

# 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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## China's Economic Expansion: Will It Continue?

China has on-going quality control problems with products ranging from tainted foods to toys, as well as bridge collapses, mining accidents and reports of slave labor. This does not help its public relations blitz leading up to the August Olympics.

Some foreign analysts charge that the product recalls highlight the on-going problems resulting from China's too rapid expansion, however, China has shown that it is willing to make some changes and adjustments, so much so that its manufacturing base has shifted lately to small local producers throughout the country.

As China tries to tackle the problem, there is evidence that some of its neighbors, including Vietnam, could offer cheap labor and similar quality for the same products.

Corruption is still at the core of much of it. News reports tell us that the government has stepped up its anti-corruption campaign, establishing the National Corruption Prevention Bureau which reports directly to the State Council. Anti-corruption measures have already led to nearly 100,000 officials being disciplined in 2006.

The booming Chinese economy has led some foreign and domestic investors to continue to invest in China, despite conflicting forecasts of a slowdown. The World Bank still says that the Chinese economy will continue to grow at a rate of over 10%, fueled by exports.

If this is true, China will continue to be the largest contributor to global growth. The World Bank forecasts growth will slow to 10.8% in 2008 and drop to 7% a year through 2020.

Inflation is also a problem. The authorities are, therefore, taking action to halt overheating of the economy by raising the interest rates, the fifth rate hike in 2007. The government has cut import tariffs on electronic goods from 17% to 13% to fuel imported goods in order to

tame the trade surplus and rebalance its international payments.

Food accounts for 37% of average total urban household spending, according to 2005 government studies. As China is concerned about economic and social implications in a country where price hikes sparked pro-democracy protests in 1989, the authorities are trying to avoid excess demand that may spillover into higher inflation.

China, however, needs to optimize its use of foreign direct investments (FDI) by leveling the taxation playing field, opening the service sector to further competition, maximizing technology transfers and improving the investment climate in the interior regions. China reportedly received some 25% of all FDI to developing countries over the past decade and is projected to welcome another 30% of the expected \$250 billion in FDI inflows to emerging markets in the 5-year period from 2006 to 2010.

The use of credit cards in China has doubled between 2006 and 2007 to more than 40 million in a country where only 14% of eligible consumers hold credit cards, compared with 81% in Hong Kong.

By year-end, China's authorities are also expected to release new rules allowing several international investment banks to establish joint ventures with local securities firms. Under the revised rules, foreign investment banks will be able to own up to 33% of joint ventures in the securities sector.

On September 29, 2007, the government launched the China Investment Corporation (CIC), its new \$200 billion foreign exchange investment unit which aims to diversify part of the country's foreign currency reserves into other markets, including the U.S. Its focus will primarily be on financial products. CIC has invested \$43 billion in private equity firm Blackstone Group and more than \$5 billion in Morgan Stanley.

The financial markets in China (Shanghai stock exchange) continue to show strength as the new year begins. The three stock exchanges (Hong Kong, Shanghai and Shenzhen), all made modest gains in the first trading days of the year. If this continues, we could expect these markets to again lead the world markets. We will address this later.

The money managers of the funds we follow favor Hong Kong over Shanghai, because of lower volatility and higher

investment standards similar to those in Europe. Chinese citizens are now allowed to invest freely in the Hong Kong Exchange, a move that has boosted Hong Kong listed shares of Chinese companies that were previously valued below their price levels on the mainland.

Funds that invest in Hong Kong are still favored for this reason. Most recently, we pay attention to the continued bullishness of Kheim Do, the portfolio manager of The Asia Pacific Fund (APB:NYSE),

which we covered in the last two *Scott Letters*. APB is still our largest holding, but we have cut back on it.

When the Olympic fireworks have passed in August and the athletes return home laden with medals and souvenirs, China will still have much work to do. Some might say that, just like its growth rate, the country's tasks ahead will reach Olympian proportions. ■

Source: *Global Finance, New York Times*

## China's Traffic Jams and Growing Pollution

Concerns about China have been addressed in the current issue of *Mother Jones*, a magazine published in San Francisco. It asks the important question: "Can the world survive China's rush to emulate the American way of life?"

The emergence of China as a dominant economic power is an epochal event, as significant as the U.S. ascendancy after World War II. In a mere 25 years, China has awakened from its Maoist stagnancy to become the world's largest manufacturer.

Jacques Leslie, a reporter for the magazine, has just returned from China. Her driver, who describes himself as an "environmentalist," or more precisely, a "fellow environmental-disaster tracker", says he has toured choked rivers, depleted forests, and grasslands that have ceded to encroaching deserts throughout China.

They drive along a road in western China, one of the world's most dangerous, with the driver citing that a quarter of a million people die on Chinese roads each year – six times as many as in the U.S., even though Americans possess 18 times as many cars. The Chinese road system is plagued with traffic jams, prompted by police inspectors extracting "fees" from coal truck drivers who have waited for as long as two weeks for an inspection.

