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Manager Commentary: On the Emerging Markets

Emerging market equities display weakness through much of 2Q

By: David Semple, Portfolio Manager

Performance Review

The Van Eck Emerging Markets Fund (the "Fund") lost 4.19% in the second quarter (excluding sales charge), outperforming its benchmark, the Morgan Stanley Capital International Emerging Markets (MSCI EM) Index, which declined 7.95% for the same period. To compare, the MSCI Emerging Markets Small Cap Index declined 7.39% for the same period.

Average Annual Total Returns (%) as of June 30, 2013

	2Q13[1]	1 Yr	3 Yr	5 Yr	10 Yr
Class A: NAV (Inception 12/20/93)	-4.19	20.52	8.47	1.27	13.87
Class A: Maximum 5.75% load	-9.70	13.59	6.36	0.08	13.20
MSCI EM Index	-7.95	3.23	3.72	-0.11	14.02
MSCI EM Small Cap Index	-7.39	10.22	4.02	4.85	15.03

[1]Quarterly returns are not annualized.

Expenses: Class A: Gross 1.67%; Net 1.67%.
Expenses are capped contractually until 05/01/14 at 1.95% for Class A. Cap excludes certain expenses, such as interest.

The table presents 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 investor's 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 in the Index have been reinvested. Performance information current to the most recent month end is available by calling 800.826.2333 or by visiting vaneck.com.

Market Review

The second quarter of 2013 was generally both a volatile and a negative quarter for emerging markets (EM) equities. Although we believe we produced competitive performance in the second quarter, a negative return is always disappointing. The pain was particularly acute in June.

Currently, two key positive anchors for emerging markets are being challenged. The first is the "tapering" of the accommodative Federal Reserve monetary policy, and the second is the apparent lower trajectory of Chinese growth. Many of the long-term secular themes in emerging markets remain robust, although perhaps somewhat trite, including rising share of global gross domestic product (GDP), demographics, healthy balance sheets and a growing middle class, among others. However, investment outlook is often dictated by marginal change, which has not been helpful for the asset class. It has seemingly now become the fashionable consensus to be bearish on emerging markets. We believe that this, coupled with a sufficient valuation level, is the key counterweight to an otherwise challenging environment, at least in the short term.

The possible end of the long bond bull market in the U.S. has had significant ramifications in emerging markets. In a global search for yield, the flow into emerging market debt funds is particularly noticeable. Lower rates in many countries are, to us, fundamentally justified, but the reflux of foreign funds from counties such as Indonesia, Brazil and Turkey in late spring, precipitated by a rise in Treasury yields, caused a significant back up in EM yields and pronounced foreign exchange (FX) weakness.

A stronger dollar paired with a weaker FX is particularly unhelpful in the shorter term as it tends to tighten liquidity in those affected emerging markets as central banks manage exchange rates. In addition, higher cost of debt (particularly U.S. dollar denominated debt) may erode many companies' margins. The silver lining in the longer term is that emerging markets exports become more competitive. In the meantime, the change might be painful.

Additionally, a pervasive pall of gloom (metaphorically, as well as literally) has yet again fallen over the China investment case. We have been saying to anyone who will listen that we anticipated the Chinese growth to decelerate. *(continue on next page)*

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It's partly mathematics (it's a much bigger economy now) and partly driven by a need to rebalance growth in favor of quality rather than quantity. The refreshed leadership of China has indicated that economic direction, for the time being at least, is largely avoiding the sugar rush of fiscal stimulus. Not only is this the case, but they are also increasingly active in curtailing burgeoning excesses in the so-called shadow financing area. We expect year-on-year growth rates to continue to decelerate by most measures.

On the positive side, we also expect significant and positive structural reforms to become apparent as we move through the second half. Areas where we would expect gradual change include interest rate liberalization, currency internationalization, household registration, local government financing, property taxation and agricultural land reform. We believe these should not be underestimated.

As if these headwinds were not enough, the newsreels of political unrest in various emerging market countries provide a vivid backdrop for fashionable negativity. The socio-politico-economic reasons for protests are varied but certainly speak to imbalances ranging from deep religious divisions through income disparities, unemployment, government ineptitude and corruption. The natural tensions of developing economies appear to be lubricated by the increased use of social media.

We believe the performance of corporates in emerging markets was far from stellar in the last three years with very slow earnings per share growth materializing, disappointing upbeat expectations. We ascribe this to two main issues. The most straightforward is the relatively higher weighting to cyclical industries in the asset class. Also, in our opinion, it is problematic that many emerging market companies are simply not that efficient. In an environment of strong growth, companies can thrive by simply existing, rather than focusing on efficiencies in capital management and costs. In a lower growth era, inefficiencies may be more apparent.

