The Scott Letter: *Closed-End Fund Report*©

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Aberdeen Australia Equity Fund (IAF-AMEX)
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George Cole Scott, Editor

The Scott Letter Online is intended to educate global investors. [What are closed-end funds?] Closed-end funds can be a valuable and profitable investment tool. Please feel free to forward this newsletter to anyone who you believe could benefit from information on closed-end funds or global portfolios. You may also visit our website [www.CEFadvisors.com] Please call *(800) 356-3508* or email: cefa@CEFadvisors.com to get started with one of our managed portfolios.

For more information on closed-end funds, please visit the [Investor Resources] section on our website, [Closed-End Fund Association] or Capital Link's [Closed-End Fund Forum].

Back issues of ***The Scott Letter Online*** are available on our website. They include interviews with Adams Express, Allied Capital, Asia Pacific Fund, Ellsworth & Bancroft Convertible Funds, Central European Equity & Russian Fund, General American Investors, H & Q Healthcare Investors, Latin America Equity & Brazilian Equity Fund, Pan Pacific Realty, Renaissance Capital, Royce Funds, Templeton Funds and Tri-Continental Corp.

Aberdeen Australia Equity Fund (IAF-AMEX) is a closed-end management investment company, managed by Aberdeen Asset Management Asia Limited. The primary objective is long-term capital appreciation through investment in equity securities of Australian companies listed on the Australian Exchange. The secondary objective is current income, derived primarily from dividends and interest on Australian corporate and government securities.

Australia is the only country in the world that is also a continent. In area, it is the sixth largest country and smallest continent. The name, *Australia,* comes from the Latin word, australis, which means *southern.* Australia's economy is based on exports, primarily to China, Japan and the United States.

The largest part of the population is composed of descendants of Europeans: the largest non-white minority are the Australian Aborigines. The Asian part of the population has grown as a result of a relaxed immigration policy.

Australia is rich in mineral resources, including coal, petroleum, and uranium. The largest manufactured goods are consumer goods such as processed foods, iron, steel, and other metals; transportation equipment; paper and household appliances. Mining exports are bauxite, coal, copper, tin, tungsten, uranium and zinc. This makes it possible for most of the people of Australia to have a high standard of living.

Aberdeen, headquartered in Aberdeen, Scotland, is one of the largest closed-end operators in the United Kingdom, was founded in 1983. It is a listed company in the U.K., which has grown rapidly both organically and through acquisitions. The firm currently manages $38 (US) billion globally or $54 billion in Australian currency worldwide. Aberdeen has offices throughout the world including Glasgow, Edinburgh, London, Singapore, Sydney, New York and Ft. Lauderdale.

The Fund invests at least 65% of its total assets in equities listed on the Australian Stock Exchange Limited. The balance of its assets is invested primarily in debt securities of Australian companies, the Federal and state government of Australia, and the United States Government as well as in unlisted Australian securities. Current income is a secondary objective, which is expected to be derived primarily from dividends and interest on Australian corporate and government securities.

The Fund has an initial 10% managed distribution policy paying quarterly distributions at an annual rate, set once a year, for a percentage of the rolling average of the Fund's prior four quarter-end net asset values. The distributions are made from current income, supplemented by realized capital gains. In the event that income and realized capital gains are insufficient to meet the distribution, then the balance will be met by the return of paid-in capital.

Calendar Year Performance

	NAV Annual Returns		**Market Returns**	
	Cumulative	**Annualized**	**Cumulative**	**Annualized**
Since Inception	**249.3%**	**7.0%**	**215.0%**	**6.4%**
1 year	**25.1%**	**N/A**	**28.1%**	**N/A**
3 year	**74.3%**	**20.3%**	**75.6%**	**20.7%**
5 year	**48.9%**	**8.3%**	**60.4%**	**9.9%**
10 year	**86.4%**	**6.4%**	**86.2%**	**6.4%**

The Fund's returns are denominated in U.S. dollars and are affected by the performance of the US dollar against the Australian dollar.

On July 30, 2004, 87.4% of the fund's portfolio was held in industrial equities, which includes the financial sector; 8.9% in resource equities and 3.7% in cash. The quality of the portfolio remains high, with 75.4% of the Fund's stocks by value being included in the Australia Stock Exchange's

Fifty Leaders Index. As of July 30, 2004, the Fund was 96% invested in shares. The Fund's net assets amounted to US $160.1 million, and the Fund's net asset value was $9.54 per share.

