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Strengthening Headwinds Lead to Reduction in Local-Currency Debt

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VanEck Unconstrained Emerging Markets Bond Fund

EMBAX / EMBCX / EMBUX / EMBYX

The market framework we've used this year – real headwinds/risks set against the tailwind of relatively easy central bank policies – remains in place. However, currently, the headwinds seem to be strengthening while the tailwind of lower interest rates appears to be fading. As a result, we are in the process of adjusting the portfolio away from local-currency debt towards U.S. dollar-denominated debt and have also reduced the portfolio's duration. In the case of our local-currency reductions, many of these are failing our correlation tests, particularly those with low nominal rates that put them at risk of correlating with both rising yields and/or economic weakness in developed markets. In the case of our duration reductions, we started to assign poor correlation test scores to many bonds with high duration. They are at risk, in our opinion, either of correlating with higher credit spreads in the event of economic weakness or of correlating with U.S. Treasury weakness in the event that global growth is fine and the way to Federal Reserve Bank (Fed) rate hikes is cleared.

The headwinds/risks that concern us include Europe's fragility (one currency can't exist without one fiscal and one financial system), China (high leverage using local-currency debt), and the potential risk of global stagflation (persistent high inflation combined with high unemployment and stagnant demand in a country's economy), which central banks might be impotent against. The tailwind remains the loose monetary policy of developed-market central banks, which have been encouraging re-leveraging in the emerging markets, as well as risk-seeking behavior on the part of global investors looking for scarcer yield.

There are multiple signs that lead us to believe that headwinds are rising, and the tailwind of central bank forbearance is waning. First, the Bank of Japan and European Central Bank have recently disappointed market expectations of continued expansion of their quantitative easing programs, resulting in significant selloffs in those bond markets. The 10-year nominal Japanese Government Bond (JGB) yield widened by 27 bps and the 10-year Bund yield by 20 bps after bottoming out in July. The duration selloff (30 year) was even more pronounced – 47 bps for JGBs and 26 bps for Bunds. Second, this is happening in the context of an extended U.S. economic recovery that is overdue for a downturn. This raises the question – What would the Fed do in such event? At its meeting in Jackson Hole the Fed indicated it would do more of the same, and that any recession is far away, thus it would be able to raise rates and then cut them when the recession hits. This may be very optimistic. Third, if such a stagflation scenario occurs, the implications for economies and asset prices could be broad and deep. Most of the emerging world, led by China, has re-levered. If rolling this debt becomes more expensive, and if growth disappointments accelerate, we may witness significant outflows from emerging markets and market corrections may be in store. Since the global financial crisis, the consensus trade has become low interest rates "forever", and emerging markets debt has been a significant beneficiary of this. Fourth, Europe has key risk events coming up, including the October/November Italian referendum and next year's (April/May) French presidential elections.

What are the portfolio implications of this change in our risk assessment? First and most important, is liquidity. We are small and nimble and that is an advantage in a world where bond funds have grown significantly and have been encouraged to take risks due to the "low rates forever" consensus view. Second, we are an unconstrained fund and are taking advantage of our ability to help reduce exposure to the risky assets and sectors of our market such as local-currency debt.

More specifically, we are in the process of reducing our local-currency exposure and avoiding highly-correlated local-currency bonds with low nominal or real interest rates, and with no reform program or catalyst. This means reducing our Malaysia and Mexico exposures. We also are reducing our South Africa local-currency exposure. We should note that we do not intend to have significant exposure to Turkey local-currency (which we mention only because it is a big index component), because of political concerns surrounding the central bank which we believe is at risk of a purge following the country's coup attempt.

This leaves us with exposure to local-currency markets in Brazil, Indonesia, and Colombia. All of these have high real and nominal interest rates, declining (sharply in the first two cases) inflation and inflation expectations, and established reform programs.

In hard-currency, we have increased our exposures to the names we already own, which include sovereigns and/or corporates in Brazil (Petrobras), Korea, Mexico, Russia, and Argentina, and increased exposure to Mongolia, which might be aiming for an International Monetary Fund (IMF) program, and Ukraine which is likely to agree shortly to an IMF program. We have increased our South Africa exposure as we believe that political turmoil following regional elections is likely to be over. We see this as mapping positively to hard-currency debt, but not necessarily to local-currency debt.

Exposure Types and Significant Changes

The changes to our top positions are summarized below. Our largest positions are currently: Brazil, Mexico, Argentina, Indonesia, and Peru.

- We added hard-currency sovereign exposure in Ukraine and Mongolia. Both countries are benefitting from improving relations with the IMF, with its Board finally setting the date to discuss the disbursement of the next tranche to Ukraine. In terms of our investment process, this results in improved scores for Ukraine's vulnerability and policy/politics tests.

- We also added quasi-sovereign hard-currency exposure in South Africa and local-currency sovereign exposure in Colombia. In Colombia, the process of disinflation is finally underway, improving the country's score on the vulnerability test. In South Africa, the latest bout of political turbulence associated with the dispute between President Zuma and Minister of Finance Gordhan is now behind us. In terms of our investment process, this translates into an improved policy test score.