That being said, we certainly don't wish to appear to be "nattering nabobs of negativism." The strains that were apparent in the first half of 2013 do present opportunity. The asset class will most certainly grow at the expense of developed markets over the longer term, which we are generally confident about. Fundamentally, our strategy of bottom up stock picking focused on structural growth at a reasonable price has generally allowed us to pick the best parts of the emerging markets while avoiding the large legacy cyclical quasi-government organizations which have hurt many other emerging market portfolios.

Fund Review

Performance attribution was driven in large part by stock selection. The effect of asset allocation was small, though positive, and the only really meaningful contribution came from an underweight position in the materials sector and an overweight position in consumer discretionary. Given that our strategy focuses on structural growth, it is easier for us to be underweight in the materials sector which is dominated in market cap terms by large quasi-government organizations.

For countries, the main positive attribution from asset allocation came from underweights in Brazil and South Africa. In both cases, we have been underweight for some time due to a combination of valuations in the structural growth stories and a poor macro/currency context for the corporates. Two "off-index" weightings were positive asset allocation contributors: Singapore and Nigeria. The Singapore stocks have very little to do with Singapore, so that could be a bit misleading (they include an oil services company, a mini-conglomerate with interests in cruise ships and gaming and a consumer company – all effectively multi-nationals).

For sectors, stock selection in materials, consumer staples and financials were particularly positive, while utilities detracted. In materials, this was achieved by investing in the more downstream end of the sector, while for financials there is a fairly heavy consumer tilt to our holdings. The only materially negative contributor was utilities where we just recently initiated a position in a Turkish name, unfortunately just before the political protests broke out.

In countries, stock selection has yet again been most positive in China/Hong Kong where almost all of the holdings are non-state owned. Positive contributions also came from Korea-based Samsung Electronics (6.7% of Fund net assets*) as well as several positions in Russia (logistics, supermarket, oil services, financial) and Mexico. There were no significantly negative stock selection detractors in terms of country.

The Fund's core principles of stock picking and focusing on structural growth at a reasonable price continued to be relatively rewarding in the second quarter. An excellent example of this involves the Fund's initial investment in the Mexican pawn shop operator known as First Cash Financial Services (position was sold during the quarter). This occurred in January 2010, after one of the team members traveled to Monterrey, Mexico to conduct in-depth due-diligence where we gained our initial conviction in the company. This was done by going behind the counter of a selection of their stores and talking to both executive and middle management. At the time, we left convinced of management's philosophy of sustainable growth, which was undervalued by the market, particularly when cross referenced with management meetings in other consumer driven names. We believed that current expectations for growth were not only too conservative, but also had the expectation that increasingly apparent growth would be incrementally rewarded by a higher market rating.

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We finally exited this position toward the end of the period under review with an annualized return of over 30%.

During the quarter, the Fund incrementally increased its weightings in India and Saudi Arabia. We kept cash at a relatively elevated level. We are now finding valuations in China attractive once again, and have reduced our holdings in Indonesia.

Market Outlook

After falling hard in June, emerging market equities appear to have one thing going for them: valuation. In some cases, valuations are as cheap as or even cheaper than they were in 2008. We constantly hear pessimism being reflected from sell-side meetings with investors. This gives us a great deal of comfort that the new reality of higher U.S. interest rates and a tempering of the pace of growth in China are firmly being priced in.

In our view, while global economic growth may well remain below trend, at the margin, we believe it will improve. Economic surprises in emerging markets are now less negative. Meanwhile, for all the talk of tapering, we expect that global monetary policy is likely to remain accommodative for some time to come.

In a broader sense, we anticipate that the second half of 2013 will continue to support our growth at a reasonable price (GARP) and structural-growth-seeking investment approach. It should also show that stock selection should continue to be a significant contributor. The Fund has the flexibility to invest in large-cap and mega-cap stocks where there is a well-priced story of structural growth, but it also has the flexibility to be able to avoid many of the unattractive larger-capitalization names.

*All country and company weightings as of June 30, 2013.

All 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 Morgan Stanley Capital International (MSCI) Emerging Markets Index covers over 2,700 securities in 21 markets that are currently classified as emerging market countries. The MSCI Emerging Markets Small Cap Index targets companies that are not in the standard emerging markets index.

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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 the risks associated with its investments in emerging market securities, which tend to be more volatile and less liquid than securities traded in developed countries. The Fund's investments in foreign securities involve risks related to adverse political and economic developments unique to a country or a region, currency fluctuations or controls, and the possibility of arbitrary action by foreign governments, including the takeover of property without adequate compensation or imposition of prohibitive taxation. The Fund is subject to risks associated with investments in debt securities, derivatives, commodity-linked instruments, illiquid securities, asset-backed securities, CMOs and small- or mid-cap companies. The Fund is also subject to inflation risk, short-sales risk, market risk, non-diversification risk and leverage risk. The use of leverage magnifies losses. Please see the prospectus and summary prospectus for information on these as well as other risk considerations.

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. An investor should consider the Fund's investment objective, risks, and charges and expenses carefully before investing. The prospectus and summary prospectus contain this as well as other information. Please read them carefully before investing.

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