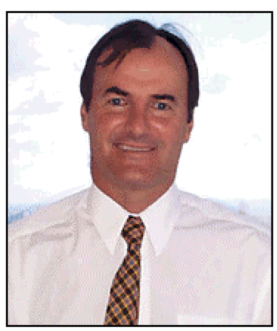
The ten largest equity holdings as of July 30, 2004,
Representing 56.2% of total assets, were:

Equity Holdings	Percent of Total Assets
Australia & New Zealand Banking Group Limited	7.8 %
QBE Insurance Group Limited	7.7 %
Wespac Banking Corporation Limited	6.4 %
Telecom Corporation of New Zealand Limited	6.3 %
Forster's Group Limited	5.4 %
TABCORP Holdings Limited	5.4 %
Rio Tinto Limited	4.7 %
BHP Billiton Limited	4.2 %
Telstra Corporation Limited	4.2 %
Woolworth's Limited	4.1 %

We spoke to Steve Robinson and Munib Madni, portfolio managers by telephone from Sydney, Australia on September 9 and later to Bev Hendry, CEO of Aberdeen's US operations, from the Ft. Lauderdale, Florida office.

This interview was about as close as we have been to a fund's management by telephone, as when we sat down in a meeting with the former managers at Equitilink in Sydney in 1993. Aberdeen purchased Equitilink in 2000.

Steve Robinson



Bev Hendry

Munib Madni

The investment team consists of four investment managers, headed by **Steve Robinson** and **Munib Madni**, Michelle Casas and Maria Papathanasiou, the other portfolio managers, were not available for the interview.

Steve Robinson is a director of the Company and head of the Australian Equities desk in Aberdeen's Sydney office. Steve joined Aberdeen in 1998 and is responsible for strategy and portfolio construction, with a specialty in financials, utilities and energy companies. Steve has a B.S. from Canterbury University, in Christchurch, New Zealand, with a Bachelor's of Science Graduate Degree in geology. He also holds a graduate diploma in mineral economics and a graduate diploma in applied finance.

Munib Madni, the investment manager, has a Chartered Financial Analyst designation (AIMR), a Bachelor of Business (Honors), specializing in Finance with a 1st class Honors and a LLB from the University of Technology (Sydney). He joined Aberdeen in 1994 and focuses on telecommunications, materials, healthcare, industrials and consumer discretionary industries.

SL: I want to ask about your investment style, the Australian economy, the portfolio and your coming election as it relates to your economy. We Americans think of Australia as a natural resource economy, but we were surprised to find the largest part of your portfolio is invested in financial institutions. What is the investment style of the Fund?

Robinson: We run what we call an "Aberdeen Process" here as well as in Singapore and the U.K. We are active bottom-up managers who believe that, over the long term, share prices are driven by fundamentals. We identify quality companies at reasonable and cheap prices.

SL: How do you handle investment risk?

Robinson: Risk for us is more than comparing the fund to a benchmark. We see risk primarily as investing in a poor quality company at a high price. Although a long-only manager, we look at risk more in absolute than in relative terms. If we don't see quality, we don't even look at companies whether they are cheap or not. We are growth oriented but lean more towards the value side and make company visits every six months. We, therefore, identify companies at a reasonable price to fit a criterion of strong management and financial strength. We stress finding managements with motivation and experience and look for companies with a commitment to small shareholders. We ask: "Do we trust them"?

We invest in companies for the long-term and do not trade stocks. We are only interested in businesses that we understand and that we can value. Regarding transparency, we always want to claim a clean company structure; visible earnings and a company run for shareholders, rather than for managers or controlling interests. Our funds consist of 15 to 40 stocks that we really like irrespective of the stocks weighting in the benchmark index.

SL: We particularly like your emphasis on being friendly to small shareholders, who are often overlooked by large institutions. How do you apply this to long-term investing?

Madni: The Company has to have a strong consistent, reliable management, which provides quality earnings.

SL: We have found, particularly in the developing world, that good, clear financial transparency is difficult to find. Any comments?

