Manager Commentary

Oil and Dollar Continue to Influence Emerging Markets

By: Eric Fine, Portfolio Manager

Executive Summary

- The broad themes in the portfolio remain unchanged
- Venezuela's government was unable to implement much needed reforms despite a challenging external environment
- We continue to regard Russia's upside/downside risk profile as unattractive

Overview

The broad themes that characterize our portfolio remain unchanged. We are still comfortable with duration and we maintain our selective exposure to high-rated, high-quality and most liquid sovereigns (most of which are also net creditors). These assets account for just less than 50% of our portfolio. We continue to limit our corporate exposure, keeping it below 15% of our portfolio because of concerns about the "liquidity illusion" and high correlation with U.S. high yield. We still prefer hard-currency over local-currency denominated debt (selective longs in Brazil debt and China offshore debt are our only exposure in local-currency). We have no Russia/Ukraine-related exposure and have approximately 20% of our exposure in idiosyncratic Argentina and Vietnam bonds, while having significantly reduced our exposure to Venezuela debt (which is now less than 5% of our portfolio).

Why reduce Venezuela exposure? First, we believe its government's inability to come up with a coherent plan of structural reforms (especially with regards to exchange rate liberalization and higher domestic gasoline prices), despite a more challenging external environment, is disappointing. As we have pointed out on previous occasions, the government's overall policy stance appeared to be a bit more pragmatic. However, many changes are "cosmetic" in nature and the failure to deliver on the structural front could imply that Venezuela might not be able to improve its macroeconomic position as fast as required by the current falling oil prices. Second, the political noise in Venezuela is getting louder once again – there are reports about long lines in stores and street protests – and this might affect the performance of bonds in the near term. Third, low oil prices imply smaller current account receipts (oil accounts for over 90% of Venezuela's export revenue) and we need more information on the country's external financing options in the absence of the internal structural adjustment. The recent meetings between Chinese and Venezuelan officials generated only vague headlines about "financial cooperation plans" without providing information about new credit/swap lines or (beneficial for Venezuela) modifications of the existing agreements. President Maduro's recent trips to the Middle East also failed to clarify this situation, while there is still much uncertainty about potential securitization of the Petrocaribe debt.

Why hard-currency over local-currency denominated debt? The first reason is that, in our opinion, emerging markets growth is likely to continue to struggle in 2015. By contrast, the U.S. economy should continue to perform well providing additional support for the U.S. dollar. Another consideration is that the commodity price weakness should likely have a significant impact on emerging markets and emerging markets' assets. The link between commodity prices and emerging markets' currencies appears to be particularly strong. Finally, even though positioning cleared somewhat in the last weeks of 2014, in our view there is still potential for sizeable outflows in the situation when the net issuance of emerging markets government local-currency debt is expected to decline only marginally in 2015. By contrast, J.P. Morgan expects a sizeable $15.4bn decline in emerging markets net sovereign issuance this year.

Why China local currency debt? Even though we remain apprehensive about emerging markets local-currency debt exposure generally, we chose to keep approximately 6.6% of our portfolio exposure in China because we believe its economy is in the process of transitioning from the investment/exports-based growth model to a more balanced model with a larger share of consumption. The authorities have, so far, showed their willingness to aid this transition by easing their policy stance. We also expect that a solid current account balance and sizable capital account inflows will provide support for the currency. Our China exposure is concentrated in the longer part of the sovereign curve which, in our opinion, is best positioned potentially to benefit from these trends.

Why no exposure to Russia? We continue to regard Russia's upside/downside risk profile as unattractive. First, falling oil prices appear to exert a heavy toll on Russia's external position. The Central Bank of Russia's interventions to support the Ruble put additional pressure on international reserves which declined from $428.6bn at the end of October to $388.5bn at the end of December 2014. Second, even though there are some signs of import substitution in Russia, the economy is set to contract in 2015, while inflation is now back in double digits. Third, we see virtually no signs of longer-lasting stabilization in Ukraine that would allow lifting/easing sanctions. As such, the potential refinancing risks for Russian corporate bonds are likely to rise with wider-spread corporate defaults being a distinct possibility.

