Lipper’s Year-End Mutual Fund Performance Review and 2005 Outlook

Presented by
Lipper’s Research Department

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Agenda

- Equity Mutual Fund Performance and Outlook
  - Don Cassidy, Senior Research Analyst
- Fixed Income Mutual Fund Performance and Outlook
  - Andrew Clark, Senior Research Analyst
- Topical Presentation: Opportunities In Closed-End World Equity Funds: Tax Loss Carryforwards
  - Martin Vostry, Research Analyst
- Today's Moderator: Tom Roseen, Senior Research Analyst

Lipper's 2004 Year-End Equity Funds Review and 2005 Outlook

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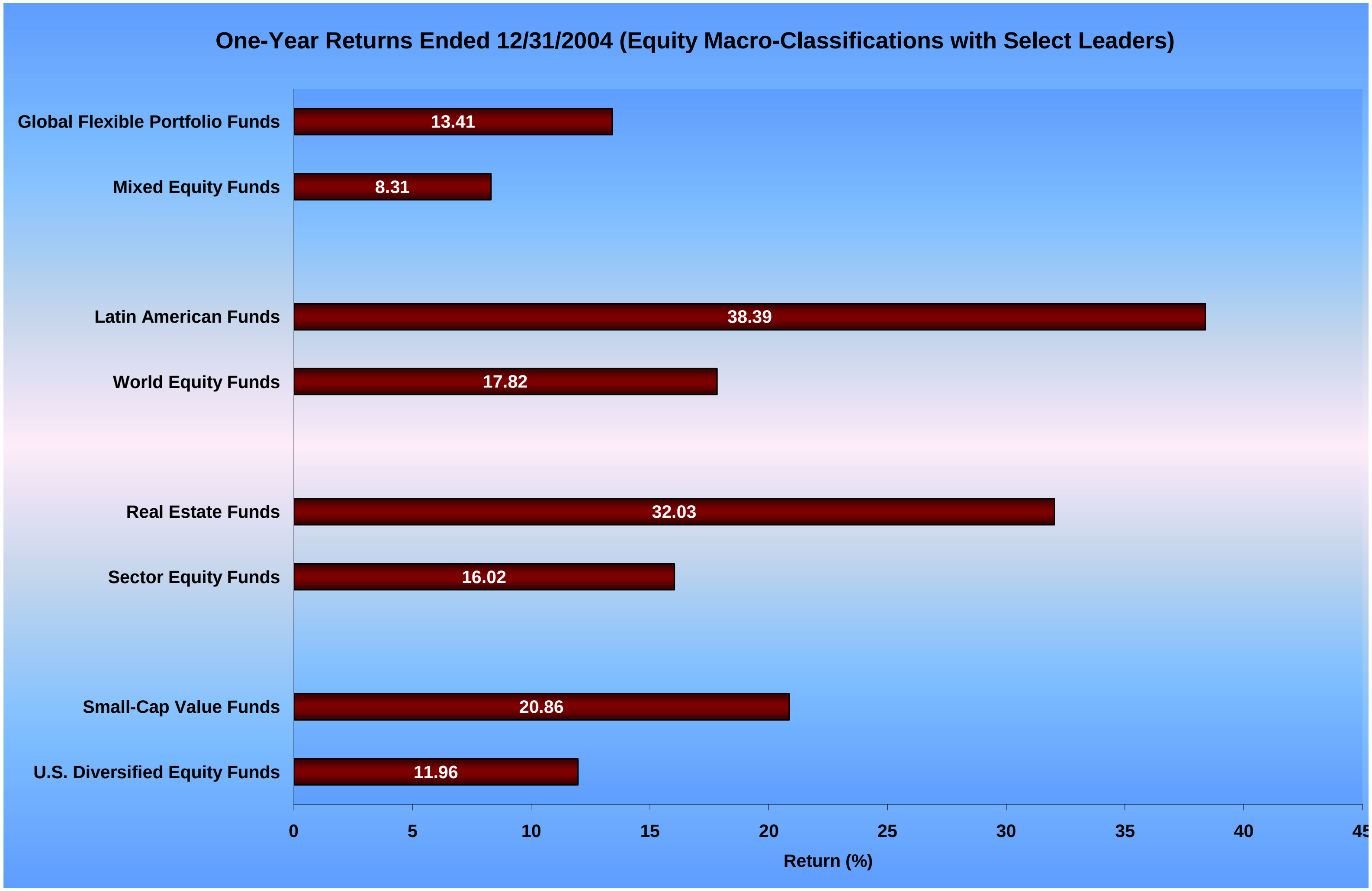
Equity Macro-Classifications with Select Leaders



Equity Funds Overview

- (No Awful Surprises)
- Domestic Up a little (2-10%) but Choppy
- World Better (US$ and Maturity) — 7-20%
- Pivot Factors: Oil, Inflation, Interest Rates
- Downside Dollar Wildcard?
- NO BUBBLE or Flows Mania!

