing $4 billion over the next three years in China, bringing the total investment to more than $7 billion beginning in 2012. Muhtar Kent, chairman and CEO of The Coca-Cola Company, stated, "China is one our most important growth markets in the world as we work to achieve our 2020 Vision goal of doubling system revenues and servings this decade."

China a Sweet Spot for U.S. Companies

From what Chinese consumers drive, drink and eat to where they buy, U.S. manufacturers have benefited by having a footprint in China. The country's ease of doing business, its minimum wage and workforce size makes it an Eastern sweet spot.

In its Ease of Doing Business report, the World Bank annually evaluates regulations that either enhance or constrain business activity among 183 economies. For a business seeking to expand into different markets, this report is helpful in determining the ease or difficulty in obtaining construction permits, electricity and credit, as well as hiring workers and trading across borders. On this scale, the chart from CLSA shows the business environment across Eastern Asia is easier in countries such as Thailand and Malaysia than in China and Vietnam, but companies would find it more difficult to expand their businesses into Indonesia, India and Cambodia.

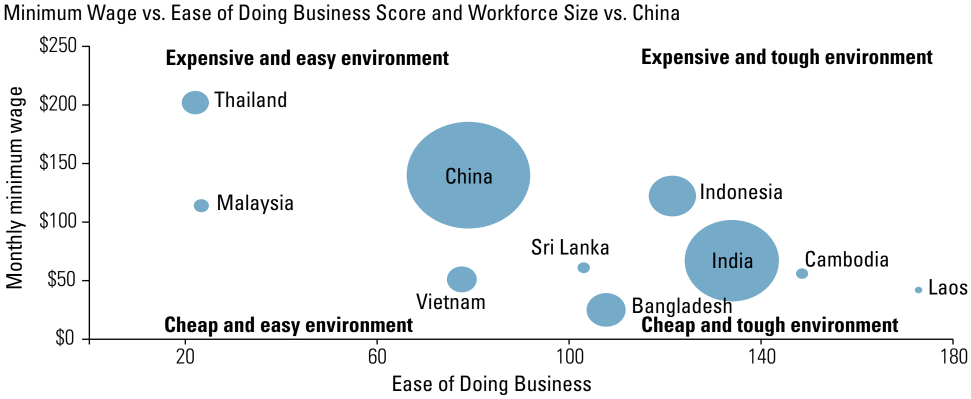
However, when wages are factored in, Indonesia, India and Cambodia have cheaper labor markets than China or Thailand.

But of all these Eastern Asian countries, China's largest labor market along with its moderate wages and relatively easy business environment makes the country an "appealing hub for manufacturing," reports CLSA.

In addition, CLSA says China's workforce is better educated and more highly skilled compared to other Southeast Asian countries. China was also named the "world's most connected economy" by the United Nations Conference on Trade and Development's Liner Shipping Connectivity Index, when it comes to how integrated global shipping networks are to enable worldwide trade. The country also has superior infrastructure and trade connectivity compared to many emerging markets, "even occasionally besting developed economies," says CLSA.

China Remains Attractive Place to Do Business

Minimum Wage vs. Ease of Doing Business Score and Workforce Size vs. China



Source: The World Bank, CIA, CLSA Asia-Pacific Markets

How do Investors Benefit?

I believe savvy investors can benefit from these emerging trends by having an allocation of natural resources, emerging markets and multinationals in their portfolios. However, investing, like life, is about managing expectations, so you should be cognizant of the DNA of volatility for these asset classes. Based on the past five years, the MSCI Emerging Markets Index has seen 10 percent swings over 20 trading days 11 percent of the time. This is more than twice that of the S&P 500, which has rarely experienced 10 percent swings over any rolling month.

The past few years have certainly been turbulent, and 2011 was among the most chaotic. In fact, according to a financial advisor survey by SEI Advisor Network, 2011 was named "The Year of Volatility." Yet, it's important to put the negative facts in perspective along with other positive signs in the market. Oppenheimer recently said, "when the future return potential of an asset class is widely doubted, the exact opposite tends to occur." I believe great opportunities can be found during turbulent times like today.

Wishing you peace and prosperity in the new year.

