

Watchlist Focus Stock 2

U.S. Global Investors, Inc.

by Tim Eriksen, *m10 member*

The asset management industry has been one of the best performing industries over the last few decades. In fact, the best performing stock over the last 25 years is Eaton Vance, which delivered an incredible 32% average annual return.

One of the primary reasons for this outstanding performance is operating leverage. There are minimal costs to service additional accounts in relation to the additional fees the accounts generate. In addition, the industry does not require significant investment in fixed assets. This allows earnings to be used for dividends, debt reduction, share repurchases, or acquisitions.

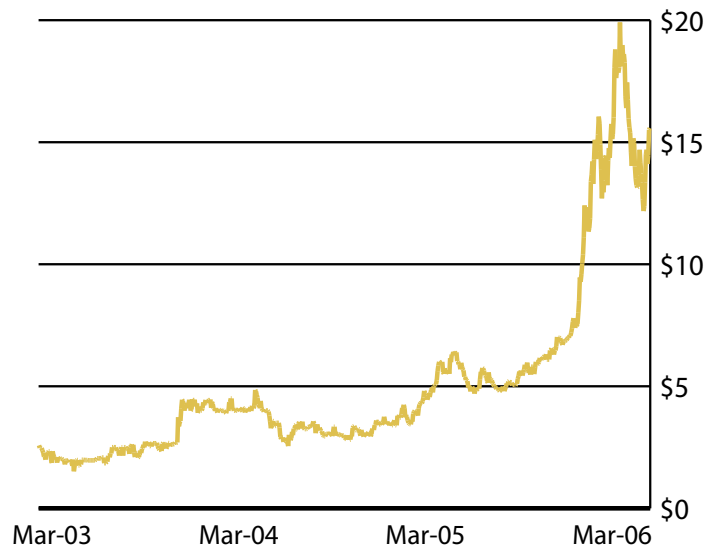
The typical asset-management firm has historically traded at a PE ratio similar to overall market, currently 16-25 times earnings. The problem is that the larger firms have become so large that their growth rates have slowed dramatically, and as a group appear to be fully valued in the market. What I want is a small firm that is growing assets and could be the next Eaton Vance.

One firm I like is U.S. Global Investors (nasdaq: GROW). The company was founded in 1968, and struggled for years to grow assets due to its emphasis on gold funds and money market funds. Unfortunately for U.S. Global, gold has been a poor performer for much of the last two decades, excluding a few short-lived rallies.

In recent years, the company expanded fund offerings into other natural resources and Eastern Europe. Both areas have been hot of late, and I while I can't comment much on Eastern Europe's prospects, I do think natural resources will continue to outperform. For example, oil stocks are priced as if oil prices will drop in the future, yet the futures market says current prices will not go away. By focusing on natural resources GROW has experienced spectacular growth. In the last three years, AUM has increased by 40%, 20%, and 67%, respectively. At the end of 2005, AUM was \$3.0 billion. In the first three months of 2006 AUM has already increased by 33% to \$4 billion.

Stock Price

U.S. Global Investors, Inc. (nasdaq: GROW)
3/01/03 to 3/31/06



The result is that earnings which typically ran from breakeven to \$0.05 per quarter, on after-tax margins of 8%, suddenly surged to \$0.15 per share in the September 2005 quarter, on after-tax margins of 16%. The stock took off, going from \$5 to \$20 before falling back to around \$13 after flat December 2005 earnings. It appears that there was a temporary dip in AUM in October which has since been reversed.

Assets are now 70% higher than in the September quarter. If they maintain the same profit margins, earnings should increase to an annualized \$1.00 per share. Thus the company is trading at 14 times run-rate earnings, a big discount to the industry average.

The main concern for the company is clearly the lack of diversification in its funds and the heavy reliance on natural resources. There is no doubt that this is a legitimate concern. But since I am bullish on natural resources, I don't mind the reliance. By investing indirectly through an asset manager that focuses on a certain area of the market, I believe it actually allows me to get more upside on the investment than I would get from owning a basket of stocks.

Note: Due in part to his success at Marketocracy, Mr. Eriksen has registered as an Investment Advisor, and started a private investment partnership. Both Mr. Eriksen, and funds he manages, have a position in U.S. Global, as well as other investment advisory firms