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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

IN THIS ISSUE:

India and China: Uneasy Neighbors and Fierce Competitors Find Ways to Cooperate in the Global Economy

The emerging markets have been on a tumultuous ride in the past year. As the full impact of the credit crunch in the United States became clear, emerging market investors, fearing contagion, began pulling out of some of the less established markets, triggering a sharp rise in volatility worldwide in late 2007 and early 2008.

The economies of China and India, it is argued, have "decoupled" from the rest of the emerging markets before the spring sell-off in the Asian markets. The Shanghai Composite index has dropped –30.9% as of June 3, while Bombay's Sensex index declined –21.3% during the same period.

Despite this nervousness, some of the other large emerging markets, including those in Latin America, benefited from the turmoil. This region now has a growing maturity (see May 2008 issue of *The Scott Letter*).

In this issue, we compare the differences and similarities in the elephant (India) and the dragon (China) as neighbors and global competitors. We have already spent much time analyzing China and only recently have we looked more deeply into India, a more complicated country to understand. An interview with management of The India Fund is planned.

Nobody can now afford to ignore the two largest BRIC countries: India and China. This includes the CEOs of multinationals, the U.S. government or cash-strapped financial institutions. Western consumers have cut back on imported goods while worrying that their jobs might be "off-shored" to India or some other low cost center. The rapid rise of India and China, two new economic superpowers, with a combined population of 2.4 billion (40% of humanity) compels our attention.

These nations show that there is a huge shift in the economic gravity from West to East. If you take an extremely long view, this may be a return to the global balance of 200 years ago, when China and India between them accounted for roughly half of the world's economic activity.

In their recently revised book, *The Quest for Global Dominance,* Anil K. Gupta, Vijay Govindarajan and Haiyan Wang argue that global corporations will lose out unless they leverage China and India to transform their cost structures, growth prospects and pace of innovation.

In a recent report, "Mapping the Global Future," the U.S. National Intelligence Council identifies the rise of these two fast-growing economies as "among the most profound developments transforming the political landscape of the world".

If projections based on recent annual growth rates of around 11% for China and 9% for India hold, these two countries will generate half of the world's GDP by 2050. By that time, China will be the largest global economy, followed closely by India. Between them, these two Asian giants will consume the lion's share of the world's additional energy production. Also, unless there is a radical move away from their dependence on coal combined with an introduction of clean technologies, China and India will become the largest emitters of greenhouse gases. The world is finally waking up to this reality.

These growth projections depend on a number of assumptions, the most crucial being the depth and extent of the current U.S. recession and whether recent momentum toward free trade and globalization continues.

A broader slowdown in India may be avoided as its relatively closed economy is less susceptible to global trends. By this measure, its equity market has held up well on a relative basis, and a recession is not seen in the near future.

This could be changing as India's government strongly hinted recently that it was prepared to take the politically sensitive step of raising its domestic fuel prices as it grapples with the soaring price of oil. This could affect India's growth, which might slip from 8.7% to 7.8% in 2008, while China could slow to a 9.8% growth rate. The different growth rates may be because the Indian trade account is not as important a driver of its economy as it is for China.

Apart from the fallout from a slowdown in global trade, future growth prospects will depend very much on how far the two countries' governments and central banks are willing to go to curb rising inflation.

China, with inflation currently running at 8.7%, seems to be facing a tougher challenge while India's rate has lagged its neighbor by about 2%. Both countries are faced with sharply higher commodity prices on the international markets – especially with the recent price surge in rice, which hit a 34-year record. However, China's top-down decision-making structure may be better placed to cope with this particular challenge.

Few observers, however, see the Indian economy to be anywhere near overheating, despite the surge in commodity prices. Fuel and agricultural goods are still subsidized well below those on the global market.

India's democratically elected coalition government doesn't have the same leeway as China's leadership in imposing radical policy shifts from above. The inability of the government in Delhi to push through major infrastructure projects in the face of local interests, state governments and an independent but slow moving judiciary capable of defending individual rights may frustrate central policymakers and foreign investors alike. India represents a system of checks and balances absent in China.

