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Manager Commentary

Mexico and Costa Rica Local Currency Shine in January

By: Eric Fine, Portfolio Manager

We continue to expect the following longer-term themes to drive our investing in 2013, and they happen to be generally, although not completely, supportive of emerging market ("EM") debt risk.

- 1. Capital flight from countries with central banks focused on enabling government finances. The "push" of money out of developed economies and the "pull" of money into emerging economies looks likely to continue. Japan's recent moves to follow the US into larger central bank balance sheets and expansionary fiscal policy is the latest character to join this story. This is likely to benefit local-currency over hard-currency, in our opinion, as developed-world economic policies are close to policies of debasement.
- 2.The US economy as the global growth leader among so-called developed economies. To us, housing appears to be stabilizing, in particular. Given the economics training of policymakers, most notably Federal Reserve Chairman Bernanke, we believe any economic weakness will be met by easier money, and any early green shoots will be ignored until they grow into young trees. This growth may turn out to be nominal, not real, in retrospect, but we believe US market participants and consumers are conditioned to ignore or not understand the distinction. This encourages our greater exposure to Latin America, commodity producers and any Asian exporters that are cheap.
- 3. Central banks limiting tail risks that either are, or appear to be, in their control. Growth in the US and new monetary stimulus in Japan could be a boost to risk assets. We see local currency as the higher-beta to this theme, and some EM local-currency debt duration as vulnerable in the event of a sell-off in US Treasuries; we also believe high-yielding and distressed corporates should also benefit.
- 4. Idiosyncratic asset-price behavior. As a lot of money has entered the asset class, it is very hard for us to find value in hard-currency credit spreads. In fact, our models only show Venezuela, Argentina, and Ukraine as cheap, but further tests (including recent visits to each country) led us to reject these exposures. This has led us to be comfortable focusing on a few good positions, rather than a general long exposure to "the market."
- 5. Geopolitical tensions in the middle east/north Africa may escalate and potentially expand. We view the conflict in Syria as a proxy war between the US and its regional and European allies, against Iran. This has led us to avoid countries with direct exposure to the conflict, such as Egypt. The expansion of conflict into Mali means we may eventually have to broaden our definition of the afflicted areas.

However, we also see several investment themes rising in importance over the coming month or so, and they generally happen to be consistent with a bumpy road in EM debt risk.

- 1. A strong US dollar? Recently strong US trade data, especially in the energy balance, which many argue is structural (e.g., shale oil and gas production), could point to new support for the USD. Moreover, planned fiscal tightening as the authorities allow sequestration starting on March 1 could mean that the US becomes a little "tighter" than usual, on the global stage. Look at the Euro's rally, despite ongoing political problems, weak growth, etc. - our conclusion from that episode is that markets rewarded their currency for "tight" policy (in their case both fiscal and monetary). Of course, we see the US central bank as ultimately targeting growth and employment via asset prices, but we believe the central bank likely still sees itself as independent, and may need risk-hiccups to allow it to step up with more dollar debasement. This scenario gives us a higher bar for our EM local-currency allocations, namely higher rates and balance sheets that are more a function of commodities.
- 2. A strong US dollar? G-7 and G-20 leaders are jawboning again, and the general jist is to stop these "currency wars" from spreading. We believe Japan is the latest offender in this narrative. Coordinated statements could risk a reversal of recent currency moves, meaning that the JPY would strengthen and the EUR would weaken, both consistent with a risk-off dollar rally. We would expect the stronger fundamentals of EM countries to eventually re-assert themselves, but the USD becoming less-bad than the other majors has in the past happened with weaker EM currencies. This scenario gives us a higher bar for our EM local-currency allocations, namely higher rates and balance sheets that are more a function of commodities.
- 3. Credit no longer attractive? US high grade and EM hard-currency debt are down for the year. We also believe both asset classes are also no longer attracting the dramatic inflows of last year. Some models, such as those of Martin Fridson of Fridson Vision, moreover, show US high-yield spreads generally to be expensive relative to economic conditions (by about 140 bps). This gives us a higher bar for EM risk, generally, and for EM hard-currency, especially, other than new issues and distressed.

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4. US Treasury rallies or selloffs mean risk-off for EM debt?

This is a bit superficial, but we'll mention it anyway. If treasury yields rally, that is usually, in our experience, consistent with USD rallies and risk-off, generally. If treasury yields sell off, that may pressure recent years' inflows into "risky" debt, generally, and at least duration risk. This gives us a higher bar for the yield on any debt we own, whether hard- or local-currency – it should be high enough (among other characteristics) to be idiosyncratic.