Domestic Equity Funds Overview

- Value STILL Over Growth, Narrowly
- Dividends Give a Starting Advantage
- Large versus Small?
  - A long time!
  - Conflicting Forces:
    - New Leadership to Extend Rally
    - Small best if Economy on Upper End
    - Where Can the Money Go?

Domestic Equity Funds Styles

- No BIG Relative Winners
- No Runaway: Frustrating for the Impatient
- Valuation Measures Considerably Converged
- Stock Pickers' Market
  - A Merger Year; Small Overall Gains
  - Implies Freedom Can Define Winners
  - Core, Multi-Cap Least Regrettable

Lipper U.S. Diversified Equity Funds Matrix

Lipper U.S. Diversified Equity Matrix	Value	Core	Growth
Large-Cap	**LCVE**	**LCCE**	**LCGE**
Multi-Cap	**MLVE**	**MLCE**	**MLGE**
Mid-Cap	**MCVE**	**MCCE**	**MCGE**
Small-Cap	**SCVE**	**SCCE**	**SCGE**

Domestic Equity Funds Sectors

- Technology improves (when market up!)
- Natural Resources repeats (but smaller gain than '04)
- Utilities' power continues (mergers; better bal sheets; divs!)
- Real Estate. (really?: would be a 6-peat). Earnings *and DIVs!*
- Toughest Calls: Financials and Health/Biotech
  - Possible Split Verdicts Inside Both
  - Not a Time for the Passive
  - Danger: ANOTHER Bitter Pill Coming?

World Equity Funds Overview

- Honey, They Shrunk the Dollar (Again)!
- Except EU, Growth Bests USA Rate
- Still Value Somewhat over Growth
- Better Chance Small Retains Size Edge
- Emerging Markets
  - China to resume, Much of Asia up
  - Russia, Mexico, Brazil
- Japan as Contrarian/Catch-Up

No Bubble In 2005

- So Soon after the Big Bust?
- Fundamentals Not Compelling
- Psychology is Required Driver
- Memory of Pain is Long
- A "Wall-of-Worry" Year
- Uncertainty Trumps Greed

Pivot Factors (Oil, Inflation, and Interest Rates)

- Drive Fundamentals on the Margin
- Clearly Drive Psychology
- Greenspan Nov-23: Warning Will Defend $?

Lipper's 2004 Year-End Bond Funds Review and 2005 Outlook

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Topics

- Model Portfolio and last year's outlook
- Review of 2004
- Model Portfolio versus "popular" bond classifications
- Outlook for 2005

Model Portfolio and Last Year's Outlook

- 12 months ago we expected:
  - Corporate bond funds to outperform overseas debt funds
  - And International Income (INI) and Emerging Market Debt (EMD) funds would outperform Mortgage funds
  - And Mortgage funds would do the same or better than Treasury/Government funds.