Sincerely,

Frank Holmes

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

All opinions expressed and data provided are subject to change without notice. Some of these opinions may not be appropriate to every investor. The following securities mentioned in the article were held by one or more of U.S. Global Investors Funds as of 12/30/2011: Caterpillar, Inc., Starbucks, Coca-Cola. The United Nations Conference on Trade and Development (UNCTAD) liner shipping connectivity index is generated from five components: (a) number of ships; (b) total container-carrying capacity of those ships; (c) maximum vessel size; (d) number of services; and (e) number of companies that deploy container ships on services from and to a country's ports. The S&P 500 Stock Index is a widely recognized capitalization-weighted index of 500 common stock prices in U.S. companies. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

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View my presentation of how our investment team looks for Super S-Curves.

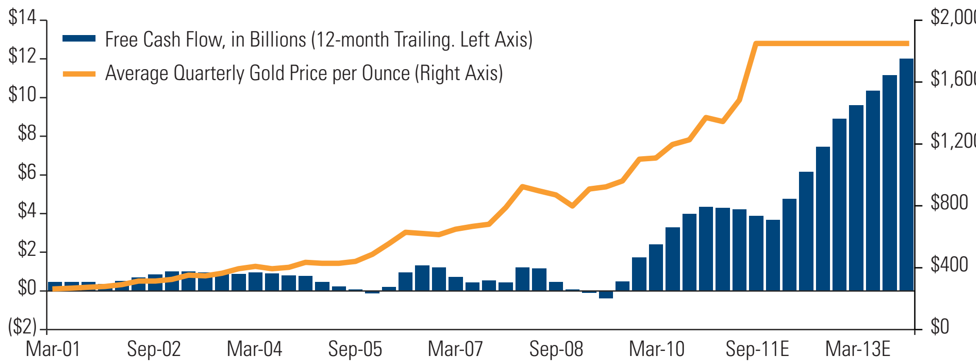
Buyouts Crystallize Value in the Market

The cheapest barrels of oil and ounces of gold aren't always in the ground; currently, they can be found on the stock exchange. In the past few months, as equity investors shunned small oil and gas and gold mining companies, larger, well-capitalized companies have scooped up their assets, including their barrels or ounces.

Many of these acquisitions represented more than a 50 percent premium to the trading price on the day of the takeout announcement. Sinopec, Asia's largest refiner of oil and supplier of 80 percent of China's fuel, announced plans to purchase Canadian oil and shale-gas company, Daylight Energy, for $2.1 billion in cash—more than twice its market value. In July, BHP Billiton announced plans to purchase Petrohawk Energy for just over $15 billion, giving BHP access to the highly coveted shale gas reserves. This acquisition, along with purchasing Chesapeake Energy's Fayetteville field increased BHP's resource base by more than 300 percent.

As of mid-October 2011, the oil and gas industry accounted for the second-largest volume of mergers worldwide, according to Bloomberg. And it's been a globalized event, as companies all around the world—Australia, Canada, China, Norway and the U.S.—participated in this activity.

Record High Free Cash Flows for Tier I Producers



Source: Bloomberg, Company Reports, RBC Capital Markets estimates

Purchasing the undervalued assets of smaller companies is a cost-effective way for large companies to replace diminishing reserves. Decline rates for oil-producing wells in the Gulf of Mexico can range between 15-30 percent a year, according to BP, and establishing new wells is expensive: An offshore exploration well, for example, can cost $100-$200 million dollars, but that doesn't guarantee it will become a producing well.

In the gold mining sector, skyrocketing prices of the yellow metal have translated into increased profit margins for larger producers. This means more free cash flow (FCF) which can be used to enhance shareholder value, such as pay dividends or acquire companies. You can see this incredible increase in the rising FCF of Tier 1 producers, such as Barrick, Goldcorp, Kinross and Newmont Mining. Historically, FCF never rose above $2 billion. In the last two years, FCF among these Tier 1 companies stair-stepped up to $4 billion. If the price of gold remains at current levels, RBC estimates FCF should stay elevated as well.