Here are other observations according to *Mother Jones*. Among the planet's 193 nations, China is now first in the production of coal, steel, cement and 10 kinds of metal. It produces half of the world's cameras and nearly a third of its TVs. By 2015, China may also produce the most cars in the world.

China is also a ravenous consumer. Its appetite for raw materials drives up international commodity prices and shipping rates while its middle class, projected to jump from fewer than 100 million at the end of 2007 to 700 million by 2020, is learning the gratifications of consumerism.

China is a leading importer of iron ore, steel, copper, tin, zinc, aluminum and nickel, as well as the world's biggest consumer of coal. They use more coal than the U.S., Russia and India combined. China also tops the world in consuming refrigerators, grain, cell phones, fertilizer and television sets. This rapidly growing country will probably construct over half of the world's new buildings over the next decade.

### Ecological Devastation

Ecological devastation in China is now far worse than when I was there in 1997. Although it began during Chairman Mao's "Cultural Revolution", the current industrialization has been worse. A fourth of the country is now a desert. Acid rain falls on a third of the land mass, tainting soil, water and food. Excessive use of groundwater has caused land to sink in at least 96 Chinese cities, producing an estimated \$12.9 billion in economic damage in Shanghai alone.

Each year, uncontrollable underground fires, sometimes triggered by lightning and mining accidents, consume some 200 million tons of coal, massively contributing to global warming. A miasma of lead, mercury, sulfur dioxide and other elements of coal burning and car exhausts hover

over most Chinese cities. Of the world's 20 most polluted cities, 16 are Chinese.

As a result, healthcare costs for premature death and disability related to air pollution is estimated at nearly 4% of the country's GDP, and estimates show that 400,000 people die prematurely from respiratory illnesses each year. Four-fifths of the China's rivers are too polluted to fish, and half the population drinks water contaminated with waste.

The Yangtze, Asia's longest river, is in a dangerous situation. The nation annually dumps a billion tons of untreated sewage into this river.

If these reports are true, all of this devastation could put an abrupt end to China's rapid economic growth. In concert with other nations (in particular, the United States, India and Brazil) that are also guilty polluters, this could cause havoc in societies and ecosystems throughout the world. ■

**Editor's Note:** We are uncertain as to the validity of these assertions but want to make our readers aware that environmental problems are not new to China and that they are attempting to deal with them.

Dr. Carlos Frescata, located in Palmela, Portugal, is responsible for the web site, [www.greenchinaview.com](http://www.greenchinaview.com). He writes that the purpose of the site is "to contribute to a mutual understanding between the Chinese and Westerners". The role of the countryside, he says, "is important to China, and [will show] how they will be able to influence the world in a positive way can be seen with a constructive ecological perspective."

## Protectionists Hide Behind Concern for the Environment

One of the remarkable and heartening features of the global economy over the past couple of years has been the high ratio of rhetorical protectionist sabre-rattling to actual restrictions on international trade in goods and services.

But, as negotiators meet for new talks on the Doha Round [trade negotiations], the price of liberty is eternal vigilance. Protectionism has the miraculous ability to shape, shift or exploit new issues to insinuate itself afresh into public policy debates. Examples from the recent past range from spurious appeals to national security to concerns over Asian currency manipulation and safety of products made in China.

This is not to deny the existence of real and substantive problems in those areas, but the alacrity with which the usual suspects on Capitol Hill and E.U. member states seize on each issue to push the same old calls for tariffs and other barriers to imports and foreign investment, suggests opportunism, rather than reason as the driving force for the argument.

The latest vehicle within which protectionism can shelter is a concern for the environment which, though right and proper in itself, is vulnerable to manipulation by sectional trade interests.

Both E.U. and U.S. politicians – the European voices unsurprisingly emanating from Paris and the American ones from the power industry and its unions – have called for some version of a carbon border tax which would impose new import tariffs based to the amount of greenhouse gases emitted during a product's manufacture.

Assuming these merely equalize the carbon taxes paid by domestic and foreign

producers, they need not necessarily be against World Trade Organization rules, which allow countries to use trade policy to stipulate production methods and protect natural resources as long as they do not discriminate between companies from different countries. But that does not make them a good idea. The problem with the unilateral imposition of tariffs is that, as U.S. trade representative Susan Schwab warned fellow trade ministers in December's climate change talks in Bali, it could very easily lead to tit-for-tat restrictions as other countries craft their own import restrictions.

The irony of this is that climate change ought to be an opportunity as much as a threat for the globalization of markets in goods and services. The increased efficiency that comes from economies being able to specialize can help minimize carbon output by ensuring that the lowest-emitting country does the job.

