Published by
Closed-End Fund Advisors

# THE SCOTT LETTER: CLOSED-END FUND REPORT

Vol. VI, No. 11 *A Global View of the Closed-End Fund Industry* November 2006

**THE SCOTT LETTER** is intended to educate global investors about closed-end funds. Closed-end funds can be a valuable and profitable investment tool. To learn about closed-end funds, visit our web site, www.CEFAdvisors.com, and in particular, read our article, *What Are Closed-End Funds*. Feel free to forward this newsletter to anyone who you believe could benefit from information on closed-end funds or global portfolios.

– George Cole Scott
Editor-in-Chief

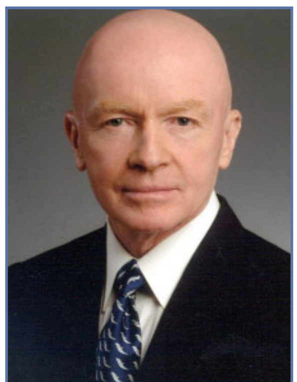
**IN THIS ISSUE:**



## Dr. Mark Mobius Seeks Bargains in Eastern Europe

Dr. Mark Mobius pioneered emerging markets investing in 1987 with the Templeton Emerging Markets Fund (EMF). Mobius is currently Managing Director of Templeton Asset Management, Ltd. As of September 30, 2006, he was responsible for over $28 billion in assets in closed-end funds, mutual funds and private accounts.

Dr. Mobius and his developing markets team have professionals in 28 countries, including South Korea, China (Shanghai and Hong Kong), Singapore, Poland, Russia, Turkey, India, South Africa, Austria, Brazil and Argentina. They typically venture to some 40 countries a year, visiting nearly 1,200 companies. Most of the analysts are natives of the areas they cover and provide a unique perspective on opportunities for investments.



Dr. J. Mark Mobius

Dr. Mobius has spent nearly 40 years working in Asia and other parts of the emerging markets world. He manages three closed-end funds: Templeton Emerging Markets Fund (EMF-NYSE), Templeton Dragon Fund (TDF-NYSE) and Templeton Russia and Eastern European Fund (TRF-NYSE).

Clients of Closed-End Fund Advisors hold shares in TDF and EMF, including the accounts of George Cole Scott and his family.

Dr. Mobius, who holds a bachelor and masters degree from Boston University and a Ph.D. in economics and political science from MIT, is the author of three books: *The Investors Guide to Emerging Markets, Mobius on Emerging Markets* and *Passport to Profits.*

George Scott and Jon Chatfield interviewed Dr. Mobius by telephone on October 20, 2006 at Ljubljana, the capital of Slovenia. This small country was once a part of the Austro-Hungarian Empire and is surrounded by Croatia, Hungary, Austria and Italy. Dr. Mobius was looking for new investment opportunities throughout the region.

**GS:** Good day, Mark. Please tell us why you are in Slovenia.

**Mobius:** We are finding some interesting bargains in both Croatia and Romania.

**GS:** We see that you don't have much exposure to Eastern Europe in your Templeton Emerging Markets Fund. Are you expanding your exposure there?

**Mobius:** Not really, but there are some opportunities. We have started a private equity fund and are looking for opportunities. We have also started a small cap mutual fund.

**GS:** How is it going and what size is it?

**Mobius:** Very well. In October, we launched the Franklin Emerging Markets Small Cap Fund in the U.S. with $10 million and about 50 stocks with market capitalizations of $1 billion or less. It is expanding rapidly. Our universe has so many companies that are bargains which we were overlooking.

**GS:** How much have you been able to focus on small caps?

**Mobius:** We have been able to find lots of bargains with large cap stocks. We like their liquidity but decided to have a small cap fund using the 17,000 names in our master list of emerging market companies around the world. Only about a third of those qualify for the small cap market capitalization – about 5,000 names. This is a good opportunity to be exposed to that group of companies, enabling us to get into the smaller companies and countries beyond the purview of our global funds.

For example, in Croatia and Slovenia, there are only a few companies that qualify for our large global funds. Recently, the largest pharmaceutical company in this region, Pliva, was sold at a nice profit to Barr Pharmaceutical (in the U.S.). This opportunity was quite exciting.

