

# 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](http://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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## The Beijing Olympics: Games Should Increase Chinese Gross Domestic Product

Beijing 2008 was the most spectacular and lavish Olympics ever held. Investors in China wonder what will happen to the city after the Games? Paul French, Chief China Representative of Access Asia, discusses likely scenarios for Beijing's economy after the Olympics have come and gone.

Will Beijing suffer an economic slowdown at best, a crash at worst? Following the climax of the Games is the momentum of construction and investment required unsustainable?

Other summer Olympic cities (Barcelona 1992, Atlanta 1996, Sydney 2000 and Athens 2004) incurred significant debt. Barcelona recovered the money relatively quickly through increased investment and tourism. However, Montreal had a long financial slump and didn't pay off its debt until 2006. Other cities which spent large sums to host the Games have not recouped their investment, including Los Angeles, Sydney and Athens. A better case study for Beijing would be the last time the Olympics were held in a developing country: Seoul 1988. However, even Seoul is not really applicable, as China is so much larger, more populous and expanding compared to South Korea in the late 1980s.

No Olympics host city had such a large building spree as Beijing did. Nor has any previous city been in the grip of such a construction and development boom as what Beijing has had for 15 years. Beijing, unlike recent host cities, is rapidly expanding and has large amounts of inward investment. Do the same economic "rules" apply to Beijing as they adversely affected previous cities?

After initial estimates of \$1.6 billion USD to host the Games and a further \$16 billion USD for environmental protection and improved highways and rail links for the construction of Olympic venues, there was a call to frugality after estimates placed the total expenditure for the Games at \$40 billion USD.

### The Impact

- Beijing's population is 15 million. As a percentage of the country's population, it is the smallest Olympic city to-date. This means that more than any other Olympics, the "trickle down" effect to the rest of China will be less than has previously been the case. There is no reason to expect an Olympic-related downturn post 2008.
- There will inevitably be some "white elephants" after the Games, e.g. some sports stadiums not suitable for future domestic sporting events.
- The key difference is that the Beijing Games will promote development rather than require re-development or regeneration. The infrastructure in place is needed as part of the city's overall long-term development, rather than being put in place to support the hosting of the Games.
- The Olympic effect should add an advantage of 0.3%-0.4% to China's GDP. This is impressive for an event lasting slightly less than one month and shows that China's economy is still booming.
- The Beijing Olympics will have little impact on the wider Chinese economy. There will be some important and positive regional effects, especially in the surrounding Habel province and the neighboring Tiajing municipality.
- Cities that hosted Olympic events outside Beijing should see some positive effects – notably Quigdao, where there is a growing domestic tourism industry.
- Beijing's long-term development will be strengthened in many ways following 2008, including an overhaul of the city's service industry and improvements to the city's financial services infrastructure, its communications network and energy grid. ■

Source: J.P. Morgan,  
*Hands-on China Alert*, August 2008

## Asia Is a Net Beneficiary of Falling Commodity Prices

The investment objective of The Asian Pacific Fund (NYSE:APB) is to achieve long-term capital growth by investing in equity securities in the Asia Pacific countries. APB is managed in the Hong Kong office of Baring Asset Management Company Ltd. of London. As of July 31, 2008, this office manages over U.S. \$9.6 billion of assets in Asian (ex-Japan) equities. The fundamental approach prefers quality growth stocks, believing it more prudent to find a stock that has the potential to be re-rated (upgraded) two to three times than a risky small-cap stock that could be re-rated five to six times.

Barings has a “growth at a reasonable price” (GARP) investment philosophy to add value at both the macro (asset allocation/theme selection) and the micro (stock selection) levels.

APB will distribute any net capital gains in excess of net carry loss forward to shareholders near the end of each year. APB may use leverage but rarely uses it. Its region is divided into three sections: North Asia (Hong Kong, China, Korea and Taiwan), Southeast Asia (Singapore, Malaysia, Thailand, Indonesia and Philippines) and South Asia (India).

CEFA interviewed portfolio manager, Khiem Do, chair of Asia Multi-Asset Group and member of Targeted Solutions Portfolio Construction Group, Hong Kong. Khiem sees China growing at a solid pace.

**SL:** We asked Khiem on August 27, 2008 how much the economy of China has changed after the Beijing Olympics?

**Do:** China won a great number of gold medals and exhibited a fantastic showcase for the whole world to see. For the Olympics, about \$42 billion were spent by Beijing City, mostly to improve the much-needed infrastructure and transport logistics in and around the city. This will benefit the people of Beijing and the surrounding cities for decades to come.