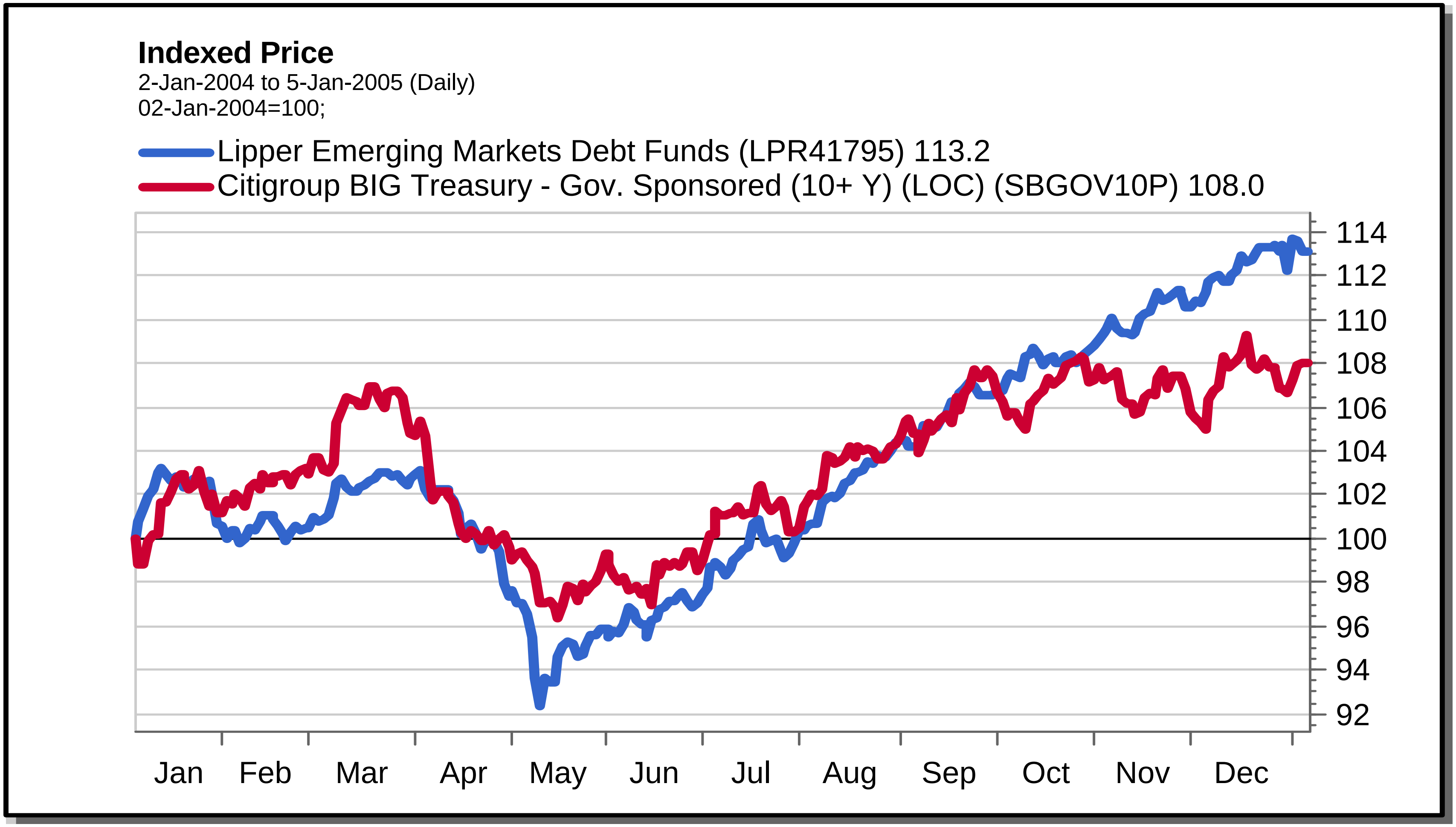
Model Portfolio and Last Year's Outlook

- So our Model Portfolio was:
  - 50% in Corporate bond funds
    - Split evenly between BBB and High Yield funds
  - 30% in overseas bond funds
    - Split evenly between INI and EMD funds
  - 10% in U.S. Mortgage funds
  - And 10% in General U.S. Treasury funds

