

# THE SCOTT LETTER: CLOSED-END FUND REPORT

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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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## Investment Adventures in Emerging Markets Year-End Update by Mark Mobius

I believe emerging markets are now in a secular bull market, a trend we expect to continue into 2011. As investors around the world realize that emerging economies are growing three times faster than developed economies, more and more money may be directed into these markets.

The International Monetary Fund estimated that emerging markets grew an average of 7.15% in 2010 and will continue to grow 6.4% in 2011, well above the 2.7% and 2.2% growth expected for developed markets.

Economic recovery in emerging markets is likely to be sustainable in view of their strong fundamentals. In addition, financial and fiscal indicators remain positive. Moreover, the search for higher returns in a low interest rate environment coupled with attractive valuations could continue to support equity prices.

Emerging economies may face inflationary pressures from capital inflows spurred by continued loose monetary policies in developed markets. In addition, if central banks in emerging markets continue to buy dollars to prevent currency appreciation, they may appear increasingly safe to investors seeking markets with higher economic growth and yields. This may lead to a "vicious" cycle with some untoward consequences that need to be watched carefully. Monetary and exchange rate policies around the world could also impact markets.

Emerging markets, like most other global equity markets, will experience some corrections along the way as the markets continue to expand globally. Short-term volatility may provide investors with appealing entry points if valuations drop to attractive levels, while over the longer term, emerging markets should reflect the underlying strong economic growth in those countries.

Most important for value investors, we believe current valuations in emerging markets are still more attractive than those in developed markets, despite their having risen from the extreme lows of early 2009. We are able to find attractively valued stocks in most emerging markets. (Source: [Mark Mobius blog](#))

Mark Mobius, Ph.D., is executive chairman of Templeton Asset Management, Ltd. and joined Templeton in 1987. Currently, he directs the Templeton research team based in 15 global emerging markets offices and manages emerging markets portfolios.

We caught up with Mark in Singapore on December 30, 2010:



Dr. Mark J. Mobius

**SL:** Are you on vacation, Mark?

**Mobius:** No, I am always working; in our business, there is no vacation. E-mails and so on keep us busy.

**SL:** We try to keep up with you, Mark, and we recently saw that you are now 72. We hope that you still have no plans to retire.

**Mobius:** That's right.

**SL:** Our clients own Templeton Emerging Markets (NYSE:EMF)

and Templeton Dragon Fund (NYSE:TDF). We will, therefore, ask you about the sectors and holdings in these portfolios. These funds did very well in 2010, and we like that they pay good dividends. EMF is 16.1% invested in mainland China and 6.2% in Hong Kong, much of it in energy companies. TDF has 62.5% of its assets invested in China, 28.9% in Hong Kong and 9% in Taiwan. Where is your current investment emphasis now?

**Mobius:** We are bullish on oil companies and most commodities. In our sector breakdown, 27% is invested in energy, 22% in consumer banks and 19% in materials, including raw materials and mining stocks.

**SL:** High oil prices will be good for renewable energy development. Forecasts call for

\$100/barrel oil prices. What will be the effect of this on world growth?

**Mobius:** It will impact Europe and the U.S., but the dollar has weakened against all of these currencies, so higher oil prices will not affect the emerging world much. The OPEC nations are quite aware of this so they may not push the envelope too far in raising oil prices. However, we will have to get used to higher and higher oil and commodity prices, and \$150/barrel is a possibility.

[**Editor's Note:** Oil prices appear to be closing in on the key psychological \$100/barrel level. This is due to mounting optimism that global economic growth as well as strong investment inflows in commodities will continue. The price of Brent crude, after reaching an intraday high of \$99.20, is now at its highest level since October 2008.]

**SL:** What do you think about rising inflation in China and the possibility of sovereign debt defaults in Europe?

**Mobius:** Inflation is a problem faced by countries around the world, not just emerging markets. It is an important and acute question for emerging markets because it hits lower-income groups especially hard and that group represents a large portion of the total population in emerging markets. Some emerging countries are raising interest rates, but that presents a problem in itself because it draws many more speculators to their currencies. Emerging markets currencies have already appreciated substantially during the last two years, and I think many of them are over-valued on a price parity basis. These countries are in a dilemma because they want to export, but their currencies are appreciating. Thus, some countries have introduced various capital controls to prevent their currencies from rising further. For instance, Brazil has put a tax on incoming money for fixed income instruments while China actively controls its currency. Inflation is a big challenge, and I believe it will be very important going forward.

