

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, 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

Emerging Markets Fast Becoming Engines Powering Global Growth

Emerging markets investments have been the hottest investment around for the past three years. Now, according to a report in *The Wall Street Journal*, there is something even hotter – and riskier – **BRICs**.

Goldman Sachs popularized this acronym in 2003 for the four emerging markets economies – **Brazil, Russia, India and China** – which they suggested might one day surpass Japan and the West as the most important in the world. Their research showed that by year 2050, only the U.S. and Japan could have larger economies than any of the BRICs.

Our clients have participated in these markets with closed-end funds (and a few mutual funds) on an increasing basis since the 1990s. They are our investment focus for 2006.

Franklin Templeton Investments has just announced that they have registered a BRIC fund. It will be a mutual fund, which will invest at least 80% of its assets in securities of “BRIC” companies and will be managed by Dr. Mark Mobius.

In 1987, Dr. Mobius pioneered emerging market investment when he launched the world’s first fund listed on a stock exchange to invest in the emerging markets.

The Templeton Emerging Markets Fund was the first to specialize in the emerging markets. Since then, many other fund companies, including a host of new mutual funds, now invest in these markets.

It is important to analyze these markets so our readers can understand how and why we invest in the emerging markets.

Emerging markets can be defined, according to the International Finance Corporation, as “a stock market in any developing economy, no matter how well developed it may be, with the implication that the stock market’s potential to emerge further is

strongly linked to the overall development potential of that country’s economy.”

The development of emerging equity markets, according to Dr. Mobius, “offers the future promise of outstanding benefits for developing nations’ economic growth.”

Such markets provide a means to distribute the ownership of privatized companies and a method where market forces may allocate financial assets. Most importantly, it will be a stimulus for the attraction of new equity capital for growing emerging-market companies.

In his 1995 book, *Mobius on Emerging Markets*, Dr. Mobius wrote:

“If these benefits are to be fully realized, the emerging nation governments must create favorable conditions through market liberalization as well as adequate infrastructures ... which will allow for the smooth and efficient operation of equity markets.”

“The important thing is to keep an open mind and to diversify your equity exposure,” he adds. “Studies have shown that stock market investments made in a patient and consistent manner will inevitably grow, since there is a natural tendency for the value of equity investments to rise in order to keep up with inflation.”

Mobius also believes that, in spite of many negatives and risks in investing in the developing countries, you have to be optimistic because “in emerging markets investment, it is necessary to be optimistic since the world belongs to optimists; the pessimists are only spectators.”

This philosophy, which originated with Sir John Templeton, is featured in the introduction of the 1996 edition of the book.

“The fact remains that there have always been problems, and there will continue to be so in the coming years throughout the world. But we are entering an era which is perhaps

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unparalleled in the history of mankind. With better communications, improved travel, more international commerce and generally better relations between nations, the opportunities for mankind and for emerging markets investors are better than they have been before.”

In our December interview with Dr. Mobius, he was still optimistic. He says that it is important for investors to realize that global diversification also lowers rather than increases risk, despite more volatility.

John Templeton described it this way: “When I first started the Templeton Growth Fund in 1954, I already instinctively knew that international investing was the way to find the best bargain stocks with the most appreciation potential and to protect myself from losses by being diversified. I’ve stuck with those principles my whole life, and they’ve never served me wrong”.

After the year 2005, in which many regions of the world saw explosive growth, expectations are now high that there will be further growth for people living and working in these fast expanding and dynamic markets.

In January, a special report identifying which countries are most likely to present growth opportunities in the near future was published by *Global Finance* magazine. The idea was to help potential investors pinpoint those markets with a balanced view.

What follows is a short history and review of each of the BRIC countries, followed by a list of the closed-end funds applicable to each area.

Brazil

Brazil, after enduring some stormy times, is beginning to see the results of President Lula’s careful but sometimes controversial economic management. The important election this October, after a corruption scandal, may now find that the President will have a better chance of re-election. Strong international liquidity, orthodox economic policies and easing interest rates may be the winning combination to put Lula’s star on the rise again.

Both Brazil and Mexico are expected to expand slightly faster than anticipated – an overall 4.3% for the region, according to the United Nations regional research group.