Madni: In the longer term, the company has to be able to be a quality company at a reasonable price. It has to have strong, consistent reliable management and balance sheet providing quality of earnings to produce value. These characteristics will outperform the market and deliver good returns. You can claim to be very transparent in a 150-page report, which many people don't read through, and, therefore, cannot find the possible pitfalls. Even in the West, people can hide behind financial rules. Transparency has to be supported by honesty, which is often reproduced in consistent reliable actions.

SL: Exactly. This is good stuff. You mentioned you were value players. How do you use these criteria?

Robinson: The Australian dollar is currently around 70 US cents. It is partly viewed as a commodity currency so when global commodities were running pretty hard, the Australian dollar was supported by the interest rate differential with the US, the cash rate, which is now 5.25% moved up from a low of 4.25%. The expectation from our economists is that they will rise to about 5.50% where they will peak in the next twelve months.

SL: How do you think this will affect your stock and bond markets?

Madni: In our bond markets, we have a flat yield curve as short-term cash rates have been rising. (The yield curve is the relationship of long rates to short rates). There is little price differential between the three and ten year notes in the bond market.

Robinson: The three and ten year maturities are currently around 5.50% after rising to 6.0% in June ahead of the cash rate.

SL: I hope that means you will have a lot of cash for distributions to shareholders. Why do you have so large a percentage of the portfolio in the financial sector in a natural resource economy?

Robinson: The GDP growth rate of Australia is 4.1%. The Australian markets have a large weighting in financials, particularly in banks, so that influences us. The Bank sector has done well because of our strong economic and credit growth. However, we reduced our bank holdings over the last year.

We have a big position in QBE Insurance Group, a diversified general insurer. This remains a core holding for us. We also hold 1.4 million shares of AXA Pacific Holdings Limited, a multiple line insurance company, which has just been taken over by its French parent, AXA, SA. We continue to hold positions in bank stocks because of this growth and we don't think interest rates will rise significantly. We also hold money management firms.

SL: What about mining stocks?

Robinson: We hold Rio Tinto Limited and BHP Billiton, (both of these stocks trade on the NYSE-Ed.) in the materials sector. Rio Tinto, the largest mining company in the world, is about 1.50% of our Index and 4% of the Fund. They are diversified, very large suppliers of coal and iron ore for export to China.

SL: How large is the China market?

Madni: The Chinese market for coal and iron ore is growing rapidly. This is important for Australia's mining industry and represents about 14% of our stock market. In Australia, we have many single commodity companies in the Index, holding about 10.0% in mining and oil stocks. This group is composed of iron ore, copper, aluminum and gold. We also have Woodside Petroleum, the biggest listed oil company on the Australian market. It produces oil and gas on the Northwest Coast including LNG natural gas, which they sell to Asia, particularly to Japan and China. BHP has production in Bass Strait, South of Melbourne.

Robinson: Exports to China drive the infrastructure growth in Australia's resource projects. There are big volume increases in iron ore, minerals, new projects that drive economic growth.

Madni: Growth into China and Asia work directly through companies like BHP Billiton, Rio Tinto and Woodside. We have also seen other Asian economies investing in Australia. Our focus in China is, therefore, specifically through the materials companies.

Robinson and Madni: The exports to China, largely raw materials, will be driven by a lot of investment here in minerals that drive economic growth. In a nutshell, growth in China and exports to Asia flow directly through to their suppliers and contractors and into the economy. Longer term, we are focused on our economy and have increased tourism, a positive for Australia. Shorter term, we are focused on China specifically through the materials companies.

SL: I see you have consumer stables at 20%. Where do you focus here?

Robinson: We focus on beer and wine, which are highly profitable.

SL: You also have consumer companies that, here in the US, historically have low margins such as Woolworth's. How profitable is it?

Robinson: Woolworth's is the largest retailer in Australia (no connection to a chain with a similar name in the US-Ed). They do pretty well with good returns on equity.

SL: Why are property companies so small in Australia? Aren't they good investments?

Robinson and Madni: We have increased this sector recently with Westfield America to 4%. Properties have limited growth here because the Australian property market in the last twelve months has been consolidating, and we don't think the pricing is reasonable.

SL: To change the subject, you also have a coming election. Will the Labor Party be able to overthrow the conservative Liberal-National Party coalition, after so many years of steady economic growth? You have a challenger, but, seeing that your unemployment is close to a 20-year low, the budget is in surplus and your stock exchange has been hitting new highs, does he have a chance? What's up?

