

The Scott Letter: *Closed-End Fund Report*©



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Asia Pacific Fund

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The Scott Letter Online is intended to educate closed-end fund investors. [What are closed-end funds?](#) Closed-end funds are a valuable and profitable tool for many of our clients and colleagues. Please feel free to forward this newsletter to anyone who you believe could benefit from information on closed-end funds or go to our website (www.CEFAdvisors.com) Please call (800) 356-3508 or email: cefa@CEFAdvisors.com to learn about or get started with one of our managed portfolios. For more information on closed-end funds, please visit the [Investor Resources](#) section on our website or the Closed-End Fund Association's website (closed-endfunds.com). As always, we encourage feedback from our readers so we can continue to serve you better. Please make a note of our new website: www.CEFAdvisors.com. We are currently revamping our website to better serve our clients.

Back issues of *The Scott Letter Online* are available on our website. They include interviews with [Adams Express \(2\)](#), [General American Investors](#), [Ellsworth & Bancroft Convertible Funds \(2\)](#), [The Royce Funds](#), [The Templeton Funds\(3\)](#), [Renaissance Capital](#), [Tri-Continental Corp](#), [Allied Capital](#), [Pan Pacific Realty](#), [Central European Equity Fund](#), [The Asia Pacific Fund](#), [H & Q Healthcare Investors](#) and [Latin America Equity & Brazilian Equity Fund](#).

The investment objective of The Asia Pacific Fund (APB-NYSE), a US registered 1940 Act closed-end investment company, is to achieve long-term capital appreciation through investment in equity securities in the Asia Pacific countries (excluding Japan and Australia).

APB is managed by Baring Asset Management Ltd. of London from its Hong Kong office by James Squire. Mr. Squire has worked eight years at Barings with a team of nine analysts. He uses the “growth at-a-reasonable price” strategy in choosing stocks.

BAM has about US\$2.3bn of assets under management in Asia ex-Japan that are run out of the Hong Kong office. APB is one of two closed-end funds the office manages, the other being The Great China Fund, Inc. Mr. Squire also manages three mutual funds, two based in Dublin; one is the Baring Eastern Trust, which is similar to APB and the other is the Baring Korea Trust. He also manages a Japanese-based fund – the Asia

Manufacturing Fund.

Baring is selective and quality stock focused. They believe it is easier to find a company that has the potential to be re-rated from five to seven times than it is to find a company that is to be re-rated twenty to twenty-eight times. The risk is higher the more highly rated a company is. For a “growth-at a reasonable price” investor, this is common sense.

The manager is looking to reduce the underweight position in China through placements and new issues. Elsewhere, low expectation stocks and markets are favored.

APB is allowed to use leverage to the amount of 125%. Little of this has been used, but early in 2004, the manager used it briefly in order to buy some IPOs (new issues of stock). Also, leverage was temporarily used at the time of July 2002 tender offer (25% repurchased) as a form of bridging loan.

Other Asian funds can invest in Japan, but APB has a strict mandate to invest in Asia, ex-Japan and Australia.

APB divides the region into three sections: North Asia: South Korea, Hong Kong, China and Taiwan; South East Asia: the ASEAN countries of Indonesia, Philippines, Malaysia, Singapore and Thailand; and South Asia: India.

The country breakdown on April 30, 2004 was Hong Kong/China, 28.5%; South Korea, 26.8%; Taiwan, 19.0%; Singapore, 9.0%; Malaysia, 7.2%; Indonesia, 3.5%; Thailand 2.6%, and India, 1.5%.

The Fund has performed well against both the competition and the benchmark, the MSCI All Countries Combined Far East ex-Japan Index:

Compound Annual Returns			
	<i>NAV</i>	<i>Benchmark</i>	<i>Market Price</i>
1 Year	66.14%	70.48%	73.97%
3 Years	14.57%	13.19%	21.45%
5 Years	12.18%	6.28%	15.51%

Dividends from net investment income, if any, are declared and paid at least annually, The Fund will distribute any net capital gains in excess of net capital loss carry forwards. Income and capital gains distributions are determined in accordance with income tax regulations, which may differ from accounting principles generally accepted in the United States of America. Dividends paid from net investment income in 2004 were \$0.18 per share.

The total expense ratio to average net assets to March 31, 2004 was 2.06% versus 2.25% in 2003. The portfolio turnover for the same period was 73% versus 34% in 2003.

We interviewed James Squire on June 30:



James Squire

S.L: In your annual report you wrote, “Asia’s economic and financial position remains healthy; on demographic and competitive measures, it is well positioned...” Is this still true?

Squire: Yes. My long-term secular theme is East versus West. Since 2001, I have thought that the Asian markets would out-perform the developed markets over the next five and ten years. This view was based on a reversion to mean approach since these markets under-performed so severely in the previous 5 years.

Although Asia has been under-performing over the last few months, what is interesting to note is that two of the most developed markets in the world (Australia and the Russell 2000 Index – the latter shows a double top with 1999) have only recently peaked (in 2004). Overall, developed markets have significantly underperformed Asia over the last 3 years, but I think the Asian up cycle is still early phase. This is the long-term investment story for the region.

