

Manager Commentary

Hard Currency Outperforms Local, Argentina Falls

By: Eric Fine, Portfolio Manager

Summary

In October, the J.P. Morgan Emerging Markets Bond Global Diversified Index (EMBI), representing hard currency (HC) debt*, returned 0.89%. The J.P. Morgan Government Bond-Emerging Markets Global Diversified Index (GBI-EM), representing local currency (LC) debt*, returned 0.52%.

In our opinion, the U.S. elections generated the best possible outcome for the status quo – especially in regard to ongoing support for large banks, monetary easing, and capital outflows from the U.S. into emerging markets hard- and local-currency debt.

For emerging market debt asset prices, we prefer the simpler, cleaner race to the bottom for the dollar and interest rates that we expect under Obama to the bumpier and less certain ride that we think markets might have anticipated under Romney. We also think there will likely be a period of nominal rises in GDP growth and asset prices confused with real rises, and, if that is the case, investors will need to navigate that.

On the other hand, geopolitical concerns may be higher now under an Obama presidency. This thought makes us less-than-otherwise comfortable with significant exposure to countries such as Turkey and, potentially, Nigeria.

Europe remains fraught with risk, as the ECB looks to have over-promised and under-delivered, and doubts still remain as to whether peripheral fiscal problems can be contained.

Our portfolio currently has low cash levels that could soon rise due to a combination of fears around Europe, fears surrounding the fiscal cliff, and a desire to keep some powder dry to participate in new issues.

Venezuela remains our largest allocation in hard-currency. We completely exited Argentina before its October weakness, and Portuguese debt before its late-October selloff. Nigeria, Russia, Uruguay, and Mexico remain our largest allocations in local-currency.

Against these reductions, we increased allocations to new issues in hard-currency and long-standing local-currency positions in India and Russia.

*See definitions on last 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.

*Beta is a measure of sensitivity to market (benchmark) movement.

Mutual Funds

Performance Review

The Van Eck Unconstrained Emerging Market Bond Fund returned 2.08% in October for its Class A shares (excluding sales charges). The Fund has now produced positive performance in all four months since inception.

Average Annual Total Returns (%) as of October 31, 2012

	1 Mo*	1 Yr	Life
Class A: NAV (Inception 7/9/12)	2.08	--	6.63
Class A: Maximum 5.75% load	-3.76	--	0.52

*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.

In October, Portugal and Uruguay were the Fund's big winners, but its outperformance relative to the hard- and local-currency indices was also the result of having no Argentine exposure in hard-currency, and no South African exposure in local-currency.

In October, Argentina was the clear hard-currency loser, in stark contrast with its leading performance in September. Argentina's weakness was triggered by fears of a technical default resulting from U.S. court proceedings. In particular, holdout creditors, who did not participate in an exchange offer from Argentina to settle claims on defaulted debt, appeared to get a boost from a court ruling in their favor. As a result, the possibility of these holdouts' receiving full repayment on Argentina's defaulted debts has risen. (The holdouts represent about 7% of affected debt. Despite the ruling, Argentina has vowed to defend its position legally.)

In local-currency, the Philippines led positive returns, with no particular trigger other than high inflows into an emerging market asset class that found Philippine fundamentals attractive. The biggest loser for the month was South Africa, with strikes and emerging political risks (including the ANC's upcoming party conference in December) hitting the currency. The chart below reviews performance of hard- and local-currency markets by country.

For the Fund, the biggest contributors to October's performance were Portugal and Uruguay. The Fund's outperformance relative to the hard- and local-currency indices was also largely the result of having no Argentine exposure in hard-currency, and no South Africa exposure in local-currency.

Portugal gained because the market continued to respect the ECB's potential to buy its debt. Uruguay's returns were the result of currency strength, led by strong fundamentals and declining yields, both of which were the result of inflows to the asset class, attracted by positive fundamentals. Mexico again was among our losers, and it was led by currency risk, with no specific trigger other than perhaps heavy positioning.