Why duration? First, the generally stronger U.S. macro data flow still contains dovish surprises. An unexpectedly weak hourly earnings growth is one recent example. In another example, the Employment Cost Index has just started to move in the direction of the pre-crisis averages. These wage indicators, as well as low money velocity, contribute to low inflation pressures in the economy – which is our second point. Third, there seems to be some uncertainty about the long-term growth outlook in the U.S., despite the bullish third revision of the figure for Q3 2014 real GDP growth. A survey of professional forecasters conducted by the Philadelphia Fed expects real GDP growth to decelerate on a three-year horizon. Finally, the long end of the U.S. Treasury ("UST") curve (30-year) remains highly correlated with German Bunds, which will be anchored by the forthcoming European Central Bank Quantitative Easing (QE).

Please note that the information herein represents the opinion of the portfolio manager and these opinions may change at any time and from time to time.

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Why exposure to Argentina and Vietnam? Exposure to selected idiosyncratic opportunities in Argentina and Vietnam remains important for our portfolio. Even though Argentina has high macroeconomic risks, we expect the presidential elections – to be held later this year – to be a positive catalyst for the country (Cristina Kirchner is constitutionally unable to run for elections in 2015). We realize that there appears to be uncertainty about the resolution of the holdouts issue. Still, a more orthodox policy is likely to emerge and this can create opportunities for Argentina to access, eventually, international markets. Argentina's total indebtedness remains low in comparison with the single-B rated economies and a positive change in the policy vector can give a boost for the sovereign to re-price. Vietnam, on the other hand, where signs of economic improvement have become apparent during the past year, saw its credit rating upgraded by rating agencies citing improved economic stability. Growth in the economy has been supported by a mix of increased exports and foreign investments among other things.

Exposure Types and Significant Changes

The changes to our top five positions are summarized below. Our largest positions are currently: China, Brazil, Argentina, Vietnam, and Chile.

- We added exposure to local debt in Brazil based on our expectations that the government's new economic block, led by the Minister of Finance Levy, will be able to kick start a much-needed fiscal adjustment.
- We added exposure to sovereign duration in China (where we remain comfortable about the outlook for growth and reforms), as well as the Philippines, South Korea and Chile (where we like a combination of strong fundamentals and low correlations).
- We reduced our sovereign exposure in Venezuela due to concerns about the impact of lower oil prices and signs of a lack of reform. We also reduced our exposure in Indonesia, Paraguay, Argentina and the Dominican Republic due to high correlations.

Fund Performance

The Unconstrained Emerging Markets Bond Fund (Class A shares excluding sales charge) lost 4.57% in December, compared to a loss of 5.93% for the J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM) and a loss of 2.31% for the J.P. Morgan Emerging Markets Bond Index (EMBI). The Fund's biggest winners were Peru, Colombia and Chile (all in hard-currency). The Fund's biggest losers were Venezuela, Indonesia and Argentina.

Turning to the market's performance, the GBI-EM's biggest winners were Chile, Philippines and India (with the last two benefitting from lower commodity prices). The biggest losers were commodity-exporting countries including Russia, Colombia and South Africa.

The EMBI's biggest winners were Panama, Uruguay and Romania, while its biggest losers were Ukraine, Belarus and Ecuador where lower oil prices and local political/economic risks (Ukraine) were in general the main drivers in December.

Average Annual Total Returns (%) as of December 31, 2014

	1 Mo	3 Mo	YTD	1 Yr	Life
Class A: NAV (Inception 7/9/12)	-4.57	-4.90	1.83	1.83	3.06
Class A: Maximum 5.75% load	-10.10	-10.34	-4.01	-4.01	0.64
GBI-EM Index	-5.93	-5.71	-5.72	-5.72	--
EMBI Index	-2.31	-0.55	7.43	7.43	--

Average Annual Total Returns (%) as of September 30, 2014

	1 Mo	3 Mo	YTD	1 Yr	Life
Class A: NAV (Inception 7/9/12)	-2.58	-2.39	7.07	9.14	5.78
Class A: Maximum 5.75% load	-8.18	-7.96	0.93	2.88	3.01
GBI-EM Index	-5.11	-5.66	-0.01	-1.54	--
EMBI Index	-1.81	-0.59	8.02	9.67	--

Data Sources: Van Eck Research, FactSet. All portfolio weightings and statements herein as of December 31, 2014. Unless otherwise indicated.