Professor Turun Khanna of Harvard Business School, whose recently published book, *Billions of Entrepreneurs: How China and India Are Reshaping Their Futures and Yours,* stated that the two countries' approach to decision-making and market forces are strikingly different.

Professor Khanna sees that they are "inverted images of each other," arguing that "what China is good at India is not."

The absence of an overriding central authority in India may explain why China can build cities overnight while Indians have trouble building roads. In fact, each country has developed quite separate strengths: China is the world's factory, while India is its back office. This did not occur because each country is "hard-wired" to excel in different fields.

Many Indian facilities with English and "soft" skills make them supremely adaptable to IT programming and call centers, but the country's inadequate transport infrastructure inhibits their competing with finished goods as the Chinese do. The opposite is true of China.

"Actual production costs in India are quite low, and on that basis alone, it could be competitive in supplying finished manufactured goods such as motorcycles. But inadequate transport infrastructure raises both costs and reliability of delivery," says Professor Khanna. "While China courts foreign capital and has recently, but reluctantly, acknowledged the private sector," he writes, "China's internal opacity and lack of private property rights emasculate its internal markets in comparison to the parts of India where competition is allowed to run amuck. On the other hand, its unconstrained fiat allows it to override coalitions that might block material progress in a way that India cannot."

That may explain why, until recently, both India and China have focused on selling their goods and services to the developed world rather than to each other.

Bilateral trade between the two nations has grown from just $5 billion in 2003 to around $38 billion over the past five years. But that is small change compared to their exports to the U.S. and other developed countries.

Moreover, further growth in bilateral trade, expected to reach $60 billion by 2010, is likely to raise tensions between the two countries. The trade balance is skewed heavily in China's favor, the surplus rising from $4 billion to $9 billion in 2007. Indian businessmen complain that the Chinese renmimbi currency linking to the declining U.S. dollar gives their exporters an unfair advantage. China's exports are primarily manufactured goods, while bulk commodities such as iron ore still make up a large part of India's trade with China. Hence, the balance is even more skewed.

India is also pursuing acquisitions abroad, particularly in resource companies. India's Sterlite Industries is set to become the third largest copper producer after agreeing to buy the assets of bankrupt U.S. copper miner, Asarco LLC for $2.6 billion. Sterlite outbid three other groups.

During a recent visit to Beijing, Indian Prime Minister Manmohan Singh called for the dismantling of non-tariff barriers and tougher action protecting IT and other intellectual property rights. At the same time, he sought to reassure Beijing that India's closer relationship with the U.S., notably the proposed pact on civil nuclear energy and possible purchase of 162 new (U.S.) fighter aircrafts, does not mean India is becoming part of a broader strategy to contain China.

Mutual distrust between the two countries goes back to the Sino-Indian war of 1962 and the unresolved territorial claims along their 2,000-mile Himalayan border. They officially declared 2006 the first year of their "friendship" by taking down the barbed wire on the Nathu La border pass and reopening the old trans-Himalayan trade route.

However, the two nations still glare at each other across the "Bamboo Curtain". Recent pro-Tibet demonstrations while the Olympic torch made its way through Western capitals have repercussions because India continues to host the Dalai Lama and Tibetan government-in-exile, who are condemned by China.

This historical rivalry has spread to Africa and central Asia, where the two countries are competing for energy and other raw materials needed to fuel their fast-growing economies. They bid against each other. It may be a rerun of "The Great Game", when Imperial Britain and Russia vied for dominance in 19th century Asia. Occasionally, they collaborate in the interests of mutual energy security often throwing in broader aid or arms deals.

Recently, however, there is evidence of reduced tensions at the Chinese-Indian border between Nepal and Pakistan, symptomatic of China's and India's closer ties.

"Both the Chinese and the Indians are partnering with newly emerging resource-rich nations," observes Norman Villamin, head of research and strategy at Singapore-based Citi Global Wealth Management. The rivalry now extends to the Indian Ocean, with Delhi "pursuing defense and commercial engagement with countries such as Seychelles, Mauritius and Mozambique in order to counter Chinese expansionism," according to a recent report. It also points out that "most of India's trade and 89% of its oil arrive by sea, so keeping shipping lanes safe is a strategic priority."

