Manager Commentary

Russia's Fundamentals Deteriorate at a Fast Pace

By: Eric Fine, Portfolio Manager

Executive Summary

- Russia-Ukraine geopolitics took a noticeable turn for the worse
- We remain comfortable with duration for now
- We continue to limit our exposure to corporates

Overview

There were no changes in the broad themes that characterize our portfolio. We continue to prefer hard-currency over local-currency denominated bonds, have no Russia-/Ukraine-related exposure, and like a combination of idiosyncratic high-and low-yielders. We remain comfortable with duration and continue to limit our corporate exposure. More specifically, we have increased our selective exposure to duration in steep credit curves of high-rated and most liquid sovereigns, while further reducing our corporate exposure.

Russia-Ukraine geopolitics took a noticeable turn for the worse, while Russia's fundamentals are deteriorating at a fast pace. The Minsk cease-fire between the pro-Russia rebels and the Kiev government appears to be in shambles following the elections in Eastern Ukraine and the subsequent military offensive by the Ukrainian army. Leading indicators show that Russia may slide in to recession in the coming months and this risk will increase as more and more companies and banks are cut off from the international financial markets. Falling oil prices and large net capital outflows (including a noticeable increase in the "flight to safety" demand for U.S. dollars among households) weigh heavily on the Ruble. The Ruble is depreciating at an alarming pace – weakening by almost 20% since the beginning of October (and taking inflation higher with it) – despite the Central Bank of Russia's 150 basis point interest rate hike and massive interventions. The bank's international reserves fell by $27B in October (a nearly 6% decline) and are now close to the levels last seen in late 2009/early 2010. In our view, the probability of another round of sanctions on Russia is high – especially after the Republican sweep of the Senate – which could mean the market will begin to see that there's no end to Russia's cut-off from U.S. financial markets. A wave of corporate defaults in Russia might, then, be the next stop. Summing up, the current upside/downside balance for Russia- and Ukraine-related assets continues to look unattractive.

As a side note, putting the sanctions into legislation is likely to push Russia to explore more actively (such as China) other financial markets. Would the U.S. legislators be willing to impose sanctions on financial entities from these countries as well? This is clearly a slippery slope (especially following the recent Argentina debt debacle) which might further taint the image of the U.S. as the financial center of the world – potentially becoming the Smoot-Hawley of the 21st century. (The infamous Smoot-Hawley Tariff Act of 1930 increased U.S. economic isolation, arguably prolonging the Great Depression).

The weak growth outlook in emerging markets and emerging markets debt reinforces our view of owning hard-currency debt over local-currency debt (with one exception – China). Emerging markets growth currently remains anemic – the upward move in emerging markets' Purchasing Managers Indices (PMIs) has faded away. The Bank of Japan's bold policy move and a weaker Yen might encourage central banks in emerging markets to weaken their currencies to maintain competitiveness. Further, our sense is that institutional investors have finally adopted the view (the correct view, in our opinion) that emerging markets have excellent fundamental debt characteristics (i.e. lower debt and deficits, etc.) and that perhaps the execution of the view has been too narrowly focused on either hard -or local-only mandates. We continue to argue that an unconstrained approach is appropriate for the asset class, and that institutions should seek managers who can optimize the different risk/return characteristics of hard-currency sovereign debt, hard-currency corporate debt, and local-currency sovereign debt.

We continue to limit our exposure to corporates. We are concerned that vague "worries about liquidity" might translate into a full-blown "liquidity illusion" scare – both are likely to find their best expression in emerging markets corporates. Accordingly, as part of our investment process, we are assigning an increasing number of failing grades in our "vulnerability" test, which measures short-term external financing pressures for corporates. Moreover, we see the risk of emerging markets corporates correlating with a weakening U.S. corporate market as global growth is challenged; we have also assigned failing grades in our "correlation" test.

