



Matthew McLennan
Portfolio Manager & Head of the Global Value Team
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Our Investment Philosophy

One of the things that made me most comfortable with joining First Eagle Investment Management was when I first met John Arnhold, all he talked about was the issues with the business. And, when I first met Jean-Marie and started to speak about stocks, was all he talked about was the problems with some of his largest investments, the things that were less than perfect. That mindset of focusing on the downside, made me realize that I could be comfortable in my own skin in this environment.

Importantly as well, John and the Arnhold family had bought the funds Jean-Marie was managing [purchased the majority share of Société Générale Asset Management] at the very bottom of the value cycle in the late '90s at the turn of the millennium. That was a time I remember clearly as a very painful period where value was dramatically out of favor, yet the family had the insight to buy into an enduring philosophy.

Warren Buffett said, "Rule number one, don't lose money. Rule number two, never forget rule number one." Ludwig von Mises, an Austrian economist said, "One cannot make all people richer by printing money." Karl Popper, who was a philosopher and studied scientific methods said, "Our knowledge must be finite, our ignorance must necessarily be infinite." Ben Graham talked about a margin of safety. And there's an old Chinese proverb that says, "Patience is a virtue."

This handful of observations encapsulates the heart of what it is that we do at First Eagle. We haven't necessarily created a new approach. What we've tried to do over the years is to incorporate time tested wisdom into how we allocate capital. The first part of that is to set a goal, a goal that makes sense and is intuitive.

In our industry, people have goals that don't necessarily make sense. If you think of what Warren Buffett said, "Rule number one, don't lose money," it's obvious in a way, if you're going to save – and here we are talking about how we're entrusting your clients' savings to a particular strategy – the first rule ought to be to try and avoid the permanent impairment of capital. If you can't meet that threshold, then you're better off consuming than saving.

So we take our attempt to preserve capital very seriously. And when Ludwig von Mises said, "One can't make all people richer by printing money," what he made very clear in that statement was that we live in a nominal world. We live in a world where the printing presses are running. There are fiat monies. Preserving capital is not just about keeping money in a bank deposit that's constant in nominal terms, it's about keeping pace with the inflating nominal trajectory of the economy. It's preserving capital in real terms. So cash, net of taxes and inflation, just doesn't cut it. Cash is useful as a form of deferred purchasing power to take advantage of market panics. We always like to be a provider of liquidity in times of distress. But as an asset allocation answer, it doesn't cut it.

We believe that you have to own things that over time scale in line with nominal incomes in order to preserve the real purchasing power of your clients' capital: only good businesses or scarce real assets like gold. In a portfolio context, they serve different functions. The advantage of buying good businesses is not only that their earnings power accretes over time in line with the nominal economy, but that their securities can be mispriced. This affords us, as long-term investors, the opportunity to have a margin of safety and the opportunity to create wealth.



On the other hand, gold, since the breakdown of the Bretton Woods agreement in the early '70s, has largely kept pace with the growth in the world nominal income per capita, so it has historically been a global store of value. But if you look at the peaks and troughs of gold's history, it's often held its value, or peaked in value, when people were most worried about the integrity of the system. So from a portfolio standpoint, we feel nature's currency is a useful counterbalance to the ownership of enterprise.

The goal for us is simply to avoid the permanent impairment of capital through selective investments in good businesses and gold and having some cash as deferred purchasing power to grow that capital in real terms over time.

But what's the goal that most people have in our industry? It's usually expressed in terms of relative returns and tracking error. For us, those words didn't actually come into the definition of the goal. For us, a tracking error is somewhat of a flawed construct. For one, it's based on the notion that stock market returns are normally distributed, and I think we have ample evidence to suggest that that's not the case. The tail is fatter than usual when crises occur as everything becomes correlated. But more importantly, tracking error equally weights the upside and downside. To go back to what Warren Buffett said, "Rule number one, don't lose money," clearly downside tracking error is worse than upside tracking error. More importantly, however, than short-term volatility in stock prices that can lead to downside periods like we saw in 2008, is that a measure like tracking error does not distinguish on the downside between temporary impairment of capital and permanent impairment of capital.

