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Manager Commentary

Local currency bests hard currency in September, Argentina the exception

By: Eric Fine, Portfolio Manager

Summary

In September, the J.P. Morgan Emerging Markets Bond Global Diversified Index (EMBI), representing hard currency (HC) debt*, returned 1.63%. The J.P. Morgan Government Bond - Emerging Markets Global Diversified Index (GBI-EM), representing local currency (LC) debt*, returned 2.62%.

The Eurozone has faded as a market driver, with the possibility of Outright Monetary Transactions (OMT) by the European Central Bank (ECB) perceived as close enough to U.S.-style quantitative easing to scare away the bears, at least for now.

Idiosyncratic, country-specific developments are now driving asset price performance. September produced several examples of this trend, with bond prices falling in Turkey and South Africa and rising in India, Russia and Nigeria.

The key positive influence for emerging market debt is ongoing inflows into the asset class, most of which represents transfers from capital markets of developed nations. In bonds, as in equities, investors appear to be gradually shifting assets into countries with higher GDP growth prospects than developed nations offer.

Investors remain wary of risks including ongoing uncertainty in Europe, U.S. elections, and spreading political and economic tensions in the Middle East, North Africa, and the Persian Gulf. If these tensions escalate into conflicts – such as the war in Syria – risk perceptions could rise sharply because these wars are not just traditional civil conflicts over power. Rather, they can inflame deeper and older cultural divides, as we saw in September on the Syria-Turkey border.

The current portfolio continues to hold low amounts of cash and is concentrated in higher-yielding and higher-beta hard-currency and local-currency debt. Venezuela and Argentina remain our largest allocations among hard-currency debt. Nigeria, Russia, Uruguay, and Mexico are our largest allocations among local-currency debt.

During September, the most significant changes to the portfolio were: 1) the closing of our South African and Turkish exposures (both in local currency); and 2) increased exposure in Nigeria, Russia, Uruguay, and Venezuela. Portugal is our newest and now our third-largest allocation to hard-currency debt, after Venezuela and Argentina.

Performance Review

The Van Eck Unconstrained Emerging Market Bond Fund's Class A shares gained 2.44% for the month (excluding sales charge). Launched on July 9, the Fund is actively managed and focuses on emerging market debt instruments all over the globe. The Fund has produced positive performance in all three months since inception.

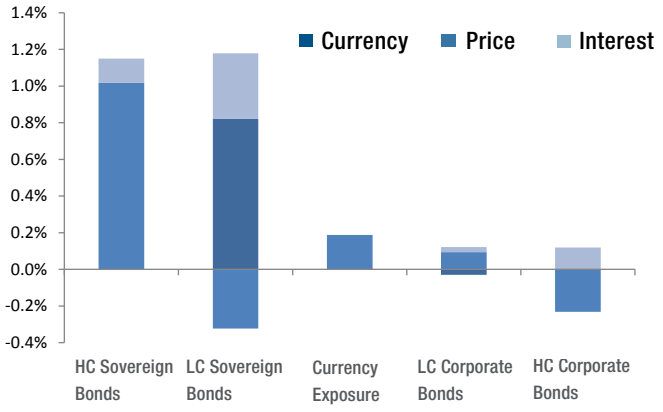
Average Annual Total Returns (%) as of September 30, 2012

	1 Mo*	1 Yr	Life
Class A: NAV (Inception 7/9/12)	2.44	--	4.68
Class A: Maximum 5.75% load	-3.44	--	-1.32

*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.

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



Source: Van Eck Global.

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

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Performance Review (continued)

In September, Argentina was the clear hard-currency winner, with all other countries basically in a different zip code. On its own, the Argentine hard-currency component of the EMBI index generated roughly 13% for the month. In local-currency, India led the way with Russia, Poland, Brazil, and Mexico also adding significantly to performance.

The biggest contributors to Fund performance were Argentine and Venezuelan hard-currency debt and Mexican local-currency debt. The biggest detractors were hard-currency debt of Indonesia and Portugal. The chart below details returns by country including the price, interest and currency components. Note that Portugal's stand-alone performance was offset by our euro currency hedge, as those bonds are denominated in euros and we hedged the bulk of currency risk, taking only the pure credit risk. Also note that the Portugal position was established in September, in line with what we wrote last month regarding possible new positions.