Current Views

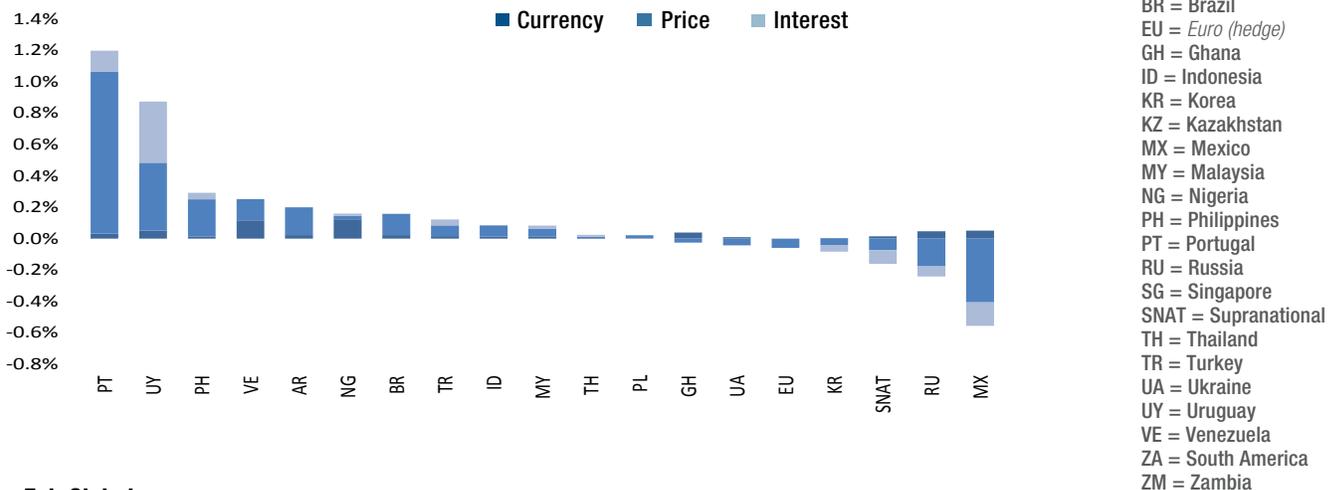
We believe U.S. elections generated the best possible outcome for the status quo, especially in regard to continuing support for large banks, ongoing monetary forbearance, and capital outflows from the U.S. into emerging market (EM) hard- and local-currency debt. The fact that the election was not close or subject to legal challenges in any particular state was an additional positive. Most importantly, the re-election of President Obama was ideal for EM debt, in our opinion, because it means the Fed will likely continue its balance sheet expansion for the foreseeable future.

At the end of Mr. Bernanke's term, moreover, an even looser framework is likely, in our opinion, with Janet Yellen his potential successor. Dollar debasement and "don't-worry-be-happy" approaches to fiscal and monetary policy have been key push-factors for money out of the U.S. and into EM. By and large, EM has benefited by having the opposite policy – generally tight fiscal policy combined with more austere central banks.

For EM debt asset prices, we prefer the simpler, cleaner race to the bottom for the dollar and interest rates that we expect under Obama to the less predictable race to the bottom that we would have anticipated under Romney. We think the policy mix likely to be offered under an Obama presidency will end badly for the U.S. The lack of fiscal constraints and the co-opting of the central bank by the fiscal authority (i.e., enabling low-cost borrowing not set by market interest rates) usually ends badly, in our experience. In addition, we think a Romney presidency would have been more complicated and confusing. At minimum, there would have been the pretense of addressing these issues, which might have falsely boosted confidence for several months, only to ultimately disappoint. In our view, Romney's economic policies eventually would have become essentially the same as Obama's, with differences mainly in structural policy areas such as regulation. We also think that there will likely be a period of nominal increases in growth and asset prices that are confused with real rises, and investors will have to navigate that.

On the other hand, geopolitical concerns may have escalated with the election. Following the election, the U.S. appears more openly allied with anti-Assad militias in Syria. The U.K. is taking the lead in coordinating this support, just as it (along with France, Italy and the U.S.) did in Libya.

Price, Interest and Currency ("FX") Components of Returns by Country



Source: Van Eck Global.

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In our opinion, a policy of toppling the current regime in Syria goes beyond humanitarian aims and has moved closer to a proxy war with Iran, which we believe will be different and perhaps much more destabilizing than other conflicts in the region. This is due to Russian and Chinese opposition, Iran's size, and the destabilizing effects on domestic politics in neighboring countries such as Egypt, Saudi Arabia, and Pakistan, especially if militant factions can persuade larger populations that these governments are sympathetic to Israel. Moreover, the spread of weapons from Libya to Mali, and its negative implications for Nigeria and other parts of Africa, are a reminder of the breadth of this potential geopolitical crisis.