Delhi is painfully aware that, both militarily and economically, China is the dominant player. Looking ahead, however, Indians point to their "demographic dividend" – the competitive advantage 10 years out of having a large population of working age people while China's aging population will have to support more dependents. [**Editor's Note:** This is seen as a huge issue in the future, a negative for China, but a positive for India.]

In order to capitalize on this and take-on China as a great manufacturing power, India needs to catch up on infrastructure. Current government estimates are that $400-$500 billion will need to be spent over the next 10 years.

Mr. Villamin points out: "The key challenge in today's markets is how that will be funded," noting that "the execution challenges of pushing major infrastructure through, including the nature of decision-making, are much greater [in India] than in China."

So which of the two, the elephant or the dragon, will achieve global dominance?

As things stand, most of the money is backing China, though a question mark remains as to whether it can continue to combine market-driven growth with a system of "social stability" built around the absence of democratic freedoms and property rights over the long term.

As for India, it has been slower to get "off the blocks" and certainly needs a firmer sense of direction, but it is more likely to stay the course. ■

Source: *Global Finance*

Closed-End Regional Funds for India

The India Fund (IFN)
MS India Investment Fund (IIF)

Closed-End Regional Funds for China

Asia Pacific Fund (APB)
Asia Tigers Fund (GRR)
ING Asia Pacific High Dividend Fund (IAE)
JF China Region Fund (JFC)
MS Asia Pacific (APF)
Templeton Dragon Fund (TDF)

Single Country Funds

China Fund (CHN)
Greater China Fund (GCN)
MS China A Share Fund (CAF)
Taiwan Greater China (TFC)

Templeton Emerging Markets Fund Publishes Its Semi-Annual Report (February 29, 2008)

This summary of the CEFA's largest holding, the high performing fund EMF covers its global focus in the emerging markets.

Templeton Emerging Markets Fund delivered cumulative total returns of +14.38% based on market price and +11.25% based on net asset value for the six months ended February 29, 2008. The geographic breakdown, based on total assets was, 50.5% Asia, 25.3% Europe (to include Russia) and 23.8% Latin America.

Asia, India, Indonesia and Pakistan were among the top performing emerging markets. India's strong economic growth gained because of its large consumer base and vast foreign reserves. The overall Asian region benefited from a weak U.S. dollar, and consequently, countries such as Thailand delivered higher returns. China and South Korea, on the other hand, underperformed during the period.

In Europe, the strong Russian market was supported by high commodity prices for the country's exports, robust foreign direct investment inflows and marked economic growth. Turkey, Poland and Hungary, however, recorded declines.

Latin American markets were among the strongest performers during the reporting period. Stronger regional currencies, high commodity prices and greater demand for metals and soft commodities supported resource producers in markets such as Brazil. Accelerating economic growth, high foreign investment flows and lower interest rates pushed the Brazilian stock market to end the period with double digit returns.

Mexico underperformed its regional peers as concerns of slowing U.S. growth led investors to stay on the sidelines.

For the six months under review, the Fund's exposure to energy, materials, banks and telecommunication services contributed to absolute performance.

Rising oil and commodity prices, coupled with growing demand for oil, coal and metals in China as well as in other emerging markets, benefited our companies. Russia contributed the most in the telecommunications services sector.

It is important to recognize the effect of currency movements on the Fund's performance. In general, if the value of the U.S. dollar goes up compared to a foreign currency, an investment traded in that foreign currency will go down in value because it will be worth fewer U.S. dollars. This can have a negative effect on a fund's performance. Conversely, when the U.S. dollar weakens in relation to a foreign currency, an investment traded in that currency will increase in value, which can add to fund performance.

For the six months under review, the U.S. dollar declined in value relative to most non-U.S. currencies. As a result, the Fund's performance was positively affected by the portfolio's investment, predominately in securities with non-U.S. currency exposure. However, one cannot expect the same result in future periods.