The direct expenditures for the Olympic Stadium and the associated sporting shelter and infrastructure was estimated to cost only about \$4 billion,



Khiem Do

**Khiem Do** has 30 years of investment experience and is responsible for the management of portfolios for clients located in Asia. He was appointed to be a member of the Strategic Policy Group, Baring Asset Management Company’s global macro research and asset allocation team in 2006 and headed the Asia Pacific Specialist Investment Team from 1997-2006. He has co-managed the Baring China Absolute Return (long-short hedge fund) since July 2004.

Khiem joined Baring Asset Management in 1996 from Citicorp Global Asset Management in Sydney, as the Australian Chief Investment Officer, chaired the Australian Asset Allocation Committee and is a member of the CGAM International Asset Allocation Committee. Prior experience includes seven years at Bankers Trust Australia and seven years at Equitilink Australia Ltd.

Khiem received his B.A. in Economics (Honors) from Macquarie University and is an Associate Member of the Securities Institute of Australia. He is fluent in English, Vietnamese and French.

### Asia Pacific Fund Performance as of March 31, 2008

Market Price (USD) Return Gross	1 Year to 3/31/208	3 Years to 3/31/208	5 Years to 3/31/208	10 Years to 3/31/208	20 Years to 3/31/208
Asia Pacific Fund - NAV	19.0	101.1	276.1	270.0	1,030.9
Asia Pacific fund - Price	28.7	118.7	304.7	271.3	1,252.3
MSCI AC Far East Ex-Japan	17.9	89.3	255.8	159.2	635.0
MSCI World	-2.8	33.8	114.8	63.2	380.5
S&P Composite 500	-5.1	18.6	71.0	41.1	699.7
NASDAQ Composite	-6.1	18.7	81.8	59.8	594.3
MSCI Europe	0.7	53.7	187.3	96.4	778.2
MSCI Japan	-14.6	20.9	102.1	42.2	-10.0

insignificant compared to the total of \$42 billion spent on the entire event and compared to a \$2+ trillion GDP economy.

There are concerns about the significant and continuing fall of the leading economic indicators, plus signs of an economic slowdown in China. Beijing’s factories have re-opened so China will continue to grow at a solid pace. This will surely lift their morale and pride as well as improve consumer confidence.

However, due to the restraint imposed on bank lending by China’s Central Bank (PBOC), small and mid-sized private companies, together with property developers in China, have been feeling the pinch. Thus, the economy will definitely welcome more bank easing.

**SL:** Do you think interest rates will fall anytime soon?

**Do:** Yes, further monetary easing in China will occur in the coming months. The banks can lend only a certain amount

each year, based on a “quantitative target” fixed by the PBOC. This is not a very efficient way to finance a dynamic and growing economy, and it is not properly adjusted for inflation or external shocks such as the January snow storm and the Sichuan earthquake in June.

**SL:** Your March report stated that “the elevated food prices and the surging oil price caused upward pressure on inflation, notably in Vietnam, China and India”. What do you see for inflation in China and its growth rate in 2008?

**Do:** The headline inflation rate is currently 6.3%, having fallen from a peak of 8.7% in May. We think inflation will continue to fall towards a 5% annualized rate, helped by falling food and other commodity prices. Some estimates show that economic activity has slowed to an annualized rate of about 7% in August, but this may be a temporary slowdown. The

economy should return to a growth pace of 9%-9.50% in the coming months.

**[Editor's Note:** The *Financial Times* recently wrote: "At current levels, oil is still 60% more expensive than at the same time in 2007 and should continue to weigh both on the external balances and economic growth in South Korea as elsewhere in Asia."

Although China now has slowing price growth, inflation has declined due to falling commodity prices and a resultant slowing of food prices. The inflation rate since July is at its lowest level since September 2007, but the consumer price index rose. Inflation declined from 7.1% in June, peaking to 8.7% in February. China, however, still has power shortages and an increasing inflation rate.]

**SL:** Will there be any adjustments to the Chinese currency?

**Do:** The renminbi may appreciate very slowly against a resurging U.S. dollar and has also risen significantly against the yen, euro and other global currencies.

**SL:** Do you think that the world commodity boom will slow down enough to help in the recovery in the world stock markets? Do you think the decline in the world oil price will benefit these countries?