**GS:** Could you give us a quick rundown on the four BRIC countries, Brazil, Russia, India and China?

**Mobius:** We manage three BRIC mutual funds: one in Canada, another in the U.S. and one in Europe. A lot of money has come into these mutual funds, almost a billion dollars. There are now five of these large funds in the industry.

This is an exciting category popular among many investors around the world, who like to get exposure to these large countries. It makes it easier for investors to follow and understand them in a concentrated fund. (The MSCI BRIC Index rose 4.2% in the third quarter and was up 21% for the year. For a detailed discussion of the BRIC countries, see The Scott Letter for April 2006).

**GS:** It is probably better to be in the BRIC fund than to be restricted to an India or a Brazil fund. However, it still doesn't have the diversification of a fund such as your Templeton Emerging Markets Fund. Which of these four BRIC countries excite you the most now?

**Mobius:** China. Chinese stocks are still quite reasonably priced and are very large. The Commercial Bank of China (ICBC) has just brought out a major IPO (new issue of stock), the largest IPO in the world. This company raised $19.1 billion with heavy demand from retail investors in mainland China, a global record. The liquidity of these Chinese companies is reasonably priced. Unless you have liquidity and size, it is quite difficult to manage a billion dollar fund. A secondary consideration is to the good valuations of Chinese companies.

[Editor's Note: The record-breaking initial public offering of ICBC will further fuel interest in emerging markets, according to a veteran investment consultant.]

**GS:** Beijing is trying to stem the outflow of hot money from leaving the country. Any comment?

**Mobius:** Actually, I don't think they necessarily want to stem the cash outflow as much as to ensure that the money outflow is controlled. They also have a problem with the build up in foreign reserves, which has reached about $900 billion, and is embarrassing. They would like to see more money flow out, but at the same time, they don't want to change the foreign exchange regime. They are worried about currency control problems. The Chiense are at a difficult juncture in their history.

**GS:** There are some rumors that there will be a change in the Shenzhen and Shanghai listed "B" shares which could be linked with the renminbi-quoted "A" shares.

**Mobius:** There is talk about merger. The "B" share is a big disappointment, but there won't be any change until foreign exchange controls are eliminated. Unless you eliminate foreign exchange controls, you really can't have open markets for foreigners. That will take time. Hong Kong will continue to be the major gateway for foreigners to invest in China.

**JC:** Dr. Mobius, do you feel that the MSCI Index is a good reflection of the investment opportunities in China?

**Mobius:** I think it is a reasonable reflection of how to invest in China. The "H" (Hong Kong) shares and the China "Red Chips" or "A" shares are a big part of that Index. The "A" share market is closed to foreign investors except for those who have special permission. I believe that it is

**1-, 3- and 5-Year Compound Annual Returns for Templeton Emerging Markets Funds, Inc; Templeton Russia and East European Fund, Inc. and Templeton Dragon Fund, Inc. (as of August 31, 2006)**

| | Inception Date | Inception* to Sep-06 | 1 Year to Sep-06 | 2 Years* to Sep-06 | 3 Years* to Sep-06 | 4 Years* to Sep-06 | 5 Years* to Sep-06 | 10 Years* to Sep-06 | 15 Years* to Sep-06 | 20 Years* to Sep-06 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Closed-End Funds: NAV**** | | | | | | | | | | |
| Templeton Emerging Markets Fund, Inc. (EMF) | Feb-26-87 | 14.93 | 17.22 | 28.37 | 28.58 | 31.34 | 25.77 | 10.28 | 12.80 | N/A |
| Templeton Russia and East European Fund, Inc. (TRF) | Jun-15-95 | 21.06 | 44.13 | 46.54 | 42.53 | 50.40 | 48.60 | 21.06 | N/A | N/A |
| Templeton Dragon Fund, Inc. (TDF) | Sep-20-94 | 11.69 | 15.06 | 20.94 | 24.10 | 30.81 | 28.82 | 11.65 | N/A | N/A |
| **Closed-End Funds: Market Price** | | | | | | | | | | |
| Templeton Emerging Markets Fund, Inc. (EMF) | Feb-26-87 | 14.10 | 7.59 | 22.35 | 25.67 | 33.45 | 26.50 | 9.21 | 11.85 | N/A |
| Templeton Russia and East European Fund, Inc. (TRF) | Sep-13-95 | 23.61 | 46.30 | 58.47 | 52.44 | 62.71 | 58.96 | 22.06 | N/A | N/A |
| Templeton Dragon Fund, Inc. (TDF) | Sep-20-94 | 10.34 | 18.13 | 22.83 | 20.84 | 35.21 | 31.98 | 13.01 | N/A | N/A |

*Average Annual Returns. All returns in U.S. dollars.