Madni: We have concerns about the economic policies, but the two governments are quite similar short-term. Longer term, their policies are not too expressive against the unions. The current government is the friendliest towards the stock markets, while the opposition is more union-friendly.

SL: I see that the Labor Party is committed to keeping the government in surplus. A report in *The Financial Times*, however, says tobacco taxes may rise, but they also say that there may be a possible rise in international business and tourist taxes. Tourism is booming so why would they raise taxes on guys like me who might come to Australia to take the train from Melbourne to Perth and visit your wonderful cities?

Robinson: That is just the politics of the moment.

SL: We also have learned that your Prime Minister, John Howard, won't be able to relax because your long-standing economic alliance with the US puts you in a dilemma. *The Financial Times* points out that it may be difficult to balance your friendship with the world's only superpower against your relationship with China, the emerging power in Asia. They see other US allies in the region facing the same difficulties with the rise of China because "the interdependence of the Chinese and Australian economies makes Australia's headache particularly severe." The report also says Australia is supplying much of the iron ore, non-ferrous metals and coal, as well as higher education that fuel China's industrial revolution. (Some 50,000 Chinese are studying at Australia's universities).

Recent success of the Australian economy is underpinned by the best trade terms in 30 years as more than half of Australia's exports go to Asia, and, according to one of your government officials, this may remain for decades to come. Are you aware of any of this?

Robinson and Madni: Australia has benefited from increased trade with China and the rest of Asia over the last 40 years. Throughout this period, Australia has maintained a very strong relationship with the United States that goes beyond economic trade and has strengthened in recent times. We see this strong relationship continuing as it is in Australia's best interest as is standing on our own two feet economically through competitive international trade.

SL: We also study many markets to try to see how much they are coordinated with the US stock markets. Can you help us with this?

Madni: Over the mid to long-term, the Australian market has followed the US markets although in the short-term it may diverge. For example, in 2004, the Australian stock market is up so far, making new highs while most of the US and European markets are flat to down. Over the long-term, we have been more correlated with the US and Europe than with the Asian markets.

Robinson: In the last year, we haven't seen the Australian markets closely linked to those in the US and Europe. The Australian market is up 12% this year compared to the Dow, which is down 1%. It is operating on the strength of the Australian economy because we have strong exports to Asia, and when the Australia dollar declines, that helps our economy.

SL: We later spoke to Bev Hendry, CEO of Aberdeen Asset Management about this issue.

Hendry: There is a certain degree of correlation between the US and Australian stock markets, but I think there is a lot of possible potential for currency gains for us. If the US dollar goes through a rough time, the Australian dollar should benefit. In the long-term, we will see the Australian dollar resume its upward trend. After the US dollar strengthened against the Australian dollar for many years, this has now been reversed as our dollar has recovered because of the differential between the US interest rates and Australian interest rates. The Australian dollar is seen as a commodity currency as demand for commodities has been strong from China. We think the steady upward shift in the Australian currency will continue in the future. In sum, there is some correlation between the markets, but the Australian dollar still has a heavy dominance of resources the US markets do not have.

SL: That was illuminating. Steve, what can you tell us about the economy in New Zealand and your telecommunication investments there? Is this industry growing in the two countries or are there the same problems we find elsewhere?

Robinson and Madni: Interest rates are a little higher in New Zealand and are rising, as the economy is a little stronger. In telecoms, we only hold companies listed on the Australian Stock Exchange such as Telecom New Zealand. The Australian company, Telstra, has a New Zealand subsidiary, which has both landlines and mobile operations. The key is reasonably limited competition, two or three players, and very strong cash flows used to pay down debt.

SL: I wanted to work in some questions about New Zealand because it is an economy that is tied to yours in many ways. I also have questions about what is a widely discussed subject in the US: terrorism. Are Australians as concerned about terrorism as we are here?

Robinson: We take the threat of terrorism seriously and are concerned about it from an international perspective. In spite of those events, we are not so concerned as you seem to be.

SL: Many Americans wonder where we can travel to that is safe from bombing attacks. Australia and New Zealand seem to be a favored, safe area to visit. Is tourism booming there?

Robinson and Madni: Yes, but most tourism companies are run by small to medium enterprises so that we can't invest in that sector. We also have casino and gaming operators here, heavily used by tourists, in which we can invest.

SL: To wrap up, any concluding remarks?