Another factor is the possibility of sovereign debt defaults in Europe and what that may imply for other countries around the world. Greece, Spain, Portugal and

Ireland continue to have problems managing their debt. While they obviously do not want to default, when I look at their numbers, I think it may be quite difficult for them to avoid it. The question now is how they can re-instill confidence into the markets, how they might restructure their debt or how they raise more debt to repay the old debt. That said, I believe the governments in these countries continue to be very focused on coming up with a constructive approach to restructuring their debt obligations and in working within the European Union to try to avoid large scale problems. (Source: [Mark Mobius blog](#), January 21, 2011)

**Mobius:** China will have to focus more and more on the consumer for growth. Their high savings rate will continue to drive their economy, so they are in pretty good shape.

**SL:** However, the Shanghai stock index fell on five consecutive days in late December to its lowest close in three months.

**Mobius:** We are not too worried about the Shanghai stock market as the market drop was partly caused by tightened bank lending. Secondary issues in these markets have been very hot. In 2009, about 250 new and secondary issues were launched. In 2011, that amount is expected to double as a great deal of new money will come into the market. Improved housing starts will drive investments forward as real estate prices on the mainland are the only asset classes still selling at decent prices.

**SL:** Why have so many people moved back to their villages from the cities?

**Mobius:** Because government policy dictates that they return home. They want to develop the interior and eliminate the large disparity in income between economic groups. They are also rapidly cracking down on corruption as they now realize that they must encourage the development of smaller companies. There are about 240 new companies today; the government wants to allow private companies to have greater access to private growth in equity capital. This is a big change that will mean higher income for the whole economy.

Over 80% of China's energy comes from coal. They realize that the rising pollution is a major problem because it affects health, which is expensive. They are launching a number of projects including coal liquification to make petrochemicals. They are also closing down many small coal mines to consolidate the industry and curtail pollution. Given their track record, they are making good progress. They are now outpacing the U.S. in cleaning up their coal plants and in building more efficient new ones.

[**Editor's Note:** Recent high prices of coal were caused by the flooding in Australia, a major exporter. This run-up in prices has put financial pressure on the electric power industry in the U.S. Coal-generated power is much cheaper than that produced by a modern gas-fired plant. Other forces pushing coal prices higher include mining problems, hiccups with railroad deliveries and greater demand for coal, both in the U.S. and abroad. (Source: *Financial Times*)]

South Africa has been able to remove carbon from coal by producing gas which they convert into liquids, using new technology. The Chinese have really gone right out there in terms of renewable energy, particularly in the development of wind power. China is taking a longer view because they have a command economy and are now the world's leader in wind energy, just as India is in solar power.

[**Editor's Note:** Over the past decade, renewable energy and natural gas have emerged as potential cornerstones of a low carbon power sector. Wind and solar resources are abundant and can be converted to electricity using technologies that emit no greenhouse gases. Thanks to growing policy support for renewable energy, the costs of many renewables are falling, and renewable energy has started to penetrate power markets in a significant way. The global installed capacity of wind and solar power is now growing by 30% to 50% a year, but there are limitations that make it difficult for electrical systems to accommodate all the power that is available. (Source: [Worldwatch.org](#))]

**SL:** It is also a good thing that China is working hard on cleaning up its coal to

reduce their pollution in most of their cities. About five years ago, we tried to get some information about what China was doing about pollution. On the “Green China” web site, we found little mention of the pollution, even skepticism. Thomas Friedman, in his 2008 edition of *Hot Flat and Crowded*, wrote that after asking Chinese officials about pollution, he was told: “China will clean up when China gets rich enough to afford to clean up.” Friedman replied: “China can get rich only if it cleans up.”

China realizes that cleaning up the environment is a first priority. They are becoming rich faster than any other nation.

Mark, because of your large exposure to China, aren't you concerned that the Shanghai stock market has been showing weakness lately and may continue to do so?

**Mobius:** Not really, because China is still on track to continue high growth.

**SL:** You do have a good record of being right on China. It has been 11 years since we visited Hong Kong, Shanghai and Guangzhou. In 1997, the people were just moving up from bicycles to motor scooters.