In 2008, we owned a lot of businesses that went down, their multiples contracted. But when you own businesses that have little or no debt, that have strong market position, that contraction was a temporary impairment of value and we've seen the Global Fund recover those losses. But if you owned AIG, Bear Stearns, Lehman, Citi, Freddie, Fannie, etc., those we believe were permanent impairments of capital. That money is not necessarily coming back.

For us, the goal is not about saying we should look like the market with a certain dispersion. The goal should be to avoid the permanent impairment of capital. Ironically, for the many people who define their goals by tracking error and relative returns, they felt compelled to own Japan in the late 1980s because Japan was the largest market in the MSCI World Index. They felt compelled to own tech, media and telecom in the late '90s. I heard people telling me, "We've got a neutral risk profile where we have a market weight in technology." And I thought to myself, how can that be a neutral risk profile when you're buying the most expensive sector in the history of humanity?

I remember going to a retirement committee presentation and someone said to me, "Look, you talk about high price to sale ratios, high price to earnings ratios, but what does it matter if we're in a new era?" There is one thing that matters, and that is the price you're paying per human being to own these companies. There were companies back then that were trading at values of over \$100 million per employee, whereas some of the best businesses that have been around for generations, were valued at \$1 million per employee. This was as a time of record low unemployment, 3.9%. Where were they going to find all these great people? Things just didn't add up. But people felt they were moderating their risk by being market neutral technology at the time.

Financial services, the largest sector in the 2008 market, had the same message. Well, something's wrong with this. Measures like that are about managing business risk, not about managing investment risk, and our goal has always been to manage investment risk rather than business risk. Jean-Marie said in the late 1990s, "I would rather lose half of my shareholders than half of my shareholders' money." So when you invest with us,



understand that there will be times that we look mundane. There will be times when we are short social acceptance, for the very simple reason that our goal is different from most. Our goal is not to look like the markets. Our goal is to avoid the permanent impairment of capital.

Now a logical question that follows from that is, "How do you go about the process of avoiding the permanent impairment of capital? What was it about your crystal ball that told you that Japan was going to go down, that tech was going to go down, that financials were going to go down?" Well let's go back to what Karl Popper said, "Our knowledge can only be finite, our ignorance must necessarily be infinite." Ludwig von Mises, who I quoted on the subject of money, made a very strong statement as well. He said, "Omniscience is denied to man." Thucydides, a Greek historian from two thousand years ago said, "Ignorance is bold, knowledge is reserved." And Ben Graham talked at length about the fact that the many market environments we have seen highlight the futility of trying to predict the future with precision. So when you speak with anyone at First Eagle, the first thing you ought to know is that we have a foggy sense of the possibilities. Jean-Marie and the team were very vocal about the risks of the credit cycle. We don't profess to have a crystal clear crystal ball, because no one does. I often like to speak with people about their sense of uncertainty. Think of what you've experienced in your own life.

I was born in Papua, New Guinea in a town called Rabaul. In 1994, a volcano went off that wiped out most of the town of Rabaul. In 1989, I was in Berlin. I had been there in '87 visiting Checkpoint Charlie. Well, when I was there in 1989 the wall fell. It was a very different world. I was in lower Manhattan when the twin towers fell. So whenever someone gives me a scientific, precise asset allocation, I think to myself, 'I wonder how they would have been allocated in 1913, when emerging market bonds were all the rage.' We tend to think that it's fresh to invest in emerging markets today, but people were very enthusiastic about emerging markets in 1913. Then in 1914, was the assassination in Sarajevo. How many people realized that that one event would spiral out of control and produce World War I, which in turn would lead to harsh reparations on Germany, produce a hyperinflationary environment and lead to the rise of Hitler in World War II?

In the wake of World War II, we had a new financial architecture with the Bretton Woods Agreement. But it was an imperfect link to gold that was ultimately undermined due to the U.S. dollar reserve role. The point I'm trying to make is that it's very hard to predict the precise path the future will take, and you only have to reflect on the events of the last two years and be honest with yourself: did you predict the peak, did you predict the bottom? Which pundits got it right? There were some people who looked great when the markets were going down, but many of them were perpetual bears who had their moment in the sun. And there were many people who looked prophetic when the markets came up, but many of them had a bullish propensity that was only confirmed in that moment of time. So for us, the answer is not to spend all of our time pondering the imponderable, but to simply take advantage of market moves after they've occurred.