As Frank Holmes explained in the book titled, *The Goldwatcher: Demystifying Gold Investing*, rather than endure the headache of drilling core samples and filling out permit applications, big gold miners can increase reserves by purchasing the known assets of their rivals. As long as junior exploration and development stocks remain depressed, the "smart money" will continue to pick up reserves at discounted prices.

Selected Oil & Gas and Gold Mining Acquisitions in 2011

Premium to Share Price on Day of Announcement	
Sinopec purchasing Daylight Energy	120%
B2Gold purchasing Auryx Gold	74%
Agnico-Eagle purchasing Grayd Resource Corp	66%
Superior Energy Services purchasing Complete Production Services	61%
BHP Billiton purchasing Petrohawk Energy	50%
Norway Statoil ASA purchasing Brigham Exploration	40%
Kinder Morgan purchasing El Paso Corp	37%

The following securities mentioned in the article were held by one or more of U.S. Global Investors Funds as of 12/30/2011: Agnico Eagle, Barrick, BHP Billiton, Goldcorp, Kinder Morgan, Kinross, Newmont Mining.

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View the stock price charts to see how the market reacted to the buyouts.

Big Shift in Gold Demand

On January 23, China celebrates the beginning of the Year of the Dragon. Historically, five percent more babies have been born during Dragon years, as the creature symbolizes power and wealth, says Bloomberg. This may drive an incremental increase in the buying of golden baby gifts, in addition to the traditional gifts of gold dragon pendants and coins.

Gold buying in China hit record levels in 2011 as the World Gold Council (WGC) reported that China's total demand through the third quarter has eclipsed that of 2010. In addition to consuming every speck of gold mined in China, it's estimated that the country's gold imports could reach 400 tons in 2011. That's roughly equal to the combined tonnage of gold demand for the Middle East, Turkey and Indonesia in 2010—and that's just imports. Consumer demand for gold in China increased 13 percent year-over-year during the third quarter of 2011 as the country continued to close the gap on India. Chinese jewelry demand, also up 13 percent, eclipsed India for only the fourth time since January 2003.

The WGC says, "China's increase in demand is being fueled by rising income levels, a by-product of China's rapid economic growth." This growth has given birth to more than 100 million gold bugs in China's rural areas. The smaller third- and fourth-tier cities in China were responsible for the bulk of the increase in jewelry demand, the WGC says. In addition, the Gold Accumulation Plan (GAP), a joint effort from the Industrial & Commercial Bank of China (ICBC) and the WGC which allows investors to purchase gold in small increments, reached 2 million accounts in September 2011. Similar to a bank account, people participating have access to the underlying gold or the cash value at any point. The WGC reported GAP sales had exceeded 19 tons by the end of September.

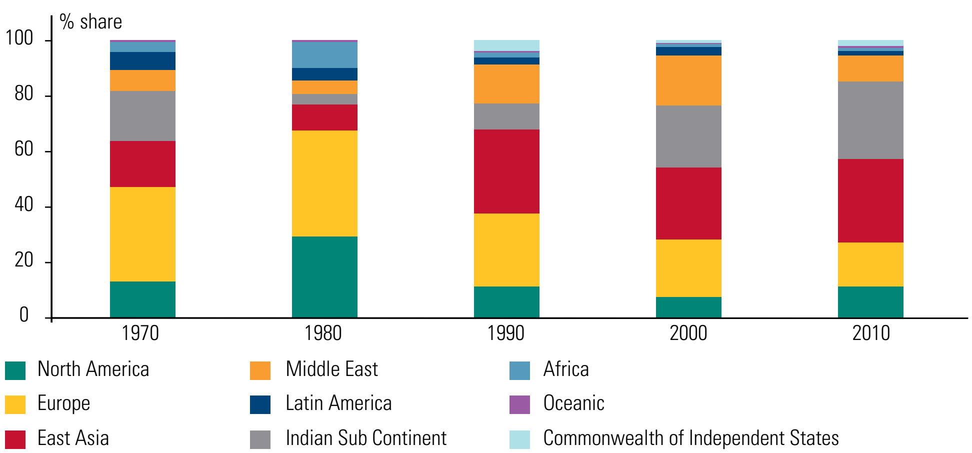
Today's Eastern domination of demand is quite different than the gold market of the 1970s, which was driven by Western buyers. At that time, half of the world's gold was purchased in two regions—North America and Europe, says the WGC. Ten years later, the figure rises to 68 percent during a period of high inflation, a weak economy and spiking gold prices. At the same time, China and India (broadly represented in the chart as East Asia and Indian Sub continent) saw their combined share of gold demand diminish from 35 percent to 15 percent.

