

# THE SCOTT LETTER: CLOSED-END FUND REPORT

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*A Global View of the Closed-End Fund Industry*

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THE SCOTT LETTER is intended to educate global investors about closed-end funds. Closed-end funds can be a valuable and profitable investment tool. To learn about closed-end funds, visit our web site,

[www.CEFAdvisors.com](http://www.CEFAdvisors.com), and in particular, read our article, *What Are Closed-End Funds*. Feel free to forward this newsletter to anyone who you believe could benefit from information on

closed-end funds or global portfolios.



– George Cole Scott  
Editor-in-Chief

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## The Central Europe and Russia Fund The European Equity Fund

The European Union has recently expanded from 15 members to 25. Twelve EU countries have joined the monetary union: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Spain and Portugal. Three EU countries – Denmark, Sweden and the United Kingdom – have chosen not to join the European Monetary Union. If the remaining 10 EU countries (several of which are located in Eastern Europe) want to adopt the single currency, they will have to meet certain requirements, called the “Maastricht” criteria, named after the treaty that set out the timetable for monetary union. The key requirements are as follows:

- Inflation rate should be within 1.5% of that of the eurozone.
- Exchange rates should be stable in relation to the euro.
- Annual budget deficit should be below 3% of the gross domestic product (GDP).
- Total amount of the money owed by the state, known as public debt, must be less than 60% of GDP.

The Eurozone, or “Euroland” as some call it, is one of the largest exporters in the world. Its gross domestic product (GDP) comes close to that of the U.S. With more than 290 million inhabitants, the Eurozone is larger than the United States.

Given the importance of this market and the recent eastward expansion of the EU, we interviewed Sandra M. Schaufler, Chief Investment Officer of the Central Europe and Russia Fund, the European Equity Fund and the New Germany Fund. Prior to joining Deutsche Asset Management in 2004, Ms. Schaufler had eight years of experience, including director of equity sales at HVB Capital Markets, portfolio manager and equity

analyst at Deutsche Asset Management in Frankfurt and portfolio manager at Allianz Asset Management in Munich, Germany. Ms. Schaufler has a M.Sc. in International Economic Sciences from the University of Innsbruck in Austria. She is a Chartered Financial Analyst.

The Central Europe and Russia Fund, Inc. (CEE:NYSE) is a non-diversified, closed-end investment company seeking long-term capital appreciation through investment primarily in equity and equity-linked securities of issuers

domiciled in Central Europe and Russia. CEE had net assets as of October 31, 2005 of \$431.98 million, an expense ratio of 1.20% and a portfolio turnover rate of 30%. The fund has a Dividend Reinvestment Plan and a voluntary Cash Purchase Program. Dividends paid in 2004 were \$0.17 from ordinary income only.

The European Equity Fund, Inc. (EEA:NYSE), formerly The

Germany Fund, seeks long-term capital appreciation through investment primarily (normally at least 80% of its assets) in equity and equity-linked securities of companies domiciled in countries utilizing the Euro currency. Previously, the Fund sought long-term capital appreciation investing primarily in large capitalization equity securities trading on the German stock exchanges. The fund's Board of Directors approved an expansion of the Fund's investment objective and fundamental policies to include equities of companies in all European countries using the Euro currency. On October 27, 2005, stockholders approved the expansion of its investment focus from Germany to the 12 countries utilizing the Euro currency. Effective October 31, 2005, the Fund's shares trade on the NYSE under ticker



Sandra M. Schaufler

symbol “EEA”. The Fund had total net assets of \$118 million as of December 31, 2005, an expense ratio of 1.57% and a portfolio turnover rate of 61% for the (unaudited) six months ended June 30, 2005.

These funds are not diversified and may focus their investments in certain geographical regions, thereby increasing their vulnerability to developments in that region. Investing in foreign securities presents certain unique risks not associated with domestic investments, such as currency fluctuation, political and economic changes and market risks. This may result in greater share price volatility. The investment manager is Deutsche Investment Management Americas, based in New York.

We interviewed Sandra M. Schaufler on February 17:

**SL:** Let’s begin by talking about the Central Europe and Russia Fund. As of December 31, 2005 the Fund was invested 52% in Russia, 15% in Poland, 14% in Turkey, 8% in Hungary and 6% in the Czech Republic. How has that country allocation contributed to the Fund’s performance?