In early 2008, we had a decent amount of cash and gold. We'd just been through a five-year bull market and it was hard to find good opportunities so the cash was building. In early 2009 we had our lowest cash levels, not because we timed the market recovery, but because we bought good businesses at good prices. For us, the mindset is simply about taking advantage of market moves after they've occurred rather than trying to predict every zig and zag. Importantly as well, if you can't predict the future, but you feel your job is to preserve value and you know that you've got to own businesses to preserve value, your secret weapon by necessity has to be what Benjamin Graham called, margin of safety. Ben Graham pointed out that it's the margin of safety that prevents you from having to predict the future with precision. What does a margin of safety mean to us? A margin of safety, simply put, is buying businesses at a discount to intrinsic value.

Perhaps where we look at things differently is we define intrinsic value very conservatively. We don't look at PE ratios and price to book ratios the way most people do. We treat equity as a residual claim on a business. You're



able to accumulate the cash flows of a business after the debt holders are paid off, after minorities are taken care of at fair market value, after pension and post retirement liabilities are taken care of, after legal contingencies are funded. Equity ownership is a residual claim, and we often have a more conservative sense of the value of a business than the street because we look at it that way.

The second thing that we do differently in thinking about a margin of safety is that we recognize that nothing is a permanent store of value. The thing that comes closest to a permanent store of value has been gold.¹ I took my children to the Metropolitan Museum to the new Greek and Roman wing, and there you see the Greek coins from a couple of thousand years ago. Well, gold was a store value then and we believe it is today. But most businesses only have generational relevance. Charles Darwin spoke about this at length. When we wrote his book, *The Origin of Species*, he talked about the fact that no one species has ever maintained its form indefinitely. The evidence is clear that things change, and as it relates to businesses, businesses evolve because consumer tastes evolve. Consumer tastes are not static. The important thing is that we price businesses for fade. When we look at equities on an intrinsic value basis, we assume that we're not going to pay for real growth prospects tomorrow. In fact the multiples that we would put on a business assume no real growth in a business's cash flow stream. We want that future for free. That's our margin of safety.

Beyond that, we're very sensitive to avoiding vulnerable capital structures. Seth Klarman talked about the fact that you can drown in an inch of water. Well we saw that in the financial crisis. Vulnerable capital structures meant that as an equity investor, you didn't get the benefit of the assets when they recovered because the assets changed hands to the debt holders.

Importantly, we're also focused on management behavior. If you look at the history of countries like Argentina and Zimbabwe, it's clear that poor governance has the ability to erode wealth at the macro level and obviously at the micro level.

So for us, it's a margin of safety that we seek out. If you look back at the acts of omission that we've made which have largely defined the track record of the product over time, being out of Japan, being out of tech, being out of financials, was less about having that specific crystal ball that knew the copy book for the future, and more about avoiding the pockets of highest valuation, the pockets of greatest balance sheet growth or vulnerability or the pockets of new era thinking.

Temperament is our key touchstone: not only humility to accept the future is uncertain, but the courage to implement the conclusions that come from that and the patience to wait for markets to validate that. Jean-Marie was out of Japan by 1988. The market still rallied for another year. That was painful. Being out of tech in the late '90s was painful as was missing the action in the financial services. But being willing to wait, willing to look different from the market, for us, those acts of omissions were in the biggest segments of the market. Those acts of omissions were made in an attempt to preserve capital. But those acts of omission were large tracking error events for our funds. We looked very different from the markets. It's because the funds stuck to their goals rather than trying to manage the business as it were. And it's very important that by doing the right thing for our clients long-term, the business takes care of itself.

Now in terms of having the courage to implement your views, there's also an element of flexibility that's required. We have been willing to invest across the globe, looking for the least aggressively valued businesses in the world.

¹ Source: www.measuringworth.org. Investment in gold and gold related investment presents certain risks, and returns on gold related investments have traditionally been more volatile than investments in broader equity or debt markets.



We've been willing to invest across the capital structure. If we find a business we like but a capital structure that's less than perfect, sometimes we'll buy the debt rather than the equity if we believe we can get an equity-like return to get a more secure position in the capital structure.