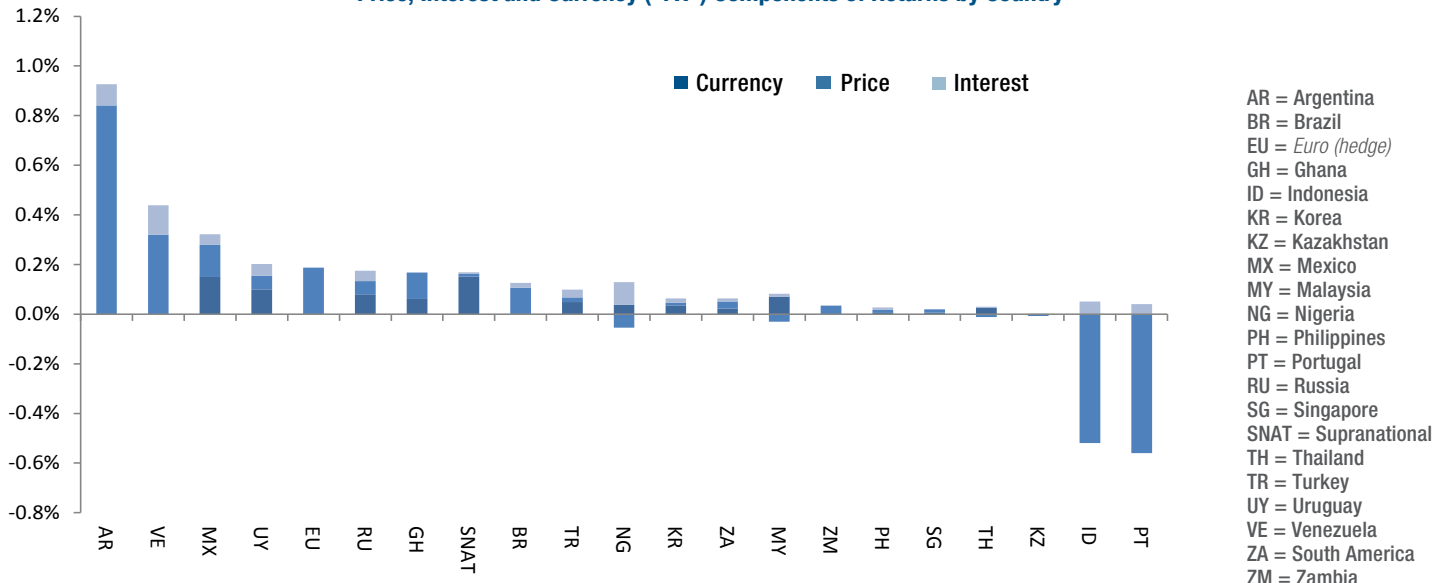
Current Views

The Eurozone has faded as a market-driver, with the possibility of Outright Monetary Transactions (OMT) by the ECB perceived as close enough to U.S.-style quantitative easing to scare away the bears for now. Europe's crisis has driven the risk-on, risk-off market pattern for the past two years. With the ECB now appearing more willing to engage in open-ended direct intervention in sovereign bond markets, fiscal and political developments are having far less impact. It appears the market is at least viewing the threat of ECB action as containing Europe to itself. At most, we think the market's view will drive another phase of strength in all asset prices, as occurred after the similar policy action during the U.S. phase of the global crisis. Either way, it's no longer all about Europe, in our opinion.

Idiosyncratic, country-specific developments are now driving asset-price performance, and September confirmed this view with multiple examples. Turkish hard-currency and local-currency debt (neither of which are large positions for the fund) were driven by tensions related to fighting in neighboring Syria. The South African currency, which the Fund does not currently hold, was driven lower by the threat of labor unrest expanding from the mining sector into others, such as transportation. On the positive side, India's currency was boosted by strong government reform announcements, and Russia's currency was lifted by rising oil prices. Nigeria's currency strengthened on high oil prices combined with the imminent inclusion of its bonds in the GBI-EM Index of local-currency EM debt.