By far the largest in size and most populous country in South America, Brazil overcame more than a half century of military intervention in the governance of the country when in 1985 the military regime peacefully ceded power to civilian rulers. Brazil continues to pursue industrial and agricultural growth and development of its interior. Exploiting vast natural resources and a large labor pool, it is today South America’s leading economic power and regional leader, although a highly unequal income distribution remains a pressing problem.

Characterized by large and well-developed agricultural, mining, manufacturing and service sectors, Brazil’s economy outweighs that of all other South American countries and is expanding its presence in world markets. From 2001-2003, real wages dropped and Brazil’s economy grew on average only 2.2% per year, as the country absorbed a series of domestic and international economic shocks.

That Brazil absorbed these shocks without financial collapse is a tribute to the resiliency of the Brazilian economy and the economic program put in place by former President Cardoso and strengthened by its current President.

The three pillars of Brazil’s economic program are a floating exchange rate, an inflation-targeting regime and tight fiscal policy, all reinforced by a series of International Monetary Fund programs. The currency depreciated sharply in 2001 and 2002, which contributed to a dramatic current account adjustment.

In 2003 to 2005, Brazil’s world trade was at record levels, and the country recorded its first current account surpluses since 1992. Productivity gains – particularly in agriculture – also contributed to the surge in exports. Brazil in 2005 surpassed the previous year’s record export level.

Brazil’s long-term sovereign credit ratings were recently upgraded by Standard & Poor, citing “the continued

improvement in the external debt indicators.” This and declining interest rates have been extremely positive for their bond markets.

While economic management has been good, there are important economic vulnerabilities.

The most significant are debt-related: the government’s largely domestic debt increased steadily from 1994 to 2003, straining government finances, before falling as a percentage of GDP in 2005, while its foreign debt (a mix of private and public debt) is large in relation to Brazil’s small (but growing) export base.

Another challenge is maintaining economic growth over a period of time to generate employment and make the government debt burden more manageable.

Brazilian-produced ethanol is expected to gain increased penetration in global markets as a result of efforts by the World Trade Organization to liberalize trade. Meanwhile, in Brazil and elsewhere, there is a trend towards greater consumption of renewable energy, especially using ethanol.

Brazilian sugar producers have also been celebrating the commodity’s strongest performance in 25 years because of the nation’s thirst for ethanol which is derived from sugar cane. This sugar powers “flexfuel” cars that also run on gasoline. About half of Brazil’s sugar cane is used for domestic ethanol production.

It is not all rosy, however, as chicken and corn prices have fallen to their lowest levels in 11 years due to international bird flu concerns. As a result, the government is taking steps to increase demand. Falling chicken prices are a concern because Brazil is forecast to harvest a record crop of corn soon.

Closed-end funds which invest in Brazil and the surrounding region are the Brazil Fund (BZF), Latin America Equity Fund (LAQ) and Latin America Discovery Fund (LDF).

Source: Global Finance. www.gfmag.com;
The World Factbook

Russia

After the brutal rule of Joseph Stalin (1929-1953) which strengthened Russian dominance of the Soviet Union at a cost of tens of millions of lives, the Soviet Union stagnated until General Secretary Mikhail Gorbachev (1985-91) introduced glasnost (openness) and perestroika (restructuring) in an attempt to modernize communism. His initiatives inadvertently released forces that by December 1991 splintered the USSR into 15 independent republics.

Since then, Russia has struggled to replace the strict social, political and economic controls of the Communist period. While progress has been made on the economic front, we have seen a recentralization of power under Vladimir Putin and erosion in nascent democratic institutions. A determined guerilla conflict still plagues Russia in Chechnya and threatens to destabilize the North Caucasus region.

Corruption is growing and democratic freedoms that the Russians embraced in the 1990s are being diminished by President Putin, who came into office in 1999 after Russia's first President, Boris Yeltsen resigned and appointed him President by decree. Putin who was then elected President twice (in 2000 and 2004) has increased state control over the media and other industries, attacked big business and scared-off much-needed foreign investment. Many Russians feel that the government does not care about the people but only about themselves.

Millions of Russians have fallen on hard times as state-run industries have collapsed. Despite the country's oil (Russia is the world's second-largest oil producer) and other natural resources, the gap between rich and poor has widened.

Russia has 36 billionaires, but the average income is only \$300 a month. With a population of 143 million, a per capita GDP of \$9,800 versus \$40,100 in the U.S., a life expectancy of men at 59 and women at 72 (versus 75/80 in the U.S.) so that 25% of the Russian people live below the poverty line versus 12% in the U.S.