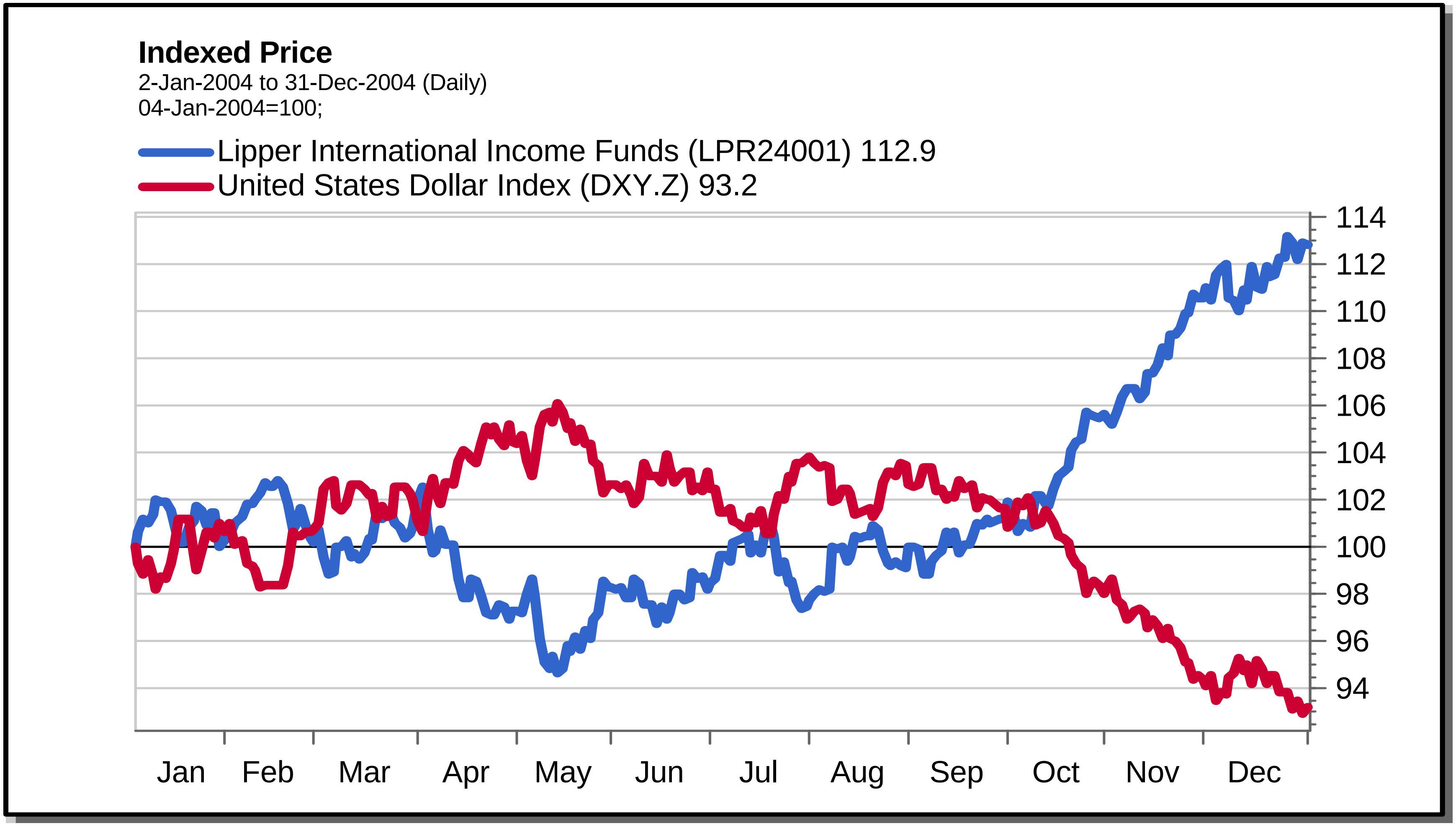
Review of 2004

- As it turned out, our directional forecast was reasonably correct
- BBB and High Yields did beat Mortgage funds and all but one Treasury/Govie category
- INI and EMD however outperformed Corps on a year-over-year basis but with a lot of volatility

Select Bond Fund Performance: 2004



Select Bond Fund Performance: 2004



Review of 2004

- So because of these two periods of turbulence:
  - We were out of EMD funds from June through July
  - And out of INI funds for all of the 3rd Quarter
- We split the EMD money and INI money evenly between Corps and Mortgages during these periods

Model Portfolio versus “Popular” Bond Classifications

Returns	*Model Portfolio*	*High Yield*	*TIPS*	*Loan Pars*	*INI*	*EMD*
Net	7.71%	9.89%	7.75%	3.77%	10.47%	12.33%
Risk-Adj.	6.52%	8.78%	5.44%	3.76%	6.67%	8.05%
Difference	(1.19%)	(1.11%)	(2.31%)	(0.01%)	(3.80%)	(4.28%)

Outlook for 2005 – Main Scenario

- We expect GDP, employment, and other macroeconomic indicators to show moderate growth
- Inflation will continue to creep up in 2005
- The Fed will continue to hike the overnite rate in 25bp increments
- The U.S. dollar will continue to weaken against the major crosses
- “Spread Product” funds will *tend* to make their coupon and probably not any more

Outlook for 2005 – Main Scenario

- Model Portfolio composition will remain the same
- Except ½ of the Treasury allocation (5%) be invested in TIPs as a hedge
- We will watch currency volatility and 10 Year Treasury volatility as signs of when and if to exit INI and EMD respectively

Outlook for 2005 – 1st Alternative Scenario

- Similar to the main scenario
- But inflation, as measured by the PCE deflator (currently 1.5% per annum), begins to surge in a *sustained manner*
- This will probably cause the Fed to hike the overnite rate in 50bp, maybe 75bp increments.

