Closed-end funds are more complicated than their open-end siblings, but they also offer special attractions, such as the ability to purchase them at double-digit discounts.

Tailoring an International Investment Portfolio Using Closed-End Country Funds

By Albert J. Fredman

Most closed-end foreign stock funds focus on a single nation or region. I use the term "country fund" in this column to include both categories. In contrast to broad-based global and international funds, these portfolios allow sophisticated investors to tailor their international exposure, emphasizing parts of the world they favor.

The closed-end structure is well-suited for investing in illiquid markets because large redemptions could prove disastrous. If the target market plunges and an open-end manager is forced to sell stocks to meet redemptions, the most liquid companies typically are sold first, causing the portfolio to become even more risky and volatile. With fewer holdings, the fund would be more sensitive to firm-specific problems.

Conversely, if the market surges, an open-end manager may be inundated with cash. A closed-end skipper, by contrast, has the luxury of working with a stable pool of capital, which may lead to better performance. Because they don't face redemptions, closed-end managers can be more long-term oriented and can invest more of their assets in less-liquid companies.

There are other reasons for considering closed-end country funds. You can benefit from greater growth potential in many emerging economies and pricing inefficiencies can be found in different markets as well as among the funds themselves. In addition, including weakly correlated markets in a portfolio provides a free lunch because volatility can be reduced without sacrificing long-run return.

Profiting From Inefficiencies

Although bargains are the exception rather than the rule on Wall Street, foreign stock exchanges often are less efficient. In an efficient market, new information is freely available and acted upon so rapidly that it's difficult to find a mispriced stock. However, information is often difficult to obtain in smaller, thinly traded markets. It takes special skills, lots of experience and dependable contacts to gather and analyze information on the more obscure emerging markets companies. There's plenty of opportunity for the most savvy global managers to outperform the rest.

Investor overreaction is another way astute global investors can profit. As sentiment shifts, small, thinly traded markets experience far wider price swings than the world's largest, most liquid bourses. In addition, country funds sometimes bounce around a great deal themselves, alternating between double-digit discounts and premiums.

Low Correlations Reduce Risk

Although the volatility of an individual single-country or regional fund itself is high, an internationally diversified portfolio may have a bit more stability than one with a total U.S. allocation because different stock markets do not always move in lockstep.

Table 1 shows the correlations between the S&P 500 and the International Finance Corporation global indexes for a wide variety of emerging markets. In theory, the correlation coefficient can range between +1.0 and –1.0. Stock returns in different countries generally are positively correlated, but the coefficients typically are far below the maximum of +1.0, which indicates a perfect positive association—in other words, the markets move in lockstep. The lower a positive reading, the weaker the relationship—one market may move up, for instance, while the other is flat—and the greater the diversification benefits. Slightly negative correlations sometimes are observed, as in the cases of India and Morocco, and can offer even more beneficial diversification. Developing markets typically exhibit the lowest correlations, but Japan also has had a weak link with the S&P 500. Of course, stock-market correlations are subject to change.

Keep in mind that correlations between different stock markets can increase dramatically within brief periods of a few days or a week, particularly

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during times of intense event-driven selling. The longer you hold your investments, the more effectively international diversification works. The strategy is doubly appealing at times when U.S. stocks are pricey.

Table 1. Correlations† of Country Index Price Returns to the S&P 500 (in U.S. dollars; December 1991–December 1996)

Latin America:	
Argentina	0.37
Brazil	0.06
Chile	0.15
Colombia	–0.11
Mexico	0.18
Peru*	0.08
Venezuela	0.02
East Asia:	
China*	0.06
Korea	–0.04
Philippines	0.12
Taiwan, China	0.09
South Asia:	
India	–0.20
Indonesia	0.42
Malaysia	0.21
Pakistan	0.02
Sri Lanka*	–0.07
Thailand	0.20
Europe/Mideast/Africa:	
Czech Republic*	0.00
Egypt*	–0.06
Greece	0.10
Hungary*	0.30
Jordan	0.06
Morocco*	–0.22
Nigeria	0.00
Poland*	0.24
Portugal	0.21
Russia*	–0.09
South Africa*	0.13
Turkey	–0.08
Zimbabwe	0.13

†A correlation of 1.0 means the markets move in lockstep; correlations close to 0 indicate weak relationships.