Robinson: We are conservative investors, holding stocks for the long-term. The Australian economy is chugging along quite nicely, and we think that will help the stock market.

Madni: Investing in Australia is a good medium to long-term play.

SL: It sounds like Americans who want a smaller country with many opportunities could consider Australia.

Bev Hendry, CEO of Aberdeen's US operations in Ft. Lauderdale had some thoughts about corporate governance issues:

SL: What changes have there been at Aberdeen since it purchased Equitilink four years ago?

Hendry: Equitilink was purely an Australian company with one office in Sydney. Aberdeen is a worldwide company with over 20 offices and has much greater resources.

Aberdeen also manages two bond funds: Aberdeen Asia Pacific Income Fund, (FAX-NYSE) and Aberdeen Global Income Fund (FCO-NYSE). They are managed from Aberdeen's large office in Singapore. The Aberdeen Group, at the end of August 2004, managed over $38 billion including closed-end funds, open-end funds and institutional accounts.

SL: Regarding your managed distribution policy, have you ever had to distribute a return of capital to meet your target?

Hendry: We just started the managed distribution policy in April in an effort to reduce the discount. In 2004, we have declared three distribution payments: 22 cents per share for the quarter ended 31st March, 23 cents per share for the quarter ended 30th June and 24 cents per share for the quarter ended 30th September. So far, the distributions are from current income and realized capital gains, but there can be no guarantee that this will continue to be true. To the extent required, returns of capital will be made to complete the managed distribution payment.

SL: *The Financial Times* recently telephoned me because some of their readers were confused about closed-end fund distributions. Many thought that ten percent paid-out by a fund was a "yield" on their investment like from a bond fund, a common misunderstanding. Are you aware of this confusion?

Hendry: We try to make it as clear as possible with press releases and notifications with each distribution payment to shareholders so that these payments are not just dividend yield and that a managed distribution policy is in operation.

SL: Do you ever repurchase your shares to reduce the discount?

Hendry: We have a share buy-back program for our other closed-end funds commencing in June, 2001. We have not made any buy-backs recently as we wanted to see if the managed distribution program was successful and how it works out over time. We find from the experience of other closed-end funds that shareholders like to get several distributions before they are comfortable with the policy.

SL: That is a good answer. I see in your quarterly report that you have had some litigation with someone called "Full Value Partners". Who are they?

Hendry: Full Value Partners are closed-end fund activists. The litigation is now over. We have included some proposals which were passed at the annual meeting to allay their concerns over corporate governance. They were pleased to see the managed distribution policy.

SL: This is an issue that has been plaguing our industry for a long time. Many investors don't realize that some simply want to open-end or liquidate a closed-end fund for a quick gain just because of the discount.

If the fund is doing a lousy job or has a persistent deep discount without taking any action such as share buy-backs or managed distribution plans, they have a good case. But, if the fund has good management or a niche as you have, we see these efforts as a way to destroy all the advantages of closed-end funds over mutual funds, which we explain on our new website. We feel strongly that closed-end funds are a conservative and far superior way to invest in the stock markets of the world. Do you have adequate protection against open ending?

Hendry: There are not many Australian open-end funds. I believe that there few funds that offer the active management we have nor have they done as well. One thing about this fund is its consistently good performance. We feel that it is in the best interests of our shareholders to be in a closed-end fund. Obviously, we would like the discount to narrow and hope that the managed distribution policy will achieve this over time.

SL: We have reports about your interest rates and a slowdown in your currency and your housing market. Comments?

Hendry: There have been two things that have slowed the currency recently: the general election will take place soon and the Reserve Bank will not raise rates during an election campaign. The housing market has been very buoyant over the last three years, and, therefore, some slowdown was to be expected. The Reserve Bank raised borrowing costs in 2003 to a three-year high to cool the demand for housing, and this now seems to be working.

For more information on this Fund or the other two managed by Aberdeen Asset Management, including a market review and current outlook, weekly updates of share prices, NAV and details of recent distributions, telephone toll-free 1-800-522-5465 in the United States or e-mail InvestorRelations@aberdeen-asset.com. The website is www.aberdeen-asset.com/us

"Motivation is what gets you started. Habit is what keeps you going."

-- Jim Ryun
Olympic medalist and politician

*"Decide what you want, decide what you are willing to exchange for it.
Establish your priorities and go to work."*

-- H.L. Hunt

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