We've been willing to hold gold and cash when we can't find great ideas. We typically hold cash with a view to deploying cyclically at a more advantageous time. Gold we hold more as a form of potential generational protection against those long-term events that we can't forecast. If we could predict the future with certainty, we wouldn't need the cash and gold. But the fact is, we've tried to structure ourselves for uncertainty and that's why we hold them.

Now patience is critical to what we do. If you look at the businesses that we've invested in, we often own them for a very long period of time. When the funds came back into investing in Japan in '94, '95, the funds started buying companies like Shimano in bicycle components or Chofu Seisakusho in boilers. We still own those businesses today, a decade and a half later. We like to plant the seeds and watch the trees grow. It's not about zigging and zagging ahead of every market move. It's not about frenetically going out and mowing the lawn every week. It's about planting the seeds and watching them grow and waiting for the markets to come to you rather than trying to react in a time sensitive way at all points in time. And we can only do this with the right team. In the last couple of years, most people in this industry have been in the process of laying off human capital. There have been a lot of layoffs in the financial services industry. Well, we've been in the fortunate position to have been supported organizationally to invest in our human capital at what has been a propitious moment. We think that today we have the most experienced team with the best temperament that the organization has ever fielded. I am blessed to have a team of portfolio managers with a great deal of experience. We're well positioned with our team because each analyst tends to follow a few different industry groups. That's critical to understanding what we do because if you had one analyst for one sector, they'd feel compelled to own it. We like our analysts to be able to roam free. But importantly, the stock to human ratio for our analysts is very low, less than 20:1 typically. And because we tended to have a five year average holding period, they are only looking for a few ideas a year. A few ideas across a few industries allows the analysts to be incredibly selective. And, we also have a dedicated trading floor. So we have what we think are the right resources to go forward and beyond the immediate team, we operate fundamentally in the right environment.

You can take the seed of a grand tree like a sequoia, but if you plant it on the beach, it's not going to grow. It has to be in the right environment. Well for us, we could only do what we do as a team if we're in the right organizational environment that shares our time horizon, that's willing to invest its capital with us, that's willing to fund us to invest in our human capital in a distressed moment of time. First Eagle Investment Management and the Arnhold family have been willing to do that. Not only have they invested in us in the downturn, but we're absolutely delighted to have broader organizational resources through the down cycle. Bridget Macaskill, who is our new chief executive officer, brings tremendous experience and perspective to what we do having been a CEO of Oppenheimer Funds some time ago and having been a successful director in many different corporations involved in successful financial transactions.

Today we have about 10% to 15% of the portfolio in cash and shorter dated government securities. That's well less than the 20% or so that we had at the beginning of 2008, but it's more than the 5% or so that we had in March of 2009. This shouldn't be a surprise. It's harder to find new ideas today than it was a year ago. But it's certainly not a bubble environment in our view. Most businesses that we look at today are pretty rationally priced. That means we have to work hard to find new ideas, but that's the way it usually is in our business and that's why you need a dedicated team. We have just over 10% of the portfolio in a combination of gold bullion and gold equities. There are a few drivers for this. If we saw no imbalances in the world, then perhaps we wouldn't need the gold, but we do live in a time of great imbalance. We're in the midst of arguably the greatest Keynesian



experiment in the history of the world with the major economies of the world having applied quite a bit of fiscal stimulus to try to solve the deflationary adjustment that are occurring at the moment.

What worries us is a simple question. The Keynesian stimulus is a response to the lack of political will to have a deflationary adjustment. Will we, therefore, have the political will to put in place the discipline required to unwind those deficits going forward if the deficits were born out of a lack of political will? It's an important question. It's not impossible. We came out of World War II with bigger deficits and we had two decades of prosperity. But it's a fundamental question to which we don't know the answer.

Secondly, the price of oil has doubled from the bottom, yet the labor market has not even turned yet. The economy is only on the cusp of a recovery. Oil consumption as a percentage of GDP is approaching 5% globally. The variability in the oil price is arguably more important than monetary policy variability. Think about the fact that the output gap, or the way the economy is relative to trend, may be more in the hands of OPEC than the Fed. That's the world we live in.

