

Manager Insights

Natural Evolution / An Unconstrained Approach to Emerging Market Bonds

Overview

The growth and development of emerging markets (“EM”) has led to the expansion of a wide set of EM investment options. EM equities have been a long-standing investment option allowing access to the economic growth potential of these markets. On the other hand, EM bond investing—particularly in local currencies—has been a more recent phenomena.

To date, managed investment strategies focusing on EM bond investments have generally been limited to specified category subsets, such as local or hard currency, sovereign or corporate and investment-grade or high yield. Relative to this landscape, we believe an “unconstrained” investment approach may allow for full access to an evolving universe of opportunities by permitting the strategy to allocate to a wide array of investments globally—by country, currency, credit, maturity and security type.

This flexible and opportunistic mandate is the basis of the Van Eck Unconstrained Emerging Markets Bond Strategy. It reflects the experience and knowledge of an investment team that has worked in and with EM for decades, and an investment process built on fundamental analysis and valuation.

An Emerging Appetite with Room to Grow

According to JP Morgan, investment demand for EM bonds has grown rapidly in insurance and pension funds, increasing 83% from 2005 to 2011, yet allocations to EM bonds through such funds account for roughly 1% of total assets. In our view, demand continues to strengthen due to attractive economic and investment characteristics, which are described below.

Improving EM Fundamentals: Currently, lower debts and deficits and higher growth rates versus developed markets; strengthening currency reserve portfolios; improved balance sheets and healthy reserves.

Improving Credit Quality for EM Debt: Approximately 75% of the countries in the J.P. Morgan GBI-EM Index are currently rated investment grade.

Return Potential: EM bonds provide two distinct sources of return—currency appreciation potential and yields.

An Evolving Universe

Over the past decade, the EM bond market has grown dramatically in size and depth (Figure 1), with increased liquidity, longer maturities and more issuers. The universe is extensive, complex and constantly changing and we find it important to seek to understand how it has developed over the past thirty years and continues to expand today. Please note, each country has had its own journey and this narrative is simply designed to capture what we consider general themes.

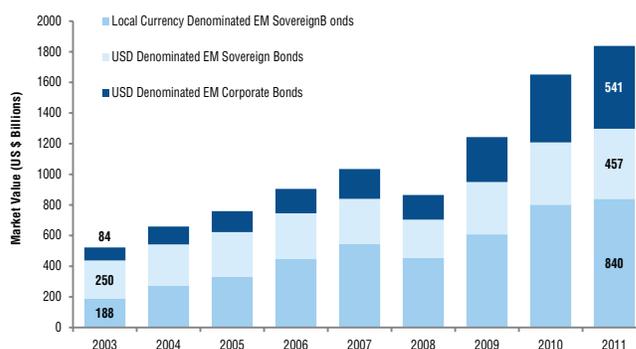
Hard Currency EM Sovereign Bonds: The initial development of the EM bond market was led by the exchange of illiquid and non-performing bank debt into bonds in the 1980s and 1990s, denominated mostly in U.S. dollars and other traditional reserve currencies. In general, confidence in local currencies was very low.

Hard Currency EM Corporate Bonds: As leading EM economies realized stronger capital markets and credibility, the debt market saw a steady increase in hard currency corporate bond issuance. In fact, many governments began issuing sovereign debt in hard currency as a benchmark for rising corporate issuance.

Local Currency EM Sovereign Bonds: Those economies with steady and significant growth were able to take their own distinct path toward issuing sovereign bonds in local currency.

Local Currency EM Corporate Bonds: Recently, the EM corporate bond market has expanded into local currency and liquidity and issuance limitations are slowly being resolved.

FIGURE 1: GROWTH OF EM BOND MARKET



Source for Chart: JP Morgan. All data illustrations as of 2012. Please read important disclosure and definitions on the last page.

FIGURE 2: PHILLIPINES FUNDAMENTALS

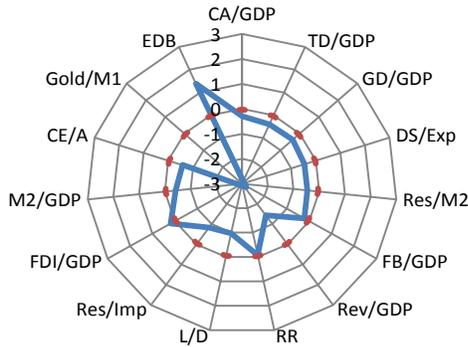
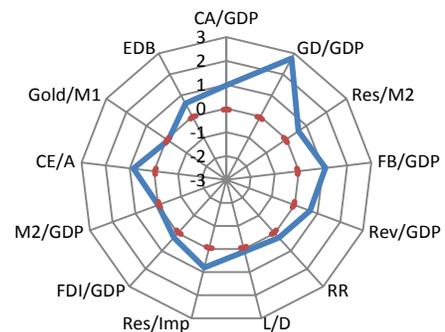


FIGURE 3: GREECE FUNDAMENTALS



An Unconstrained Approach: Van Eck Investment Methodology

Our actively managed, Unconstrained EM Bond Strategy attempts to gain access to a broad universe of EM debt asset classes – local currency, hard currency, corporate and sovereign debt. This Strategy also attempts to avoid traditional notions of emerging versus developed economies by, for example, investing in “orphaned” countries (fallen sovereign angels) such as those currently suffering debt and financial crises in southern Europe. This allows the investment team to “go anywhere” and adapt to changes within the ever-evolving EM bond universe.