**Correlations based on less than 60 months of results.*

Source: International Finance Corporation

Single-Country Funds

Table 2 identifies the universe of more than 50 single-country closed-end funds. Thirty nations have at least one U.S.-based closed-end fund specializing in their markets. Virtually all trade on the New York Stock Exchange. (WEBS, an alternative single-country vehicle, are discussed in the accompanying box at the end of this article.)

Not every foreign market is targeted by these funds but more may be created, even though closed-end IPOs (initial public offerings) fell substantially in 1994 and have practically dried up since then. A major bear market in emerging markets began in 1994 and traumas such as the Mexican peso crisis—which began late that year—turned off investors even more.

Are any additional country funds likely to go public during the next several years? At least a dozen possibilities exist, according to William Dinning, a country fund analyst at Merrill Lynch. These include Colombia, Peru, Venezuela, Sri Lanka, Egypt, Greece, Hungary, Jordan, Morocco, Nigeria, Poland, and Zimbabwe.

A few funds specialize in smaller companies. Emerging Germany and New Germany invest in small- and medium-sized German companies. Japan OTC Equity targets that country's volatile, over-the-counter market. As a consequence, it fluctuates more in tandem with Japan's Jasdaq index of more than 800 OTC firms than with the Nikkei 225, which includes the more familiar large caps.

A unique portfolio, Templeton Vietnam Opportunities went public in 1994, even though a stock market did not exist in that nation. Their goal was to have at least 65% of assets invested in Vietnam by October 1997. In the meantime, manager Mark Mobius has invested in companies in other countries expected to benefit from economic development in Vietnam. Because it appears that a Vietnamese stock market will not be established for some time, this fund may change its objective or liquidate.

While speculators use country funds as short-term trading vehicles, they also are appropriate as long-term holdings because they offer an individual a high degree of control in building a custom-made global portfolio. For example, an investor's Latin American holdings could be structured to overweight Argentina, Brazil and Chile, while Mexico is underweighted.

Focusing on a Region

Table 3 lists the regional equity funds. As evident, closed-end funds exist that target Europe, Eastern Europe, Asia, Latin America, Africa, the Middle East, and even the Caribbean and the Iberian Peninsula.

A regional fund may represent countries in its portfolio for which no single-country closed-end funds exist in the U.S. Latin American examples include Colombia, Peru and Venezuela. Check the countries in their portfolios and the respective weightings because funds that focus on the same region can differ markedly. For instance, some Asian funds, such as Morgan Stanley Asia-Pacific, include Japan in their mix whereas others, such as Asia Tigers, do not. The former recently had about 40% of its assets allocated to Japan.

Morgan Stanley Russia & New Europe, the most recent country fund offering, began trading in September 1996. The fund recently had about 60% invested in Russia, 13% in Poland, 13% in Hungary, and 6% in the Czech Republic. In an unusual move, Morgan Stanley absorbed all offering costs to make the new issue more appealing by helping to protect IPO buyers from incurring losses, as closed-end funds often slip to a discount several months after the IPO date.

Because they target primarily developed markets, Central European Equity, Europe Fund, and Scudder New Europe may experience less volatility than their regional relatives focusing on Asia and Latin America. However, European Warrant Fund can provide fast action similar to an emerging markets regional fund.