Meanwhile, the authorities have put off many structural reforms. Liberal economists warned that, in so doing, Russia was

laying itself open to the so-called resource curse and long-term stagnation. The most dramatic illustration of this was the state re-acquisition of the major asset of the Yukos, the oil company which was sold in 2004 to secure the recovery of overdue taxes. The presidential administration strengthened its hold over natural resource companies in this action.

Rapid Reversal Under the New Russia

We contacted Dr. Mobius to see what he had to say about Russia, a part of his Eastern European regional coverage. He promptly replied: "Emerging markets ended the quarter (3/31/06) with positive returns with the MSCI emerging markets index gaining 12.15% in dollar terms. In Eastern Europe, the Russian market recorded the strongest gains as investors continued to be drawn towards the country's strong economic growth, strengthening finances as a result of high commodity prices and a stable political environment. We continue to see good opportunities in Eastern Europe and will continue to position our funds to benefit from the positive developments."

Our research shows that Russia has recorded its seventh consecutive year of economic growth since the prolonged output collapse of 1989-98. The economy grew robustly and had high international liquidity. For 2005, GDP was projected to grow at a rate of 6%, compared to the 7.1% officially reported in 2004.

In the 15 years since the Soviet Union collapsed, a new middle class has emerged, especially in cities like Moscow and St. Petersburg. Russia's economy is growing, and the standard of living has improved for many of its people. Credit cards are now widely available as are longer-term mortgages. Increasingly, the transmission of money from savers to borrowers is being conducted in a manner that would be recognized elsewhere in the developed world.

Growth was largely attributed to record oil prices, which generated big export revenue. As a result, Russia maintained a high trade surplus and was able to repay its external-debt repayments ahead of schedule.

In January, Russia repaid its outstanding \$3.3 billion debt to the IMF, and the state budget recorded its sixth successive surplus. For much of the year, Russia continued to accumulate foreign currency reserves, which exceeded a year's supply of merchandise imports. They formed a "Stabilization Fund" to reduce debt, largely to offset the potential inflationary impact of large capital inflows. The fund was based on tax revenues from high oil prices and was designed to protect the budget against any subsequent fall of oil prices.

With oil at record prices, however, Russia is awash with petrodollars that many politicians and spending departments of the government have said should be used to lay the groundwork for a more diversified economy.

The pressure to spend this money – whether for public-sector pay, infrastructure projects or both – is hard to resist. The Finance Ministry, supported by Putin, resisted this pressure for many months, citing the need for macroeconomic stability. Compromise has now been reached whereby the threshold price at which oil-tax revenues would be diverted into the Stabilization Fund was raised from \$20 per barrel of Ural crude to \$27, taking effect at the beginning of 2006.

Other revenue would be allocated to a new investment fund. This included initiatives to spend an additional \$4.7 billion in 2006 on human capital development: education, health care, housing and rural development. This alarmed some economists who saw it as a sign of reduced fiscal prudence. Others viewed it as a first shot for the 2008 presidential election.

The leading state-controlled energy companies, Gazprom and Rosneft, engaged in a long battle over which company would acquire the gas company. Rosneft was the eventual winner, but the leadership was fragmented by fighting over control of the assets. In September, Gazprom bought a 72% share in Sibneft, the fifth largest producer of crude oil as well as another acquisition, giving Gazprom 75% control of the company.

Russia could become a member of the World Trade Organization in 2006.

Negotiations are underway to resolve the issues involved, but the transition from a one-party, totalitarian Communist state in which the government controlled all aspects of the economy to democracy and free-market capitalism has been erratic.

In spite of this, Russia has now climbed back into international recognition. Even though whole sections of the society have been left out, the upward momentum is powerful. Russia is making efforts to pay off its public debt should be watched by other nations, especially the U.S. which is expanding its national debt at a rapid pace.

Closed-end funds focusing on Russia are Central European Equity Fund (CEE), Morgan Stanley Eastern Europe (RNE) and Templeton Russia and Eastern Europe Fund (TRF).

India

India has attracted an unprecedented amount of attention lately and has become a favored travel destination for Americans and others. The economy has a growth rate over 8%, accelerating corporate profits to all-time highs. In 2005, India's stock markets were among the best performing in the world. The country also saw record foreign portfolio investments, which easily topped 2004's impressive \$8.5 billion.

