

THE SCOTT LETTER:

CLOSED-END FUND REPORT

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A Global View of the Closed-End Fund Industry

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



– George Cole Scott
Editor-in-Chief

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Five Years and Counting for the Real Estate Surge

Just when it seemed that real estate funds couldn't continue their surge in 2006, a recent survey forecasts that the U.S. commercial real estate cycle will pull back in 2007. The Urban Land Institute survey reached more than 600 developers, investors, brokers, consultants and lenders for an annual report on the industry.

Commercial real estate is beginning to return to its norm as an income-producing investment. The easy lending of the past several years may tighten in 2007, in part because of worries about the economy.

We have heard this before. In this issue, we will first explore the domestic real estate markets. We had 17.2% of our clients' funds invested in domestic real estate funds and REITs, and 10.2% in global real estate funds at year-end. Secondly, we will examine the progress of the emerging global real estate markets, whose shares are rising so fast that many of these funds are selling above their net asset values.

Domestic real estate funds have been on a winning streak with average annual returns of 22% for the five years through September 2006, far more than any other fund category. Some analysts are cautious, however, and advise investors not to continue to bet too heavily on real estate after such a long run.

We still see the real estate sector as one of the best ways to give our clients a more diversified portfolio. The best reason to own a real estate fund is not only for greater portfolio diversification but to reduce risk, something we value highly at Closed-End Fund Advisors.

Investors continued to invest in real estate funds in 4Q06, after pouring \$3.32 billion into funds in the previous quarter. We have been trimming real estate positions, especially when they are overvalued. Once everyone chases after a hot segment, there is inevitably a correction. After nearly a half century of investing, we know that corrections create

opportunities for value-oriented investors. The May 2006 correction in the emerging markets created many opportunities for our clients, helping us to yield unbelievably strong returns in 2006.

One of the biggest clouds now over the real estate markets has been the potential impact of higher interest rates. Higher interest rates could wind-up benefiting the current owners of office buildings, shopping malls and hotels. It is now more expensive for developers to start new construction projects, and rents are rising in all types of commercial properties as new supply is low.

This may explain the popularity of dividend-paying real estate funds, which own large portfolios of commercial property. Many investors are attracted to these funds because they offer higher yields than other funds. We are using numerous Cohen & Steers funds for their high monthly cash pay-outs.

Many leases for office space were signed 3-5 years ago, at rates well below current levels. As they come up for renewal, landlords should be able to charge more because occupancy rates are rising, particularly in strong markets like mid-town Manhattan, southern California and Washington, D.C.

Analysts see hotel stocks as among the best deals in commercial real estate right now. Host Hotels and Resorts, Starwood Hotels, Resorts Worldwide and Hilton Hotels are prime holdings for funds.

Host Hotels manages more than 100 hotels in North America under various brand names, including Marriott, Ritz-Carlton, Hyatt, Four Seasons, Fairmont, Hilton and Westin. Of these, Starwood and Marriott Hotels are our favorites. Host, organized as a REIT for tax purposes, has to distribute 90% of its income to investors, taxed as ordinary income. Starwood and Hilton are operating companies. They have been selling some of their properties around the world to put more emphasis on

franchising their well-known hotel brand names. [Note: Clients of Closed-End Fund Advisors, including the family of George Cole Scott, own shares of Starwood Hotels and DiamondRock Hospitality, a REIT which finances Marriott Hotels.]

Another reason for continued strength in the commercial real estate markets is the number of mergers in the industry. Equity Office Properties Trust (EOP-NYSE) is a good example. It is the largest real estate buy-out on record and was sold in

November to the Blackstone Group (a private equity firm) for \$48.50 a share or \$20 billion by real estate legend Sam Zell. The deal, if executed, will end Equity Office's 10-year brilliant run in the public markets.