Table 2.
Single-Country Closed-Funds

Fund (Exchange: Ticker)	Inception Date	Net Assets (mil $)*	Fund (Exchange: Ticker)	Inception Date	Net Assets (mil $)*
Argentina (N: AF)	10/91	150.6	Jardine Fleming China (N: JFC)	7/92	167.0
Austria (N: OST)	9/89	143.6	Jardine Fleming India (N: JFI)	3/94	116.7
Brazil (N: BZF)	3/88	580.5	Korea Equity (N: KEF)	11/93	52.2
Brazilian Equity (N: BZL)	4/92	134.0	Korea Fund (N: KF)	8/84	512.2
Chile (N: CH)	9/89	418.3	Korean Investment (N: KIF)	2/92	68.3
China (N: CHN)	7/92	234.5	Malaysia (N: MF)	5/87	158.7
Czech Republic (N: CRF)	9/94	88.9	Mexico Equity & Income (N: MXE)	8/90	177.5
Emerging Germany (N: FRG)	3/90	171.5	Mexico Fund (N: MXF)	6/81	1,172.6
Emerging Mexico (N: MEF)	10/90	145.9	Morgan Stanley India (N: IIF)	2/94	404.8
Fidelity Advisor Korea (N: FAK)	10/94	54.7	New Germany (N: GF)	1/90	661.9
First Australia (A: IAF)	12/85	188.1	Pakistan Investment (N: PKF)	12/93	66.3
First Israel (N: ISL)	10/92	84.3	Portugal (N: PGF)	11/89	112.7
First Philippine (N: FPF)	11/89	186.5	ROC Taiwan (N: ROC)	5/89	493.0
France Growth (N: FRF)	5/90	219.1	Singapore (N: SGF)	7/90	112.3
Germany Fund (N: GER)	7/86	262.3	Spain (N: SNF)	6/88	179.5
Greater China (N: GCH)	7/92	328.1	Swiss Helvetia (N: SWZ)	8/87	385.6
Growth Fund of Spain (N: GSP)	2/90	311.5	Taiwan Equity (N: TYW)	7/94	81.8
India Fund (N: IFN)	2/94	328.8	Taiwan Fund (N: TWN)	12/86	527.0
India Growth (N: IGF)	8/88	123.1	Templeton China World (N: TCH)	9/93	346.0
Indonesia (N: IF)	3/90	56.8	Templeton Dragon (N: TDF)	9/94	1,074.3
Irish Investment (N: IRL)	3/90	92.7	Templeton Russia (N: TRF)	6/95	185.8
Italy (N: ITA)	2/86	108.4	Templeton Vietnam (N: TVF)	9/94	114.9
Jakarta Growth (N: JGF)	4/90	55.8	Thai Capital (N: TC)	5/90	41.6
Japan Equity (N: JEQ)	7/92	101.4	Thai Fund (N: TTF)	2/88	143.2
Japan OTC Equity (N: JOF)	3/90	83.9	Turkish Investment (N: TKF)	12/89	48.6
			United Kingdom (N: UKM)	8/87	62.5

**As of 6/30/97*

Exchange Key: N=NewYork Stock Exchange
A=American Stock Exchange

Source: Lipper Analytical Services, Inc.

That's because it normally has at least 65% of its assets in several different warrants on stocks traded in markets such as Germany and Switzerland.

Regional funds offer a compromise between narrowly focused single-country portfolios and much broader multi-region funds. By investing in the right European, Asian, and Latin American funds, you can pretty much cover all major non-U.S. stock markets—with each region weighted as you see fit.

Small positions in Africa and the Middle East can spice up a portfolio, if the price is right. A pan-African fund, Morgan Stanley Africa spreads its assets among a variety of countries on that continent including Zimbabwe and Egypt as well as holding a large stake in South Africa. Foreign & Colonial Emerging Middle East invests in countries throughout that region, including Morocco, Israel, Turkey, and Egypt.

Scudder Spain & Portugal fund has a narrower focus than most regionals. About 62% of its assets were recently invested in Spain and the remainder was in Portugal. The tiny, $10.6-million Nasdaq-traded Herzfeld Caribbean Basin Fund expects to invest in Cuba when that becomes possible. In the meantime, it has positions in the U.S. and Latin America. This fund is illiquid and has a 3.3% expense ratio.

Caveat Emptor

You are exposed to plenty of volatility with a single-nation fund. Even regional portfolios can exhibit significantly higher volatility than their broader international counterparts. Country funds can soar or plunge on the basis of three factors:

- ***The performance of the economy and stock market:*** Economic dangers include unstable governments, economies based on only a few commodities or industries, and runaway inflation. Many small bourses are illiquid and volatile.
- ***Currency fluctuations:*** Changes in the dollar value of a foreign currency may result in substantial gains or losses. The turbulence in Southeast Asia's currencies triggered by the Thai baht devaluation in July led to falling Asian