Outlook for 2005 – 1st Alternative Scenario

- Model portfolio composition would probably initially change to:
  - No Treasury allocation
  - No EMD allocation
  - INI reduced to 10%
  - BBB and HY reduced 10% each
  - 50% placed evenly in Loan Participation funds and Short-Intermediate U.S. Govie funds

Outlook for 2005 – 1st Alternative Scenario

- This would be a particularly difficult scenario for the Fed
- Especially if the inflation up tick is energy related
- This would mean earnings growth would probably slow and quite possibly GDP growth
- Basically, we would have stagflation – rising inflation and slow to moderate GDP and earnings growth

Outlook for 2005 – 2nd Alternative Scenario

- GDP growth slows below trend (3% - 3.5%)
- But inflation remains moderate
- In this case, the Fed would probably stop raising rates
- And the Model Portfolio would shift out of corps (10% - 20%) and into intermediate and long-dated Treasury funds
- To take advantage of probable "flight-to-safety" issues
- This is another scenario that the Fed would probably like to avoid

Outlook for 2005 – 2nd Alternative Scenario

- Why?
  - If the recovery peaks in 2005, it would be good to keep these facts in mind:
    - Wages and salaries have accounted for 15% of real income growth in this recovery
    - Vs. an average 49% in every other post-WWII recovery
    - Corp. profits have accounted for 47% of real income growth in this recovery
    - Vs. 21% average in all other post-WWI recoveries

Outlook for 2005 – 2nd Alternative Scenario (Cont.)

- Real wages and salaries have grown at a 0.8% rate in this recovery
- Vs. 5.5% average in all other post-WWII recoveries
- The employment level still hasn't recovered to the peak of the prior cycle (43 months ago)
- This is the first time since 1939 that this has happened

Outlook for 2005 – 2nd Alternative Scenario

- Our point here is that wage and salary growth has seriously lagged in this recovery
- And while this may give grounds to expect the expansion to end or slow in 2005
- It bodes ill for the future
- Could it be the global economy's way of equating Asian wages to U.S. wages?
- Remember, most Chinese workers make 1/20th what the average U.S. worker makes.

Opportunities In Closed-End World Equity Funds: Tax-Loss Carryforwards

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Overview

- Tax overhang and tax-loss carryforwards can, and often do, affect performance when realized.
- CEF prices are unique among collective investment vehicles in being able to adjust to differences in net overhang between like funds.
- Some do, some don't.
- Opportunity exists for investors to benefit from including potential tax burden as ONE OF their investment criteria.

Background

- MFs and CEFs must pass through at least 90% of net investment income and realized gains to retain regulated status.
- Must distribute 98% of net realized gains to avoid 4% excise tax.
- These distributions are taxable to the individual investor in the year received.
- Postponement of distributions pushes back the potential tax bill until a later point, and arguably should be valued more by CEF investors.
- Academics have long maintained discounting of tax liablilities is a reason for discounts to NAV.

The Data

- Looked at the CE World Equity Funds group (48 funds).
- Data as of 11/30/04, or latest available at that time.
- Unrealized gains and realized losses gleaned from semi-annual or annual reports to estimate potential tax overhang and tax-loss carryforwards.
- Adjusted the difference between the two for subsequent performance through 11/30/04 to estimate the current “net tax benefit.”
- Net tax benefit was then compared to the premiums and/or discounts among like funds.

The Results- Overall

- Virtually all of the funds had some net unrealized gains on their books.
- However, most (80%) had tax loss carryforwards that offset some, if not all, of the unrealized gain.
  - 50% had tax loss carryforwards greater than unrealized gains.
  - Six funds had tax loss carryforwards in excess of 170% of unrealized gains.
- "Net tax benefit" was 12.6% on average through latest reporting date (an estimated 3.5% net potential tax burden through 11/30/04 after the market runup).
- 8 of 10 funds with largest net tax benefit are in Pacific Ex-Japan
- Highest overhangs in Europe and Latin America

Net unrealized appreciation (depreciation) on Investments and Currency Per Share (% of NAV)