Now, let's look at India. India has more than a billion people and rivals China in size, but not economic growth. That is changing now as growth in computer programming, call centers and other service businesses is thriving. India is also a major player in steel and mining. The country still has high poverty in many of its states that are not participating in its boom, despite the fact that more and more of their people are moving into the middle class. A select few have made enormous fortunes, but they are resented by those who are still without.

**Mobius:** Most of the wealth is concentrated in the western side of the country, but it varies tremendously. A huge consumer market is developing, one even bigger than in China by 20%-30%. The latest growth rate of 8% appears to be accelerating. It was 14% in July alone. India still has some 50% of its population below the age of 25.

**SL:** Why is their standard of living rising faster than in China?

**Mobius:** Education is one of the prime focuses of the government. The English language also ties them together. More and more young people are also staying home now, due to better economic conditions, rather than immigrating to the U.S.

**[Editor's Note:** In his new book, *India Calling, An Intimate Portrait of a Nation's Remaking*, Anand Girdharadas tells the story of an Indian native who returned home to find that “globalization is reducing people to their specific economic task, stripping them of their humanity, just as caste has done. And software engineers in gated communities have become the new Brahmins.”]

**SL:** The latest reports show that 12% of Templeton Emerging Markets (“EMF”) is invested in India, much of it in mining, oil and gas, as well as in services and real estate.

**Mobius:** We have primarily invested in two areas: outsourcing and minerals. We also hold a large position in an iron ore company that sells its ore all over the world.

**SL:** President Obama recently visited India and brought back a possible new trade deal as the administration is pushing them to remove restrictions on imports, particularly on solar technology products, which threaten American companies such as General Electric. India has one of the most ambitious solar projects in the world, and the U.S. is concerned about the trade restrictions.

**Mobius:** Like many emerging nations, India is aware of the importance of free trade to their economy as they want to have an open trade society. They are not as dependent on exports as China and have a large trade deficit.

**SL:** Sir John Templeton once told me: “Free trade helps everybody”. The world is opening up to free trade, but the U.S. is not. Why is this?

**Mobius:** That is a worry. I knew that President Obama was in that stance when he was running for President.

**[Editor's Note:** President Obama recently chose William Daley, former President Clinton's commerce secretary, to be the new chief of staff. This is seen as a good move, as Daley is a free trader who

helped the Clinton administration negotiate the NAFTA treaty with Canada and Mexico. He has strong ties to the business community and will help with agreements such as the pending free trade agreement with South Korea. This could fulfill the president's wish to double U.S. exports by 2015. The administration is also relying on business groups to take a lead in passing trade deals, countering opposition from unions and a skeptical public. (Source: *The Wall Street Journal*)]

**SL:** India will be investing in clean energy but isn't yet ready to accept a cap on carbon emissions. This is an important issue because both China and India hope that their rapid expansion will continue, but we worry about the environmental consequences. However, India emits far less CO<sub>2</sub> than China.

In China, renewable energy provides a larger percentage of power than in the U.S. or India. China has to import energy and raw materials and gives huge state subsidies to clean-tech companies whereas India subsidizes poor consumers and its farmers get electricity free. However, India's hugely decentralized democracy doesn't move as quickly as its highly controlled neighbor. China has a top-down approach while India's is bottom-up. Since the U.S. model has much more in common with India, there ought to be opportunities for our nations to collaborate more closely. If bottom-up India can't compete with top-down China, the bottom-up U.S. economy is likely to be in big trouble. (Source: *Financial Times*)]

**SL:** Does that fit into your scenario, Mark?

**Mobius:** Yes.

**[Editor's Note:** European stocks finished mostly lower in the week ending January 14 after China raised the reserve requirement ratio for banks and worries if more policy tightening may be needed. In Mumbai, India's Sensitive Index (“Sensex”) continued its recent weakness. The retreat came after data showed India's wholesale price inflation for December rose 8.43% from a year earlier, accelerating from November's 7.48% which kept expectations for interest rate increases alive. Other markets that were weak in

early January include Shanghai, Tokyo, and London. (Source: *The Wall Street Journal*)

**SL:** Now let's look at Brazil, the largest country in South America. The Latin American markets, for the most part, had a good 2010.