**Schaufler:** We view Russia and Turkey, which were among the top performing equity markets in 2005 and have had a very strong start in 2006, as two particularly attractive investment markets. Both of these countries are high beta (volatile market) countries, but the ever-increasing risk appetite of investors makes those countries attractive. That is why you see strong inflows into those countries. Following the crisis in Russia in 2004, people were hesitant to put more money down, but they saw that the market performed quite strongly in the first half of 2005, and we saw good demand for equities in Central Europe and Russia.

**SL:** Russia is a significant focus for you, but we read in *The Financial Times* that the “dizzying growth of Russia’s market in the past year has run ahead of economic fundamentals and is not without danger,” according to the head of Russia’s Financial Markets Service. The newspaper also stated that Russia’s dollar-denominated RTS stock index rose 83% last year and has jumped a further 20% this

year (through February 2006), already topping many analysts price targets for 2006. Can we ignore warnings such as this particularly in a country that may be solely driven by oil prices?

**Schaufler:** Russia is a country driven by the oil price, but there are other factors that make Russia an attractive investment destination. For example, President Putin has renewed his commitment to reform, with a focus on issues important to investors, such as limiting the authority of tax officials and clarifying property rights.

In addition, Russia has enjoyed investment-grade status with all three major

ratings agencies since January 2005. The government’s efforts toward continued fiscal responsibility made it compelling for rating agencies to further upgrade Russia’s sovereign debt rating in the second half of 2005. Russia has also experienced strong GDP growth partly due to rising prices for exported oil and gas.

We believe that high energy prices could well persist. Russia should be a major beneficiary, as an improved infrastructure (rail, road and pipelines) should facilitate the expected growth in oil output. These positive trends and developments may translate into attractive investment

### CEE Performance\*

Performance history						Cumulative returns as of 12/31/05			
Average annual total returns as of 12/31/05						YTD			
	1-year	3-year	5-year	10-year	Life of fund		1-month	3-month	Inception date
Market price	62.54%	47.17%	29.64%	15.83%	10.46%	62.54%	5.11%	-7.31%	3/6/90
Net asset value	54.39	46.19	25.03	14.65	10.66	54.39	4.52	3.96	3/6/90
Benchmark†	44.43	39.12	19.98	13.79	n/a	44.43	3.75	2.8	n/a

The benchmark is a mix of 45% CECE/45% RTX/10% ISE National 30. The CECE is a regional capitalization-weighted index including stocks from the Czech Republic, Hungary, Poland and Slovakia and is published daily by the Vienna Stock Exchange as well. The RTX is a capitalization-weighted index of Russian blue-chip stocks and is published daily by the Vienna Stock Exchange. The ISE National 30 is a capitalization-weighted index composed of National Market companies except investment trusts and will also be used for trading in the Derivatives Market. Index returns assume reinvestment of any and all distributions and, unlike fund returns, do not reflect fees or expenses. It is not possible to invest directly in an index.

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### EEA Performance\*

Performance history						Cumulative returns as of 12/31/05			
Average annual total returns as of 12/31/05						YTD			
	1-year	3-year	5-year	10-year	Life of fund		1-month	3-month	Inception date
Market price	9.66%	25.68%	-0.87%	6.89%	7.97%	9.66%	3.90%	2.81%	7/23/86
Net asset value	7.17	24.42	-1.22	6.32	8.60	7.17	5.25	4.49	7/23/86
Benchmark†	8.41	27.55	0.97	7.41	n/a	8.41	3.99	3.42	n/a

On 11/1/05 the fund adopted a new benchmark, the MSCI-EMU Index, which is an unmanaged, capitalization-weighted index comprising stocks of companies domiciled in the 12 countries utilizing the euro currency. Until 10/31/05, this fund’s benchmark was the DAX Index, a total rate of return index of 30 selected German blue chip stocks traded on the Frankfurt Stock Exchange. Index returns assume reinvestment of any and all distributions and, unlike fund returns, do not reflect fees or expenses. It is not possible to invest directly in an index.

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### Country Breakdowns

#### CEE Country Breakdown

Geographic distribution as of 12/31/05	
Russia (RU)	52%
Poland (PL)	15%
Turkey (TR)	14%
Hungary (HU)	8%
Czech Republic (CZ)	6%
Austria (AT)	3%
Cyprus (CY)	1%
Netherlands (NL)	1%

Geographic distribution is subject to change. Percentages represent % of market value, which refers to all securities in the portfolio except cash and equivalents.