**Do:** Countries affected by the rising commodity prices include Vietnam, India, and Thailand, as well as China to a certain extent. Yes, they are better off, but lower commodity prices more severely impacted commodity exporters in Latin America and Russia. Asia is net beneficiary of falling commodity prices.

**SL:** Why have you have increased your Hong Kong/China allocation from about 33.5% in March to 44.6% now?

**Do:** The Fund was moderately overweighted in both markets relative to the reference benchmark, the MSCI AC Far East Free ex-Japan. We now focus on investing in Hong Kong listed stocks.

We use the H-shares or what are called "red-chips". We have only a small exposure to China-listed A-shares in the portfolio (via a Hong Kong listed ETF) because of restrictions imposed on foreign investment in renminbi-denominated securities. Only a very small portion of the A-shares is accessible to foreigners.

Foreigners can buy the B-shares, also listed in China, without limit. Unfortunately, they are illiquid so only a handful of companies offer investment quality characteristics.

**SL:** You always give us good explanations of what you see everyday, as many investors have a hard time understanding the various ways to invest in Hong Kong and China. Keep up the good work!

Why do you think the summer market rally in the emerging markets occurred on very low volumes?

**Do:** The daily trading volumes in equity markets are still quite thin in Asia. This global phenomenon is also happening in New York, London and in other markets around the world because of the cutback in bank lending after the sub-prime disaster.

There are reasons for this. First, the investment banks' and hedge funds' risk capital and their leverage have been drastically reduced. Secondly, retail money has been very quiet, and little of it has been invested outside of the money markets and government bonds. Thirdly, there are macro uncertainties in the G3 economies, together with the de-leveraging of the Western consumer and their banking system. Finally, there is the spike in commodity prices, which is now easing.

**[Editor's Note:** The G3 economies include the 25 countries of the European Union and developing Asia, accounting for 9.9% of world gross domestic product compared with 30.6% for the United States, 14.0% for Japan, and 24.9% for the European Union.]

**SL:** We don't understand all of the gloom about the commodity markets, led by cheaper oil. Sure, it's hurting countries like Brazil and Russia, but what a bonanza this is for the countries in Asia. Maybe, investors will wake up about this one of these days.

The U.S. money markets are holding \$3.5 trillion in cash! Why do you think so many investors continue to hold onto so much cash with equity prices so low?

**Do:** That massive amount of liquidity is currently earning next to nothing. Once these funds find their way back to the equity markets, we'll surely have a wonderful fireworks display, similar to

those at the Beijing Olympics' opening and closing ceremonies.

Liquidity is a serious issue, and there's very little interest in equities around the world now because the confidence of retail investors hits new lows each week, particularly as bad news about the U.S. economy continues to make headlines.

Investors are missing something as Asian equities now have very cheap valuations (compared to P/Es of 24 in the U.S.). The stock markets appear to be attracting only the long-term "value" investors, not the average retail or trading type of investor (including hedge funds), which have been behaving more like "momentum" investors.

**SL:** We are among the few "value" investors who are constantly looking for bargains. Do you see any signs of improvement in investment sentiment?

**Do:** It is difficult to predict when the poor sentiment in the Asian equity markets will change. The largest economies of G7, notably the U.S., Europe and Japan, are close to zero growth, so there is not much hope for an early easing of monetary policy by the European Central Bank or any additional fiscal or monetary easing from the U.S. or Japan.

**[Editor's Note:** Euro-zone inflation fears have prompted the European Central Bank to leave their interest rates unchanged on September 5, 2008.]

**SL:** How long do you think that the price of oil will remain in an inverse relationship to stock prices in the U.S.?

**Do:** A lower oil price reduces an implicit tax imposed on the average consumer and corporation. If the fall is sustainable, then this will ultimately boost corporate profits, a positive for equities.

**SL:** The trend in oil prices is down, but it may not happen right away, due to supply problems and geopolitical events. Recent demand from the U.S. consumer is down. Aren't India and China still importing large amounts of oil?

**Do:** Yes, indeed. Over the past few years, China, India and the Middle East have been consuming a lot more oil because they have been building massive infrastructure projects and commercial/office and residential property sites, which



are all very energy-intensive activities. Nevertheless, as the central banks have been tightening over the past 12 months in order to cool down inflation, there are signs of a slowdown in many of these economies because of a lower demand for oil and other commodities.

**SL:** We are glad to hear that, although there is still a large deterioration in the environment in China – notably air pollution, soil erosion and the steady fall of the water table, especially in the north. How successful has China been in solving this tough environmental endeavor?

