Manager Commentary

Headwinds Intensify in Emerging Markets Debt

By: Eric Fine, Portfolio Manager

Executive Summary

- The Ukrainian crisis appears to be already broadening to become a Russian crisis.
- The tension between China's commitment to reform and the need for continued economic expansion persists.
- Local currencies continue to be punished.

Overview

Headwinds intensify. In our previous monthlies we described tailwinds and headwinds, but we now see the headwinds for EM as increasing in both number and intensity. Since our positioning already largely reflected these perceived headwinds, we have not had to make significant changes to our portfolio. As of month-end the portfolio has almost no local-currency exposure and no exposure to Ukraine or Russia (and almost none in the region), because of our concern over these potential headwinds.

The crisis in Ukraine seems to be deepening and broadening, and we are not hopeful…particularly compared with those who use a too-common "civil war will be prevented because nobody wants one" 'argument'. Our basic framework for Ukraine is one in which domestic politics are radicalizing and dragging in regional powers (Russia, US/NATO) who are also being radicalized. This is precisely what has happened in the crisis so far, with every 'truce' getting quickly radicalized (by violence of, often, unknown provenance). In a previous state of nature, most Ukrainians wanted to remain a single country. In the current state of nature, these same Ukrainians appear to be increasingly driven by the dynamic of radicalization and the only choices are becoming extreme ones. For example, a resident of Donetsk (closer to the Russian border) is confronted by a government security apparatus that is increasingly anti-Russian (at least from the viewpoint of Donetsk). This might push the individual closer to an extreme response that there seems no way to avoid because the center no longer holds, even if nobody happens to 'want' a civil war.

We believe the radicalization of external powers is happening in a similar fashion, also because of internal politics. In our view, Europe is seen as either weak or ineffective, so it responds with sanctions and discussions of an expansion of NATO. The Russians see this as provocative and thus become more willing to continue their physical expansion beyond Crimea. Likewise, it is probable that President Putin fears a similar anti-state movement in Russia, and thus has to demonstrate his resolve as a simple act of survival. In our opinion, a divided Ukraine will probably produce the most stable long-term equilibrium, but splitting countries, particularly one as large and as geostrategically important as Ukraine, has, historically, been fraught.

The Ukrainian crisis appears to be already broadening to become a Russian crisis, and we see it potentially broadening even more. We believe Ukraine, in itself, is not that important economically. Russian banks have the financial exposure, and Europe is exposed to the usually-reliable gas pipelines. However, given the escalation of the crisis, these linkages are now in play. For example, the Western reaction of imposing sanctions on Russia seems to be depressing all Russian asset prices, and Russia also seems to be a non-trivial part of the investment landscape. For example, the now-serious risk of physical conflict appears to be forcing the market to examine scenarios in which gas doesn't flow to a Europe that gets between one-quarter and one-third of its gas from Russia (depending on the time of year).

In addition, the tension between China's commitment to reform (which we believe is anti-growth in the short term) and the need for continued economic expansion seems to be still working itself out. This is the famous "rebalancing toward a less credit-intensive and export-dependent" growth model. We are not ideologues on China. We neither think that it is a giant bubble about to collapse, nor do we think that its policymakers are perfect and can risklessly manage an economic transition that has foiled many other governments. (We say this because, in the equity world at least, the China discussion seems to be between two extremes with no room for middle paths.) Anyway, our main point on China is that we believe riskier scenarios continue. In particular, the market remains focused on ongoing defaults in sectors that have, so far, ranged from coal to housing. Moreover, CNY (the onshore Chinese Yuan) has been weakening in recent weeks, when the priority for financialization was that CNY should strengthen (thus increasing domestic demand, etc.). In this context, finally, the authorities widened the trading band for CNY, underlining the scope for further weakness. Again, we do not seek to draw any lines from these points, only to note that they appear negative and are still happening.

Finally, even though the policy reaction of many EM policymakers to the challenges is appropriate, we believe it is also insufficient, punishing to local currencies (FX and rates), and anti-growth. We've written about this view in the past, so we'll only summarize it here. First, we believe it is good that EM policymakers are allowing currency weakness and are hiking interest rates in the face of market concerns over current account deficits. Higher rates and a weaker currency directly address current account deficits that worry market participants. Second, policy appears to have worked to stabilize reserves in a number of countries, with even Argentina's recent flirtation with orthodoxy bearing fruit so far. This means that even if one is unfortunate enough to have significant exposure to local currencies, there is potentially an end in sight. In our opinion, however, it's just not today. And it is a very painful ride that close to the shock absorbers – the weakening currencies and rising interest rates. It also means that if one is so-minded, and has the portfolio flexibility that we do (as managers of an unconstrained fund), there are, we believe, safe places to invest – namely, the hard-currency bonds of the countries protecting their reserves.

But, as attractive as the reaction of EM policymakers has been, and as supportive as it has been for hard-currency bonds, rising interest rates are, to us, a growth headwind. This is important for a few reasons. Most important, in our view, is the fact that flows into EM economies are driven significantly by their growth rates relative to the developed world. A faster-than-expected growth rate in the U.S., in fact, was a key driver of outflows from EM into DM (developed markets), and defined the "taper-tantrum" that started in April/May of last year. As a result, we see this policy reaction as negative for flows into EM economies, and flows into local-currency debt in particular. Another way to put it is that, if the DM world surprises on the upside on growth (relative to EM), local currencies and interest rates are likely to come under more pressure – as was the case in the wake of the sharp sell-off in U.S. Treasuries during the "taper-tantrum." On the other hand, if the DM world surprises on the downside on growth (relative to EM), then EM are likely to see more pressure on currencies (to engineer competiveness). Hard-currency debt is not, to us, really in the crosshairs of growth-derived risk scenarios.