**The returns for the NAV-based series are in the process of being revised in oder to include the NAV as the reinvestment price versus the DRIP calculated reinvestment price that has been used historically. Returns shown here are subject to change depending on the impact of the revision.

now changing. Taiwan companies are also a good way to invest in China because, almost without exception, they are involved in China in some way.

**GS:** Did you see that CALPERs, the California Public Employees Retirement System, is considering investing in China for the first time? We wonder what took them so long.

**Mobius:** Yes, and I was really surprised that they are also going to invest in two major Korean companies.

**JC:** Which of the global markets that you follow would you consider to be the highest risk now and why?

**Mobius:** India, which has rather high valuations. I hate to make a blanket statement as we are still invested in India and they have a lot of cheap companies, but this market is relatively expensive. India has many growth companies which may justify a high price/earnings ratio. This is something we have to watch carefully.

**JC:** Would you say that the risks in the emerging markets are associated more with the valuation levels than with the political risks?

**Mobius:** Most definitely. We have been able to handle the political risks over the years, as you see what has happened in the recent Thailand coup, where the stock market didn't really move down at all. I don't think that the political risks are as salient as they used to be. There are risks, but not as much as previously.

**JC:** Have the weightings of the countries in EMF changed much since August, and if so, why?

**Mobius:** No, there hasn't been much significant change. Korea is still at the top of the list, followed by China and Turkey. After the big May crisis and correction in the emerging markets, we increased our exposure to Turkey, overweighting it and Brazil, but there is no big change really. We hold our stocks relatively long-term.

**JC:** Do you think that there is much danger in Brazil and in other Latin American countries that a move toward leftist-leaning governments could destabilize the economies and markets? Is this activity limited to Venezuela?

**Mobius:** No. In Venezuela, Ecuador and some of the smaller countries around Brazil, there hasn't been much leftist influence. In Peru, for example, they tried to get a radical in, but they failed. You will find the small countries are influenced by Venezuela because of the desire for cheap oil.

This is not true at all in Brazil. In fact, the elections in Brazil were between two people who are very much oriented towards a market economy and take a prudent fiscal approach. We are in pretty good shape in that regard.

***"Some people have been saying that the U.S. and the global economies are in trouble. The reality is that the U.S. economy continues to grow at a very good pace."***

[Editor's Note: Incumbent President Luiz Inacio Lula da Silva defeated centrist Geraldo Alkmin in the October 29, 2006 run-off election, although his once formidable lead eroded. Lula said he would follow tough fiscal policies.]

**GS:** There is some concern in the U.S. that there will be a global slowdown next year. We have seen mixed signals coming from the Asian Development Bank and the World Bank. What are your thoughts on these scenarios for the U.S. and the world?

**Mobius:** Some people have been saying that the U.S. and the global economies are in trouble. The reality is that the U.S. economy continues to grow at a very good pace. The export-import business continues to do very well. There is a U.S. housing slowdown, but we haven't seen much impact yet. Economic growth is still relatively high.

If you look around the world, the growth rate is still quite astounding. For instance, Romania is growing at a rate of 7%-8% a year. In China, they are happy that their economy has moderated, slowing down to 10%!

[Editor's Note: The IMF has just reported that China's growth in 2006 is likely to exceed 10.5%. It is doubtful that Beijing can cool its economy. See our report below for more discussion on this development.]

The numbers are quite remarkable if you look at the history of global growth. Some people were saying that the emerging markets have gone too far and are overblown. After the May correction, some mutual funds have closed (to new investors). Since then, the (emerging) markets have gone up much more than anyone expected.

**GS:** Many commodities, including oil, have dropped sharply off their highs, with some exceptions such as nickel. Where do you think the global flow of funds is now going?

**Mobius:** The numbers from dedicated emerging markets funds have moderated and, in fact, have come down. They are still increasing but not at the rate they were. Remember that the amount of money going into emerging markets in the last two years was greater than any other category. This is quite remarkable, considering that the emerging markets represent about 12% of the world's market capitalization. More money is still going into those funds than into U.S. funds or global funds, although I think now it is moderating somewhat.

