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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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Emerging Markets Offer Many of the Biggest Opportunities:
Transforming the World's Most Coveted Markets

"The past 20 years have, by no means been plain sailing. Many countries in the developing world have suffered setbacks along the way, and by and large, the countries that have suffered the greatest shocks – including Turkey, Thailand, Russia, Argentina, Brazil and Mexico – have not only recovered but have grown stronger, more dynamic and more stable than before.

"Some of these countries are now so advanced economically and socially that they can realistically claim to have joined the ranks of the world's developed economies. They have, as it turns out, emerged. For those nations that are still clearly in the emerging bracket, these success stories provide hope and inspiration.

"Further evidence of the coming of age of the emerging markets can be found in the fact that some of the biggest and most influential investors in emerging markets are from other emerging markets. U.S. and other Western nations have been fighting-shy of pouring money into Latin America, for example, deterred by the sharp rise in the region of what some are calling 'resource nationalism.'

"Asian investors, unfettered by such concerns, are piling in, led by China, Japan and South Korea. In Africa, too, investment from China is rapidly eclipsing that coming from Western corporations, partly because China seems to have no qualms about investing in countries that have despotic or tyrannical regimes.

"Perhaps the most remarkable development of all, though, is the sharp rise in the global influence wielded by these burgeoning economic powerhouses. The central banks of several of the larger emerging markets have built up such huge foreign exchange reserves that they are now in a position to manipulate not just their own currency's strength but the value of the U.S. dollar – and by influence, that of the euro and other major currencies.

"This is a remarkable transformation and one that is making policymakers in the so-called developed world increasingly uncomfortable. It will take a while for the world to adjust to this changing balance, but in the end, that transfer of economic and political power from the hands of a few to the hands of the many can only be a good thing. Ultimately, it should lead to a fairer, more stable and prosperous world for everyone.

"The steep declines in emerging market assets and currencies in the summer of 2006 and again in February of this year were clear reminders of the hot-and-cold nature of portfolio flows and the risks involved in international investing. The rewards remain high, however, and the emerging markets offer many of the biggest opportunities.

"While countries rich in oil, gas and mineral resources are among the more attractive emerging market economies, other countries lacking natural wealth have also succeeded in attracting growing amounts of foreign investment because of their sensible economic and business policies.

"A country like Jordan, for example, has no natural resources other than phosphate rock, yet it has become an emerging market because of its investment in education and human capital. While Egypt is self-sufficient in energy production, the reason for its recent economic success has been a series of reforms (e.g., tax cuts), privatizations and pro-business policies enacted in the past few years.

Global Finance magazine recently reported on how 81 hot emerging market countries are attracting foreign investment. Surprisingly, two of the big emerging markets – Russia and Brazil – failed to qualify as among the 20 hottest places to invest based on the magazine's analyses of the hard facts.

These ratings were based on average scores for projected economic growth in 2007, global competitiveness, changes in actual foreign direct investment inflows, levels of corruption and subjective factors such as opinions of analysts and economists. CEFA understands the concerns about Russia but wonders about the concerns for Brazil. We will be looking into these economies more closely in future issues. ■

Source: *Global Finance*, May 2007

Emerging Markets Round-Up: An Update on the Four BRIC Countries

Brazil

By far the largest and most populous country in South America, Brazil, with a population of 169.7 million, is today South America's leading economic power and regional leader. The GDP growth of Brazil, has just been revised upward to 4.4% for 2007 by the IMF.

Exploiting vast natural resources and a large labor pool, Brazil has continued to pursue industrial and agricultural growth and development of its interior. This vibrant country has a median age of 28.6 years, with only 6.3% of its population over 65. However, it has a highly unequal income distribution – a pressing problem – as well as a high incidence of AIDS, resulting in a lower life expectancy.

As a sign of its growing economic confidence, the Brazilian government tapped its local currency bond due 2017 in April, raising $500 million. The deal carried an option to sell another $25 million to Asian investors. The new bonds offer a 6% coupon and yield 5.888%, the lowest yield for any global denominated paper, benefiting the economy.

Last year's merger and acquisition activities topped out at just under $63 billion, a year-on-year increase of 273%. Ending a year-long corporate surge, Brazilian low-cost airline, Gol, agreed in April to pay $320 million for cash-strapped Varig, the country's former international flag carrier. Varig, plagued by financial and labor woes, is on the brink of bankruptcy.

The Brazilian currency, the real, has experienced an extraordinary run-up in the past two years. Further upward moves are occurring as we go to press, sending the real to its highest level since January 2001. The real has appreciated 14% in 2005 and 9% in 2006. Since January 2007, it has continued to rise: 9% to-date. This strengthening of the real occurs as trade and investment inflows continue to defeat the central bank's attempts to slow its upward march.

Various reasons are offered for the gains: a credit rating upgrade, the Brazilian economy growing faster than expected, inflation at only 3%. All these things feed into the exchange rate.

