Aberdeen Israel Fund, Inc. (ISL)

Fund Manager Interview

February 2013

ANDY BROWN

Senior Investment Manager
Aberdeen Asset Management
Global Emerging Markets

Europe is Israel's largest trading partner. How is the on-going debt crisis and weak economic growth there affecting Israel?
As a general point, Israel's economy has been very resilient. Despite Israel's status as a small open economy and the importance of exports, the country weathered the global financial crisis well thanks to its sound economic fundamentals, stable banks and generally prudent fiscal policy. The economy expanded 3.3% in 2012, outperforming many other developed countries, and gross domestic product (GDP) growth in 2013 is expected to continue at a similar pace. Economic data has softened slightly recently with a pick-up in unemployment, but this is from a near all-time low a year ago.

That said, in our opinion, Israel is impacted by the slowdown in European growth, but its export partners are fairly diverse and this is increasingly true of our holdings in Israel as well. For example, fertilizer company **Israel Chemicals** (9.3%) and flavorings company **Frutarom Industries** (5.1%) have seen growing contributions to revenue from emerging markets, particularly Latin America and Asia.

What impact does political unrest in the Middle East have on Israeli companies?
The stand-off between Iran and the international community with regard to uranium enrichment and on-going unrest in Syria have added to the uncertainty in the region. It is difficult to say with any confidence how these issues might play out other than to comment that the State of Israel has faced similar concerns from its very inception.

Israel's largest trading partners are Europe and the U.S., and its trade with neighbors has historically been limited. One notable exception to this was the agreement with Egypt for the supply of gas to Israel, which was in place until early 2012, when the agreement was cancelled by the Egyptian side. At the same time Israel's own producing gas field is in decline and very nearly depleted.

KEY POINTS

- **Israel has the third-most companies listed on the NASDAQ, only behind the U.S. and China**
- **Israel's population growth trends may pose well for domestic spending and lending**
- **Increasing exports to Asia may soften Israel's exposure to the effects of the fiscal issues of Europe and the U.S..**

The gas supply disruption led to what has been the most visible impact of regional unrest on the results of our companies to date: higher energy input costs as companies turned to diesel to run their operations. A number of our companies have been affected to some degree, however, substantial reserves of natural gas discovered off the coast of Israel in recent years are currently under development and once the first of these fields enters production in 2013 we believe this cost pressure should ease.

The region's political situation does not alter our conviction in the investment case for Israeli companies. We believe our holdings are well equipped to cope with any short term stress in their operating environment and perform well in the long term. Indeed we would take the opportunity of market weakness to selectively add to our existing positions.

You mention the significant discoveries of natural gas in Israeli waters in recent years. What is your view on the energy sector and the gas companies in particular?

Energy security is an important issue for Israel and the new discoveries present the country with a huge opportunity as the reserves are able to satisfy Israel's domestic demand for decades with capacity to likely export a portion. Development of the Tamar field, the first of the two large discoveries, is happening quickly, with first production expected in early 2013 – this is in the interests of producers, buyers and government alike given the shortage of natural gas in the country today. Australia's Woodside Petroleum will help develop the largest field, Leviathan, bringing its expertise in liquefied natural gas (LNG) to the project. Projected growth in demand for gas is healthy as Israel is expected to become an increasingly gas-powered economy. Analysts estimate that Tamar will contribute a full percentage point of GDP growth for 2013, from which one would expect the gas producers to benefit.*

At this stage however, there are a few reasons we remain cautious on the gas producing companies: first, regulation of the sector, including the tax regime and pricing scrutiny, is not yet finalized. The government is concerned that there may be an effective monopoly on gas supply and is watching the sector closely; second, there is little visibility on future sales and cash flow. The listed gas producers in Israel are for the most part holders of licenses for areas which are not yet producing, and it is unclear how exactly the reserves destined for export will be commercialized. Also, stock prices of the gas companies generally reflect some speculative value for potential further discoveries. We have no exposure to the energy sector at this early and relatively uncertain stage – we prefer to remain on the sidelines for now and observe how the industry develops.

What impact on Israel's domestic economy do you expect from the recent elections?

Prime Minister Benjamin Netanyahu returned to power in January despite weaker support. The new coalition government, regardless of its composition, will have little alternative but to pass a responsible budget, which will likely include spending cuts and tax increases. These are necessary to reduce the fiscal deficit which reached 4.2% of GDP in 2012. Less than two years after protests about the high cost of living in Israel, these measures may prove unpopular. Domestic demand may see some impact as a result of this, as well as from higher levels of unemployment compared to the prior two years. However, we remain optimistic: the underlying structural drivers of domestic demand – namely, the young and growing population and the increasing participation in the labor force – remain intact.

* Forecasts are offered as opinion and are not reflective of potential performance, are not guaranteed and actual events or results may differ materially

What has been the effect of the 2011 protests over the high cost of living in Israel?

The summer 2011 protests had, and continue to have, far-reaching effects – most notably increasing regulation and scrutiny of the food producers, food and staples retailers, and telecoms companies. In the near term, regulatory change may create uncertainty over future profitability, which could weigh on specific stocks. Indeed, we have seen this play out in the telecoms sector where, following significant regulatory change, the price of mobile phone contracts for consumers has declined dramatically and both corporate profits and share prices have suffered. In the long term, we believe the likely increase in competition and removal of structural inefficiencies may facilitate growth in these sectors and in the economy overall.

Which industry sectors do you expect to do well for the remainder of the year?