Since 1980, we've seen a slow transition in demand, with the East Asia and Indian Sub continent devouring roughly 68 percent of the world's gold today.

The WGC says the shift in these high-growth economies is "undeniably conspicuous in the gold market" and we expect the trend to continue through the Year of the Dragon. As David Lamb, the WGC's managing director for jewelry, told Reuters recently: There is a "significant tidal shift to the Asian markets, to India and China in particular, and gold rising upwards and disappearing from the mass merchandising in the West."

Gold Demand Shifts from the West to the East Over Past 40 Years

Distribution of demand by region



Source: Bloomberg, LBMA, Thomson Reuters GFMS, World Gold Council

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How much do you know about gold? Quiz yourself today.

Poland's Power Play for Energy

Poland is setting the stage to become a leading player in the European natural gas market. Europe has long been reliant on Russia for its supply of natural gas, but domestic discoveries of shale gas—along with strong governmental support for drilling—might soon catapult Poland to energy's main stage.

According to BP's 2011 Statistical Review of World Energy, Poland's production of natural gas has been relatively flat over the past 40 years. The country has historically produced less than 1 percent of the world's natural gas, vastly paling one of the biggest natural gas players, Russia, which produced 18 percent of the world's natural gas supply.

The European Union now imports 30 percent of its natural gas from Russia, says Morgan Stanley, and Poland has historically been one of Russia's best customers. Last year, Poland alone imported nearly 63 percent of its natural gas—87 percent originating in Russia.

BP reports that the only country outproducing Russia in natural gas is the U.S., which accounted for nearly one-fifth of the world's natural gas in 2010. However, America's natural gas production has recently risen to its highest level since 1973 due to the extraction of shale gas. "Shale gas related horizontal drilling surged in early 2010 and shale gas output rose to account for 23 percent of total U.S. production," reported BP.

The new drilling technique in the U.S., which extracts natural gas from rock deep underground, is "reshaping the world of natural gas," BP says. To unlock the resource in shale basins, engineers must employ horizontal and hydraulic drilling, commonly referred to as "fracking" or "hydrofracking." This requires pumping highly pressurized amounts of water, chemicals and sand underground to release gas trapped in shale formations.

Now this groundbreaking technique could shift Europe's natural gas market to the East, and the U.S. Energy Information Administration (EIA) found that Poland has the largest shale gas reserves in all of Europe, with 187 trillion cubic feet of recoverable natural gas resources.

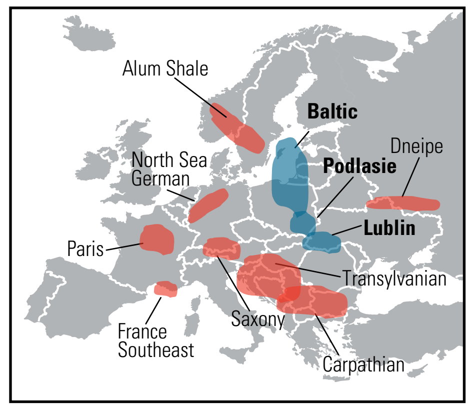
Three organically rich shale formations in Poland—the Baltic, Podlasie and Lublin basins—are favorable for gas exploration development, says the EIA. The largest is the Baltic Basin, roughly 102,000 total square miles in size, larger than the Marcellus shale basin in the U.S., and extends over a portion of Poland, Lithuania, Russia, Latvia, Sweden and the Baltic Sea. This basin could contain significant levels of natural gas, making it the most promising deposit in the region.

Substantial infrastructure is needed for companies to be able to extract and transport reserves, including thousands of miles of pipelines and dozens of rigs, but Morgan Stanley cites several reasons for Poland's likely success: a large resource base, gas pricing that is almost twice the pricing of the U.S., a developed gas market, and political support that welcomes foreign firms and hydraulic fracking permits compared to other countries in Europe.