#### EEA Country Breakdown

Geographic distribution as of 12/31/05	
Germany (DE)	33%
France (FR)	22%
Italy (IT)	13%
Switzerland (CH)	7%
Spain (ES)	5%
Austria (AT)	4%
Norway (NO)	4%
Other	12%

Geographic distribution is subject to change. Percentages represent % of market value, which refers to all securities in the portfolio except cash and equivalents.

**\*Performance Disclosures**

All performance shown is historical, assumes reinvestment of all dividend and capital gain distributions and does not guarantee future results. Investment return and principal value fluctuate with changing market conditions, so that, when sold, shares may be worth more or less than the original cost. Current performance may be lower or higher than the performance data quoted. Please visit [www.germanyfund.com](http://www.germanyfund.com) or call (800) GERMANY and speak to a representative to obtain the fund’s most recent performance.

Total return based on market price reflects changes in market value. Total return based on net asset value reflects changes in the fund’s net asset value during each period. Each figure assumes that dividends and capital gains, if any, were reinvested. These figures will differ depending on the level of any discount from or premium to NAV at which the fund’s shares traded during the period. Returns during part or all of the periods shown reflect a fee and/or expense waiver. Without this waiver, returns would have been lower and any rankings/ratings might have been less favorable. If a voluntary fee waiver is applicable, it may be terminated or adjusted at any time without notice.

opportunities throughout various sectors of the Russian stock market.

**SL:** What can you tell us about how Russia has diversified its economy?

**Schaufler:** If you look at Russia's economy, you first look at oil and gas stocks, but the wealth coming from high oil prices is filtering into the economy, partly through higher incomes. Consumption levels in Russia are well below those in Western Europe, but as income levels rise, consumption levels are subsequently increasing. This is how consumer companies benefit from the growth in the country. Additionally, with rising consumption, there should also be a pick-up in consumer loans. The resulting attractiveness of the Russian banking sector is one of our investment themes.

[A report in *Business Week*, "Russia: Shoppers Gone Wild," points out that Russian consumers are on a buying spree, packing shopping malls that are crammed with expensive Western merchandise. We have subsequently learned that Russian consumer prices jumped in February – a 1.7% monthly rise, taking the consumer-price inflation rate so far in 2006 to 4.1%, according to a report in the *Wall Street Journal*. Panic buying of staples such as sugar sent food prices soaring. – Editor]

**SL:** How often do you travel to the region to visit companies?

**Schaufler:** I travel to our investment region approximately four times per year. I traveled to Russia last summer visiting many of our top Russian holdings. Additionally, I met with the management of several smaller Russian companies, which only have local listings. Last autumn, I visited several European companies and also spent some time in our Frankfurt office.

**SL:** Turkey is also a significant investment destination for the Fund, but this is a market with which our readers may not be familiar. Could you outline the key characteristics of the Turkish market for us?

**Schaufler:** Turkey had a crisis in 2001, but the government has undertaken important structural reforms in its economy and recently began formal membership discussions with the EU. Furthermore, the government's tightening of its fiscal policy has

led to a decline in inflation and interest rates.

Growth has been healthy as data for the second quarter showed some moderation from 2004's pace, but with GNP still expanding at better than 5% per annum. Industry continues to take the lead, but tourism is also strong, providing an important boost to the economy and to currency reserves.

We believe that the investment appeal of Turkey is improving as the country continues to be a candidate for rating upgrades, having most recently been upgraded by Moody's in December 2005. Given Turkey's well-developed financial markets, we believe that an increasing number of attractive investment opportunities are emerging, and that the valuation of the market is still attractive, even after the recent strong performance.

**SL:** As you mentioned, Turkey recently entered membership negotiations with the European Union. How much of an effect has that had on the performance of the Turkish market?

**Schaufler:** Turkey's negotiations with the EU have certainly had a positive impact on the market, but negotiations will probably continue for a decade. What is more important than EU membership is the commitment from the Turkish government to continue to implement reform programs.

[Our research shows that the Turkish market offers a range of first and second tier companies, and is very liquid for an emerging market. – Editor]

**SL:** Do you have any comments on the Eastern European countries such as Hungary and Poland as well as the other states in your focus?