Recent economic figures also show that Brazil is getting record high sugar prices for its major agricultural crop due to high domestic demand from its flex-fuel cars using cane-ethanol which, in turn, have pushed raw sugar futures to record highs. Cane–ethanol, used to power cars, rose to 25% (from 23%), as disappointing sugar crop news suggest that Mexico may have to import more sugar from Brazil.

"International market liquidity is unusually high, and this has benefited Brazil. That situation will endure," said central bank president, Gustavo Loyola.

[**Editor's Note**: We remain positive on the Brazilian economy and plan to interview the portfolio managers of the Latin American Discovery Fund and the Latin American Equity Fund in the near future.]

Russia

The Soviet economy and society stagnated following the Communist takeover in 1917 for decades until General Secretary Mikhail Gorbachev (1985-91) introduced glasnost (openness) and perestroika (restructuring) in an attempt to modernize Communism. His initiatives inadvertently released forces that, by December 1991, splintered the USSR into Russia and 14 other independent republics.

Russia has since struggled in its efforts to build a democratic political system and market economy to replace the social, political and economic controls of the Communist period.

While some progress has been made on the economic front and Russia's management of its windfall oil wealth has improved its financial standing, a recentralization of power under Vladimir Putin has caused the world to become somewhat disillusioned with Russia's progress and the growth of democratic institutions.

Political uncertainties ahead of the 2008 elections, corruption and a widespread lack of trust in institutions continue to dampen domestic and foreign investor sentiment. President Putin has granted more influence to forces within his government in the desire to reassert state control over the economy, causing concern among his allies.

Russia ended 2006 with its eighth straight year of growth, averaging 6.7% annually since its financial crisis of 1998. Fixed capital incomes have averaged gains of more than 12% per year. During this time, poverty has declined steadily, and the middle class has continued to expand.

Although high oil prices and a relatively cheap ruble initially drove this growth, consumer demand (since 2003) and more recently, investment growth, have played a significant role. Russia has used its oil revenues to prepay all Soviet-era sovereign debt to Paris Club creditors and the IMF. Foreign debt has decreased to 39% of GDP, mainly due to decreasing state debt, although commercial debt to foreigners has risen sharply.

Russia has also improved its international position since the 1998 financial crisis. The federal budget has run surpluses since 2001, and 2006 ended with a surplus of 9% of GDP. [U.S. take note.]

Oil and gas export earnings have allowed Russia to increase its foreign reserves of $12 billion in 1999 to some $315 billion at year-end 2006, when Russia's GDP grew 6.6%. Inflation was below 10% for the first time in the past ten years, while growth has been driven by non-tradeable services and goods for the domestic market, as opposed to oil, mineral extraction or exports.

Russia has signed a bilateral market access agreement with the U.S. as a prelude to possible WTO entry, and its companies are involved in global merger and acquisition activity in the oil and gas, metals and telecom sectors.

Despite Russia's recent success, serious problems exist. Oil, natural gas and timber account for more that 80% of exports and 32% of government revenues, leaving the country vulnerable to swings in world commodity prices.

Russia's manufacturing base is dilapidated and must be replaced or modernized if the country is to achieve broad based economic growth. A 290% appreciation of the ruble from 2005 to 2006 has made attracting additional foreign investment more difficult.

The banking system and increased consumer lending is growing at a high rate but is still relatively small in the banking sectors of Russia's emerging market peers.

Russia has made little progress in building the rule of law – the bedrock of a modern market economy. The government has promised additional legislation to make its intellectual property protection conform to WTO standards, but enforcement remains problematic.

The end result is that Russia is a difficult economy to understand. Nevertheless, it is one of the four largest economies outside the U.S. and will continue to play a large role on the world stage.

We are following economic progress in Russia. Recently, CEFA has been increasing its investments in Russia through purchases of the Central Europe and Russia Fund. An interview with portfolio managers of Central European and Russia Fund will be published in the July 2007 *Scott Letter*.

India

India's economy continued on its red-hot streak, despite major bottlenecks in the nation's rickety infrastructure, as a boom in manufacturing and services fueled economic growth of 9.4% in the fiscal year ended March 31, 2007. The growth was up slightly from the previous year's 9%.

Economists have been warning for some time that higher interest rates (introduced to dampen inflation) could slow India's economic growth in coming months. In addition, the strengthening rupee, which reached a 9-year high against the dollar recently, could slow the results of Indian exporters.

There are reports that Indian information technology firms face three challenges: (1) the exchange rate, (2) a general slowdown in the U.S. and (3) the housing/ mortgage sector in the U.S.

Indian technology companies cater mostly to overseas clients, many of which are in the U.S. where they earn a large portion of their revenue in dollars. India's economic growth has been greater than 8% for the past four years. This growth is expected to continue at rates of at least 8%.

Foreign direct investment into India is also growing. It hit a new record high in 2006, a record $15 billion for the fiscal year to March 2007. These figures do not reflect re-investment of earnings by foreign companies. In addition, foreign portfolio investors during 2006 have invested approximately $8 billion in the Indian stock market.