Asked about whether he thinks the flood of capital into real estate will continue, Mr. Zell said: "This is the greatest period of monetization in the history of the world. That huge amount of liquidity floating around is not something that

would be absorbed in six weeks. It will take more than six years. Overall, liquidity will be there, and real estate will be a significant beneficiary because, in the end, it gives people great comfort. I think it's proven to be a terrific investment over a long period of time." Mr. Zell also sees a 6%-7% growth in revenue in the commercial real estate market over the next 24 months. ■

Source: *The New York Times*,
The Wall Street Journal

What Blackstone's Bet Means for Real Estate Investors

At least four different entities expressed interest in acquiring all or part of Equity Office Properties before the company agreed to sell itself to Blackstone Group. In addition, the Chicago real estate investment trust said it would consider higher bids than Blackstone's large offer, a prospect dividing analysts about whether it may come before the scheduled closure in the first quarter of 2007. Some observers say the company was under-priced, while others see the price as relatively high compared to other office REITs.

Blackstone Group is betting that commercial real estate valuations haven't gotten out of hand, despite the run-up in prices in the past several years. When the buy-out was announced in late November, it sent ripples through the real estate trust industry and immediately lifted REIT shares across the board. Many experts believe that merger activity, including privatizations, won't end here.

The Equity Office deal underscores the gap in valuations of real estate companies between the public and private sectors as well as the flood of private equity waiting to invest in real estate. The largest shareholder of EOP, Cohen & Steers, says the deal is worth even more. "Replacement for this portfolio is in the \$60 range," a spokesman for the firm said.

Equity Office has a strategic collection of office properties containing leases with below-market rents. In spite of that, the number of institutions that could buy a company as large as Equity Office is limited.

Blackstone bets that corporate tenants will clamor for more space as the economy continues to expand. That, combined with high construction and land costs, should keep the fundamentals strong.

At the end of 3Q06, the nationwide office vacancy rate was the lowest in six years, and rental rates have surged over the

last three quarters. Brokerage firm A.G. Edwards says, "We believe the national office market to be in the middle of a slow economic recovery." Edwards has both a good record and a depth of experience in both REITs and closed-end funds.

Blackstone's office-buying spree has similarities to its hotel expansion (May 2004 to February 2006). Blackstone bought into the recovery, taking \$8 billion worth of public hotel companies private and wagering that revenue per available room and occupancy would rise. Thus far, the investment has paid off as the hotel industry set a record for profitability in 2006. This could continue each year through 2008.

Observers say that despite the trend toward going private, there is still a place for (public) REITs, noting that the privatizations have culled some of the weaker performers. ■

Source: *The Wall Street Journal*

Global Real Estate Funds: Trends and Issues

Emergence, evolution and energy – three words that best describe current global real estate markets and capital flows.

"There is clearly an emergence of the growth and number of international real estate funds, global real estate fund of funds and diverse opportunities in the private and public capital markets for domestic investors to participate in foreign real estate markets. It is truly exponential over the last several years. In addition, growth of public equity real estate markets

has yet to emerge in countries such as India, China, and South Korea.

"If the forecasted growth in Asia Pacific countries' public equity markets reaches a comparable benchmark level as real estate investment trusts (REITs) in the U.S., then there is a reasonable probability that the Asia Pacific public real estate equity markets will surpass the U.S. REIT [market] in terms of capitalization over the next five years based on recent trends.

"There is an evolution occurring in many international real estate markets,

especially for cities in Brazil, Russia, India and China (BRICs), central and eastern Europe and even in the Middle East.

"Real estate markets are moving from immature status to maturity via various economic, political, financial and real estate factors. An economic factor that moves cities towards maturity is the impact of multi-national firms that locate goods-producing and service-producing activities throughout the world, such that a host of real estate service providers and foreign real estate investors soon follow. Real

estate investments in Sao Paulo, Mumbai, Prague, Beijing or Moscow are now generally discussed in conjunction with Paris, London, New York and Tokyo as prudent diversification strategies.