**Schaufler:** We believe that the long-term outlook for the Czech Republic, Hungary and Poland has improved considerably since their accession into the EU in May 2004 and their planned entry into the European Monetary Union. We think that EU admission has improved transparency, corporate standards and liquidity of the regional capital markets, thereby further attracting both foreign and domestic investor interest. Attractive investment opportunities may well arise in other Central European countries currently not

represented within the Fund's portfolio such as Ukraine, Bulgaria and Romania as these economies and capital markets develop further. Overall, attractive investment opportunities in the region may also take the form of initial public offerings and government planned privatizations.

**SL:** Do you have any interest in investing in the Baltic states of Latvia, Lithuania and Estonia?

**Schaufler:** We look at these countries, but it is not only about how attractive a country is but also how attractive the investment opportunity is. We currently have no exposure.

**SL:** You have had two rights offerings for CEE in the past two years. We wonder if rights offerings are always a good idea for shareholders. Would you address that issue?

**Schaufler:** We believe that the outlook for a number of industries and companies in Central Europe, Russia and Turkey is promising. Based on our advice, together with the advice of our investment advisor in Frankfurt, the Board of Directors of the Fund determined that it would be in the stockholders' best interest to increase the Fund's assets available for investment to capitalize on these attractive market opportunities. The Fund's Board of Directors also determined that increasing the assets available for investment could result in a modest lowering of the Fund's expenses as a percentage of average net assets because its fixed costs would be spread over a larger asset base.

**SL:** We have mixed feelings about rights offerings. They can be very complicated for money managers to work out and to find the funds for the new shares. There also may be suspicion that the motives of some funds may be for their own reasons, rather than for the best interests of shareholders. However, there are not as many offerings now as in previous years. In your case, your two offerings with CEE in the past two years show that you have given us good reasons to do them.

Now let's look at the European Equity Fund which has been concentrated in Germany but is now a fund for the Euro countries. Our investment focus in 2005 was the Western European countries where

we correctly foresaw that there could be a large rise in the stock markets throughout the region. These markets did so well that we are now cautious on the region and are lightening-up our holdings there because our 2006 investment focus is the emerging markets. This is in spite of the benefit of continued restructuring, including mergers by so many European companies. These events could propel these markets higher. What are your thoughts on this issue?

**Schaufler:** Many companies have had an extremely strong year, but as the financial performance of multinational companies becomes increasingly independent of local economics or politics, an environment of moderate global economic growth overall and limited inflationary threats provides a benign backdrop for healthy corporate margins and cash-flows.

The key risk we see lies in potential policy errors by the major central banks, such as aggressive monetary tightening driven by exaggerated inflationary concerns.

However, even if financial markets may be volatile on such deliberations, we continue to have a constructive view on European equities as the arguments of solid earnings growth and attractive valuation, particularly versus many other asset classes, still hold. Indeed, given the earnings growth achieved in 2005, equity markets have not experienced much in terms of valuation expansion, thus leaving room for further upside in 2006.

[Jean-Claud Trichet, European Central Bank president, warned of (increasing) inflationary dangers. He signaled that further interest rate increases could follow the quarter point rise to the 2.5% announced on March 2, according to a report in *The Financial Times*. This report was followed by preliminary data showing that Germany's manufacturing sector grew in January, reinforcing the picture of an expanding German economy. – Editor]

**SL:** The financial media has been raising questions about the viability of the single currency area which, they say, is showing evidence of renewed weakness. What are your thoughts about this assertion?

**Schaufler:** The financial media focuses on the macro-economic picture which has been an on-going struggle. We concentrate on finding local companies that do well in this economic environment and, in spite of sluggish economic growth, many companies are doing very well due to internal restructurings. Even though the economic environment remains challenging, we believe the Fund is structured to reap the benefits from European companies that have good operational performance. When investment spending and industrial output pick up, we capture these investment themes and choose companies that will benefit. If consumer spending is sluggish in Eurozone countries, we try to limit our exposure in those sectors.

**SL:** How much of your portfolio is outside the Eurozone? We also wonder why you are invested in Switzerland. Where else are you invested outside Euroland?

**Schaufler:** Our investment mandate requires us to be 80% invested in Euroland. The remaining 20% may be invested in countries outside the Euro region, which includes Switzerland as well as the new EU countries. This allows us to position ourselves to take advantage of a variety of attractive investment opportunities.

As of December 31, 2005, Switzerland was our largest ex-benchmark investment, but we also had investments in Norway and Sweden.

**SL:** Since you have expanded your investment universe in The European Equity Fund from Germany to the Eurozone area, have you had to add research capabilities?