**Do:** Pollution control is taken seriously in China. The government is trying to improve water and air quality. China is a country with a population of over 1.2 billion people, with 65% of the population living in the rural area and the rest concentrated in a number of mega-cities. It is, therefore, not easy to exercise effective control over such a vast geographical area. But they are trying.

**SL:** We will continue to watch their progress now that the Olympics are over.

## Hong Kong

Hong Kong is one of the world's leading financial centers, has a highly capitalist economy and is built on a policy of free markets, low taxation and government non-intervention. Hong Kong has had high growth rates and rapid industrialization from the 1960s through the 1990s, which has continued into the 21st century.

The Hong Kong Stock Exchange, the sixth largest in the world, had a market capitalization of \$2.97 USD in late 2007. It also has the sixth largest value of public offerings after London.

**SL:** Has Hong Kong's relationship with mainland China changed much? Do you see any changes in the relationship of the Hong Kong dollar to the renminbi?

**Do:** The Hong Kong people want a closer relationship to China, and as a result, the Hong Kong dollar will ultimately be more closely linked to the Chinese currency, but that won't happen for another three to five years. In the short-term, it appears that the citizens are quite satisfied with the U.S.-dollar link.

**SL:** The Hong Kong stock market has declined sharply (down 36%) from its peak of 36,100 last October to close to the psychologically significant 20,000 level. How do you account for this drop?

**Do:** The solid fundamental backdrop, unfortunately, was not sufficient to prevent the share price trend of Hong Kong and other Asian banking shares to decline in sympathy with their global counterparts. The banking system, like the majority of the others in Asia, continues to operate in a normal and healthy way. Over the past 12 months, they did not need their central bank's assistance, unlike their counterparts in the U.S., U.K., Australia and Europe.

The top four banks in China, in the six month period to June 2008, earned about \$26 billion USD in net profits, about \$2 billion USD more than the total profits of the top four global banks in the world. None of these were U.S. banks.

In addition, the poor sentiment in the A-share market in China also negatively affected the Hang Seng Index over the past few months. Nevertheless, we think that the 20,000 level will hold, because of very attractive prices at these levels.

Therefore, a strong rally in the Hang Seng Index is a likely event, but it depends ultimately on the turn in the sentiment in the U.S. Dow Jones Index and the Hong Kong A-share market.

**SL:** How strong is the all-important property market in Hong Kong?

**Do:** The property market is stable because there still is little supply in both the residential and office segments. In addition, the local banks have plenty of available capital for property buyers – a sharp contrast with the U.S., Australia and the U.K. which have more supply and restrictive mortgage lending.

Regrettably, equity sentiment just took another dive in recent weeks as investors were negatively surprised by the news that U.S. banks had to continue to provide for more potential losses on their mortgage securities and loan books. In addition, the negative second quarter European and Japanese GDP data and a slowing Chinese economy did not improve sentiment. Predicting a turn in sentiment is almost impossible, and the only certainty is that

many equity markets are extremely oversold, with sentiment indicators reaching "panic" levels.

Equities, among the various asset classes, are now the cheapest (and thus, are the most attractive, fundamentally speaking) [investments] relative to cash, bonds, commodities or real property.

Based on past history, these sign posts show we are close to a very important bottom in the equity markets.

**SL:** We agree and want to thank you for this excellent analysis of the China and Hong Kong stock markets.

## South Korea

South Korea has been a major economic power and has been one of the wealthiest countries in Asia, even though that is changing. The economy is still the fourth largest in Asia and the 13th largest in the world. Their tremendous economic growth over the years has been fueled by the export of high tech goods. South Korea also has the highest industrial growth rate in the developed world, and its scientific competitiveness is ranked among the top five in the world.

South Korea leads the world in the manufacture of semiconductors, RAM, flash memory and digital display (e.g., LCD and plasma panels) industries, as well as in consumer electronics. Telecommunication technology has thrived. Korea is the most wired and wirelessly connected country in the world, having the second highest number of broadband users worldwide. Nationwide high-speed internet access, interactive full high definition TV broadcasting and other technologies have rolled out since 2000.

Recent weakness in the technology sectors in the U.S. have led many of the Asian markets lower. South Korea has been the biggest decliner, additionally burdened by a rapid depreciation in the currency and mounting concerns about the country's economic outlook.

**SL:** You have reduced your Korean holdings from 25.2% at the end of March 2008 to 20.7% on July 31, 2008. Is this because of the economic outlook?