"The evolution of real estate markets in these geographies occurs with increased foreign owners and investors and the maturity of domestic real estate firms and capital markets. As real estate markets mature, so too [does] the increase in transparency [corporate visibility], consistent production and quality of real estate market information and the expansion of the breadth and depth of the market. The continued growth of global real estate funds is supported by the increase [in the] number of the real estate markets moving towards maturity.

"There is energy surrounding global real estate markets concurrent with the recent exponential growth of international capital flows. Recent economic growth rates and trends in many emerging markets such as China, India, and Singapore have ranged from high single-digits to low double-digits. [Of these nations, China has the highest growth, then India and Singapore.]

"Whether or not such economic growth rates are sustainable, growth nevertheless creates significant demand for residential and commercial property types alike. According to the World Bank, world growth domestic product (GDP) is expected to continue at 3.5% per year in 2007 and 2008, with developing and emerging countries averaging in the 6%-7% range.

"The capital accumulation within developing economies through international trade in goods or services, or based on internal economic growth, has implications for global real estate capital flows.

"Domestic and foreign investors gravitate towards countries, regions and cities experiencing growth. For example, Asia Pacific investors and firms can redeploy capital within their respective countries, within their region or invest outside of the Asia Pacific region. Demographic-based investment strategies targeting residential developments, retail, mixed use or retirement properties may appear just as reason-

able as an international fund focusing office properties in cities with a significant presence and demand from international firms.

"Middle East petroleum dollars have invested within their region in locations such as Dubai or outside their region such as the U.S., where Middle East investors now rank second behind Australia in foreign real estate capital flows into the U.S. in 2006.

[A new Dubai-led fund is looking for up to \$10 billion in investments in blue chip stocks around the world as investors in the United Arab Emirates (UAE) seek a leading role in recycling of petrodollars abroad, according to a *Financial Times* report. The UAE is also converting dollars – 8% of its foreign exchange reserves – into euros. They have nearly \$25 billion currency reserves, 98% in U.S. dollars. This is expected to drop to 90% within months, if approved by the Central Bank. The implication of a cash-rich friend of Washington selling off its dollars shows that the central banks elsewhere may also be looking to cut losses from a dollar widely expected to slip further in 2007.]

"The emergence, evolution and energy surrounding global real estate markets raise several questions. Why now, why the emergence of global real estate funds? How can one explain the model where the money is coming from and where is it going? Is it possible that real estate as an asset class has reached international acceptance with investors and, if so, are recent trends in global real estate capital flows following an evolutionary path similar to international equity capital flows?

"Tracking global real estate capital flows is not an easy task. Transparency across countries is not equal to the same standards of reporting transactions or quality of information available. Using various information sources, it is possible to provide a reasonable estimate of capital flows from one region to another. According to Jones Lang LaSalle, there were approximately \$475 billion USD in global real estate direct investments completed in 2005, a 21% increase from a total of \$393 billion USD in 2004. Global

sources of funds also showed that \$5.3 billion USD went into the Asia Pacific region. This provides a road map of real estate capital flows into world regions. [Note: As of July 2006, the Asia Pacific market capitalization was only \$60 billion USD less than the U.S. REIT market.]

"As real estate becomes more global, investment strategy, valuation, accounting and tax issues are becoming increasingly complex for investors. The more significant issues are that international real estate funds targeting a specific region tell a story, whereas a global real estate fund of funds tells another story.

[In our global manager interviews, we ask the same questions and get a variety of answers which helps us to make sound investment choices for our clients. We think this approach helps us achieve our superior investment returns.]

"If international and global real estate funds of funds continue to gain acceptance and momentum with investors, then international advisors need to accept the challenges of delivering research-supported, timely and creative investment strategies. Whether or not international equity markets are more correlated today than a decade ago is a healthy debate.

[This is another aspect of international investing and one which we question our interviewees about constantly.]