5. Is Europe back as a risk? Many skeptics of the European experiment were effectively stymied by the threat of ECB bond purchases of sovereign credit risk, and gave up being bearish and perhaps even looking at Europe. Still, risks appear to us to have risen, recently. And, they've appeared to have risen in the one sphere that technocrats find harder to control – democratic politics. A corruption scandal in Spain, Italy's upcoming election which is trending against the status-quo, French concerns over the level of the Euro, and the possibility of a French downgrade appear to be the specific worries. New precedents – in which depositors and bank debt may be hit - being set in a new Cyprus bailout are another. Ultimately, the new "tools" at the ECB and the fact that all political actors have a stake in the experiment mean very high levees if the water starts to rise, but that doesn't mean we may not see rain. This makes us less willing to look to Europe for investments, and makes us more focused on a potential risk-off event.

Exposure Types

Exposures are relatively unchanged. The Fund still has over 90% of its exposure in local-currency debt. We find little value in hard-currency debt, where our models find value further tests aren't passed, and local-currency is what should appreciate in the face of so-called developed world currency debasement. The fund still has under 10% of its exposure in corporate debt. Given the risks we enumerate above, we are especially keen to keep buying either cheap bonds at new issue, when some involved price discovery has occurred, or when a bond has cheapened dramatically due to what we believe is a market over-reaction.

Top Positions

The themes above, our valuation framework, and the additional tests we apply, have resulted in the following top 5 positions. Nigerian local-currency debt, 14.5% of AUM; Russian local-currency debt, 12.8%; Mexican local-currency debt, 11.9%; Indonesian local-currency debt, 11.4%; Uruguay local-currency debt, 7.8%. These are all long-standing positions, and ones we had last month, so we have no further comments to add to our earlier rationales.

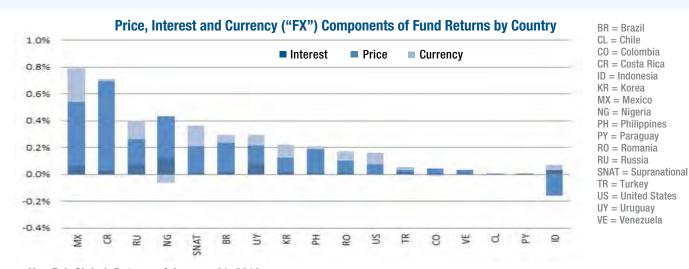
Biggest Changes

We initiated exposure to Romania, with an allocation that now stands at 5.1% of AUM. We initiated the position before the country's recently announced eligibility for, and inclusion in, the GBI-EM index. The country had recent elections, which in our view paved the way for a period of reduced political risk, constructive work with the IMF, and the potential to benefit from any absence of crisis in Europe.

We have re-initiated our exposure to Venezuelan hard-currency debt, as envisaged, to 4.9% of AUM. The bonds are cheaper than where we exited our original exposure. Moreover, we did not have our exposure during a period when we thought risks were high – in particular concerns around any transition to a post-Chavez era. We think this exposure could increase or decrease. Reasons to increase would be pro-active policy. Reasons to decrease would be half-hearted policy and a market over-reaction to President Chavez's demise.

Performance/Milestones

The Fund's biggest winners were Mexico, Costa Rica, Russia, Nigeria, and India, all in local-currency. The Fund's biggest (only) loser was Indonesia in local-currency. In Mexico, we believe the currency finally started helping our longstanding position, and hints at a rate cut boosted duration. In Costa Rica, interest rates continue to decline. In Russia, we believe the currency and interest rates benefited from its inclusion into the GBI-EM and steady oil prices.



Source: Van Eck Global. Data as of January 31, 2013.

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In Nigeria, yields continue to decline due to steady oil prices combined with inflows. In India (SNAT, as the issuers are Supranationals issuing in INR), the currency finally reacted to policy reforms.

The EM debt market's biggest winners were Belize, Ivory Coast and Ecuador, in hard-currency, and Philippines, India, and Mexico in local currency. The EM debt market's biggest losers were Argentine, Peru, and Uruguay in hard-currency, and South Africa, Indonesia, and Malaysia in local-currency.

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

	1 Mo [*]	1 Yr	Life
Class A: NAV (Inception 7/9/12)	2.94		14.32
Class A: Maximum 5.75% load	-2.96		7.77
GB-IEM	0.72		10.35
EMBI	-1.34		7.05

All weightings as of January 31, 2013.

*Monthly returns are not annualized.

Expenses: Class A: Gross 1.91%; 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 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.

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 Consumer Price Index (CPI) measures changes in the price level of consumer goods and services purchased by households.

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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. 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.

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