[Editor's Note: As we were going to press, share indexes in Australia, Hong Kong, India and Indonesia all hit record levels in spite of weakness in the U.S. markets.]

**GS:** We find that the No. 1 driver of global growth, according to recent studies, has been women. This workforce has done more to encourage global growth than increases in capital investment and productivity. Southeast Asia's economic success is due primarily to women, who hold two-thirds of the jobs in the export industry, the region's most dynamic sector. This rise is linked to the increase in wealth per capita as women around the world have become directors, managers and entrepreneurs. What have been your observations about this phenomenon in the emerging markets?

**Mobius:** This is most definitely true. If you visit a factory in China, you see men, but women are the key. By the way, women are also big shoppers: they buy things and create markets. Income growth has been growing rapidly so that supermarkets are being built everywhere in the emerging markets. Companies like Wal-Mart want to get into these markets because they see the opportunity.

**GS:** Is Wal-Mart in Russia and would you update us on Russia?

**Mobius:** Per capita income in Russia is expanding faster than any other nation in the world. Wal-Mart is not yet there, but they are in China where they have launched a credit card. (Wal-Mart has 253 stores in China.)

There is a large supermarket in Russia, which is the most lavish I have seen in my life. It is doing very well because economic growth is growing in spite of a shrinking population due to a low birth rate and emigration. On a per capita basis, you see increases. Here in Slovenia they use the Russian language in the hotels as much as English because the Russians are so prevalent.

**GS:** Really! We saw in *The Wall Street Journal* that because of the low birth rate in Eastern Europe, some countries are paying women to have babies to increase the population. Are there any plans to do that in Russia with more money available?

**Mobius:** Mr. Putin has mentioned giving more benefits to pregnant women in Russia. Pharmaceutical sales are growing at a fast pace because of the benefits the government is giving, particularly to pregnant women.

**GS:** What is Russia doing to diversify its economy?

**Mobius:** There have been improvements because the economy is much more diversified than it was, but there are still problems such as an underworld and gangsters. We watch this very carefully.

**JC:** Have fund flows into the Russian market slowed down as a result of some of the economic steps being taken?

**Mobius:** There has been no slowdown because the corporate profits are so good. They pretty much ignored the recent assassination of a journalist and murder of one of the central bankers in Russia. These events have not deterred investors.

**JC:** Vietnam has been sizzling over the last year with its stock market up over 60% year-to-date through mid-September. Most investors are in the dark about looking at Vietnam as a potential opportunity. There are only about 49 stocks on the exchange, and it is also difficult to find a fund in which to invest in Vietnam. You've been quoted that you will invest there when it becomes more liquid. Are you beginning to explore opportunities in Vietnam?

**Mobius:** We already have an investment in Vietnam in an apartment building. The market is not easy and is still quite illiquid. One big problem is that they do not yet have delivery versus payment (DVP), a big drawback because we won't risk our clients' money when you can't guarantee payment. While the government is quite conservative, I don't think there is any big rush to be in Vietnam. Other than for our private equity funds, Vietnam is not for us at this time. However, we are having our analyst conference there in January.

[Editor's Note: Vietnam's laws, rules and regulations now comply with World Trade Organization agreements making it eligible to become the 150th member.]

**JC:** Do you think that Vietnam will follow China's example in the development of capital markets?

**Mobius:** Yes, definitely. They have to reform and change. They are quite slow in their decision making, but they will be following China.

**GS:** Do you have any comments about the Mexican election?

**Mobius:** It has been quite embarrassing to delay the election results. The economy is going well in Mexico because this is also true in the U.S. A change in the administration in Mexico could have a beneficial effect on growth.

**GS:** Thailand has had some problems. Do you see any effect on its stock markets because of its recent coup?

**Mobius:** We have seen many coups in Thailand; it is par for the course. They have had elections, and the people they have picked for the interim government are quite experienced and capable so I don't think it will be a negative. In fact, greater stability may mean that the market there will do even better than expected.