**Do:** We have been underweight in Korea for sometime. Their equity markets have been experiencing a larger fall in U.S. dollar terms over the past few months vis-à-vis its Asian counterparts. As a result, its relative weighting in the portfolio and in the reference index has declined.

Furthermore, the Korean market has significant exposure to global cyclical industries such as technology, autos, ship-building and chemicals. In a global downturn, investors tend to liquidate these cyclical holdings first, dragging down the performance of the Korean equity index. Not everyone is worse off, however. Consumers can buy LCD TV screens and other electronic gadgets from Korea or Japan much more cheaply these days.

Both the Korean equity market and the Korean currency are getting a lot cheaper and are offering good long-term value. Once the upturn in the global economies becomes visible, this market could enjoy a massive V-shaped rally.

**SL:** What about a possible Korean Development Bank (KDB) merger with Lehman Brothers? In early September, the *Financial Times* reported that talks were underway between the beleaguered U.S. investment bank and the KDB.

**Do:** I found that quite surprising because KDB is not really a strong bank. It went bankrupt in the '97-'98 Asian crisis and had to be nationalized by the government. It may be re-privatized soon. What can KDB bring to the table if they were to acquire Lehman or another institution? Hopefully, this is just a far-fetched rumor.

**SL:** It has been reported that KDB is actively seeking overseas takeovers, but Lehman has just had a management shake-up, so now there are doubts as to whether the current round of talks with any of its suitors will succeed.

More importantly, how long do you think it will be before Korea will be able to resume its high growth record?

**Do:** Perhaps in 2010. The reason is that in 2009 the global economies in the developed world are expected to remain lackluster while consumer and business de-leveraging continue. In addition, we expect the Chinese economy to grow at a slower rate of 9%-9.5%.

Thus, one may have to wait until 2010 for the U.S. and European banking systems to regain their strength and increase their loans again.

**[Editor's Note:** Khiem is still very positive on China, Hong Kong and is seriously looking at India. In this interview, however, we noticed that he has shown less interest in the smaller countries in his region since our interview with him in 2007. APB has 18.4% of its assets in Korea, 11.5% in Singapore, 6.5% in Malaysia and 3.2% in Indonesia, much lower in each country since 2007. ]

### Taiwan

**SL:** You have reduced your Taiwan exposure to 15.2%. How has this economy fared in the global economic downturn?

**Do:** The corporate earnings prospects are not really exciting in Taiwan, and a closer business and political relationship with mainland China will have to pass many hurdles as normalization between the two nations will take a long time. We continue to watch the global technology demand trend and changes in business dealings between Taiwan and China, and remain underweighted in this market.

### Singapore

Singapore has a highly developed and successful free market economy which is remarkably open and corruption-free. Relying heavily on exports, Singapore is dependent on consumer electronics and information technology products. The government has attracted major investments in pharmaceuticals and medical technology – and will continue its efforts to establish Singapore as Southeast Asia's financial and high-tech hub.

**SL:** You have raised your exposure in Singapore from 7.5% to 8.1% since March 2008. Will Singapore remain Southeast Asia's financial and high tech hub?

**Do:** Singapore has succeeded within a short period of time to rival Hong Kong. However, their effort to build strong high tech and pharmaceutical industries appears to have failed to-date.

**SL:** That is the first time I have heard anything negative about Singapore. Is it a city or city-state like in ancient Greece?

**Do:** Singapore is a small, cosmopolitan and prosperous city-state, somewhat similar to Geneva or Zurich. It doesn't have the vast rice fields or palm oil tree plantations like its neighbors, Indonesia and Malaysia. The Lion City state is well-planned, wealthy, beautiful and clean, and is known for being one of the cleanest cities in the whole of Asia.

**SL:** Where have you increased your holdings in Singapore?

**Do:** We like the banks, property developers and some engineering companies involved in the oil servicing and other engineering industries.

### Indonesia

Indonesia is the world's largest archipelagic state and has the world's largest Muslim population. Current issues include alleviating poverty, preventing terrorism, consolidating democracy after four decades of authoritarianism, implementing financial sector reforms, stemming corruption, holding the military and police accountable for human rights violations and controlling avian influenza – a lot to deal with. Indonesia is also a resource-rich country and an oil producer.