Expenses: Class A: Gross 1.42%; Net 1.25%. Expenses are capped contractually until 05/01/15 at 1.25% for Class A. Caps exclude certain expenses, such as interest. Please note that, generally, unconstrained bond funds may have higher fees than core bond funds due to the specialized nature of their strategies. The tables above present past performance which is no guarantee of future results and which may be lower or higher than current performance. Returns reflect applicable fee waivers and/or expense reimbursements. Had the Fund incurred all expenses and fees, investment returns would have been reduced. Investment returns and Fund share values will fluctuate so that investors' shares, when redeemed, may be worth more or less than their original cost. Fund returns assume that dividends and capital gains distributions have been reinvested in the Fund at NAV. Index returns assume that dividends of the index constituents have been reinvested. Investing involves risk, including loss of principal; please see disclaimers on next page. Please call 800.826.2333 or visit vaneck.com for performance current to the most recent month ended.

RATINGS DISCLOSURE: Bonds and preferred stock which are rated B are considered speculative and are subject to high credit risk.

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Duration measures a bond's sensitivity to interest rate changes that reflects the change in a bond's price given a change in yield. This duration measure is appropriate for bonds with embedded options. **Quantitative Easing** by a central bank increases the money supply engaging in open market operations in an effort to promote increased lending and liquidity. **Correlation** is a statistical measure of how two variables move in relation to one other. **Monetary Easing** is an economic tool employed by a central bank to reduce interest rates and increase money supply in an effort to stimulate economic activity. **Holdouts Issue** in the fixed income asset class occurs when a bond issuing country or entity is in default or at the brink of default, and launches an exchange offer in an attempt to restructure its debt held by existing bond holding investors. **Liquidity Illusion** refers to the effect that an independent variable might have in the liquidity of a security as such variable fluctuates overtime.

Emerging Markets Hard Currency Bonds refers to bonds denominated in currencies that are generally widely accepted around the world (such as the U.S.-Dollar, Euro or Yen). **Emerging Markets Local Currency Bonds** are bonds denominated in the local currency of the issuer. **Emerging Markets Sovereign Bonds** are bonds issued by national governments of emerging countries in order to finance a country's growth. **Emerging Markets Quasi-Sovereign Bonds** are bonds issued by corporations domiciled in emerging countries that are either 100% government owned or whose debts are 100% government guaranteed. **Emerging Markets Corporate Bonds** are bonds issued by non-government owned corporations that are domiciled in emerging countries. A **Supranational** is an international organization, or union, whose members transcend national boundaries and share in the decision-making. Examples of supranationals are: World Bank, IMF, World Trade Organization.

Any indices listed are unmanaged indices and include the reinvestment of all dividends, but do not reflect the payment of transaction costs, advisory fees or expenses that are associated with an investment in the Fund. An index's performance is not illustrative of the Fund's performance. Indices are not securities in which investments can be made. The **J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM)** tracks local currency denominated bonds issued by Emerging Markets governments. The index spans over 15 countries. The **J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI)** tracks returns for actively traded external debt instruments in emerging markets, and is also J.P. Morgan's most liquid U.S.-dollar emerging markets debt benchmark. The **Employment Cost Index** tracks the changes in the costs of labor for businesses in the United States economy.

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Investing involves risk, including loss of principal. You can lose money by investing in the Fund. Any investment in the Fund should be part of an overall investment program, not a complete program. The Fund is subject to risks associated with its investments in emerging markets securities. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. As the Fund may invest in securities denominated in foreign currencies and some of the income received by the Fund will be in foreign currencies, changes in currency exchange rates may negatively impact the Fund's return. Derivatives may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. The Fund may also be subject to credit risk, interest rate risk, sovereign debt risk, tax risk, non-diversification risk and risks associated with non-investment grade securities. Please see the prospectus and summary prospectus for information on these and other risk considerations.

Investors should consider the Fund's investment objective, risks, and charges and expenses carefully before investing. Bond and bond funds will decrease in value as interest rates rise. The prospectus and summary prospectus contain this as well as other information. Please read them carefully before investing. Please call 800.826.2333 or visit vaneck.com for performance information current to the most recent month end and for a free prospectus and summary prospectus.