**[Editor's Note:** Brazil has many new problems after its recent election. Dilma Rousseff, the new president, has signaled that she will make the battle against the sharp appreciation of the currency a priority in 2011 as it has been trading near two-year highs against the dollar, and its rise is blamed for undermining Brazil's competitiveness. The government is very sensitive to exchange rate appreciation. Inflation rose 7.6% in 2010, the highest rate in six years.

When its currency rose sharply in 2009, Brazil declared that the world was engaged in a "currency war", after realizing it had some of the world's highest interest rates, rising inflation and a need to reduce the expansion of fiscal spending. They are considering tax breaks and other unspecified measures to help local manufacturers. Brazil is planning to raise the issue with Beijing at an April meeting of the BRIC countries. (Source: *Financial Times*.)]

What are the largest Brazilian holdings in Templeton Emerging Markets Fund (NYSE:EMF)?

**Mobius:** One of our largest is Valle, the big mining company and Petrobras, the government-controlled oil company which has a major new find offshore.

**SL:** What are your thoughts about the huge share offering offered by Petrobras?

**Mobius:** We didn't like it and complained to the government because they decided to track the price of oil in the ground which we think is too high. They converted the offering into shares with no opinion about minority positions. This was not a good thing from a corporate governance point of view. China has majority stakes and treats their minorities very fairly.

In most of Latin America, perhaps a holdover from the colonial days, they really "rake it in" on the minorities. Mexico treats its minorities very well, but

most of the other countries have a bad record.

**SL:** Maybe you better work on that, Mark.

**Mobius:** We hope to improve shareholder relations.

**SL:** We were surprised that you are more pessimistic on Brazil than you were in 2009. Do you think about Brazil will be able to continue to prosper with all of these problems?

**Mobius:** The good news is that Brazil has the World Cup and the Olympics in 2014 and 2016. The major challenge is to make sure that Dilma continues the same policies that President Lula had. Lula surprised everyone by instituting a very conservative fiscal policy that was more "hands off" and worked very well during his tenure. I hope that prosperity will continue. Inflation is still a challenge, but the bigger one is the rise in the currency. The money supply is increasing along with interest rates. To stabilize their currency, they have had to buy U.S. dollars.

There are also concerns that the new government will wield a heavy hand by micro-managing the economy, affecting the banking sector; this may not work. One good thing: They are repairing the infrastructure and building a high speed rail line connecting Rio to Sao Paulo.

**[Editor's Note:** Brazil's national development bank (BNDES) confirmed that it will provide nearly \$12 billion for construction of a bullet train that will link Sao Paulo with Rio de Janeiro. Following this move, Bradesco (Brazil's largest private sector bank) signed a \$320-plus million contract to become the first domestic sponsor for the 2016 Olympic Games in Rio de Janeiro. The deal includes marketing rights connected with the Brazilian Olympic Committee and will allow the bank to highlight its services during the event. Brazil has also just announced that General Electric plans to invest \$500 million to expand its operations in Brazil as well as accelerate technology partnerships with leading local companies. (Source: *Global Finance*)]

**SL:** There is another important issue that the world is following: expansion of hydroelectric power in the building of

many new dams in the Amazon basin, home to 60% of the planet's tropical rainforests, an immense region nearly the size of the U.S. Increasingly, the construction of as many as 60 other dams creates a grave concern. These dams, if built, will dramatically affect the Amazon's fragile web of aquatic and terrestrial life as well as displace tens of thousands of indigenous people and river bank communities, accelerating its destruction.

The most controversial is the Belo Monte dam, a \$17 billion project on the Xingu River, which would divert the flow of the river, devastate an extensive area of the Brazilian rainforest and displace over 20,000 people, threatening their survival. It will also flood national parks, reserves and indigenous lands. James Cameron, the director of *Avatar*, recently visited the Xingu River, accompanied by both Amazon Watch and the Brazilian Environmental Organization. We were disappointed to learn that the government has already signed the contract to build the dam, after ignoring warnings about the project's serious ecological, financial and technical risks.

The Belo Monte dam is predicted to be one of the worst engineering projects in Brazil's history. More information is available at [www.internationalrivers.org](http://www.internationalrivers.org).

What do you think about this project?