Israel is renowned for expertise in the technology sector, thanks to its high quality education, highly skilled workforce, and fostering by government grants and tax exemptions for research and development (R&D). Many businesses in the sector have expanded from their origins in Israel to now boast vast operational reach across Europe, North America and increasingly farther afield to Latin America or Asia. Companies in this sector have generally made cautious comments on the outlook for 2013, and this was reflected to some degree in stock prices in the latter half of 2012. We feel that our holdings in this sector will remain resilient to any headwinds.

Which areas of the economy are you most concerned about? What type of exposure does the Fund have to these areas?

One area of concern for the government is holding companies, which have come under much scrutiny since the protests brought the issue of concentration of wealth and corporate ownership in Israel to the fore. The government is seeking to limit cross-holdings and also to limit the number of layers in the holding structures, which are typically pyramidal. Holding companies are in some cases highly leveraged and have borrowed against the value of their investments in subsidiaries, whose market value has declined, leaving the holding company in a precarious financial position. The fund does not have any direct exposure to these companies – we prefer to hold the operating subsidiaries directly.

How would you sum up the outlook for Israeli equities?

Considerable uncertainties in the external environment persist; in Europe, structural imbalances in key economies remain, while the U.S. faces political impasse over budget negotiations. We believe the resulting impact on demand will continue to weigh on Israel's exports. Additionally, to counter Israel's rising budget deficit, the implementation of austerity measures is expected. Nevertheless, the longer-term prospects for the economy are positive. Unemployment remains low and careful monetary policy has seen inflation ease. The commencement of its natural gas production may also improve fiscal balances and boost growth. In view of this, the finance ministry raised its 2013 growth forecast by 0.5% to 3.5%. The economy has also proven its resilience in weathering security crises. At the corporate level, we remain confident in our holdings, which are backed by competitive business models, sound finances and strong management. We believe this positions Aberdeen Israel Fund, Inc. to help overcome potential headwinds and to perform in the years ahead.

RISKS

- **Geo-political issues pose security issues for Israel with respect to offshore energy installations.**
- **Energy price volatility has contributed significantly to Israel's soaring trade deficit due to a dependency on importing natural resources.**

For more information

Aberdeen Asset Management is a global investment management group, managing assets for both institutions and private individuals from offices around the world. Aberdeen Group is the largest manager of emerging market closed-end funds offered around the world by both value and number.*

For more information on Aberdeen Israel Fund, Inc.: Visit **www.aberdeenisl.com**

For more information on Aberdeen's fund range, please:

- Visit our Closed-End Investor Center at: **www.aberdeen-asset.us/cef**
- Enroll in our online services at: **www.aberdeen-asset.us/aam.nsf/usclosed/email**
- Watch the latest fund manager films and webcasts on our Closed-End Fund Talk Channel at:

www.aberdeen-asset.us/aam.nsf/usClosed/aberdeentv

Aberdeen Asset Management Inc.
Investor Relations
InvestorRelations@aberdeen.com
(800) 522-5465

*Fund Consultants LLC, March 2012. Based on analysis of emerging market closed-end funds offered in multiple jurisdictions as of June 30, 2011; data provided by Morningstar Inc. Closed-end funds are defined as investment companies that are 1) listed on a recognized exchange; 2) possess fixed share capital and; 3) were formed via subscriptions from the public via an open offer or placement. Criteria for inclusion in the emerging markets category is based on the World Bank's definition of emerging countries as measured by lower and middle income per capita. Criteria for fund inclusion is 1) at least 75% of gross assets invested in emerging markets; 2) funds with under 25% exposure to Asian developed markets.

Important information

PAST PERFORMANCE IS NOT AN INDICATION OF FUTURE RESULTS.

Aberdeen Asset Management ("AAM") is the marketing name in the U.S. for the following affiliated, registered investment advisers: Aberdeen Asset Management Inc, Aberdeen Asset Management Investment Services Ltd, Aberdeen Asset Management Ltd and Aberdeen Asset Management Asia Ltd (collectively, the "Aberdeen Advisers"). Each of the Aberdeen Advisers is wholly owned by Aberdeen Asset Management PLC. "Aberdeen" is a U.S. registered service mark of Aberdeen Asset Management PLC.

International investing entails special risk considerations, including currency fluctuations, lower liquidity, economic and political risks, and differences in accounting methods; these risks are generally heightened for emerging market investments. There are also risks associated with investing in Israel, including the risk of investing in a single-country fund. Concentrating investments in the Israel region subjects the Fund to more volatility and greater risk of loss than geographically diverse funds. Equity stocks of small and mid-cap companies carry greater risk, and more volatility than equity stocks of larger, more established companies.

The Tel Aviv 100 (TA -100 Index), is a stock market index of the 100 most highly capitalized companies listed on the Tel Aviv Stock Exchange. Indexes are unmanaged and provided for illustrative purposes only.

Indexes are unmanaged and have been provided for comparison purposes only. No fees or expenses are reflected. You cannot invest directly in an index.

We hold the companies highlighted. Holdings are subject to change and provided for informational purposes only and should not be deemed as a recommendation to buy or sell any of the securities referenced herein.

The above is for information purposes only and should not be considered as an offer, or solicitation, to deal in any of the investments mentioned herein. AAM does not warrant the accuracy, adequacy or completeness of the information and materials contained in this document and expressly disclaims liability for errors or omissions in such information and materials.

Closed-end funds are traded on the secondary market through one of the stock exchanges. The Fund's investment return and principal value will fluctuate so that an investor's shares may be worth more or less than the original cost. Shares of closed-end funds may trade above (a premium) or below (a discount) the net asset value (NAV) of the fund's portfolio. There is no assurance that the Fund will achieve its investment objective.

Aberdeen

007402-0213-PHL