**JC:** What outlook do you have on exchange rates for the U.S. dollar? Will it be appreciating versus the yen or euro?

**Mobius:** Generally speaking, the Asian currencies are undervalued against the U.S. dollar starting with the Chinese renmimbi. I think you can see currency appreciation in Asia with the exception for Korea, where the exchange rate has already appreciated dramatically. In Europe, the currencies are overvalued versus the U.S. dollar, so I don't expect much appreciation. In Latin America, it is pretty stable.

**GS:** In North Korea, they are testing nuclear devices, yet in the South the markets are doing well. In fact, they are close to their highs. Do markets tend to ignore political events in these situations?

**Mobius:** You have to remember that this is nothing new as they have been living with this since the Korean War. The danger that we see in Korea is that we have a new generation in South Korea, who don't remember the war and who are inclined to listen to the propaganda coming out of North Korea. Hopefully recent events will wake these people up and change their thinking about North Korea and what the North Korean government represents.

**GS:** What about China which fears that many North Koreans will flood into their country?

**Mobius:** They don't want a lot of problems, and obviously they have to move very carefully. I sympathize with the Chinese in that regard. It is a different situation so they are between a rock and a hard place.

[Editor's Note: Since we spoke to Dr. Mobius, China was responsible for bringing North Korea to six-party talks (including the U.S.) to discuss their nuclear testing. These talks have been scheduled to start in late 2006 in Beijing.]

**JC:** One question I wonder about is that China has access to the oil fields in Africa. What is your outlook on how the Chinese see development of resources around the world?

**Mobius:** They are looking for oil everywhere. They have a long history of relationships with African countries, which is positive.

**JC:** Do you think that could be detrimental to U.S. interests, or is the U.S. working with the Chinese companies?

**Mobius:** The Chinese will be working with the U.S. companies as well. Africa is quite unstable and has huge mineral resources. As the Chinese invest in that area, the increased stability will be positive.

[Editor's Note: *The Wall Street Journal* reports that total trade between China and Africa has been increasing 30% a year with resources and raw materials dominating the relationship. Also, China has just announced a new type of partnership with 48 nations in Africa, intended to strengthen links between China and some of Africa's poorest nations. Chinese and African enterprises have just signed 14 business deals with African nations valued at $1.9 billion for telephone systems, factories and roads in Ghana, Egypt and Nigeria. China will also double its aid to Africa and cancel some of the debt of the poorest African nations.]

**GS:** What progress is being made for bringing more energy into China from Russia?

**Mobius:** Yes, they have a pipeline deal from Siberia into China, perhaps in two or three years. One of the Chinese companies has signed an agreement to explore for oil and gas in Siberia. The Americans are also more active in seeking new energy supplies in Russia.

**GS:** Have you seen any improvements in cleaning the air and water pollution in China?

**Mobius:** I have seen a big improvement in Beijing, but it is still a problem in other cities. China has been growing so fast that they haven't paid much attention to pollution.

**GS:** Mark, have you continued to work for improvement in corporate governance issues?

**Mobius:** Yes, that is one criterion that we use for selecting companies in which to invest. We have a situation with Taro, a pharmaceutical company in Israel, which hasn't reported their financial figures and refuses to say why their financial numbers have not been released. We have been quite concerned about it.

**GS:** I hope that you can resolve that one. We didn't realize Israel is an emerging market. How does it look in Eastern Europe?

**Mobius:** Eastern Europe has been quite conscious about pollution, and they have to watch this very carefully. Our analyst, Greg Konieczny, who is Polish, can respond here.

**Konieczny:** In Eastern Europe, most countries have all signed the protocol to comply with EU regulations and pollution standards. Pollution problems are pretty non-existent in Poland, Hungary, Czech Republic, Slovenia and Croatia. Further east, into Russia, the environment is not protected yet. Going forward, Russia has huge investment plans to improve this, so there should be some progress in 5-10 years.

**GS:** Thanks, Greg. Where are you headed next, Mark?

**Mobius:** We are going to Taiwan, which is recovering nicely as the valuations are quite cheap. They are a tech-oriented market; their stocks have come down. They also pay good dividends. Then we go to Indonesia. We are concerned about the Islamic fundamentalism spreading around those countries. That is something to watch.

**GS:** Are you worried that global terrorism may discourage tourism? How does that affect you as you travel around the world?

**Mobius:** One of the problems is the terrible entry requirements and the attitude of the U.S. Customs and Immigration officials toward foreigners when they enter the U.S. This is quite discouraging and will be a bigger and bigger issue.