Europe remains fraught with risk, as the ECB looks to have over-promised and under-delivered and doubts remain as to whether peripheral fiscal problems can be contained. We are surprised to still be writing about Europe. After ECB President Mario Draghi's trumpeting of Outright Monetary Transactions (OMT), which basically means buying sovereign debt through an EU/IMF/ECB-approved program, the ECB seemed to be on the offense. However, our interactions with ECB and other officials suggest that OMT will be used only if yield spreads widen, which makes it a defensive tool. The problem with this approach is that it will likely mean ongoing instability at the least, potentially combined with rising debt-servicing costs. Time is not on the authorities' side, in other words. Given weak political support among populations, this also is worrisome from the perspective of growing social tension. For now, the threat of OMT and restrictions on shorting sovereign debt mean that pressures may be contained or absorbed by a weaker Euro, which has become basically the only short-able European asset.

Current Positioning

Our current portfolio has low cash levels that could soon rise due to a combination of Europe, fears surrounding the fiscal cliff, and a desire to keep some dry power to participate in new issues.

The market may need to digest hiccups from the developed world, as discussed above. In the short-term, this could mitigate in favor of higher cash levels to seek to take advantage of better buying opportunities later. Also, 2012 thus far has seen very little new issuance in the high-yield corporate sector. The bulk of this year's record corporate debt issuance has been investment-grade, where we've seen little value. As a result, we want the flexibility to participate in new issues, buying on the bid in a sense, for credits that are cheap according to our models and in countries where we are either neutral or positive. Another reason we want to participate in new issues is that we have low exposure to hard-currency EM debt, seeing little value in that sector generally, and want to be able to gain this exposure, if and when desired through new issues.

We like Venezuela simply because it has more hard-currency reserves (and resources) than external debt. In short, it is a net external creditor with credit spreads north of 700 basis points! In addition, most of its debt is denominated in local currency.

In my opinion, devaluations should not trigger a vicious cycle of rising debt service and greater devaluations. We mention this because we continue to expect a devaluation of the bolivar, and official denials of such a scenario increase its likelihood, in our opinion. Also, President Chavez has continued to pay debt service even when oil prices were very low.

Nigeria, Russia, Uruguay, and Mexico remain our largest allocations in local-currency debt. We are reluctant to generalize beyond any single country, but we view these as having strong balance sheets and yields that are either consistent with inflation trends or supportive of stable currencies.

We recently returned from a trip to Nigeria, which strengthened what was our already positive outlook for the country's local debt. In particular, we believe good policy and populism actually coincide in some cases. For example, energy reform is a priority of President Goodluck Jonathan, following protests earlier in the year. The risk, in our opinion, is that the country is in the process of rebuilding reserves, so upside to the currency will be limited by central bank reserve accumulation. Our trip to Ghana, on the other hand, has caused us to lower our allocation to its local market. Upcoming elections, low reserves, and a policymaking framework that appears to require near-crisis conditions for a return of the IMF have pushed us in the direction of waiting for a better entry point.

The most significant change to the portfolio from the end of September is our complete exit from Argentine hard-currency debt and our complete exit from Portuguese debt. We closed Argentina due to risks surrounding the court case described above. Also, we were concerned over the potential for changing debt obligations denominated in dollars to Argentine pesos ("pesification"). While this may sound extreme, it appears to be legal for the local-law debt of some provinces, and the process is symptomatic of the dollar shortage in the country. President Cristina Kirchner, herself briefly discussed (but then denied) pesification of Argentina's sovereign debt. Given the un-analyzability of policymaking in Argentina, we are taking the denials with a grain of salt. (For details, please see the report we wrote on Argentina and other Latin American countries in last month's commentary.)

We closed our Portugal position for two reasons. First, it had approached our price target. Second, we returned from the annual IMF meetings in Tokyo viewing the ECB's OMT as a weaker (or at least more defensive) instrument than we think the market appreciates. We may re-establish a position here, but only when the ECB is cornered into being less ashamed of manipulating borrowing costs. We don't think this is good long-term policy, but it would make Portuguese debt more attractive, while perhaps increasing tax obligations on northern European taxpayers.

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All weightings as of October 31, 2012.

*Hard Currency refers to 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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