Exposure Types and Significant Changes

As an ongoing reaction to the above, we continued to do three things in the portfolio – diversify, increase exposure to hard-currency debt (and thus reduce exposure to local-currency debt), and avoid Eastern Europe. Our top five positions are almost unchanged from last month, as we've been rebalancing the portfolio for several months already. They are currently Argentina, Brazil, Mexico, Indonesia, and Venezuela. The only change is that Hungary is no longer a top five exposure, and Venezuela is.

Biggest Country- and Bond-Level Changes

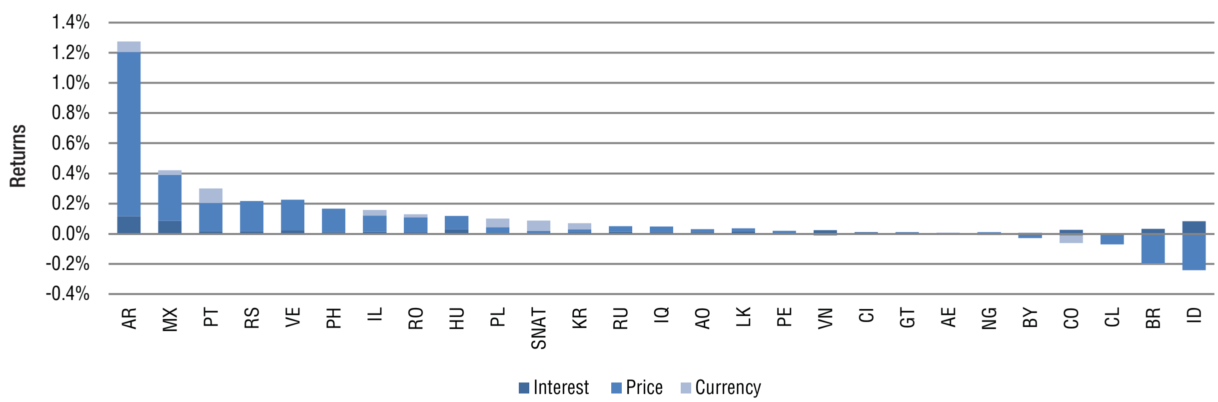
- We increased hard-currency debt to 90% of AUM from 60% last month.
- We further diversified the portfolio into a wider range of hard-currency bonds. Among these are Peru, Colombia, United Arab Emirates and Ivory Coast.
- We closed Eastern European names such as Romania, Belarus, Serbia, and Russia.

Fund Performance

For February, the Fund's Class A shares at NAV returned 3.29%, compared to 3.92% in the local-currency index (GBI-EM Index), and 3.03% in the hard-currency index (EMBI Index). The Fund's biggest winners in February were Argentina (hard-currency), Mexico (local-currency), and Portugal (hard-currency). The Fund's biggest losers were Brazil (hard-currency), Indonesia (hard-currency), and Chile (local-currency).

The market's best performers during the past month were Argentina, Venezuela, and Belize in hard-currency, and Indonesia, Brazil, and South Africa in local-currency. The markets' worst performers of the past month were Tanzania, El Salvador, and Jordan in hard-currency, and Nigeria, Russia, and Colombia in local-currency.

Price, Interest and Currency ("FX") Components of Fund Returns by Country for February 2014



AE = UAE
AO = Angola
AR = Argentina
BR = Brazil
BY = Belarus
CI = Ivory Coast
CL = Chile
CO = Colombia
GT = Guatamala
HU = Hungary
ID = Indonesia
IL = Israel
IQ = Iraq
KR = South Korea
LK = Sri Lanka
MX = Mexico
NG = Nigeria
PE = Peru
PH = Philippines
PL = Poland
PT = Portugal
RO = Romania
RS = Serbia
RU = Russia
SNAT = Supranational
VE = Venezuela
VN = Vietnam

Source: Van Eck Global; Bloomberg. Data of February 28, 2014.
This chart is for illustrative purposes only. Historical information is not indicative of future results; current data may differ from data quoted.

Average Annual Total Returns (%) as of February 28, 2014

	1 Mo*	YTD	1 Yr	Life
Class A: NAV (Inception 7/9/12)	3.29	1.24	-6.51	4.30
Class A: Maximum 5.75% load	-2.67	-4.57	-11.93	0.61
GBI-EM Index	3.92	-0.89	-10.14	--
EMBI Index	3.03	2.33	-1.42	--

Average Annual Total Returns (%) as of December 31, 2013

	1 Mo*	YTD	1 Yr	Life
Class A: NAV (Inception 7/9/12)	0.54	-4.70	-4.70	3.91
Class A: Maximum 5.75% load	-5.22	-10.16	-10.16	-0.15
GBI-EM Index	-0.55	-8.98	-8.98	--
EMBI Index	0.51	-5.25	-5.25	--

Data Source: Van Eck Research, Factset. All portfolio weightings and statements herein as of February 28, 2014.

Expenses: Class A: Gross 1.67%; Net 1.25%. Expenses are capped contractually until 05/01/14 at 1.25% for Class A. Caps exclude certain expenses, such as interest. 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 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. 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.

Emerging Markets Hard Currency Bonds refers to bonds denominated in currencies that are generally widely accepted around the world (such as the US 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 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 Barclays U.S. Aggregate Bond Index is a market capitalization-weighted index representing most U.S. traded investment grade bonds. The index comprises government securities, mortgage-backed securities, asset-backed securities and corporate securities to simulate the universe of bonds in the market. The maturity of the bonds in the index are over one year. The CBOE Volatility Index (VIX) uses options on S&P 500 Index stocks to gauge expected or implied volatility and is widely used as a measure of risk in the equity market.

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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