**Mobius:** I believe that solar energy is the way to go, as it is important to develop both solar and wind power.

**SL:** You are right, but unfortunately that isn't the way they are going. Maybe you can influence someone in the Brazilian government to understand the importance of solar and wind power, which are better ways to generate power. Brazil already gets 80% of its power from hydroelectric plants, even more reason to diversify as China and India have done.

**Mobius:** Many people in Brazil are concerned about these new hydroelectric projects, which are a menace, not only in Brazil but also in Malaysia where dams have a big impact.

**SL:** We agree. We hope this madness can be stopped. We also have concerns about Russia.

Russia has undergone significant changes since the collapse of the Soviet Union. Travel writer, Ian Frazier, in his new book, *Travels in Siberia*, wrote that people in Siberia said that after the demise of the Soviet system, they asked, “what do we do now” because they were used to being taken care of by the government.

We find that the Russian economy is now a more market-based and globally integrated economy. Economic reforms in the 1990s privatized most industry, with notable exceptions in the energy and defense-related sectors. Nonetheless, the rapid privatization process, including the much criticized “loans for shares” scheme that relinquished major state-owned firms to politically connected “oligarchs” has left equity ownership highly concentrated. The protection of private property rights is still weak, and the private sector remains subject to heavy state interference.

**SL:** Mark, we have a difficult time trying to understand how the majority of the Russian people have improved their quality of life. There is tremendous corruption, mass emigration and one of the lowest birth rates in the world.

Russia could and should have a bright future after the demise of communism, but it is going to require more time to adjust. They are wonderful, hard-working people, but there are reports that alcoholism is still a major problem. I hope that the Russians will be able to rebuild their country for the benefit of their grandchildren.

**Mobius:** I am a director of Lukoil, a big oil company, and because of this position, I am very positive on Russia and think that they are changing tremendously. There is no question that there has been a huge transformation, and the oligarch period is over. We would like to see it going faster, but the good news is that they have the Olympics in Sochi in 2012 which will really improve their world image. There is corruption, but the reality is that more people are making more money.

**SL:** What is the unemployment rate in Russia?

**Mobius:** Unemployment is high. I think the unofficial rate is about 15%, although the official rate is 6%. It is highest in the center of the country where there are few job opportunities. However, the overall standard of living is definitely rising.

For example, the large retailer, IKEA, shows how the consumer revolution is taking place in Russia. I visited one of their 11 stores in Moscow which was mobbed with shoppers. It was unbelievable, and it is amazing what they are doing.

**[Editor’s Note:** IKEA is the world’s leading retail chain founded in 1943 in Sweden that sells “a wide range of well-designed, functional home furnishing products at low prices.” The company has



over 300 stores in 37 countries, is the only large retailer with a perfect “sustainability” score and was listed as one of the most global eco-conscious companies in 2009.]

**Mobius:** Russian industry is primarily split between the globally competitive commodity producers and everyone else. They became the world’s largest producer in 2009 of both oil and natural gas and are also the third largest exporter of steel and primary aluminum. However, this reliance on commodity exports makes the country vulnerable to boom and bust cycles in global commodity prices.

**[Editor’s Note:** The latest iteration of Russian government’s privatization program calls for stakes in 900 state-controlled companies to be sold through 2015, in an effort to raise \$60 billion, which will be put toward plugging a looming budget deficit.

It has also been reported that faced with a widening budget deficit in the wake of its economic stimulus program, Russia is rolling out the red carpet to foreign investors with a \$39 billion privatization program. The government will sell minority stakes in state-controlled companies, including oil producer Rosnef and two major banks, VTB and Sherbank.

Analysts expect the desire to bolster revenues from privatization will prompt the government to continue efforts to improve the perception of the investment environment, which is expected to be slow and uneven.

Russia had one of its most successful stock offerings ever, when it raised \$912 million in a London Stock Exchange IPO.

Russia’s IPO pipeline is now bulging with Russian issuers, all aiming to get to market before liquidity is drawn out by anticipated government privatization sales in 2011. (Source: *Global Finance*)]

**SL:** Looking beyond the large cities, have you ever traveled out to Lake Baikal in Siberia, where the paper companies are polluting the waters of the deepest lake in the world?

**Mobius:** Lake Baikal in Siberia is so deep that I don’t think that will be a problem anytime soon. They are mining nickel there. Remember, a lot of these mines were born during the slave labor times under Stalin so it is not easy to make a change to clean it up. However, they were hit with a \$78 million pollution charge as the Russian government is quite aware of trying to solve these problems.