**SL:** Your investment is low there: 2.7%. Is this economy still highly dependent on its services and resource sectors?

**Do:** The resources sectors remain a key attraction in Indonesia. We have an interest in coal and energy stocks, but despite being well endowed with oil and gas reserves, Indonesia has not been successful in its effort to explore and develop its untapped resources. The multi-national corporations have adopted a cautious attitude about the country due to its past political instability.

**SL:** I see that inflation in Indonesia has been higher than expected (double digits), and they have just raised their interest rates to 9.25%, one of the highest in the world. The government is also no longer subsidizing fuel prices. Is this happening in other Asian countries?

**Do:** Yes, many Asian governments, included India, China, Indonesia, Vietnam,

Malaysia and Thailand, are reducing their subsidies on retail pricing of energy. This caused a short-term spike in the inflation rate, but the latest inflation data showed that in most Asian countries the inflation rates are declining, a positive development for equity investors. Lower inflation rates in Indonesia and other Asian countries should also occur in the next few months.

The decline in oil and other food prices has been very favorable news for commodity importing nations in Asia. This helped to put a hold on monetary tightening as well as provide consumers and businesses with more buying power.

**SL:** Do you see enough investment opportunities in Indonesia now to increase your allocation?

**Do:** Yes, the stock prices in Indonesia have also fallen significantly as in the rest of the region. Moreover, listed Indonesian companies have tended to operate quite efficiently and have been successful at achieving a high rate of return on equity.

As a result, any further weakness in the Indonesian market may present a good buying opportunity for long-term investors to add to their positions.

**SL:** There is an Indonesian closed-end fund (The Indonesia Fund). We usually avoid single country funds because of their high volatility. We prefer global and regional funds because of their diversity. We rely on your expertise and knowledge of the countries in this region.

At Closed-End Fund Advisors, we try to find areas in the world that are immune from the problems we have been discussing. We try to diversify our assets as much as possible.

## India

**SL:** For years now, you haven't been very keen on India, which I once visited as an investment destination. You correctly cited its huge infrastructure and inflation problems. In the [July/August 2008 Scott Letter](#), we interviewed the portfolio manager of [The India Fund](#) and addressed all of the problems you mentioned. We were given good answers, but the valuations are low now and the discount has widened. They also have the best perform-

ance record of any closed-end fund investing in the emerging markets. Is India an investment opportunity for you now?

**Do:** We are definitely looking more closely at India as equity valuations have fallen to much more realistic levels. We didn't like this market 12 months ago because valuations were too high. If oil prices continue to stay at these levels or fall further, this will definitely help India to ease up on its monetary tightening.

Longer term, I still have a residual issue with India; that is, whenever the economy grows above 8%, bottleneck and capacity problems start to rear their ugly heads. In China, these issues will only become apparent when its economy grows at 11% plus.

**SL:** Yes, we will be sure and sell our shares if India comes in with that growth rate. Unlike China, India has a democracy and many factions to deal with while the Chinese government can just order something to be done.

**Do:** Yes, it is certainly much more difficult for a 51-party coalition to develop and implement a national railway strategy than the one-party in China. Nonetheless, given that a number of world-class growth stocks [in India] are offering better valuations now, we certainly are looking at them more favorably at current levels.

**SL:** That is encouraging to hear.

**[Editors' Note:** The Indian economy grew 9.2% in 2007. Economists predict that growth will continue to slow as India's central bank focuses on fighting inflation, which has recently reached an annualized rate of more than 12%. On the positive side, the oil prices are declining, and India's GDP has expanded an average of +8.5% a year for the past five years.]

**SL:** What are your conclusions about the region, despite all of the negatives we have covered?

**Do:** We remain a long-term bull on Asia, as it has a healthy balance sheet and banking system to grow its GDP and earnings, a favorable demographic profile, a high savings ratio, a gradually more technically-abled and well-educated workforce. The region has relatively undervalued equity and currency markets. Over the next 12-18 months, all of the Asian countries

are expected to continue to grow at a relatively solid pace.

China grew by 10.2% in the first half of 2008 and could grow more than 9% in the second half. Asian stocks are low on a price/earnings basis. To illustrate, the pan-Asian regional index is selling at around 11.5 times 12-month forward earnings, which is still cheaper than that of the U.S. The U.S. is selling at 24 times its earnings, with continued downward adjustments.

That represents a pricing opportunity which will be corrected in the coming 12 month period, as Asian fundamentals are stronger than those in the U.S.

The two most expensive markets in terms of P/E are Hong Kong and India, which are selling at 14.2x and 14.1x forward earnings, respectively.