Valuation, Tax and Accounting Issues

"A large number of investments are made by funds that follow the accounting and reporting requirements for investment companies, which require reporting of investments at estimated fair value. The key issue: determining a reasonable estimate of fair value. In the U.S., fair value is readily available to utilize the estimated value of other similar investments. In some foreign jurisdictions, (1) funds are not required to report using fair value, (2) fair value may be defined differently and (3) information needed to estimate fair value may not be readily available and even more difficult to substantiate.

[We try to understand the markets in which the assets are located and the valuation methodology employed. This gives us

time to challenge management's value estimates from different angles. In the case of real estate funds, we find that estimates become more complex as their diversity increases.]

"U.S.-based real estate funds could be seeing substantial changes in reporting in the near future." We welcome this if the application more clearly defines how a fund will record investment earnings, where there is significant diversity in recognition of investment earnings as funds record earnings in different ways. We hope that it will be mandated that earnings will be recorded under the dividend method, that is, earnings are only recorded to the extent that cash distributions are made by the investment which has generated taxable earnings and profits. Otherwise, all distributions will be considered a return of capital.

"The above topics are a few of the more complex issues being considered today by global real estate funds. Other items include maintaining an effective control environment to appropriately manage fraud considerations in multiple geogra-

phies, retaining qualified operating partners in foreign jurisdictions to safeguard the assets, managing the foreign currency exposures, monitoring investment and fund level returns as returns are not consistently calculated across geographies. [They must also] understand the political and social uncertainty in foreign jurisdictions.

"The regulatory bodies are diligently working towards one set of international accounting standards but are several years away from reaching such convergence. In the meantime, the funds will have to deal with the differences between U.S. and international standards. Real estate equity funds have become complex primarily because of a geographic footprint and the diversity of the investor mix.

"The existence of global real estate funds is a natural extension of the evolution of real estate in many countries and in many cities. As the world economy continues to expand, the development, construction and operation of commercial real estate assets will likely become more global, thus creating new interactive and interdependent networks of local, regional

and global sources of financing and ownership structures.

Conclusion

"U.S.-based real estate funds ... could be seeing substantial (reporting) changes in the near future." CEFA welcomes this, as there is significant diversity in recognition of investment earnings. "Funds record earnings in a variety of ways.... If adopted, investment earnings will only be recorded under the dividend method ... to the extent the underlying has generated taxable earnings and profits. Otherwise, all distributions will be considered a return of capital.

"Is there a likelihood that in the international real estate markets, these markets will move in the same direction?"

According to Global Properties Research (www.propertyshares.com), correlations between Europe, America and Asia listed property markets indicate mixed trends since 2001 and also between global property returns compared to global stocks and bonds. ■

Source: PricewaterhouseCoopers, LLP

Global REIT Markets Exhibit Dynamic Growth

The strong performance of international real estate funds remains a hot topic, with Dow Jones launching several new real estate indices in late December. Many European and Asia/Pacific markets are benefiting from a significant amount of new capital being invested in real estate securities, most notably in countries that are adopting or have recently adopted REIT-like structures to encourage tax efficient public investment.

Cohen & Steers, the domestic and global manager of publicly traded real estate funds since 1986, expects substantial growth in the international real estate securities markets over the next five to ten years, primarily focused on Japan, China and continental Europe. This dynamic growth – 484 public REITs world-wide – has a market capitalization of more than \$608 billion USD, according to the *Global REIT Report 2006*, released by Ernst & Young. The report analyses returns and relative performance for the REIT markets

in 13 countries. The United States still dominates in market capitalization at \$395 billion USD, but South Africa posted the best three-year returns.

Other sources show that the growth of global real estate trusts, currently a \$400 billion market, is dominated by France and Japan, and soon to be joined by many European countries, because of the global boom for REITs and REIT funds. France was a stand-out in Europe, benefiting from generally positive economic conditions and considerable demand in the Paris office sector, combined with little new supply. Spain followed close behind, though its market was driven more by merger-and-acquisition activity than by shifting fundamentals.