Thirdly, if you look at where the epicenter of monetary creation today is, it's not the United States. M2 growth in the United States is only a couple of percent, as it is in Europe, as it is in Japan. The epicenter of world monetary creation today is China. China has experienced north of 20% M2 growth in the last year and in U.S. dollar terms has compounded out at approximately 20% for the last decade. The stock of M2 in China is now greater than the United States. For that matter, if you look at the CO₂ (carbon dioxide) emissions in the world, the stock of CO₂ emissions is actually largest in China now. And electricity consumption grew by over 20% last year in China.

Final sales of automobiles in China grew 100% last year. China now accounts for almost half of the world's steel and cement production. It is inevitable that there is going to be an expectational adjustment regarding China over the next handful of years. When you're already the largest monetary regime, when you're already the largest carbon emitter, when you're half the world's steel and cement, you can't grow at 10% a year indefinitely.

We think that there is enormous opportunity in Asia long-term. Jean-Marie has says it often, the east is rising. But there's an expectational adjustment that needs to happen at some point. And arguably, there's a point in time where the structure of government may change. Those are huge uncertainties. Now, I'm not implying that these are things that would take us out of markets, I'm simply saying that there's a reason we own some gold in our portfolios, and that is because there are forces at work that are meaningful, that we can't quantify with precision, and that produce uncertainty.

We have roughly 75% of the portfolio in stocks today, excluding the gold stocks. Now we could spend a lot of time thinking about the macro possibilities and we tend to reflect on the downside potential in markets. But let's not forget what Jean-Marie has always said. There's nothing wrong with making money on a simple stock idea. And for us, when we ponder the issues that I have just referenced, oil prices, China, the fiscal experiments in the developed world, it's important to note that those issues don't exist within the context of a zero sum game. Productivity is what absorbs those imperfections. And we live in a time when the scope for productivity increase is arguably very large. There are more people joining the market system. There's a greater diffusion of property rights. There's a greater transmission of ideas and information than in the history of mankind. And so for us, when we own stocks, it's because we're trying to preserve value. We're trying to own the engine of that productivity to absorb the things that we worry about. If we own cash at a zero percent yield we will not participate in a cyclical recovery of corporate profits and we won't immunize ourselves necessarily against longer term inflation that might occur once economies recover. Stocks provide us that opportunity.



If you look at what we own in terms of equities today, the biggest cluster of equities we own we don't define by industry or by region, but by type. We own a lot of businesses that I would refer to as eclectic royalties. Companies like Shimano that dominates high end bicycle components, or Secom which has over 60% share of Japanese security alarms and the services that go around that. And businesses like Cintas in uniform rentals here in the United States. These are all sorts of businesses that have a lock on a market. Some of them are going through good times at the moment, some of them less good times. But if we own them for the long term and we own them at the right price, we believe that we will participate in the growing nominal income of the world with an attractive free cash flow yield along the way.

In addition to those royalties, we own a range of businesses that own scarce real assets. If the supply of an asset is growing by less than the population or around population growth, then real pricing power ought to be growing over time. So it's not just things like gold. We are in stocks that relate to other precious metal mines in silver and platinum. We own quarries. It's one of the things that we've been very excited about. (Rob Hordon is our analyst on that team who has done a lot of work in that area.) We get excited about things like quarries. The supply of quarries in inner city areas is certainly not growing. We own timberlands. Urban encroachments mean the supply of timber over time is under pressure.

The other area of investments we own is what I refer to as sort of run offs or cheap float. And that would typically be businesses like insurance companies that we can buy at close to book value, where we get the investment float from the underwriting reserves for free. Or it could be investments in investment holding companies where we're getting a double discount, where we're buying at what we feel is a big discount to the listed value of what they own, and getting very good capital allocation acumen to boot. So businesses that would fall into this category, in insurance, would be companies like Cincinnati Financial, or in the holding company area, it could be companies like Pargesa, a Swiss based holding company jointly owned by Albert Frere and Paul Desmarais. They have been great capital allocators over time and we own it [Pargesa] at a big discount to what they own. The pieces of businesses they own are in turn cheap, giving us the double discount.