Adapting to a Dynamic Market: We believe an unconstrained investment mandate allows the fund manager to keep up with rapidly changing country characteristics. For example, Nigeria was added to the GBI-EM Index in October 2012, which increased demand for its local currency bonds. Van Eck Portfolio Manager Eric Fine anticipated this event and added Nigeria local currency bonds to the portfolio before the country benefited from the improved technicals inaugurated by its index entry.

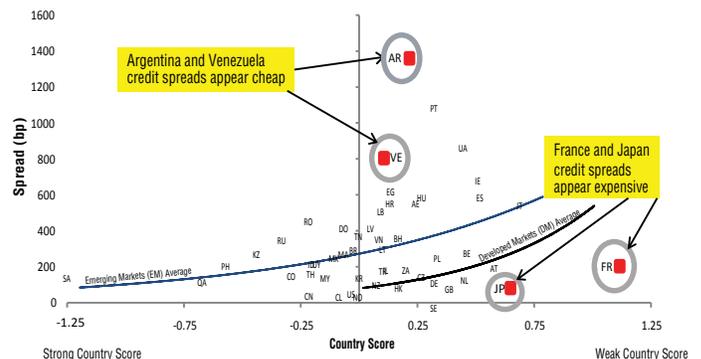
Identifying Value Opportunities: By studying credit spreads, an unconstrained manager can seek to identify EM bond sectors that may have become overvalued due to strong (or even irrational) demand and sectors that remain relatively ignored and undervalued. For instance, a recent examination of spreads in the hard currency universe—the most mature EM bond sector—led the investment team to conclude the sector was overvalued. Consequently, our Strategy has built its early track record primarily on local currency holdings. This emphasis, however, may change in the future if valuations shift.

Quantitative Research Model: The research process begins with real-time fundamental data on approximately 100 countries. To allow “apples-to-apples” comparisons between countries, 15 variables per country are normalized and translated into units of standard deviation, resulting in an overall country score. The data is viewed in radar charts to give a complete snapshot of

the relative strengths and/or weaknesses of a country (Figures 2 and 3). Radar charts are designed as bull’s-eyes, meaning if the country’s blue line is inside the red line, it is better than the mean. In the example above, the Philippines is inside the bull’s-eye on every metric, other than EDB (ease of doing business), and Greece is worse than the mean on every metric. The investment team then evaluates the expected return relative to the country score. For example, our research model identifies Argentina and Venezuela as offering good value (as measured by credit spreads relative to their country scores) and above the EM average, represented by the blue line (Figure 4). The model also includes developed bond markets such as France and Japan, which currently appear relatively expensive and are below the DM average, represented by the black line. For local currency investments, the team uses currency valuation metrics instead of hard currency credit spreads.

Flexible, Qualitative Overlay: The normal investment horizon of a position in our Strategy is 6-12 months. However, qualitative research can override country scores to exit positions sooner. The portfolio also may sell bonds whenever pre-determined price targets are reached. For example, our EM bond investment team

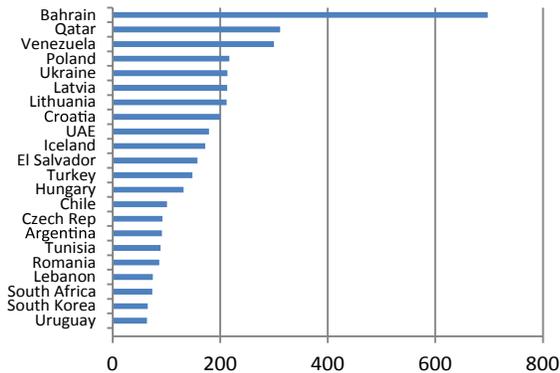
FIGURE 4: SOVEREIGN CREDIT SPREAD VS. COUNTRY SCORE: RICH/CHEAP



Source for all Charts: Van Eck Research. All data illustrations as of 2012. Please read important disclosure and definitions on the last page.