At the end of 2005, investment was pouring into India at the rate of \$1 billion a month. This has been fueled partly by a government-led drive to increase the purchasing power of the people. Lending rates have been more than halved since 2003, and consumption taxes have been cut to spur further growth. India's software and services sectors have long been the focus of investor attention, but India also has the fourth largest pharmaceutical sector in the world. Indian pharmaceutical companies export nearly \$5 billion worth of drugs annually worldwide.

India is also pouring huge amounts of money into infrastructure, particularly into road projects and the power sector to meet the government's objective of zero power deficits by 2012.

India's real estate sector is also bringing a new level of prosperity as shopping malls begin appearing across the country. In 2005, 39 malls were operating in India,

and in 2006, 54 are expected to open. The government has also allowed 100% foreign direct investment in integrated townships as prosperity has brought growing demand for high quality housing. This has caught the eye of foreign investors, particularly in the U.S., where real estate funds have focused on the India market.

Another booming sector is the automobile component manufacturing market. Indian automobile companies are now large suppliers for global auto manufacturers as well as supplying increasing demand at home. India is the fourth largest market for automobiles in Asia and the largest market in the world for motorcycles.

India's mutual fund industry is also undergoing dramatic transformation as foreign money managers pour funds into the booming stock market. There are 28 mutual fund firms in the country and at least 13 foreign ties to funds.

Franklin Templeton Investments set-up an Indian operation in the 1990's and now controls \$4 billion or about 8% of the market. Britain's Prudential manages about 10% of the market while Fidelity and J.P. Morgan Chase & Co. plan to launch a mutual fund business later this year. This is a dramatic change from as recently as 1999 when Unit Trust of India controlled 80% of all mutual fund assets. The firm ran into trouble in the late 1990s when it couldn't keep up with promised guaranteed returns on some funds. The government then deregulated the industry and created a capital markets regulator under which mutual funds would work. All this is the result of more savings that have been put into the hands of middle class Indians and the explosion of growth of the economy.

Indian technology companies have long been in demand from private equity investors, including offshore mutual funds, and that demand has enveloped sectors ranging from retail to real estate. In addition, global investment structures are emerging in the private sector equity drive that show this market is both maturing and getting stronger.

This underscores the serious interest that global investors have in the Indian market and the fact that private equity flows are now moving into high gear, with

greater liquidity being created for long-term institutional players.

More foreign companies realize that India is more than just a destination for IT outsourcing. The prospects for 2006, therefore, look exceptionally good.

What India Must Do to Catch Up with China

There is a debate in financial circles whether India's growth rate is as good as is reported. It is far from certain that the growth rate is now durably and decisively above the average for the past quarter of a century, according to the respected columnist for *The Financial Times*, Martin Wolf. After the World Economic Forum in Davos this year, Wolf wrote:

"It is equally far from certain India will do better than China in exploiting its potential. Much reform is still needed. The greater the complacency, the greater is the risk of doing too little, too slowly."

"China's growth rate over the past 25 years has averaged a little less than 10% a year while Chinese gross domestic product per head, at purchasing power parity, rose almost twice as fast as India's. A former chief economic advisor to the Indian government suggests medium-term growth is likely to remain at only 6% a year.

"This is consistent with the trends. Indian growth has not only averaged 6% over the past 25 years, but a five-year moving average shows little deviation from this level. Much of the recent growth – 7% in the past three calendar years – followed three years when it averaged 4.7%. Recent growth has been cyclical rather than structural.

"Unfortunately, India has done a poor job of absorbing its labor force into productive employment, in spite of a well-developed private sector, an entrenched legal system, a stable democracy and freedom of speech.

"However, India also has a better score on the control of corruption and rule of law than China while China has the ability to mobilize resources far faster than India as demonstrated in its vastly superior performance in improving its infrastructure. The improved performance of the Indian economy is both a fact and achievement.

Wolf concludes that if India is to thrive there have to be changes in the manufacturing and skill-intensive services sectors. This must include a change in five pivotal areas: deregulation of labor markets, a revitalization of agricultural growth, increased investment in infrastructure, elimination of fiscal deficits and finally, across-the-board privatization and further trade liberalization.

India stands on the threshold of accelerated growth but will not cross it without a great deal of assistance.