- We reduced local-currency sovereign exposure in Russia, Mexico, and Indonesia. In Mexico, the Banxico (Banco de México) Governor's frequent comments about the peso, in our view, are not helpful in the context of the bank's relatively low reserve adequacy, while the ongoing uncertainty about the Fed's intentions has a strong impact on local markets, given the strong ties with the U.S. economy. In terms of our investment process this results in weaker scores for correlation and policy/politics tests. In Russia, we point to the risks associated with issuance expectations as the government shifts to a different model of fiscal deficit financing. In terms of our investment process, we lowered Russia's politics/policy test scores. The deteriorating score for Indonesia's correlation test was the main reason for reducing our exposure there.

- We also reduced quasi-sovereign hard-currency exposure in Russia and China and hard-currency sovereign exposure in Malaysia on the back of deteriorating scores for the correlation tests for these countries.

Fund Performance

The Unconstrained Emerging Markets Bond Fund (Class A shares excluding sales charge) lost 0.62% in August, compared to a 0.91% gain for the 50/50 J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM) local currency and the J.P. Morgan Emerging Markets Bond Index (EMBI) hard-currency index. The Fund's biggest winners were Argentina, Brazil, and Russia. The Fund's biggest losers were South Africa and Mongolia.

Turning to the market's performance, the GBI-EM's biggest winners were Colombia, Russia, and the Philippines. The biggest losers were South Africa, Chile, and Indonesia.

The EMBI's biggest winners were Zambia, Iraq, and Ghana, while its biggest losers were Mongolia, South Africa, and Chile.

Average Annual Total Returns (%) as of August 31, 2016

	1 Mo†	3 Mo†	YTD	1 Yr	3 Yr	Life
Class A: NAV (Inception 7/9/12)	-0.62	2.32	7.25	4.32	-0.18	-0.03
Class A: Maximum 5.75% Load	-6.38	-3.59	1.01	-1.72	-2.14	-1.45
50 GBI-EM GD / 50% EMBI GD	0.91	6.86	14.63	12.89	3.52	–

Average Annual Total Returns (%) as of June 30, 2016

	1 Mo†	3 Mo†	YTD	1 Yr	3 Yr	Life
Class A: NAV (Inception 7/9/12)	1.99	2.63	6.90	-3.46	-0.69	-0.12
Class A: Maximum 5.75% Load	-3.90	-3.29	0.68	-9.05	-2.63	-1.59
50 GBI-EM GD / 50% EMBI GD	4.63	3.90	12.24	5.96	1.75	-

†Monthly returns are not annualized.

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.

Diversification does not assure a profit or prevent against a loss.

Expenses: Class A: Gross 1.44%; Net 1.25%. Expenses are capped contractually until 05/01/17 at 1.25% for Class A. Caps exclude certain expenses, such as interest. Please note that, generally, unconstrained bond funds may have higher fees than core bond funds due to the specialized nature of their strategies.

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 investors' 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 Net Asset Value (NAV). Index returns assume that dividends of the index constituents have been reinvested. Investing involves risk, including loss of principal; please see disclaimers on next page. Please call 800.826.2333 or visit vaneck.com for performance current to the most recent month ended.

Duration measures a bond's sensitivity to interest rate changes that reflects the change in a bond's price given a change in yield. This duration measure is appropriate for bonds with embedded options. Quantitative Easing by a central bank increases the money supply engaging in open market operations in an effort to promote increased lending and liquidity. Monetary Easing is an economic tool employed by a central bank to reduce interest rates and increase money supply in an effort to stimulate economic activity. Correlation is a statistical measure of how two variables move in relation to one other. Liquidity Illusion refers to the effect that an independent variable might have in the liquidity of a security as such variable fluctuates overtime. A Holdouts Issue in the fixed income asset class occurs when a bond issuing country or entity is in default or at the brink of default, and launches an exchange offer in an attempt to restructure its debt held by existing bond holding investors.

Emerging Markets Hard Currency Bonds refers to bonds denominated in currencies that are generally widely accepted around the world (such as the U.S.-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.

All indices are unmanaged 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 50/50 benchmark (the "Index") is a blended index consisting of 50% J.P. Morgan Emerging Markets Bond Index (EMBI GD) Global Diversified and 50% J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM GD). The J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM GD) tracks local currency bonds issued by Emerging Markets governments. The index spans over 15 countries. J.P. Morgan Emerging Markets Bond Index (EMBI) Global Diversified 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 J.P. Morgan Emerging Country Currency Index (EMCI) is a tradable benchmark for emerging markets currencies versus the U.S. Dollar (USD). The Index compromises 10 currencies: BRL, CLP, CNH, HUF, INR, MXN, RUB, SGD, TRY and ZAR. The Consumer Confidence Index (CCI) is an indicator designed to measure consumer confidence, which is defined as the degree of optimism on the state of the economy that consumers are expressing through their activities of savings and spending.

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.