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FIGURE 5: EXTERNAL VULNERABILITY RANKING



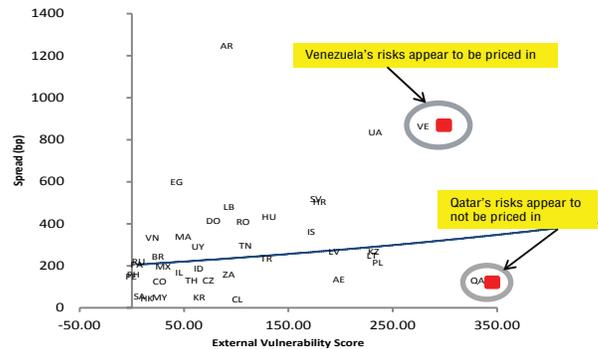
went against their quantitative model and exited Venezuela in January because its bonds began rallying with the health decline and subsequent death of President Hugo Chavez', which the team believed to be an overreaction. The bonds hit Van Eck's price targets and additional political transition risks entered the market. Mr. Fine visited the country and did not believe these risks were reflected in the bonds' prices. However, Mr. Fine believes these risks to be short term.

Risk Management: The EM bond market is no longer a monolith in which all bonds move in the same direction. Risk factors vary among sectors and particularly at the country level. The Unconstrained Strategy seeks to provide a meaningful level of risk management in that it allows for broad diversification among countries and sectors. In addition, our investment team conducts tests, such as external vulnerability rankings, which evaluate country exposures in worst-case scenarios or major risk-off environments, both on an absolute basis and relative to credit spreads. In a recent test, both Venezuela and Qatar returned high vulnerability rankings, but their valuation/risk relationships were quite different. At that time, the team concluded that an investor is paid for the risk in Venezuela; whereas in Qatar, one is not (Figure 5 and Figure 6).

Fallen Sovereign Angels: The unconstrained approach allows for investment in countries deemed to be the sovereign equivalent of "orphans"—developed countries that have been downgraded to a level that prevents original investors from continuing to invest, but have not received an EM classification by traditional means. Europe's recent debt crisis has created several "orphan" countries. For example, while Portugal is a developed nation, it currently has the same Moody's rating (Ba3) as Nigeria; our EM bond investment team has at times seen value in owning Portugal's hard-currency sovereign bonds.

Currency Hedging: Currency has historically been a major driver of return in local currency EM bonds. Although our Strategy generally avoids derivatives, it has the flexibility to

FIGURE 6: SOVEREIGN CREDIT SPREADS VS. COUNTRY EXTERNAL VULNERABILITY INDICATOR



hedge specific currency risks. Our Strategy may use currency hedging if the investment team believes a holding faces near-term currency risk or if they feel the essence of a (local currency) trade is more about the bond itself (i.e., duration and carry) than the currency. Key decision factors include the cost of the hedge and whether or not it is superior to exiting the underlying position.

Summary

The complexity of the EM bond asset class is primarily due to the vast array of local market supply/demand characteristics. An unconstrained approach has the potential to magnify the information advantage by moving freely among EM bond categories, countries and currencies. Our investment process evaluates the spectrum of EM bond opportunities by comparing asset prices to country fundamentals. This allows the investment team to seek to exploit opportunities where they believe valuations are inconsistent with fundamentals.

Investment Team

Van Eck has a dedicated EM bond investment team with approximately over 50 years of combined investment experience. Portfolio Manager Eric Fine has lived and worked in emerging markets, and has extensive experience in EM economic research and portfolio management.

Mr. Fine has conducted business in emerging markets for 20 years, including 14 years at Morgan Stanley where he ran the Global Emerging Markets Fixed Income Research Group and founded and managed the Global Emerging Markets Proprietary Trading Group. He also started and led Morgan Stanley's Europe/Middle East/Africa (EMEA) Strategy and Economics Research Group and helped start the firm's emerging markets business in London. Early in his career, he founded a Russian telecommunications company and was responsible for building that country's first securities clearing system. Mr. Fine received his undergraduate degree from Duke University and his graduate degree from Harvard University.

Source for Charts: Van Eck Research. All data illustrations as of 2012.
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CA/GDP – Current Account Balance % GDP

RR – Real Interest Rate

Rev/GDP – Government Revenue % GDP

FB/GDP – Headline Fiscal Balance % GDP

Res/M2 – International Reserve Assets % M2

DS/Exp – External Debt Service (Public + Private) % Exports

GD/GDP – General Government Debt % GDP

TD/GDP – Total Country Debt % GDP

EDB – Ease of Doing Business Index

Gold/M1 – Gold Reserves % M1

M2/GDP – M2 % GDP

FDI/GDP – Net Foreign Direct Investment % GDP

Res/Imp – International Reserve Assets % Imports

CE/A – Common Equity % Assets

L/D – Loans % Deposits

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Principal Risks: 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 may be subject to credit risk, interest rate risk and a greater risk of loss of income and principal than higher rated securities. 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, exchange controls and economic and political changes, which may be enhanced in emerging markets. Additionally, these securities are exposed to a number of risks that may make them volatile in price or difficult to trade. 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 returns. 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 will also be subject to credit risk, interest rate risk, sovereign debt risk, tax risk, non-diversification risk and risks associated with investing in below investment grade securities, which include the risk of default, a high degree of volatility and lack of liquidity. Please see the prospectus and summary prospectus for information on these and other risk considerations.

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