Source: martin.wolf@ft.com

The closed-end funds for India are India Fund (IFN) and Morgan Stanley India Investments (IIF).

Hong Kong and China

Any good study of the investment potential of China must first take a look at Hong Kong, known as a “special administrative region of China”.

Occupied by the U.K. in 1841, Hong Kong was formally ceded by China the following year; and various adjacent lands were added later in the 19th century. Hong Kong achieved its present status (SAR) on July 1, 1997.

In this agreement, China has promised that, under its “one country, two systems” formula, China’s economic system will not be imposed on Hong Kong and that Hong Kong will enjoy a high degree of autonomy in all matters, except foreign and defense affairs, for the next 509 years.

With a population of 6.9 million, a 93.5% literacy rate (versus 90.1% for mainland China), as well as direct elections, Hong Kong has a free market economy and is highly dependent on international trade. Hong Kong has an advanced civil law system and universal suffrage at age 18. No substantial political opposition exists.

Even before Hong Kong reverted to Chinese administration, it had extensive trade and investment ties with China. The former British colony has further integrated its economy because China’s growing openness with the world economy has made manufacturing in China much more cost effective. Hong Kong’s re-

export business to and from China is a major driver of growth.

GDP growth in Hong Kong averaged a strong 5% from 1989 to 2005, even with two recessions in 1997-1998 and the global downturn in 2001-2002. Since recovering from the outbreak of severe acute respiratory syndrome (Sars) in 2003 which battered Hong Kong’s economy, there has been a solid rise in exports, a boom in tourism and a return of consumer confidence. This resulted in a resumption of growth from late 2003 through 2005.

Your editor witnessed the 1997 hand-over amid much pessimism that it would ever work. It has worked much better than expected. The contrast from an earlier visit to Hong Kong in 1968 was huge, with massive new buildings being completed since the earlier visit.

Mainland China

For centuries, mainland China stood as a leading civilization, outpacing the rest of the world in the arts and sciences, but in the 19th and early 20th centuries, China was beset by civil unrest, major famines, military defeats and foreign occupation.

After World War II, the Communists under Mao Zedong established an autocratic socialist system that, while ensuring China’s sovereignty, imposed strict controls over everyday life and cost the lives of tens of millions of people.

After 1978, his successor, Deng Xiaoping, and other leaders focused on market-oriented economic development. They said: “To be rich is glorious.” By the year 2000, output had quadrupled. For much of the population, living standards have improved dramatically and the room for personal choice has expanded, yet political controls remain tight.

With a population of 1.3 billion and large improvements in both infant mortality and life expectancy, China is now making great strides. However, China entered 2005 with a goal to slow down – an achievement that may not be realized.

The economy grew at an average annual rate of over 8.5% from 2000 to 2004, as international and domestic investment flowed into projects around the country. Fears of an overheating economy

prompted new policies to slow investment and to reduce market speculation. The government limited loans to overheating industries and passed new laws to better regulate property transactions and reduce market manipulation. Remarkably, real estate, construction and other industries have cooled without crashing.

As China’s economy pushes forward into 2006, the complicated landscape of the most dynamic emerging market offers new challenges to China’s leadership. Chief among those challenges are reducing an escalating trade surplus and more clearly separating the roles of business and government. Their effectiveness will determine China’s future.

China has a centrally planned system that has evolved into a more market-oriented economy and a rapidly growing private sector, making it a major player in the global economy. Collectivized agriculture has been phased out and expanded to include the gradual liberalization of prices, fiscal decentralization, increased autonomy for state enterprises, the foundation of a diversified banking system, development of three stock exchanges, rapid growth of the private sector and the opening of foreign trade and investment.

Reforms have been implemented. In 2005, the sale of equity in China’s largest state bank to foreign investors was completed, refining foreign exchange and bond markets. This has contributed to a more than a ten-fold increase in GDP since 1978.

Economic development has been more rapid in the coastal provinces than in the interior, and there are large disparities in income between regions. Government programs have attempted to alleviate this by trying to sustain adequate job growth, reduce corruption and other economic crimes. But there is a threat to growth due to the economy’s rapid transformation.

Deterioration to the environment, notably air pollution, soil erosion and a falling water table, especially in the north, are a worry. However, they have recently cracked down in order to curb the pollution from coal-fired plants and the increasing number of automobiles. The advent of the 2010 Olympic Games, with its expected number of foreign visitors, is the impetus.