**SL:** I am planning to visit Russia in the summer of 2012 to get a first hand assessment of conditions there. My Russian friend, Anatoly Mikutin whom you met in Hong Kong, is going to visit his relatives and friends there this summer and will tell us what is really going on.

Do you think that the Arctic where Canada, Russia, the United States and other nations are planning to explore for oil and gas will be one of your new focuses for investment? I saw much of the Arctic in 1963 when serving on the U.S. Coast

Guard icebreaker, Northwind. The area was a pristine white wilderness that abounded with wildlife, including polar bears, walrus and fur seals. Now, many of these precious resources are endangered species caused by climate changes that have been melting the ice, both there and in Antarctica. Russian icebreakers have now shortened their navigation routes, as will many others. That is a good thing for trade.

**Mobius:** It is possible that there is a huge potential for finding oil in both of those regions, but, in the case of the Arctic, the countries involved still have to work out an agreement.

[**Editor's Note:** BP has also unveiled a \$16 billion swap with Rosneft, the Russian state oil company, so that the two companies will be able to explore the Arctic continental shelf in the Russian Arctic, an area equivalent in size and prospects to the U.K. North Sea. (Source: *Global Finance*)

Transparency International, a global coalition against corruption, ranks Russia 154, China 78, India 87 and Brazil 69. More information is available at [www.transparency.org](http://www.transparency.org).]

**SL:** Which emerging market countries do you think are doing well enough for you to invest in them now?

**Mobius:** Thailand is one. We were investing there when the riots were going on and there was "blood in the streets" because we felt that the country would continue to come back to normal. We are still quite bullish on Thailand.

We are also bullish on some of the African nations, especially Nigeria which has 150 million people, vast oil reserves and a large consumer market. It is the next big "hot spot" for investors. They have reformed the banking system, and we think that they will get their act together. All of these countries have continued corruption problems, but Nigeria is doing very well. It will not be easy. Nigeria is "the country of the future".

**SL:** Your September 30, 2010 report for the small cap mutual fund, Templeton Emerging Markets Small Cap Fund, shows that you had 3.7% invested in Nigeria in three banks and a smaller amount in Kenya. Transparency International rated Nigeria 134 out of 178 countries in 2010.

Since my passion is to invest in the best bargains we can find, I'd like to talk about where I think the bargains are right now: emerging markets small cap companies.

We define emerging markets small cap companies as those having a market capitalization at the time of purchase of less than \$2 billion USD. I believe many small cap companies have the potential to grow into large cap companies. Thus, the prospect for gains can be very exciting.

Small cap companies in emerging markets are generally under-researched and not as established as their large cap counterparts. Some have very short track records, not much background and very little publicly accessible information, which presents a higher level of perceived risk and deters many investors. But for these very reasons, share prices of small cap companies are less likely to reflect their true value with fewer analysts covering them, thus creating attractive investment opportunities. We try to work these "shortcomings" in our favor, essentially trying to capitalize on the challenges. Proper research and due diligence goes a long way to unearth deep and highly valuable treasures in the hidden chest of small-cap investing. (Source: "Digging For Hidden Gems Among Small Caps," [Mark Mobius blog](#), January 12, 2011)

**SL:** Vietnam is one of your frontier countries. How are they doing now?

**Mobius:** Vietnam is one of the big countries in our frontier markets fund and may be one of the cheapest markets in the world. However, they have problems with their currency and economy. The long term potential is great so, with the Templeton view, we are not afraid to invest there.

**SL:** Your management decided to invest in the frontier markets in a mutual fund. We see the weakness of these funds is the high numbers of redemptions that occur when something goes wrong in the often volatile frontier markets. In our view, closed-end funds are better suited for these markets. What are your thoughts?

**Mobius:** We may still do a closed-end fund in these markets, but we are not sure about this yet. However, these countries are so different from each other that the volatility is surprisingly low. Liquidity is

the problem in some countries but not for all of them.

**SL:** John Templeton once wrote: "Protecting the purchasing power of investments is vital to maintaining a strong portfolio. One of the biggest mistakes investors make is putting too much money into fixed income securities and failing to factor into their formula the fluctuating value of world currencies, which normally results in rising consumer prices."