To raise funds for income and capital gains distributions in 2007, we sold a number of holdings, allowing the Fund to focus on stocks we considered more attractively valued within our investment universe. We sold select positions as stocks reached price targets. As a result, the Fund's exposure to telecommunications services and pharmaceuticals companies fell.

We eliminated the Fund's exposure to South Africa and at the same time reduced investments in Hungary, India and Turkey during the reporting period.

– Mark Mobius, Executive Chairman

Templeton Asset Management ■

The Benefits of Wealth Funds

Many nations are debating whether to establish sovereign wealth funds pioneered by Singapore and the Middle East. They are collectively managing as much as $3,000 billion according to estimates cited by U.S. officials.

Some of the more sophisticated sovereign wealth funds, such as Kuwait Investment Authority (KIA), are considering acquiring, either directly or indirectly, real estate assets in the U.S. KIA also has acquired stakes in real estate investment trusts, which are trading at bargain levels in many countries. These funds allow countries to earn higher returns in equity investments than investments in Treasuries or other U.S. government bonds.

China's $200 billion wealth fund, launched in 2004, now has as much as $90 billion to invest in assets abroad, an increase of more than 30% from its original allocation. This fund has chosen a number of global fund managers to invest in offshore equities, and a mad scramble is underway to manage a portion of this and other sovereign fund assets by global money managers.

Many other governments, which have enjoyed commodity export windfalls, are setting up these funds to take advantage of investing their surpluses abroad.

India is also considering development of a sovereign fund, but it is a large oil importer and has sizeable current account and fiscal deficits. The prime minister is seeking to create a vehicle to invest in foreign companies after watching with great interest the development of these funds, both in view of their presence in India's financial markets and in the ongoing debate on establishing its own entity.

The Reserve Bank of India, responsible for managing the country's reserves, has warned that the country could once again find itself in a vulnerable balance of a payment situation should their capital inflows suddenly reverse. If a fund is developed, it is likely to be small, possibly with $5 billion to start, to finance acquisitions of companies abroad.

Current reserves in India, however, are comfortably in excess of the amount needed to cover both six months of imports and short-term foreign currency external debt. This means that the central bank is coming under pressure to be more aggressive in its reserve management.

Japan is also considering the possibility of launching a wealth fund, which would use part of the country's massive public pension fund and foreign reserves to invest in a range of financial products possibly by the spring of 2009. Iceland is another nation considering launching a fund, and we expect others will follow.

These sovereign funds are important for the development of free capital flows and to increase worldwide investments. ■

Source: *Financial Times, The Wall Street Journal*

CEFA's Universe Report: Two Relative Pricing Metrics Explained

In May issue of *The Scott Letter,* we discussed the undistributed net investment income (UNII) and Relative UNII data points in CEFA's Closed-End Fund Universe. In this issue, we discuss two relative pricing metrics: the **52-Week Relative Price** and **50-Day Moving Average Relative Price**.

How Are They Calculated?

The **52-Week Relative Price** is calculated based on a fund's current 52-week low and 52-week high valuation. The figure is expressed on a percentage basis and can be described as:

$$\text{52-Week Relative Price} = \frac{\text{(Current Market Price)} - \text{(52-Week Low)}}{\text{(52-Week High)} - \text{(52-Week Low)}}$$

For example, suppose Fund A has a current market price of $15 per share, a 52-week low of $10 per share and a 52-week high of $30 per share, its 52-Week Relative Price would then be:

$$\frac{\$15 - \$10}{\$30 - \$10} = \frac{\$5}{\$20} \text{ or } 25\%$$

For comparison purposes, if Fund B has a current market price of $33 per share, a 52-week low of $20 per share and a 52-week high of $38 per share. Its 52-Week Relative Price would be:

$$\frac{\$33 - \$20}{\$38 - \$20} = \frac{\$13}{\$18} \text{ or } 72.22\%$$

To determine the **50-Day Moving Average Relative Price (MA Relative Price)** for a fund, we begin by looking at the fund's average price over the previous 50 trading days (also called 50-day moving average). The **MA Relative Price** (stated as a percentage) and the 50-day moving average are defined as follows:

$$\text{50-Day Moving Average} = \frac{\Sigma\text{(Price of Fund For Last 50-Days)}}{50}$$

$$\text{MA Relative Price} = \frac{\text{Current Market Price} - \text{50-Day Moving Avg.}}{\text{50-Day Moving Avg.}}$$