Table 3.
Regional Closed-End Funds

Fund (Exchange: Ticker)	Inception Date	Net Assets (mil $)*
Asia Pacific (N: APB)	4/87	278.2
Asia Tigers (N: GRR)	11/93	289.0
Central European Equity (N: CEE)	2/90	342.6
Europe (N: EF)	4/90	203.5
European Warrant (N: EWF)	7/90	184.3
Fidelity Advisor Emerging Asia (N: FAE)	3/94	131.7
Foreign & Colonial Middle East (N: EME)	10/94	55.9
G.T. Global Eastern Europe (N: GTF)	3/90	141.3
Herzfeld Caribbean Basin (M: CUBA)	9/93	10.6
Latin America Equity (N: LAQ)	10/91	179.2
Latin America Growth (N: LLF)	10/94	56.4
Latin America Investment (N: LAM)	7/90	181.6
Latin American Discovery (N: LDF)	6/92	248.7
Morgan Stanley Africa (N: AFF)	2/94	327.4
Morgan Stanley Asia-Pacific (N: APF)	7/94	938.9
Morgan Stanley Russia & New Europe (N: RNE)	9/96	155.2
New South Africa (N: NSA)	3/94	87.0
Schroder Asian Growth (N: SHF)	12/93	281.0
Scudder New Asia (N: SAF)	6/87	151.2
Scudder New Europe (N: NEF)	2/90	317.0
Scudder Spain & Portugal (N: IBF)	4/88	108.6
Southern Africa (N: SOA)	2/94	129.3

**As of 6/30/97*

Exchange Key: N=NewYork Stock Exchange
M=Nasdaq National Market

Source: Lipper Analytical Services, Inc.

fund prices.

- ***Discount-premium fluctuations:*** Country funds may alternate between sizable discounts and premiums, reflecting extreme shifts in sentiment.

Table 4 shows premium-discount ranges of selected funds during both a recent 12-month period and a longer time span since the pre–Gulf War panic in international funds. As expected, greater volatility is seen over lengthier periods. Note that premium-discount fluctuations also are evident in the regional portfolios, particularly over the longer period.

It may seem paradoxical, but when a market in which a country fund invests quickly plunges, the fund's shares may go to a premium, or its discount may narrow. This has been evident in Korea, Japan, Mexico, and Thailand. For instance, Thai Capital and Thai Fund traded at premiums of 66.7% and 63.4%, respectively, on September 5. A possible explanation is that investors are using the fund as an easy vehicle to bet on that market's recovery. Another possibility is that the fund's net asset value falls more quickly than its share price. The reasoning is that closed-end funds tend to be owned primarily by individuals who respond more slowly than portfolio managers to changing conditions.

Short- and longer-term returns differ strikingly among country funds as illustrated in Table 5, which shows the top five and bottom five funds ranked by their five-year total returns. One- and three-year performances also are displayed. Only those funds that were in existence for the entire five-year period and did not experience a significant management change are included. My point is not to identify past winners and losers but rather to illustrate that individual funds can do very well or very poorly over extended periods, underscoring the need for careful selection and diversification.

Know Your Rights

With an open-end fund, sizzling performance leads to a large influx of cash, which increases the portfolio's asset base and the total management fees. The financial reward for the fund's sponsor can be dramatic. Not so with a closed-end fund.

How can a successful closed-end manager make new, promising investment without having to liquidate any existing positions? A rights offering and a secondary public offering are two alternative routes. The former, which is far more common, targets existing shareholders.

More than 50 country-fund rights offerings have occurred since Mexico Fund made the first in 1983, according to Lipper. Most have taken place during the last several years and several have been well in excess of $100 million.

How do these offerings work? Basically, subscription rights are issued to shareholders of record, giving them the option to buy up to a given number of new shares at a specified price, which is usually at a discount from the current price. Participating shareholders maintain their proportional ownership interest. Several rights are needed to acquire each new share. For instance, you may need three rights for each share you purchase. Shareholders have a few weeks to exercise their options. Offerings are either *transferable* or *non-transferable.* Transferable rights can be sold separately during the "ex-rights" period if you choose not to exercise them; non-transferable rights cannot.

Never let a rights offering catch you off guard. Read the offering prospectus carefully. If you decide not to add to your investment, do one of the following to avoid diluting your position:

- If the rights are transferable, sell them on the open market as soon as possible, because the stock typically declines during the offering period.