We think you will agree that Sir John's comments are relevant to many of the issues we have discussed. We also know that you follow his disciplined, careful approach to investing that made him one of the world's greatest investors.

Thank you, Mark, for your valuable time. We may start investing in the frontier markets and hope that closed-end fund investors will be able to participate. ■

For more information on Franklin Templeton funds, visit their web site ([www.franklintempleton.com](http://www.franklintempleton.com)) or call (800) 342-5236.

**Disclosure:** George Cole Scott and his family hold shares of Templeton Emerging Markets and Templeton Dragon Fund.

**Editor's Commentary:** One of my favorite quotes by Sir John Templeton is: "Focus on value because most investors focus on outlooks and trends." When I tell people what I do, I say: "I study countries." How is this related to my work on closed-end funds?

My answer: "CEFA invests in countries so the more we know about them, the better investment decisions we can make. Our interviews with portfolio managers of closed-end funds enable us to better understand the funds as well as to help us decide which funds are appropriate for our clients' portfolios."

Our major energy holding is the closed-end fund, Petroleum & Resources (NYSE:PEO), managed by the same team that manages one of the oldest closed-end funds, Adams Express (NASDAQ:ADX). We will be interviewing the managers of these two funds for the April issue of *The Scott Letter* as well as attending their annual meeting again this year.

## The World Should Not Fear a Growing China by Li Keqiang

There is a long history to China's pursuit of the path of peaceful development. They use the term "Xiaokang" to refer to a society where people can receive education, get paid through work, have access to medical services and old age support, and have shelter and more than enough food and clothing to lead a well-off life.

To build a Xiaokang society is China's development goal by 2020. The Chinese people both long for a happy and peaceful life for ourselves and hope to enjoy harmonious relations with our neighbors. China's development calls for international cooperation over access to markets and resources, and more importantly, requires a peaceful external environment.

World peace is an important condition for China to achieve Xiaokang or moderate prosperity, and China's development, in turn, is conducive to world peace. China's development benefits other countries.

For the past few years, China has contributed 10%-20% to world economic growth. Its contribution in 2009 was 50%. Estimates show that in 2010 China's economy grew by about 10% and retail sales by about 18.5%. Domestic demand contributed more than 90% to China's growth.

With its population making up one-fifth of the world's total, China offers a market with enormous potential. We welcome the entry into our market of competitive goods and services from around the world and will provide a fair and even more transparent environment for foreign investors. China is committed to work with other countries for a solution to the global challenge of energy and resources. China will vigorously develop the green economy and low carbon technologies to significantly bring down energy consumption and CO<sub>2</sub> emission per unit of GDP.

China worked closely with the international community to address the financial crisis and to promote global recovery and growth. In recent years, it has arranged nearly \$4 billion of debt relief for 50 developing countries and has contributed more than 15,000 peacekeepers. It also has contributed to the United Nations Millennium Development goals, the IMF bail-out program and reconstruction of Afghanistan and disaster relief. It has also taken concrete actions in tackling climate change.

China is still a developing country. It is facing grave challenges and has a long way to go before it can build a moderately prosperous society and achieve modernization. China's development will not be possible without the world's help. We are committed to work even more closely with other countries to create a bright future for all. (Source: *Financial Times*) ■

## High Speed Rail Is Growing Fastest in China

WorldWatch is a highly acclaimed research organization based in Washington, D.C. They recently published a report on High Speed Rail (HSR), written by two of its senior researchers, Michael Renner and Gary Gardner. A summary of the report follows:

"The United States currently invests a much smaller amount in rail and transit, after once being a world leader in this area, with the fastest trains in the world in the 1950s. We are years behind Canada, Japan, France, Germany, Spain and other European countries in development of high speed rail that is badly needed to ease highway congestion.

Global demand for passenger and rail equipment, infrastructure and related services in 2007 was \$169 billion and is projected to grow to \$214 billion by 2016, much of it going to Western Europe.

China spent \$66 per capita in 2009, followed by Germany, France, the U.K. and Italy. By contrast, the U.S. only spent \$9, although the stimulus funds temporarily raised this figure to nearly \$36. The frontrunners in track-building are China, Spain, France, Japan, Turkey, Germany, Italy, Poland and Portugal.