There is a trend to that kind of thinking where you have Sharia law, fundamentalism and so forth. However, I think people are giving the U.S. the benefit of the doubt and realize that it is necessary to do something about this situation. It is one of these things in which the U.S. has not been successful thus far. Generally, people are reasonably supportive of the U.S.

**GS:** I hope we can resolve this for the benefit of everybody. Good night, Mark, and thank you for all your time at this late hour. ■

For more information on Franklin Templeton funds, call 1-800-342-5236 or visit www.franklintempleton.com.

> ***Great moments are born from great opportunities.***
>
> – Herb Brooks (1937-2003)

# IMF Fears China's Growth Rate Set to Exceed 10.5%

China's growth rate in 2006 is likely to exceed 10.5%. The IMF is doubtful that the Chinese authorities are winning the battle to slow growth to a more sustainable level.

In a report just released in early November 2006, IMF staff stated unequivocally that China's currency is undervalued and called on Beijing to let it appreciate more rapidly. They may also have to consider more market-based solutions, including a tighter monetary policy. China's real exchange rate depreciated 15% from February 2002 to May 2006.

The IMF report cites the surge in China's exports and the rapid increase in its foreign exchange reserves as further evidence of its growth. China has allowed more movement in its currency since September, but still faster appreciation is probably required. ■

# Low Tax Rates Extended for Dividends and Long-Term Gains

The 2003 tax act reduced the top tax rate on most stock dividends and long-term capital gains to 15%. For taxpayers in the lowest federal income tax brackets (10% and 15%), the tax rate on dividends and long-term gains was put at 5%.

Moreover, low bracket taxpayers were scheduled to pay 0% on dividends and long-term gains in 2008. After 2008, though, the bargain rates were to expire, so dividends would be taxed as high as 35%, long-term gains up to 20%.

The tax law, enacted May 17, 2006, extends the low rates for another two years. As a result, qualified dividends and long-term gains will be taxed no higher than 15% through 2010. This creates an opportunity for longer-range investment planning.

### Double Play

Say you invested $25,000 in a growth fund that has failed to perform, so your holding is now worth only $20,000. However, you still like that fund, and you think it's even a better buy now, at a lower price.

You can buy another $20,000 worth of shares in that fund. After 31 days, you can sell your original holding. You won't run into the wash sale rules, and you won't run the risk that the fund's price will go up while you're on the sidelines.

The catch? Doubling up is not truly a year–end maneuver. You should buy the second lot by November 29 if you want to sell the original lot at the end of December and take the loss for 2006.

In addition, you should be aware that the wash sales rules do not apply to the sale and repurchase of appreciated securities. Therefore, if you take year-end gains to soak up some excess capital losses, as described above, you can reinvest in the same securities right away, without having to wait 31 days. This will result in a higher basis in the repurchased securities and reduce the tax when you eventually close-out your position. ■

Source: *The CPA Client Tax Letter,* October, 2006.

**Editor's Note**: Capital gains distributions from closed-end funds and mutual funds in 2006 are expected to be at record levels and will be announced soon. The largest part of this is usually long-term capital gains.

# Portfolio Manager's Review

October was a very busy month as we completed the semi-annual global rebalancing of our portfolios so that each category holds the right percentages. We were under-represented in both the global and domestic real estate portfolios and added to this sector. We also initiated purchases in some of the Calamos closed-end funds in both the global and domestic sectors. We also decided to lighten up on our large holding of Cohen & Steers Global Worldwide Realty Income Fund because it was selling at a premium as high as 9%.

Jon Chatfield has initiated purchases for the new Hybrid Income Portfolios, which he will continue to manage under my supervision. At month-end, our holdings in Pan Pacific Retail Properties completed its partial merger into Kimco shares. The remainder was paid in cash. We added to positions in Kimco in these accounts but haven't made a decision yet whether to add this REIT to our buy list. ■

George Cole Scott





**The Scott Letter Online**
is published by

**Closed-End Fund Advisors**
*Global Investment Counsel*
P. O. Box 1100
Richmond, Virginia 23218
(800) 356-3508
www.CEFAdvisors.com

Currently offering managed portfolios with the following objectives:

Hybrid Income
Global Balanced Growth & Income
Global Balanced Growth
International & REIT

Closed-End Fund
Advisors