Table 4.
Premium-Discount Ranges for Selected Closed-End Country Funds

	52-Week Period 7/5/96 to 6/27/97		Extended Period 8/10/90 to 6/27/97	
Single-Country Funds:	High (%)	Low (%)	High (%)	Low (%)
Brazil Fund	–10.4	–20.4	35.1	–20.4
India Growth Fund	14.7	–1.0	54.9	–31.2
Indonesia Fund	17.1	–12.9	42.4	–21.0
Japan OTC Equity	9.1	–9.1	41.8	–26.2
Korea Fund	22.5	–0.4	51.8	–7.1
Singapore Fund	0.8	–12.8	32.1	–27.6
Taiwan Fund	10.0	–22.6	62.7	–22.6
Turkish Investment Fund	4.2	–11.1	100.3	–36.1
Regional Funds:				
Asia Pacific Fund	–10.6	–19.1	33.0	–27.9
Europe Fund	–8.4	–20.1	19.6	–22.8
Latin America Investment	–12.5	–19.8	22.6	–29.3

Source: Lipper Analytical Services, Inc.

By doing this you will lock in the value of your rights and avoid diluting your investment.

- If the rights are non-transferable, exercise them and simultaneously sell those shares at the higher market price. For example, an investor might exercise his rights to buy 1,000 shares at a $9.60 subscription price and then sell them at the fund's $10 market price, capturing a $400 profit before taxes and transaction costs.

Getting Started

Keep up with major international trends and developments if you're planning to include country funds in your asset mix. Both Barron's and the Wall Street Journal provide useful articles and data, particularly in their international investing sections. For further information, consult publications such as the Financial Times and the Economist. Internet users can obtain daily price index values for developed and emerging stock markets on Bloomberg's Web site (http://www.bloomberg.com). The coverage is quite comprehensive. For instance, seven separate indexes are available for Japan and eight for China.

Among the brokerages providing ongoing coverage of closed-end country funds are Merrill Lynch, PaineWebber, Prudential Securities and Smith Barney. Standard & Poor's Stock Reports profiles virtually all closed-end funds in customary S&P format. Morningstar Mutual Funds covers about 50 country funds, and the Value Line Investment Survey tracks close to 20. Libera's Closed End Country Fund Report (monthly, $190) is published by Washington, D.C.-based Washington International Advisors (202-783-7051). This thorough publication tracks the universe of closed-end country funds. Morningstar's Principia for Closed-End Funds is a comprehensive software package covering that universe on a computer diskette. It includes editorials, analyses of portfolios, and the ability to screen, rank, and graph.

Closed-end funds are included in the quarterly mutual fund surveys contained in both Barron's and the Wall Street Journal. Last, but not least, you can phone the fund for copies of its recent shareholder reports. Unlike mutual funds, closed-end funds do not generally provide a prospectus unless they are in the process of having a rights offering.

Country Fund Checklist

- ***Don't make big bets:*** International diversification works best when you allocate your assets prudently. That said, there's nothing wrong with overweighting particular regions or countries that you feel offer especially good value.
- ***Know the premium/discount history:*** Try to buy at a wider than normal discount.

Table 5.
Top and Bottom Five-Year Performance of Country Funds

	Annualized Total Returns (%)*		
Top Five Performers:	1-Year	3-Year	5-Year
European Warrant Fund	83.6	38.4	30.8
Brazil Fund	42.6	27.2	28.5
Brazilian Equity Fund	39.4	25.2	28.2
Latin American Discovery	59.5	17.2	22.0
Swiss Helvetia Fund	26.1	21.7	21.1
Bottom Five Performers:			
India Growth Fund	–7.6	–13.8	–2.1
Japan OTC Equity	–18.9	–15.2	–1.5
Thai Capital Fund	–54.7	–21.4	–0.7
Korean Investment Fund	–21.6	–11.9	–0.6
Thai Fund	–55.1	–21.5	0.0

**Net asset value total returns for periods ending 6/30/97.*

Source: Lipper Analytical Services, Inc.