It creates a smaller carbon footprint, for example, to grow flowers in east Africa and fly them to London than it does to raise them in the heated greenhouses of Europe itself.

Similarly, the growing demand for biofuels in Europe and the U.S. could be more efficiently met, from environmental and economic standpoints, if distributors were able to buy the cheapest available.

The vested interests in the ethanol industry in the U.S. and biofuels in the E.U. have ensured that expensive and inefficient domestic production from corn and other grains is protected by tariffs and subsidies from competition from low cost, low carbon sugarcane ethanol from Brazil.

[See interview with Matthew Hickman, The Latin American Equity Fund, [The Scott Letter \(September 2007\)](#) for his comments on ethanol production and environmental problems in Brazil.]

Making globalization an ally of the environment depends on getting the prices right and then letting the market, where possible, work. Global carbon taxes would be a good way of doing this, ensuring that the price of each product reflected the environmental cost of making it. A global trade in carbon emissions would be another.

Such arguments will be far harder to negotiate than simply slapping on carbon border taxes, but they are also fairer, more efficient and far less likely to inflame protectionist sentiment in trading partners than unilaterally restricting imports in the name of halting climate change. ■

Source: *Financial Times*

**Editor's Note:** Presently there are no closed-end funds that invest exclusively in the environmental area. Up to now, when we cannot find a closed-end fund to fill our allocation, we use a mutual fund in the same area. After careful research, we have decided to invest in a no-load green mutual fund, the Winslow Green Growth Fund (WGGFX) to cover this area. This domestic no-load small-cap fund has a brilliant 5-year compound annual return in excess of +25% and a 5-star Morningstar rating.

More information on this and other Winslow funds is available by calling 888-314-9049 or visiting their web site, [www.winslowgreen.com](http://www.winslowgreen.com).

## Investment Update on India

India, China, the DJ CBN China 600 and the Venezuela stock markets are the only world markets that are higher this year to date. India's benchmark Sensex index set a record for the new year on January 4, up 2.4%, following a rise of 47% in 2007. This index outperformed nearly all other world stock markets.

India is a top global innovator for high tech products and services. Still, the country is underperforming economically relative to its innovation potential – with direct implications for long-term industrial competitiveness and economic growth.

India's 2007 stock market surge was driven by economic growth and an

unprecedented inflow of foreign funds. More than \$17 billion poured into the Indian market from overseas in that period.

However, analysts see the Bombay Stock Exchange continuing to gain in 2008. While the outlook is generally sunny, its performance is likely to be cooled by worries about a U.S. recession and the

strength of India's rupee versus the U.S. dollar. The declining dollar makes it difficult for India's technology companies to get much of their revenue in dollars. Stock market gains are, therefore, expected to moderate in 2008.

The Indian market's performance in 2008 isn't expected to be affected by turmoil in neighboring Pakistan, following the December assassination of opposition leader Benazir Bhutto. Historically, events in Pakistan haven't affected Indian stocks.

A correction in India's stock market is expected because of global economic influences which will impact India. This

could be short term as India's economy is very strong. Their gross domestic product is expected to grow 10% in 2008 after galloping along at an annual growth rate of 8.6% over the last four years.

"The Indian economy is driven primarily by domestic consumption, so the economy is well placed compared to other emerging markets," says the chief investment officer for equities at Franklin Templeton Investments in India.

Are India's stocks overvalued? Last month, Lehman Brothers said stocks in its Indian basket were trading at an average of 24.1x projected earnings for fiscal 2008.

The Australian investment bank, Macquarie, disagrees, asserting that India will be "in a sweet spot" in 2008 as its stock exchange is below historic peaks, despite interest rates being lower. The growth of its gross domestic product continues to improve, however, and Macquarie forecasts that the Sensex index will top 24,000 in 2008 – 18% above year-end level – and sees three simple themes as drivers: domestic consumption, easing interest rates and infrastructure spending.

CEFA presently only has a small exposure to one of the India funds. We plan to contact its management for an interview. ■

## Global Real Estate Review

Real estate, after the credit crunch, is now seen as a defensive way to play the stock market. In the period from November 1999 to January 2007, domestic REITs provided average annualized returns of 23.6%, outperforming the overall U.S. stock market.

The REIT era began in 1960. With the introduction of foreign REIT legislation, this should continue to provide good returns, especially in Asia and Europe. The REIT legislation has been approved in 25 countries, and several more are taking steps to adopt the legislation.

REITs are a good source for dividends, liquidity and strong, long-term performance. Better than that, investing in real estate funds has the advantages of diversification and superior managers with excellent long-term performance.

The editors of the specialty magazine, *Real Estate Portfolio*, sat down with six portfolio managers of real estate investment firms in late 2007. The group included Marty Cohen, who sees the value of using the closed-end fund format as the best way to invest in real estate funds.