The key positives for EM debt are ongoing inflows into the asset class, as investors shift assets away from developed markets. Year-to-date through the end of September, total inflows into EM fixed income were $62 billion, which is near the $80 billion record set for all of 2010. Part of this flow is driven by the soundness of emerging market sovereign balance sheets, with lower debts and deficits than most developed nations. Another part of this flow is being driven by investors' exiting from U.S. and European bond markets, where central banks are viewed as being under the influence of fiscal authorities. For example, the Fed has bought more than half of all U.S. Treasuries issued in the past 12 months, which raises questions as to whether U.S. interest rates can be described as market-determined. Of course, it also creates doubts about whether the Fed can end such a policy without triggering debt sustainability questions. Now that the ECB has joined this policy framework, at least on a modest scale, we think it leaves bond investors fewer places to hide.

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



Source: Van Eck Global.

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Investors remain wary of risks including ongoing uncertainty in Europe, U.S. elections, and spreading political and economic tensions in the Middle East, North Africa, and Persian Gulf. Although the ECB's new stance (described above) could put a floor under asset prices, the ECB is putting various degrees of pressure on member countries to comply with fiscal rules, to qualify for such support. Each time a country is pressured to comply with "austerity measures," it generates some degree of market tension. U.S. elections now appear a bit more relevant than when we wrote last month's commentary, as Mitt Romney's boost in the polls has appeared encouraged the market to discount some direct approaches to solving U.S. fiscal issues.

Finally, Middle East and Persian Gulf tensions appear to be rising. The chaos in Libya has allowed weapons proliferation to undermine countries such as Mali, and the spread of unrest in Syria now is affecting Turkey and Lebanon. We'll reiterate what we said last month – namely that we think any wars breaking out in this region (including Syria) will be unlike those of past decades. Syria appears to be a proxy war in which Iran is both supporting the Assad regime and perhaps seeking to undermine the social fabric in general. Iran's general population, Russia and China's resistance to US/NATO/Israeli aims, and the risk of further political radicalization in Egypt make for a different mix, in our opinion. Algeria is worth keeping on the radar, in our view, if only because of its significant role as a natural gas supplier to Europe.

Current Positioning

The current portfolio continues to hold low amounts of cash and is concentrated in higher-yielding and higher-beta hard-currency and local-currency debt.

We see Europe's weight on the market as lessening. With so-called reserve currencies set for low interest rates and ongoing balance sheet strains for a prolonged period, the carry and strong balance-sheet attributes belong more to EM, in our opinion. Moreover, we continue anticipating secular inflows into EM debt from retail, institutional and central bank buyers. As we've argued in the past, developed markets are characterized by weak balance sheets and policymaking oriented towards keeping government borrowing costs low. Emerging markets are characterized by strong balance sheets and policymaking that aims to maintain long-term fiscal balance, with central banks that will raise borrowing costs on governments that don't do so.

Venezuela and Argentina remain our largest allocations among hard-currency debt. We like them simply because their fundamentals are inconsistent with their high credit spreads. Countries with these sets of fundamentals usually trade a few hundred basis points lower in yield.

Nigeria, Russia, Uruguay, and Mexico are our largest allocations among 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, where our experiences strengthened our already positive outlook for the country's local debt. In particular, good policy and populism actually coincide in some instances. For example, energy reform is a priority for 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 recent excursion into Ghana, on the other hand, has caused us to reduce our allocation to its local market. Upcoming elections, low reserves, and a policymaking framework that even the IMF finds perplexing have pushed us in the direction of waiting for a better entry point.

September's most significant changes to the portfolio were the closing of our South African and Turkish exposures (both in local currency), and increases in Nigeria, Russia, Uruguay, and Venezuela. In South Africa, we are concerned about spreading labor unrest, which could challenge a decades-old reputation as a quasi-advanced economy, with the index inclusion and investment that entails. In Turkey, we are concerned with ongoing tensions with Syria, as well as the country's dependence on oil, particularly oil from Iran. As such, we reallocated capital into opportunities for which we have the highest confidence in terms of risk/reward profile.

Portugal is our newest and now our third-largest allocation to hard-currency debt, after Venezuela and Argentina. Portugal is adhering to its EU/IMF/ECB program, despite political backlash. It is slowly regaining "market access," the ECB's condition for activating OMT. We believe this will at least give bond bears pause, whether or not OMT is activated. Our favored Portuguese bond is at the long-end of the yield curve, which indicates that we are not very concerned over duration-driven downside.

All weightings as of September 30, 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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