SL: What kind of companies do you tend to favor?

Squire: I favor those companies where the management has a track record of proven integrity and where there is transparency.

SL: How have returns on equity, balance sheet strength and corporate management in your region fared lately?

Squire: In general, returns on equity are rising, balance sheet strength and corporate ethics are improving, but the latter more often than not progresses two steps forward and then one step back. By U.S. standards, however, ethics remains weak, whereas returns on equity are not greatly dissimilar.

S.L: Since you have invested the largest portion of your portfolio in Hong Kong and China-related companies (28.6%), how much does China fit into your portfolio strategy?

Squire: China is a key short-term issue, a driver for growth in Asia and a catalyst (good and bad) for investor sentiment. The Chinese authorities have recently introduced a number of austerity measures, attempting to cool those parts of the economy they see as growing excessively and unhealthily fast. Some examples are property, steel and cement related industries. They asked the banks to stop lending to those industries earlier this year. These measures are being felt today.

Our view is that the China economy will have a soft landing, slowing from nine percent GDP growth to around seven percent. However, stocks will have a hard rather than a soft landing.

SL: According to a report in the Financial Times, Asian economic growth reached its highest level in a decade in the first quarter of 2004 because of China's rapid expansion. The newspaper suggests that this rapid growth has peaked and will decline in the second half of the year, according to regional economists. Do you agree with that assessment?

Squire: Yes, from economic view, the growth (of China) peaked at the beginning of this year. The significance of China is substantial for Asia (Ex-Japan) since it is a trillion-dollar plus economy, compared to the next largest Korea at \$450 billion. China, therefore, dominates Asian growth trends.

Economic growth and earnings growth don't always move hand in hand. Warren Buffet wrote about this very point with reference to the U.S economy in 1999.

SL: With those thoughts, just how positive are you on the outlook for China?

Squire: I am positive on the economic outlook, but I am more sanguine on the stock market outlook. The difference in view is partially because equity is the rump of financing a business and, therefore, is the most susceptible part to being squeezed by the cycles.

SL: China has oil and water shortages, electric power and flooding problems, heavy debt and more...

Squire: Yes, it does. Look at this issue from an equity point of view, from an upswing you benefit, on a down swing you are penalized. Remember, the Chinese economy is neither a free market economy nor is it a command economy, driven by the government only. We have a Frankenstein economy in China, half command and half market.

For example, what happens when there is a shortage of power? In a free market, the power and coal companies will be allowed to charge what they want until demand for their goods declines. In a command economy, they are told what price they can charge. As China's economy is 'in-between', you get a mixed situation. This makes it more difficult than usual to value equity in such an economy. That is a major reason why I have a slightly different view on Chinese equities than a lot of people.

SL: What is the foreign investor sentiment for China like?

Squire: A lot of people were extremely positive on China in the fourth quarter of 2003. I was in a China stock 'trading mode' then, since I was negative on the sustainability of the index level. Now, I am starting to warm-up on China as the index has fallen 25%, but it may still be too early to re-enter in a big way. I see trading rallies. I will change my view when I feel more confident on the macro side. I don't think we have seen the full effects of the slowdown yet as we are only 4 to 6 months into it. Slowdowns usually last from 9 to 15 months.

SL: Your annual report also cites factors such as rising commodity prices, a weak US dollar, capacity shortages and a stock market heavily skewed to the cyclical and energy sectors making China an attractive investment cocktail. Is this still true?

Squire: That was last year's story. At the beginning of calendar year 2004, we were very underweight

China. By the way, I don't break-out Hong Kong and Mainland China exposure because when I want to be underweight China, people want me to be overweight and vice versa. I mostly buy the "H" shares (Hong Kong companies) rather than the "B" shares. We are prohibited from buying "A" shares. In May, I started to add back to China after the market fell, buying big defensive companies such as China Telecom, as well as energy-related issues.

SL: I notice that you held Harbin Brewery, one of the major breweries in China, which was taken over recently. Do you participate in that kind of thing very often?

Squire: We were in Harbin because we liked the business rather than for any takeover angle and made 60%+ on that investment. However, we sold a little too early. I like those (M+A) situations and every other year we tend to find one.

SL: If there were a further rise in oil prices, could this trigger a new Asia crisis?

Squire: An Asian crisis, no. We have analysis that shows high oil prices are a concern, but they are not critical to inflation or fiscal balances. Unlike in 1997, all of the Asian economies are experiencing huge trade surpluses, not deficits.

SL: Yes, the surpluses are on U.S. trade. What about the impact of higher interest rates from the U.S. on Asia?

Squire: Before the Asian crisis, the correlation of Asian interest rates with the U.S. was higher than today. This is because post the Asian crisis leverage has fallen. The trade accounts have moved from deficits to surpluses. Asia is now exporting capital; before it was sucking it in. For example, bank deposits as a percentage of GDP in the region are around 140 percent. The loan deposit ratios on average are about 70 percent at banks. In other words, there is significant excess capital in the region. As a result, Asian rates are unlikely to follow in a lock-step manner with U.S interest rates.