The January 2007 debut of REITs in the U.K. raises the prospect for a wave of consolidation in the already booming real estate markets. The new REITs will give tax breaks to companies that adopt the structure, making it easier to buy other

property companies. So far, 15 companies have announced their intention to convert, and more are expected to follow. The London office markets should continue to benefit from strong growth in demand for space, as the supply needed to satisfy this demand is still at least two years off.

Converted REITs are more attractive take-over targets. In spite of the market surge, analysts say that property stocks in the U.K. remain in favor because they are priced to reflect the higher net asset values expected when REITs come into effect. However, this property market could fizzle if U.K. interest rates rise. Investors in this market need to realize that property stocks are cyclical, though their prices, which have been rising for three years, show no signs of abating.

Meanwhile, the first exchange-traded fund featuring international real estate stocks trading in 23 countries has just been launched by State Street Global Advisors. Exchange-traded funds resemble index-

oriented mutual funds but trade on an exchange like a stock. Trading in the StreetTracks Wilshire International Real Estate ETF began on December 19, 2006. A possible rival, the Northern Global Real Estate Index Fund, is “global” rather than international, meaning that it includes some U.S. stocks.

The market for all ETFs is expected to grow at a 29% clip over the next five years, outpacing all investment products according to a report in the *Financial Times*, just after the first of the year. The sheer number of ETFs now on the market has increased 209% since the end of 2001.

We still prefer to use closed-end funds rather than ETFs. Where an investor desires exposure to a sector and is unable to buy shares of a closed-end fund for that sector, the ETF may be a more attractive option than buying a closed-end fund at premiums. We have reservations about the quality of the stocks in ETF portfolios, as you lose many advantages: discounts, steady distribution and easier portfolio

analysis with regular reports. Looking at size and recent transactions in the private and public markets, investor interest in the real estate class remains significant. This has directly and indirectly provided support for real estate stocks.

Fundamental conditions for real estate stocks around the world should remain favorable for 2007. Few factors are seen that could derail this fundamental improvement, as demand continues to grow at least at a modest pace while supply remains limited – sustaining an environment where occupancies, cash flow and rents should continue to rise. The resulting increases are likely to support continued growth in asset values. As we advance further into the real estate cycle in most markets, differences in supply growth will be more important than differences in demand.

Regionally, Asia’s growth prospects are favored relative to the rest of the world. A broadening of strength is seen in this region, as new markets have begun to take fundamental leadership and show strong

rent growth. The economic improvement in Japan is beginning to positively impact earnings for its property companies. In particular, Tokyo is seeing increased office rents and residential pricing, after more than a decade of decline.

Japan’s Financial Services Agency (FSA) is planning a regulatory tightening seen as a premature strike against overheating in the property market. There is concern that the low interest rates and rising property values, particularly in central Tokyo, could portend another bubble of the sort that inflated (properties) in the 1980s and led to the long period of economic malaise. There is also concern about bank REITs investments as Japanese financial institutions hold an estimated 56.6% of the shares of domestic REITs.

Evidence indicates that rents and values are still increasing in most property markets around the world with strength seen in London and Hong Kong. ■

Source: The Wall Street Journal, TheStreet.com

The World’s Challenge: Globalization to Benefit Everyone

The worldwide movement against globalization frequently portrays the process as one that creates mostly losers. It is, therefore, refreshing to see some new research for greater international integration. The adjustment towards a richer world, however, also creates a number of public policy challenges.

In the “2006 Global Economic Prospects Report,” the World Bank projects optimistic scenarios for the next 25 years of globalization. In the developing world, annual per capita income growth has accelerated to 3.1%, from 2.1% since 1980. Millions of people will be lifted from poverty, halving the number of people below the \$1-per-day poverty line. As a result, the World Bank sees a “global middle class” emerging.

The report describes how international trade will increasingly sustain the growth process. By 2030, trade will have probably increased more than threefold, driven by rapid cross-border commercialization of services. Despite their smaller share of

world income, the developing countries will account for around half of the global expansion in trade.