We plan to interview Mr. Cohen again this year.

The group agreed that accelerating globalization is seen as a big force in the global real estate markets. That is because the companies that operate on a global scale now demand investments that are

being driven by abundant liquidity, strong property markets and new REIT legislation in key markets, especially in Japan, Australia and Europe. Global real estate investing is also becoming a core asset class of institutional investors over time.

Mr. Cohen pointed out that recent passage of new real estate legislation in France was an important event because the French real estate success served as a good model for the rest of Europe, especially for REITs in Germany, Italy and the U.K.

The group continued by saying that the most prominent feature of global real estate is the abundance of pricing and growth opportunities compared to the U.S. Because there is limited supply in such places as Poland, the Czech Republic and other Eastern and Central European countries, this is a boon to the industry. China has tremendous scarcity of Class A office space and quality housing for its booming middle classes.

India is also favored as a potential strong real estate market, in spite of some initial difficulties. The world's largest democracy is a more professional market than many others. South Africa is also favored because of its sophisticated financial infrastructure.

The participants discussed the relative values of REITs over direct real estate investments. Publicly traded real estate has the advantage of ease of investment, high

liquidity, diversification and low turnover rates which makes it ideal for securities lending. Direct investments are also more costly to operate.

Portfolio managers still use real estate funds to manage risk and feel positive for the industry. They are well aware of the higher volatility, currency and political risk in overseas investments and, because of these risks, have advised their clients to apply the same long-term time horizon as they would to direct property investments.

It is important to remember that globalization will not bypass real estate as companies will increasingly hold cross border investments in the future.

The group summarized their thoughts by saying that worldwide, there will increasingly be a relatively benign macro-economic environment for the globalization of real estate.

The fundamentals are solid in strong economies such as Japan, Mexico, Korea and central Europe which should perform well in the coming years.

Other new real estate markets will emerge as well, particularly such as Asian countries like Taiwan, Korea and China mature.

Therefore, the relaxation on foreign ownership should present real estate investors tremendous opportunities in the future. ■

Source: *Real Estate Portfolio*; *New York Times*

## Closed-End Fund Officials Hope for Upturn

Despite starting 2007 on a high, closed-end funds grounded to a halt in August 2007 and have yet to recover completely. There is a silver lining because as demand dropped, the discounts to net asset values increased, making it bargain time for savvy investors. This does not mean that the discounts will narrow again any time soon, but historically these trends tend to go in cycles.

Fund officials are hoping for an upturn in 2008, but our view is that one should focus on the sectors/markets that perform well rather than trying to predict when the mortgage crisis will end. We are aware that the Asian and Latin American markets have been largely immune from the so-called credit crunch. Most of CEFA's investment focus has been in these regions.

Deeper discounts also mean that some funds may be vulnerable to dissident tender offers from those who try to close discounts for a short-term gain. Activists are pressuring some funds to make more

frequent distributions, which tend to reduce discounts and help performance.

Some analysts recommend that funds which adopt a pay-out policy, as many funds are now doing, will help to reduce discounts as well as please shareholders who rely on regular income to meet their income needs.

It has been pointed out that one problem with this is that if the portfolio manager focuses too heavily on getting enough cash for the distributions, he may ignore the best investment opportunities, take profits too soon or leverage the portfolio too much, increasing risks in stock markets like we have seen in 2007. ■

*Nature will not forgive those who fail to fulfill the law of their being. The law of human beings is wisdom and goodness, not unlimited acquisition.*

– Robert Maynard Hutchins (1899-1977)  
Educator

## Portfolio Manager's Review

We were unusually active in December, primarily to take advantage of tax-related selling to find better value for our clients. The stock market weakness in 2007 included the real estate funds, especially the domestic funds which may take some time to recover. CEFA has, therefore, shifted our focus to emphasize the global funds managed by Cohen & Steers and the ING Group.

Positions were reduced in some of our high performing funds which had narrower discounts, while domestic funds which had deeper discounts were added. A new position was made in Source Capital, a fund which has the kind of brilliant record we seek and which now sells at a discount, after many years of selling at a premium to its net asset value. Other funds that are now selling at deeper discounts than normal include the global real estate funds.

As we entered the new year, we had extraordinarily high (11%) cash levels. In January, we will be doing our semi-annual rebalancing and adjustment of our portfolios. Much of this money will be carefully invested back into real estate and other funds. There will be a higher allocation in global bond funds as they have been good performers in 2007.

As mentioned earlier, we are increasing our allocation to the environmental area by starting to invest in the Winslow Green Growth Fund, thereby increasing our domestic allocation. We are also keeping an eye on Winslow's second fund, the Winslow Green Solutions Fund, which invests globally in mid-size global growth companies. As it is a new fund, we will wait to see its first year performance before considering investing in this fund. ■

*George Cole Scott*

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