China's most polluting city emissions are just one-fifth of those of San Diego, the greenest of U.S. cities. Moreover, 40% of U.S. emissions come from residential and

personal transportation. Household share of total per capita carbon emissions will grow as China changes from a manufacturing economy to a service economy. As its urban population continues to grow, China will consume more electricity, and the demand for private transportation services will increase.

This country of 1.3 billion people is building the most extensive HSR system in the world, a total length of more than 15,000 miles. However, the densest rail network is emerging in Spain, where the government has a goal of 6,200 miles of track by year 2020."

For more details, read this report at [www.worldwatch.org](http://www.worldwatch.org). ■

## Pimco's Bond Fund Holdings Pares U.S. Holdings

Pacific Investment Management Co. cut U.S. government-related holdings in its flagship bond fund in December to its lowest level in nearly two years.

Optimism on the economic outlook fueled heavy selling in U.S. treasuries in

December, with many investors now favoring stocks.

The 10-year note's yield, which moves inversely to its price, hit a seven-month peak on December 16, 2010 as the U.S. market weakened.

The rotation into riskier bets hurt the Total Return Fund, which is the world's biggest bond fund with \$240.7 billion in assets. Pimco is owned by Munich-based insurance company Allianz SE. (Source: *The Wall Street Journal*) ■

## Portfolio Manager's Review

After a decade of almost no growth, A stock values around the world rose significantly in 2010. Forecasts by *The Kiplinger Letter* indicate that U.S. gross domestic product gains will accelerate to 3.5% growth in 2011, after an average growth of 2.8% in 2010.

Closed-end funds had another solid year. The average of all 614 closed-end funds tracked in our weekly *Closed-End Fund Universe Report* rose +12.4%. The average closed-end bond and equity fund was up +9.0% and +18.7%, respectively. Many of the emerging markets funds, particularly those invested in Asia and Latin America, have achieved robust returns for our clients and subscribers. This was helped by low interest rates and an improvement in global equity and credit markets as well as solid distribution yields and narrowing discounts. Many of the emerging markets countries mentioned in this issue of *The Scott Letter* are better off than many of the developed markets.

CEFA plans to increase its exposure to the emerging markets and reduce its exposure to U.S. bond funds because of rising inflation and interest rates. The municipal bond markets are particularly vulnerable because of credit concerns and a growing disagreement within the market over values. All of the bond mutual funds tracked by Lipper have been declining, marking the ninth consecutive week of outflows. One official of the Federal Reserve says that he sees "some potential for broader distress in the municipal bond market." CEFA recommends that investors be tactical in their portfolios: Look at the certainty of future dividend payments, net asset value trends and historical and relative discounts for a fund and its peer group.

We are lightening up on the emerging markets bond funds, preferring to use funds that invest in global sovereign (government) bonds. These funds are less vulnerable to interest rate fluctuations. We also have a preference for short duration,

senior loan and high yield bond funds, as they will suffer less principal loss when interest rates inevitably rise.

Mark Mobius is still optimistic about the future for the emerging markets. His largest allocation is China, but he also sees continued growth in India, Russia and Latin America.

In recent months, Mark has been focusing on some of the smaller markets, such as those in a few African countries and other overlooked countries which his experience tells him are now so oversold that they are bound to recover.

In 2011, we continue to lean towards regional and global funds rather than single country funds to reduce risk. We have invested in smaller funds such as The Asia Pacific Fund which has had a good long-term record. This year we have chosen two Templeton emerging markets funds mentioned in this *Letter* because they use the value style of Dr. Mark Mobius and because they pay good distributions.

We are also considering the possibility of investing in the emerging small cap funds that invest in the growing frontier markets that Mark mentions in his blog or newsletter.

We have urged him to talk to Franklin/Templeton about launching more closed-end funds, and he reports that they may do so. We have long followed the philosophy of John Templeton who managed many mutual funds, but in many instances, preferred the closed-end fund format especially in volatile stock markets.

The year 2010 completed a second successful year for our six portfolio models. We expect to be more tactical in the swapping of funds to fulfill client objectives in 2011. With the average closed-end fund showing a distribution yield of 6.9% on an annualized basis, the total return and health of future dividend obligations will continue to be a significant factor for 2011 performance. ■

*George Cole Scott*

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