I started by quoting Warren Buffett. The reason being, that to understand us and our actions, you have to understand the way we define our goal, which is to avoid the permanent impairment of capital. I quoted Ludwig von Mises because we understand that capital is something that has to cope with inflation over time and the interference of government. And so we have to be positioned in the kinds of businesses we own, whether it's the royalties or the free float, or the kinds of protection we own, be it scarce real assets like gold, in an attempt to protect ourselves against the corrosive force of inflation. And I quoted Karl Popper, Ben Graham, Thucydides, and so on. We don't have this perfect crystal ball, so in order to achieve our objective we need a margin of safety. And to make it all happen, we have to be patient. Those are our values. These are our beliefs. These have been our beliefs since the inception of the funds. These are time-tested approaches to investing. They're not new. What we've tried to do is create the right team, and the right environment to be custodians of this approach.



Average Annual Returns as of 06/30/2010	Year to Date	1 Year	5 Years	10 Years	Expense Ratio
First Eagle Global Fund - Class A (w/o sales charge)(SGENX)	-1.43%	15.39%	7.25%	11.94%	1.19%
First Eagle Global Fund - Class A(w/sales charge)(SGENX)	-6.35	9.62	6.16	11.36	
First Eagle Overseas Fund - Class A (w/o sales charge)(SGOVX)	0.15	14.69	7.46	11.91	1.20%
First Eagle Overseas Fund - Class A (w/sales charge)(SGOVX)	-4.85	8.95	6.37	11.34	
First Eagle Gold Fund - Class A (w/o sales charge)(SGGDGX)	10.07	33.21	21.14	24.16	1.26%
First Eagle Gold Fund - Class A (w/sales charge)(SGGDGX)	4.57	26.55	19.90	23.52	

	Year to Date	1 Year	5 Years	Inception 09/04/01	Expense Ratio
First Eagle U.S. Value Fund - Class A (w/o sales charge)(FEVAX)	-2.29%	13.95%	3.85%	8.26%	1.26%
First Eagle U.S. Value Fund - Class A (w/sales charge)(FEVAX)	-7.18	8.25	2.79	7.63	

The performance data quoted herein represents past performance and does not guarantee future results. Market volatility can dramatically impact the fund's short term performance. Current performance may be lower or higher than figures shown. The investment return and principal value will fluctuate so that an investor's shares, when redeemed may be worth more or less than their original cost. Past performance data through the most recent month end is available at firsteaglefunds.com or by calling 800.334.2143. The average annual returns for Class A Shares "with sales charge" of First Eagle Global, Overseas, Gold and U.S. Value Funds reflect the maximum sales charge of 5.00%.

There are risks associated with investing in funds that invest in securities of foreign countries, such as erratic market conditions, economic and political instability and fluctuations in currency exchange rates. Funds whose investments are concentrated in a specific industry or sector may be subject to a higher degree of risk than funds whose investments are diversified and may not be suitable for all investors. Investment in gold and gold related investment presents certain risks, and returns on gold related investments have traditionally been more volatile than investments in broader equity or debt markets. The holdings mentioned herein represent the following percentage of the total net assets of the First Eagle Global Fund as of June 30, 2010: AIG Inc. 0.00%, Bear Stearns 0.00%, Lehman Brothers Holdings Inc. 0.00%, Citigroup Inc. 0.00%, Freddie Mac 0.00%, Fannie Mae 0.00%, Shimano Inc. 1.46%, Chofu Seisakusho Co., Ltd. 0.36%, Secom Co., Ltd. 2.18%, Cintas Corp. 1.51%, Cincinnati Financial Corp. 1.12%, Pargesa Holding SA 1.20%. The portfolio is actively managed and holdings can change at any time. Current and future portfolio holdings are subject to risk.

¹ Source: www.measuringworth.org

The commentary represents the opinion of Matt McLennan as of March 2010 and is subject to change based on market and other conditions. The opinions expressed are not necessarily those of the firm. First Eagle Investment Management, LLC (FEIM) became investment adviser to the Fund commencing January 1, 2000. **These materials are provided for informational purpose only.** These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice. Any statistics contained herein have been obtained from sources believed to be reliable, but the accuracy of this information cannot be guaranteed. **The views expressed herein may change at any time subsequent to the date of issue hereof.** The information provided is not to be construed as a recommendation or an offer to buy or sell or the solicitation of an offer to buy or sell any fund or security.

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