**Schaufler:** No, Deutsche Asset Management has one of the most extensive investment teams, which is based in the world's major financial centers. For these funds in particular, we work very closely with our colleagues in Frankfurt, Warsaw, Moscow, Milan, Madrid and Paris. Our close collaboration with local offices is one of the key strengths of our funds.

**SL:** Good. Now please tell us what is your insight into your overall investment philosophy for the funds we have discussed today?

**Schaufler:** At the core of our active investment philosophy lies our belief that stock markets are not entirely efficient, meaning that not all public information is correctly considered by the market at the right time. With our own comprehensive research, we identify the most important factors for market prices and spot inefficiencies in the stock market.

We develop investment opportunities through a disciplined, yet flexible investment and decision-making process. The global reach and depth of our in-house research resources provide us with a significant advantage in identifying attractive companies that may be priced inefficiently. Thus, we believe that we are able to add value by stock selection. In addition to stock selection, we identify investment themes, as I mentioned earlier, which may be related to macro-economic variables, currencies, countries and sectors. We expect to generate additional performance beyond stock selection when implementing investment themes in portfolio construction.

**SL:** Are these methods used for both your emerging markets, Russia and those in Eastern Europe as well as in the developed markets?

**Schaufler:** Yes, it is the same investment philosophy and process. However, the relevance of one factor over the other might shift in importance, depending on our investment universe. For example, political factors sometimes still play a stronger factor in emerging markets.

Through our in-depth company visits, we gain an overview of management quality (which is especially important in emerging markets), management strategy and management's attitude towards corporate governance. Based on these findings, we evaluate the company's business model and estimate what the company's future growth trend and capital returns might be.

We believe that we are able to add the most value by our stock selection, which is based on the numerous company visits and face-to-face meetings with the senior management teams of companies in which we invest. While many companies participate in road shows, we also visit companies directly on-site. These visits are conducted

by our research analysts and the portfolio management team. ■

For more information on the three Deutsche Bank funds mentioned in this report, call 1-800-349-4281 or visit [www.GermanyFund.com](http://www.GermanyFund.com).

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## Templeton Dragon Fund Changes Non-Fundamental Investment Policy

On December 31, 2005, the Fund's Board of Directors approved a change in non-fundamental investment policy to permit investment of up to 15% of the fund's assets in a single issuer. The Fund formerly had a non-fundamental operating policy that permitted its investment manager to invest up to 10% of the Fund's assets in a single issuer. Management believes that this change will give the Fund

greater investment flexibility to pursue its investment objective of capital appreciation in light of current market conditions.

Templeton Dragon Fund posted total returns of 14.08% in market terms and 21.20% in net assets value returns for the fiscal year ending December 31, 2005. The three largest country sectors of the Fund are China, Hong Kong and Taiwan. ■

## Portfolio Manager's Review

During February, much of our equity purchases were concentrated in increasing our exposure to real estate and emerging markets funds. The real estate sector has, therefore, been increased to 25%. We have added an additional REIT and, in line with our global emphasis, we increased our holdings in the Cohen & Steers Worldwide Realty Income Fund.

As the emerging markets have become our 2006 focus, we reduced exposure to our Latin American funds in favor of several broader global funds which cover Latin America as well as other regions. The foreign sector is now 35%. The size of the position depends on the risk tolerance of the individual client. We always pay close attention to this factor.

For our more conservative investors, we have narrowed our U.S. exposure to a higher concentration in fewer better quality funds; the U.S. allocation has, therefore, been decreased to 20%. The real estate sector was increased because we see it as a strong diversification after such a run-up in both the U.S. and the foreign markets since

January. This was because of an earlier feeling that U.S. interest rates will level-off soon. It now appears that this may not happen for sometime due to inflationary concerns.

In the bond fund sector (now 10%), we have limited our exposure to two Franklin/Templeton closed-end funds after selling our former income producer, Allied Capital which did well, but sells at a large premium and is not a true closed-end fund. It also doesn't report its net asset value daily or weekly as closed-end funds do.

A major reduction was made in The Europe Fund for two reasons: (1) we are focusing on the emerging markets funds in 2006, and (2) it hasn't performed as well as The European Equity Fund analyzed in this *Letter*.

As the year progresses, we plan on investing in regional and global funds covering the emerging markets. The April issue of *The Scott Letter* will have an in-depth report on these markets.



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