As an example, if Fund C has a 50-day moving average of $21.50 and a current market price of $23.00, its MA Relative Price is:

$$\frac{\$23.00 - \$21.50}{\$21.50} = .0698 \text{ or } 6.98\%$$

Hence, the fund's market price is currently 6.98% over its 50-day moving average.

If Fund D has a 50-day moving average of $31.25 and a current market price of $29.50, its MA Relative Price is:

$$\frac{\$29.50 - \$31.25}{\$31.25} = -0.56 \text{ or } -5.6\%$$

How to Use the Data Points

These two metrics help us to evaluate the relative value of a closed-end fund as well as its sector group. Readers should be familiar with the use of the discounts/ premiums to evaluate closed-end fund relative values on a current, relative and historical basis. Both the **52-Week Relative Price** and the **MA Relative Price** help us to evaluate the current value of a fund's share price. When comparing two or more funds with similar discounts/premiums, we can compare the funds to their long-term relative pricing by looking at the 52-Week Relative Price versus the funds' peer group averages, while the MA Relative Price enables us to compare the funds to their peer group averages.

For example, if we compare Fund A and Fund B and if all other factors are equivalent on these two funds, you would be correct in stating that over the long term (previous 52 weeks), Fund A with a 52-Week Relative Price of 25% is more undervalued than Fund B which has a 52-Week Relative Price of 72.22%. By looking at a fund group's average 52-Week Relative Price, we can discover if a sector of closed-end funds are under- or overvalued.

In the second example, if all other data is equivalent, it should be clear that Fund D with a MA Relative Price of –5.6% is underpriced as compared to Fund C with a MA Relative Price of +6.98%. This metric is a good indicator of the short-term pricing of a closed-end fund.

Also, look at the group averages for both of these metrics and you may be able to identify sectors that have bean "beaten up" and as a result, could be undervalued.

CEFA's Closed-End Fund Universe now contains 26 data points. One should first consider all the data points and establish investment suitability of a fund to meet your investment objectives and risk tolerances before making any changes to your investment portfolios.

In the next issue of *The Scott Letter,* we will discuss the difference and use of Standard Deviation and Beta. For more information about the use of these relative pricing metrics in the evaluation of closed-end funds, please contact John Cole Scott at (800) 356-3508 or visit CEFA at www.CEFAdvisors.com/universe.html. Investors are advised to seek professional investment counsel before investing. ■

Portfolio Manager's Review

During May and into June, we started buying Alpine Global Premium Properties Fund to replace the real estate allocation after selling shares of Cohen & Steers Worldwide Realty Fund and ING Clarion Global Real Estate Fund. These latter funds had been selling at premiums to their net asset values. We are also selling much of Diamond Rock Hospitality Co., a hotel REIT, as the outlook for the luxury hotel sector looks dim in the near future.

We also sold shares of Cohen & Steers Closed-End Opportunity Fund and lightened up on Templeton Emerging Markets Income Fund as its discount narrowed.

Even though we see many of our markets are now oversold, we remain cautious and continue to emphasize funds with strong cash distributions and with monthly pay-outs, if possible.

It also appears that interest rate and inflation worries may be overdone as predictions by the futures markets for sharply higher interest rates often prove wrong. It could be a long time before the Fed raises interest rates. Therefore, we see opportunities in many of the markets CEFA covers worldwide.

We plan to interview The India Fund for the July issue of *The Scott Letter.* The comparison between China and India in this issue shows that these two countries are very different; yet they complement each other in many ways. ■

George Cole Scott

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