Nevertheless, given the macro uncertainties and the extreme volatility caused by the thinness of daily trading in equity markets, investors need to be patient and adopt a one- and three-year view when they purchase any equities today.

Understandably, this has deterred investors from adding to their investments. This also helps to explain the disastrously low daily turnover in all equity markets around the world.

This vicious circle can only be broken when investors feel that the G7 banking systems are working again and that their economies can rise from zero growth, back to their long-term equilibrium rate.

**SL:** What are your first and second choices for the countries which will come back the fastest?

**Do:** Without hesitation, I would say China first and India second.

**SL:** We conclude with that thought and thank you for all of your valuable insights into the Asian markets. ■

The assets of The Asia Pacific Fund on July 31, 2008 were \$197.7 million. The expense ratio to average net assets for 2008 was 1.54% versus 1.78% in 2007. Total dividends and distributions paid in 2007 were \$8.15.

There will be a distribution declared in December 2008 but not one as high as in the exceptional year 2007. For more information on APB, call 888-427-4272 or visit [www.asiapacificfund.com](http://www.asiapacificfund.com).



## CEFA Universe Report: Market Price, Net Asset Values, and Discounts/Premiums

In the July/August issue of *The Scott Letter*, we discussed [Standard Deviation](#) and [Beta](#) data points in CEFA's *Closed-End Fund Universe*. This month, the definitions of and the relationships between **Market Price**, **Net Asset Value (NAV)** and the **Discounts/Premiums** of closed-end funds are discussed to explain the best ways to analyze, buy or sell a closed-end fund.

One of the key differences between closed-end and open-end funds is that a closed-end fund (CEF) has both a net asset value (NAV) and a market price. This often causes confusion.

Investors in a closed-end fund pay market prices for shares while investors in open-end funds pay NAV which is calculated at the close of each market day.

While an investor's entry and exit point in a CEF is determined by market prices, understanding net asset value (or investment performance) is very important as it should play a major role in the evaluation process. It can help determine whether an investor should purchase, sell or maintain one's position in the fund.

Unlike an open-end fund, when buying or selling a CEF, you can use limit, stop-loss or good-until-canceled orders. Thus, CEF investors have increased control over their portfolio compared to a mutual fund investor. For example, CEFA uses limit orders 90% of the time, as we believe patient investors are well-rewarded.

### Net Asset Value

This is determined by the sum of the market values of all of the fund's security positions (stocks, bonds, etc.) plus its cash and minus all its liabilities. The result, its "net assets", which are then divided by the number of fund shares outstanding to arrive at NAV.

$$\text{NAV} = \frac{\{\text{Market Value of All Securities Held by Fund} + \text{Cash and Equivalent Holdings} - \text{Fund Liabilities}\}}{\div \text{Total Fund Shares Outstanding}}$$

### Market Price

The market price of a closed-end fund's shares is determined by supply and demand and is not directly tied to NAV. However, the price often trades in relation to NAV.

Prices of CEFs nearly always differ from NAV, sometimes dramatically. Most CEFs trade on the New York Stock Exchange (76.8% or 504 funds), while 22.3% (or 146 funds) trade on the American Stock Exchange and 0.9% (or six funds) trade on the NASDAQ. The reason most CEFs trade on the New York Stock Exchange or the American Stock Exchange is because they benefit from having a specialist to aid in the fund's trade execution.

### Discount/Premium

Closed-end funds virtually always trade at either a discount or premium to net asset value. On rare occasions, they trade at NAV.

Not unlike the price-earnings ratio (P/E) of a stock, the discount or premium on a CEF is a barometer of its popularity and is said to reflect market sentiment. The discount or premium can be computed by taking the difference between the market price of a CEF and its NAV, expressed as a percentage.

$$\text{Premium/Discount} = \frac{\{\text{Market Price} - \text{NAV}\}}{\div \text{NAV}}$$

Most funds currently trade at a discount to NAV (88.6% or 581 funds).

### Summary

As of September 5, 2008, the average equity closed-end fund had a -6.39% discount to NAV and the average CEF bond fund had a -7.23% discount to NAV. Bond funds, which historically trade closer to NAV than equity funds, have widened their discounts in the last 14 months.

Currently there are 45 CEFs trading at a discount wider than 15%. Twenty-seven of these are classified as bond funds, which represents 6.47% of the total number of bond CEFs.