Templeton Russia & E Eur	62.61%
Korea Fund	47.28%
Swiss Helvetia Fund	46.64%
Brazil Fund	40.09%
Thai Capital Fund	39.33%
Mexico Equity & Income	5.03%
Emerging Mkts Telecomm	3.97%
Eaton Vance Tx-Ad Gl Div	0.63%
Lazard Gl Tot Ret & Inc	0.30%
Taiwan Greater China	-37.78%

Accumulated net realized gain (loss) per share (% of NAV)

China Fund	13.22%
Morg Stan East Europe	12.49%
Chile Fund	4.31%
Swiss Helvetia Fund	3.63%
Templeton Russia & E Eur	1.99%
Brazilian Equity Fund	-96.94%
Thai Fund	-106.87%
Asia Tigers Fund	-110.15%
Malaysia Fund	-122.36%
Thai Capital Fund	-173.50%

(E)[1] 11/30/04 Unrealized plus Realized Gain (Loss) Per Share (% of NAV)

Brazil Fund	75.32%
Templeton Russia & E Eur	67.57%
Korea Fund	67.11%
India Fund	61.01%
Mexico Fund	60.44%
Thai Fund	-74.99%
Asia Tigers Fund	-77.16%
Taiwan Greater China	-87.36%
Malaysia Fund	-99.36%
Thai Capital Fund	-127.12%

- [1] Estimated through 11/30/04 based on perf since last reporting date

Fund Comparisons- Korea

Korea Equity Fund	Fund Name	Korea Fund
53.7	Latest TNA (Mil. $)	1151.2
2.31	Latest TER	1.27
58	Portfolio Turnover	20
22.50%	Unrealized Gain (% of NAV)*	47.28%
-81.84%	Realized Loss (% of NAV)*	0.39%
-50.67%	(E) 11/30/04 Net of Unreal. and Real. (% of NAV)	67.11%
-9.20%	11/30/04 Premium/Discount	-9.20%

* Latest reporting date as of 11/30/04

Fund Comparisons- Brazil and China

Brazil Fund	Fund Name	Brazilian Equity Fund
563.9	Latest TNA (Mil. $)	50.2
1.56	Latest TER	2.06
4	Portfolio Turnover	65
40.09%	Unrealized Gain (% of NAV)*	24.26%
-0.45%	Realized Loss (% of NAV)*	-96.94%
75.32%	(E) 11/30/04 Net of Unreal. and Real. (% of NAV)	-48.68%
-13.70%	11/30/04 Premium/Discount	-8.80%

* Latest reporting date as of 11/30/04

China Fund	Fund Name	Greater China Fund
274.1	Latest TNA (Mil. $)	222.3
1.76	Latest TER	2.04
55	Portfolio Turnover	84
29.60%	Unrealized Gain (% of NAV)*	10.89%
13.22%	Realized Loss (% of NAV)*	1.05%
49.61%	(E) 11/30/04 Net of Unreal. and Real. (% of NAV)	24.29%
23.50%	11/30/04 Premium/Discount	-4.40%

* Latest reporting date as of 11/30/04

Fund Comparisons- Germany and Mexico

New Germany Fund	Fund Name	Germany Fund
260.7	Latest TNA (Mil. $)	133.1
1.4	Latest TER	1.77
86	Portfolio Turnover	287
31.31%	Unrealized Gain (% of NAV)*	15.33%
-70.53%	Realized Loss (% of NAV)*	-38.52%
-30.22%	(E) 11/30/04 Net of Unreal. and Real. (% of NAV)	-12.44%
-15.90%	11/30/04 Premium/Discount	-12.50%

* Latest reporting date as of 11/30/04

Mexico Fund	Fund Name	Mexico Equity & Income
448.1	Latest TNA (Mil. $)	42.9
1.92	Latest TER	2.08
29	Portfolio Turnover	234
31.88%	Unrealized Gain (% of NAV)*	5.03%
1.15%	Realized Loss (% of NAV)*	-6.75%
60.44%	(E) 11/30/04 Net of Unreal. and Real. (% of NAV)	25.15%
-13.10%	11/30/04 Premium/Discount	-9.20%

* Latest reporting date as of 11/30/04

Caveats

- Trends in tax overhang and loss carryforwards are classification specific. Following this strategy ALONE would cause overallocation in specific sectors.

- In some cases, large tax overhang in CE funds is actually good for investors.
  – ATP difference between funds with and without tax overhang:

$$\frac{(\text{Discount} - \text{Tax Rate})*(\text{Estimated Distribution})}{(1 - \text{Discount})*(\text{NAV})}$$

  – Amounts to a return of capital for investors.

Questions?