Just as shale gas is significantly driving the supplies of natural gas in the U.S., in the next two to five years, Poland's shale gas production could shift where Europe gets its energy in the future.

None of U.S. Global Investors Funds held any of the securities mentioned as of 12/30/11.

Potential Shale Basins in Europe



Source: EIA, Morgan Stanley Research

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See the slideshow of where the world gets its energy.

An Analyst’s View: China Region Fund (USCOX)

Xian Liang is a research analyst for U.S. Global Investors.

His primary role is conducting macro and quantitative research to find opportunities for the funds. We sat down with Xian to discuss the factors driving the China Region Fund (USCOX).

Q. Shanghai is representative of China’s tremendous growth. What’s your experience?

I was born in and grew up in Shanghai, and when I left the city in 2002, there were three subway lines. In 2008, there were almost 10. Now, there will be 13. This gives you an idea of how the city’s infrastructure has grown, facilitating logistics, extending market reach and providing convenience for the average citizen. This really shrinks the geography of the country when people in one city can take the high speed train to another city to do shopping or business.

Shanghai has an interesting history. Back in the 1930s, Shanghai was known as the “Paris of the East” because of its tremendous European influence. When you walk down the streets along the waterfront, you would think you were somewhere in Europe because of the architecture. It was also known as a major financial center within China, and the country wants to continue this legacy. Today, it’s one of the most prosperous cities in China; Shanghai residents seem more entrepreneurial and global.

Q: The China Region Fund can hold stocks all around Asia, including Indonesia. What opportunities do you see in that country?

We think Indonesia is a growth story largely because of its sizeable domestic economy. Unlike its Asian counterparts, which are mostly export driven, two-thirds of Indonesia’s GDP is consumption, driven largely by demographics. It’s a very young country. According to research from CLSA, 45 percent of the population is under 24 years old. The workforce is expected to grow by about 2 million every year in the next decade. The country is not short of spenders and the demand will be sustainable.

Indonesia is undergoing a very similar process to what China did in the past 20 years—urbanization. As people move from villages to cities, new demand is created. People will want to fulfill all kinds of basic demands, including housing, consumer products and durables.

Very much like China, Indonesia has a high savings rate of about 32 percent. Households are underleveraged and consumer credit is in its infancy in Indonesia, with total household mortgage debt outstanding estimated to be only 3 percent of GDP. By comparison, China is 15 percent.

Finally, according to CLSA research, 72 percent of Indonesia’s middle class spends only $2 to $4 (U.S.) per person per day. There seems to be tremendous room for growth.

Q: How will Thailand’s economy recover from the recent flooding?

The flooding presents an interesting opportunity for Thailand because of the reconstruction, rehabilitation and recovery demand. We think the government will step in with some favorable policies to relieve the post-flood recovery process. What will also help businesses is the fact that Thailand’s corporate tax will be cut from 30 percent to 23 percent in 2012 and then to 20 percent in 2013.

Q: What can you tell me about the upcoming Year of the Dragon?

The Chinese dragon is an imaginary, mythical creature, but unlike its western counterpart, is not portrayed as evil. Its body parts are from nine animals, including the horns of a deer, mouth of an ox, nose of a dog, trunk of a snake, and claws of an eagle. It has auspicious power because it can make itself invisible or visible at any time. It can both fly and swim. It makes clouds and rain. Because of these magnificent things, the dragon is associated with royal powers as well. Hopefully going into 2012, the Chinese dragon will bring some new strength to the markets.

Foreign and emerging market investing involves special risks such as currency fluctuation and less public disclosure, as well as economic and political risk. By investing in a specific geographic region, a regional fund’s returns and share price may be more volatile than those of a less concentrated portfolio.

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Read an extended version of this interview from a recent Frank Talk.

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On the cover: *Happy Chinese New Year! Millions of Chinese celebrate the Year of the Dragon this January, offering gifts of gold pendants and jewelry, along with decorations and snack trays that have a hint of gold color.*

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