FDI inflows to India normally come in below the government's target for the year. Recently the actual inflows comfortably exceeded the government's $12 billion target. These inflows have shown a growth in 2006 of $270 billion over the preceding year's $5.5 billion inflows. For the new fiscal year of 2007-2008, an aggressive FDI target has been set at $25 billion.

Foreign portfolio investor's optimism in India has been well-rewarded, thanks to the boom in Indian equity values. Market value of foreign institutional investments in Indian equities stands at $119 billion.

Investments from Indian companies overseas, too, are on the rise. They have attempted a growing number of acquisitions, mostly in Europe. These acquisitions have focused on pharmaceuticals, base metals and software companies over the past several years.

On the other hand, the development of India's economy is being held back by protectionist restrictions in the accounting profession, according to one of the industry's most senior global figures.

Sir Michael Rake, international chairman of KPMG (the accounting firm), told the *Financial Times* that accounting reform in India was "essential" in order for it to achieve its full economic potential. China, in contrast, has shown itself more willing to lift restrictions to allow international accounting firms to develop large local businesses.

"The restrictions in India are inevitability going to hold back the ability of the profession to train accountants to serve a fast-growing economy," Sir Michael said. He pointed out that the situation is complex, but that on-going dialogues could result in changes. Discussions of bilateral reforms could result in a relaxation of the partner/trainee formula from two to six.

Sir Michael's comments underscore the continued frustration felt by international accounting firms that stifle foreign entrants in India and shield the indigenous audit profession from genuine competition.

Accounting firms in India are subject to a bewildering array of regulations that international companies claim inhibit the development of both the profession and the ability of Indian corporations to access the best global advice.

Indian firms can service no more than 30 statuary audit clients per partner, and local firms cannot join a "big four" international accounting network unless the bosses of that network agree not to have other offices in India. India has 130,000 chartered accountants. The profession is dominated by smaller firms.

China

International fund managers lowered their exposure to China in May 2007, moving to a neutral position from slightly overweight, while the country's mainland stock markets continued their record surges. Thousands of Chinese residents opened brokerage accounts each day. We wonder how long this can continue.

Meanwhile, China is encouraging some of its big investors to widen their scope of overseas investment in insurance companies. This will allow insurers to invest into New York- and London-listed stocks later in 2007, in spite of their remaining optimism about continued growth of the Chinese economy. Earnings from Chinese companies were stronger than expected in 2006, and many companies forecast bright outlooks. Fund managers expect a correction in the Shanghai market to occur soon.

China's stock market indexes had quadrupled over the past two years until a trading tax increase in late May prompted a 6.5% tumble in the Shanghai Composite Index. The Index is still up 53.6% at the end of May 2006, before bouncing back.

Such volatility is expected to continue, and many fund managers are choosing to keep their exposure to the less volatile Hong Kong stock market. This is fine with CEFA, as our focus on China is almost exclusively in the Hong Kong stock market which has higher standards.

The Nasdaq stock exchange plans a new index to track the performance of Chinese companies listed in the U.S. The "Nasdaq China Index" will launch later this year and will include 30 Chinese companies with a combined market capitalization of $600 billion. To be eligible for the Index, companies must have a minimum worldwide market capitalization of $200 million, a minimum average daily U.S. trading volume of 100,000 shares and a minimum price of $3 per share.

The "big four" accounting firms in China operate largely free of restrictive regulations. KPMG has recruited 1,700 trainees on mainland China. The Chinese authorities have also launched a "bigger, stronger" policy to nurture domestic accounting firms that are able to compete with their international rivals.

China stepped up its fight against intellectual property rights (IPR) infringement in early April 2007, lowering requirements for criminal prosecution and mandatory sentences. This move did not silence criticism from the U.S., however, which filed two new IPR-related cases against China at the World Trade Organization.

Fast food retailer McDonald's will allow China's state-run labor union to set up branch offices in the company's Guangdong Province outlets, the company announced. In Guangzhou, the capital city of Guangdong, the All-China Federation of Trade Unions has accused McDonalds, as well as other fast food giants, of breaching minimum wage laws.

There is increasing local opposition in China to such projects as building chemical plants, underscoring how the Chinese are becoming increasingly active over environment and pollution issues. The widening environmental toll has become a growing worry for Beijing because environmental damage could be the undoing of the country's economic gains.

CEFA applauds China's efforts to curb pollution. We hope that this movement will spread to many other countries. ■

Portfolio Manager's Review

Purchases in May were in the Central European and Russia Fund (CEE: NYSE). We increased this holding because of a wider discount, and oil prices have been moving up without a consequent increase in the value of these shares. The Central European component of this fund, which interests us immensely, has been doing well, due to EU expansion. We have arranged to interview the managers of CEE for the July issue.

We have also diversified our REIT holdings with Washington Real Estate Investment Trust and W.P. Carey. Holdings in the Latin American Discovery Fund and The European Equity Fund have also been increased. To fund these purchases, we sold some of the income-producing real estate funds, which haven't been acting well. We will also sell some of our Asian fund shares in the coming months.

CEFA is always looking for new investment opportunities. Overall, we remain positive on two areas of concentration: Western Europe and Latin America. ■

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