Avoid premiums. It's certainly better to pay 80 cents for a dollar's worth of assets than it is to fork over $1.20. Consider open-end funds or WEBS when closed-end funds trade at premiums. Or, wait for the discounts.

• ***Comparison shop:*** Do you get greater value with the regional fund or by purchasing several single-country funds and building your own regional portfolio?

• ***Check performance:*** Performances among funds investing in the same country or region can differ strikingly. Buy good performance at a discount if you can.

• ***Buy and hold:*** Nail down good values and hang in for the long-term, unless the fund surges to an outsized premium.

• ***Check expenses:*** Expense ratios of 2% or more are not uncommon among country funds. Compare a fund's expense ratio with those of its peers. A deeper than normal discount and good performance may compensate for above normal expenses.

• ***Favor lower turnover:*** Single-country funds targeting illiquid markets fare better with low turnover ratios—say, less than 30% on average—because the unfavorable price impacts of trading are much higher in thin markets. Buying a stock quickly increases its price whereas selling drives prices down.

• ***Check the cash position:*** It's preferable to stick with funds that remain fully invested, avoiding those that retreat heavily into cash. In the latter case, the market may take off, leaving the fund sitting in the dust with a hoard of cash.

• ***Stick with funds that minimize currency hedging:*** Hedging increases transaction costs and could be done at the wrong time. In any event, unhedged portfolios allow you to derive the maximum benefit from international diversification because you are diversifying across currencies as well as stock markets. Over the long-run, currency fluctuations are often a wash for investors.

• ***Be liquidity conscious:*** Closed-end funds with higher average daily volumes are more liquid than less active closed-end funds. Liquidity also is a function of the size of your order. It makes a difference whether you plan to buy or sell several hundred shares or 10,000 shares. Because larger orders can move the price unfavorably, it may make sense to break an order into smaller ones and spread them out if the fund trades in low volume.

• ***Use limit orders:*** These are orders placed with a broker to buy or sell at a specific price or better. Because closed-end funds bob up and down in price, you may often do better by placing a limit order to, perhaps, buy at the bid or sell at the asked price. Patience is needed, especially on less liquid funds, but it's often worth waiting.

Conclusion

International diversification is particularly advisable now because long-term returns on large-cap domestic stocks are likely to be more modest over the next 15 years than they averaged in the bull markets of the 1980s and 1990s.

Single-country and regional closed-end funds are especially attractive when they are at double-digit discounts, as many were at this writing. But closed-end funds are more complicated than their open-end siblings and investors should understand the special considerations including discount-premium fluctuations, trading liquidity, and the placing of orders as well as rights offerings.

Country Funds Vs. WEBS

Introduced in March 1996, WEBS (World Equity Benchmark Shares) provide a single-country alternative to closed-end funds. They are traded on the American Stock Exchange and cover 17 markets in Europe, Asia and North America. About $471 million was invested in all WEBS as of August 29.

WEBS differ from closed-end country funds in two primary ways:

• ***They are index funds.*** WEBS remain fully invested. They seek to replicate the performance of the Morgan Stanley Capital International indexes for their respective countries with a representative sample of stocks, using portfolio optimization. Finally, WEBS also are highly tax efficient since they do little trading.

• ***They trade close to net asset value.*** Professional investors can make large in-kind investments and redemptions, which should prevent market prices from deviating by more than, say, 2% from net asset value.

CountryBaskets, a competing product that traded on the New York Stock Exchange, liquidated in February due to insufficient investor interest. WEBS have been successful and it appears that new country-specific WEBS will be forthcoming for Argentina, Brazil, Greece, Indonesia, Korea, the Philippines, Portugal, South Africa, Taiwan, Thailand, and Turkey. In addition, Asian, European, and Latin American regional emerging markets WEBS are expected.

Expense ratios on the individual WEBS average about 1.4%. This contrasts with a 2% average expense ratio on single-country closed-end funds, according to Lipper.

For a prospectus and further information, call 1-800-810-WEBS or view http://www.websontheweb.com on the Internet. My Mutual Funds column in the October 1996 *AAII Journal* ("A New Route Overseas: Country Indexing With WEBS and CountryBaskets") explains how WEBS are issued and redeemed and compares this product to traditional closed-end funds.

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