We remain comfortable with duration for now. The recent U.S. dollar rally has been tantamount to monetary tightening, and most economic forecasting models show that the U.S. economy begins to reflect this with a one-year lag. Related to this, the bid to the U.S. dollar is also the result of low yields in German Bunds and Japanese Government Bonds, which, in our view, anchor Treasury yields. The Federal Reserve may need to hike to have (or pretend to have) some powder dry for any coming downturn, though longer-dated Treasuries could rally in that event.

Summing up, we continue to prefer hard-currency over local-currency bonds, have no Russia-/Ukraine-related exposure, remain comfortable with duration and continue to limit our corporate exposure. High-quality liquid sovereign bonds account for about two thirds of our portfolio. The market is still generally underweight this asset class, which is largely self-financing (with occasional debt buybacks as an extra bonus), and has many net creditor countries in it.

The remaining part of our portfolio includes carefully selected Venezuela and Argentina bonds. The market is still pricing in a 45% probability of Venezuela/PDVSA (Petròleos de Venezuela, S.A.) defaulting within one year (assuming 35% recovery) – roughly the same as prior to the October payments (our big call was that these maturities would be paid). However, there are no significant payments on the PDVSA side until the end of 2015. Further, market sentiment towards Venezuela has been negative lately, in part due to the oil price weakness, and many market participants were forced to reduce their Venezuela exposure. Similar to Venezuela, Argentina has high idiosyncratic risk. However, an expected resolution to current economic uncertainties – Cristina Kirchner is, constitutionally, unable to run in 2015 elections – is likely to result in re-pricing. We view any new president as a positive catalyst for the country. We expect to see a more orthodox economic policy and a likely resolution with holdouts giving the country, in our view, access to international finance and re-pricing the sovereign debt. We aim to grow our exposure to our maximum allocation before the election expectations are priced in.

Exposure Types and Significant Changes

The changes to our top five positions are summarized below.

Our largest positions are currently: Venezuela, Argentina, Mexico, Indonesia, and Peru.

- We added exposure to China based on our expectations that the growth slowdown will pave the way to lower local rates while the People's Bank of China is unlikely to abandon control over the Renminbi.
- We added exposure to sovereign duration in Paraguay where we like a combination of strong fundamentals and idiosyncrasy. We also increased our exposure to hard-currency debt in Chile.
- We reduced our exposure in Brazil as the outcome of the recent election will likely be a drag on the fundamental story, while corporate results are likely to be weaker in 2015.
- We continued to trim our exposure in Mexico, as certain bonds reached our target prices, even though our fundamental view remains constructive.
- We reduced our position in Indonesia and Peru, trimming select corporate bonds.

Fund Performance and Allocation Changes

The Fund (Class A shares excluding sales charge) lost 0.41% in October, compared to 1.56% gain for the GBI-EM local-currency index and 1.71% gain for the EMBI hard-currency index. The Fund's biggest winners were Argentina, Venezuela (due to bond selection) and Mexico, all in hard-currency. The Fund's biggest losers were Brazil, Peru and Colombia.

Turning to the market's performance, the GBI-EM's biggest winners were Turkey, South Africa and Indonesia, where markets reversed earlier exposure reductions. The biggest losers were Russia, Nigeria and Malaysia.

The EMBI's biggest winners were Argentina, Dominican Republic and Turkey, while its biggest losers were Venezuela, Iraq and Nigeria where lower oil prices were the one of the main drivers in October.

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

	1 Mo	3 Mo	YTD	1 Yr	Life
Class A: NAV (Inception 7/9/12)	-0.41	-2.84	6.64	5.07	5.37
Class A: Maximum 5.75% load	-6.11	-8.42	0.52	-1.01	2.72
GBI-EM Index	1.56	-3.16	1.56	-2.68	0.55
EMBI Index	1.71	0.71	9.87	8.55	5.41

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	-0.13
EMBI Index	-1.81	-0.59	8.02	9.67	4.82

Data Sources: Van Eck Research, FactSet. All portfolio weightings and statements herein as of October 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 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.

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.

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. Purchasing Managers' Indexes (PMI) are economic indicators derived from monthly surveys of private sector companies.

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.

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