This benign process of enrichment also entails some micro-level adjustment, which will not necessarily be painless. Acute inequality is wrongly perceived as an adverse consequence of globalization. While differences in income between countries are falling, inequality among individuals is growing within most nations.

The importance of trade in exacerbating inequality is often overstated. Technological change, which increases the rewards of skilled workers relative to the unskilled, is a factor.

Sensible government policies can cushion the negative impact of globalization. In the developing world, the priorities should be to increase education spending, invest in transport infrastructure and improve the business climate.

Regarding the threat to the environment, rapid growth makes it harder to achieve common global goals like climate

change mitigation or containment of infectious diseases. An international framework that achieves effective cooperation on these issues, without harming growth, is still solely missing.

Globalization can be a great force for the good. Those who attack it frequently hide some form of self-interest. Some people will face painful adjustments, but sensible policies can smooth the transition.

Where many investors and analysts see dark clouds on the global economic horizon, the Organization for Economic Co-operation and Development (OECD) also sees glimmers of light in the form of rebalancing of the world economy and no reason to expect a global downturn.

Globalization is not a new concept. Throughout history there have been times of emergence, evolution and energy surrounding international investments. ■

Source: *Financial Times*, PricewaterhouseCoopers, LLP

Be Aware of Year-End Closed-End Fund Distribution Policies

Most well-managed closed-end funds distribute their annual capital gains and income distributions before year-end. This is how it should be. However, there are a few funds which go ex-dividend in December (or even earlier) and do not distribute the cash or shares until the following January, taxable in the previous year. Because of the Bull Market, distributions this year are quite large. As a result, the fund shares ran-up just prior to the distribution date.

For those who held the shares for the 2007 distribution, their December brokerage statement will most likely show a

lower value for these shares, as the price falls after the fund goes ex-dividend. The shares or cash is distributed in January, but we think that funds holding cash for distributions are not doing the best thing for their shareholders. We urge our readers to contact their funds about this procedure. Moving money into brokerage firms has sped up in recent years so there is no excuse to hold onto the cash for as much as six weeks.

Central European Equity Fund (CEE) went "ex" on December 21 and will pay out on December 28. Thank you, Deutsche Bank! ■

Letter to the Editor

"I was reviewing my CEFA portfolio and by my calculations, you have increased my portfolio by 56.15% [net of fees and expenses, as of December 27, 2006] in the past 18 months I have been with you. I remember the concern I had while wiring the dollars to someone I had never heard of nor met. You said some months ago that you couldn't guarantee the same success,

and clearly you were wrong. Whatever you are doing, keep doing it with my thanks for a job well done. Happy holidays!

— L.W., New York

Editor's Note: This is an unsolicited letter from a CEFA client. **PLEASE READ THE DISCLAIMER AT BOTTOM OF THIS PAGE.** The Scott Letter welcomes letters on any subject about your portfolio or the content of the Letter. Please address your correspondence, preferably by e-mail, to us at cefa@cefadvisors.com.

Portfolio Manager's Review

We have been using two closed-end funds in the global markets: Cohen & Steers Worldwide Realty Fund (RWF-NYSE) and ING Clarion Global Real Estate Fund (IGR-NYSE). Both of these funds were trading at substantial premiums at year-end. Because these are the only global closed-end real estate funds we have found in the booming global real estate markets, we are using the global real estate mutual fund, Alpine International Real Estate Fund, a no-load mutual fund, in small amounts to fill the diversification allocation. We may also use some global REIT ETFs.

We have added to positions in Kimco, a highly regarded REIT which rose 40.1% in 2006, but it does not (yet) invest in the global markets.

Because we have received some new money into the firm and have higher than normal cash balances from sales, we will again be rebalancing portfolios. We see this as the discipline necessary to keep up superior performance, especially because of the likelihood of slower markets ahead. We remain value-oriented bargain hunters, however, and will not compromise our principles to risk losing money for our clients in 2007. ■



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