There are 18 equity funds representing 7.53% of the total number of equity CEFs while there are only 14 CEFs that currently trade at a 15% or greater premium to NAV. Six are bond CEFs (or 1.44% of bond funds), and eight are equity CEFs (or 3.35% of equity funds).

When comparing CEFs, one of the benefits we find in our weekly *Universe* service is how similar funds are categorized into 77 subgroups. This allows for easy and quick comparison of a fund's discount/premium compared to its 52-week average, its peer group average and its individual peers. Knowing how a similar fund is trading can help savvy investors reduce their risk and increase their returns.

Generally, a fund trading more than one standard deviation from its 52-week discount/premium level will have arbitrage-like market forces pulling the market price to its mean, which may not always be its NAV. When a CEF is at a discount, investors need to carefully scrutinize the fund to be sure that there are no serious reasons for the disruption in the pricing of the fund relative to its NAV.

Investors should always be cautious when choosing a fund because it is trading at a discount. A wide discount may suggest intrinsic factors such as poor performance, sector weakness or recent dividend cuts.

Conversely, one should only purchase funds selling at a significant premium to NAV under special circumstances. These circumstances could reflect the high yield of a fund, strong management track record, a need for a defensive position in one's portfolio or buying the fund at a premium.

Before buying a fund at a premium, we recommend looking at comparable peer CEFs. Why not wait for the right opportu-

nity to invest in a CEF as compared to buying it at a current premium?

At Closed-End Fund Advisors, we rarely purchase shares of a CEF at a premium to NAV greater than 1%. We are patient and choose our timing carefully.

If a fund we hold rises to a premium, we are careful to look for alternative investments, such as a peer fund or a mutual fund managed by the same portfolio manager. On the sell side, we rarely allow a position to grow past a 5% premium. A careful analyst always looks at the historical trend of a fund and its peers before making a move.

CEFA's *Closed-End Fund Universe* contains 26 data points. One should consider all the data points and establish the investment suitability of a fund to meet your investment objectives and risk tolerances before making any changes to your portfolio. In the next issue of *The Scott*

*Letter*, we plan to discuss the analysis of Expense Ratios, Net Assets and Average Daily Trading Dollar Amounts.

Beginning on September 15, 2008, CEFA's *Universe* will include a new data point. We will be removing Average Daily Trading Volume and including Unrealized Capital Gains which will be expressed as a percentage of NAV. This data point will allow better analysis of all equity-oriented funds, similar to how [Undistributed Net Investment Income \(UNII\)](#) helps analyze income-oriented funds.

For more information about the use of our *Closed-End Fund Universe* in the analysis of CEFs, please contact [John Cole Scott](#) at 800-356-3508, ext. 3536 or visit [www.CEFAdvisors.com/universe.html](http://www.CEFAdvisors.com/universe.html) in order to subscribe to this weekly service. Investors are advised to seek professional investment counsel before investing. ■

## Portfolio Manager's Review

This is a crucial time for investors as it has been a different kind of market in 2008. Equity markets declined in July and then staged a recovery as shares rose on weakness in oil and other commodity prices. This has two benefits: the Asian markets, such as China and India, have to import oil and other commodities. This will result in lower inflation, while countries which export large amounts of commodities will have to adjust to lower prices. Lower inflation, however, will soon result in better stock markets for all countries. Tax selling will continue, but this creates investment opportunities.

The lesson we have to learn is not to panic when your equity values decline as panic is an emotional reaction. Once the stock markets rebound, you will be rewarded for your patience. Mark Mobius of Franklin/Templeton Investments, wrote in his book, *Mobius on Emerging Markets*: "If you factor emotion out of the equation and base your strategy on long-term fundamentals, you can win when markets fall and when markets rise."

The October *Scott Letter* will focus on economic issues like economic globalization which affects all investors and how we are adjusting our portfolios for the inevitable recovery. It will be followed by an interview with the Latin America Equity Fund in November. We will catch up with Mark Mobius by year-end.

We also urge our readers to consider subscribing to the *Closed-End Fund Universe* at this crucial time in the investment cycle. We have seen many bear markets, and the best choices are always made when markets are as washed-out as they are now. Investment choices made now are crucial to your future investment performance.

Readers interested portfolio management, should contact us soon to discuss how we might be able to work with you. Please call (800-356-3508) or e-mail us at [scottletter@cefadvisors.com](mailto:scottletter@cefadvisors.com) anytime as your feedback is always helpful in our efforts to better serve you. ■

*George Cole Scott*

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