S.L: Looking at it in another way, your annual report said you were investing in high beta investments which performed the strongest as investors wanted to "buy risk" due to easy monetary and fiscal policies. Could that change?

Squire: Yes, definitely. The year 2003 was the year for "beta"—highly leveraged stocks, low quality companies, generally performed well. I am less comfortable investing in that environment; I tend to be better in "alpha" environments, where stock picking is more critical and often more value related. I think 2004 is such a year.

SL: You also wrote of different strategies towards North Asia and the other countries in your region. Do you expect many changes in this strategy?

Squire: Not huge ones. In general, I like companies that are more stable and consistent.

Recently, I have increased investments in Thailand and reduced Korea. The stocks in Korea look cheap but not as cheap as people think they are on various measures. I am very stock-specific and skeptical of technology in Korea. We have taken profits, including in names like Samsung Electronics where we had made over 10 times over cost.

SL: We found that SE Asia is growing as much as seven percent faster than the Northeast Asia economies. Is this correct?

Squire: Yes. Singapore has recovered significantly. Remember here economic numbers are dependent upon the trade side as opposed to the domestic economy. In Thailand's case, the first quarter numbers disappointed.

Malaysia was about in line. Overall, growth was strong, but you need to look at the components driving the GDP numbers. These are small markets.

Indonesia had a great year in 2003. In fact, we made good money in both Indonesia and Thailand. We sold Thailand towards the end of last year but were buying back last month. I try to time the markets.

If we make a lot of money quickly when we make investments, we are prepared to book profits and see what happens. In Thailand's case, the market fell 30% from its peak.

SL: In India, the markets have fallen also. Did you get back in there?

Squire: No, we haven't because I am concerned about interest rates and the strong foreign flows into India. The risks have increased on the political side. Maybe the new government won't change the economic policies dramatically, but the government deficit is precarious so interest rates are likely to go up. This will be bad for the banks, and I think will scare off investors. We will continue to watch with interest since this is a market where we like the long term story.

SL: That shows you have to be careful. What about Taiwan? Has the island nation recovered from what you call a "laggard China play"?

Squire: No – not yet anyway. I prefer Taiwan to Korea because of its better domestic demand story--loan growth is picking up there. Sentiment and political events, such as the recent election, have also impacted it. The equity risk premium has risen for Taiwan, however, historically the stock market has never been as lowly rated as I see it today on a price to earnings basis. Maybe my assumptions on the earnings outlook are too aggressive and, therefore, the P/E isn't what I expect. We have found a few stocks there yielding 7+ percent. We see a currency that we think will be firm versus the U.S. dollar so we are quite happy to put some of our money there in this time of uncertainty. There are also a number of attractive greater China plays in Taiwan.

SL: Indonesia?

Squire: Indonesia has disappointed, but we loved Indonesia last year and made very good money. It is a high-risk market, and, therefore trades on a low multiple. We took some profits ahead of the election because we thought there would be some uncertainty. Also, inflation is rising leading to rising interest rate concerns. We are watching the currency and the market and will continue to monitor how the election proceeds over the coming months. We continue to be constructive about some of the stocks and are looking for opportunities to add to the market if we feel the macro call is the right one.

SL: What can you tell us about corporate governance matters at APB? We see that the Fund has had a program for buying-in its shares.

Squire: Yes, they do. They discuss the issue at every Board meeting. The discount has widened again, but

the Board does not have a hard and fast policy on it. There is a level where they will buy-in shares.

SL: Has the Fund considered a set distribution policy like many closed-end funds have?

Squire: The Fund made a distribution in January. They pay-out the capital gains, but we haven't had many gains until recently. We have only made two distributions since I began running the Fund in 1997.

SL: We find that many shareholders like to have a regular distribution. With a foreign fund, there is always the risk of paying a return of capital. I have seen that to be detrimental for some funds. Growth of capital seems to be more important for APB than distributions, but we are glad you are now able to cover expenses so as to pay out dividends from net investment income.

I sometimes have had consulting contracts with closed-end funds to advise them on this and other corporate governance matters.

Would you give us a summary on the region?

Squire: Basically, the Asian markets need to catch their breath after phenomenal returns last year. The on going consolidation is healthy.

In sharp contrast to the weakness in Japan for over a decade, continued strength in that country could be an important offset for the slowdown in China as well as for overall sentiment in the region.

(The Japanese government has just has just upgraded its assessment of the country's economy for the first time in six months-Ed)

Asia continues to remain relatively attractive on valuation parameters in spite of China's outlook. However, the region is unlikely to de-couple from the broader global events in the near term.

SL: Thank you, and we will stay in touch. We are also gratified that *The Scott Letter* will be featured on your website for the second year in a row.

Daily net asset values or other information on The Asia Pacific Fund, Inc. is available at 1-(888)4-ASIA-Pac or 1-888-427-4272 or their website www.asiapacificfund.com

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