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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, 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 Europe Fund Has Stellar Performance

The Europe Fund (EF-NYSE) is one of two funds representing our 2005 focus region and seeks long-term appreciation through investment primarily in European equity securities.

"For the six-month period ended June 30, 2005, The common stock of The Europe Fund, Inc. had a total investment return of +.25% (versus -.38% for the MSCI Europe Index).

"Following a change in the Fund's portfolio manager on June 1, 2005, the structure of the portfolio was altered significantly. We reduced the Fund's exposure to smaller capitalization stocks in favor of large capitalization stocks. We also increased the Fund's weighting in U.K. listed companies, bringing the allocation to U.K. securities from a heavily underweight position to neutral, and reduced the Fund's overweight position in France. In addition, we trimmed the total number of portfolio holdings from approximately 80 to approximately 50. Finally, we reduced the size of some of the largest weightings in the Fund to create a portfolio of stocks that is more evenly weighted, which is designed to have the overall effect of reducing some of the Fund's risk exposure.

"Overall we believe the Fund is well positioned going forward, as we have a positive view toward European equities. Despite all the negative news surrounding European economic growth (e.g., German and French unemployment remains high, while Italy is facing a recession), many European companies operate in a global economic environment and can be more affected by global rather than local trends. Global economic growth remains reasonably healthy, which we believe is a net positive for European stocks.

"Additionally, many European companies are in the midst of significant restructuring, which has been an on-going theme in Europe for the last five years. Many companies are becoming increasingly focused on cost cutting and corporate efficiency, which can help provide increased returns to shareholders. On a related note, there has been a significant increase in merger and acquisition activities across all of Europe, which is generally positive for equity investors. Finally, over the past six months, the value of the euro has been declining (the currency lost 10.67% compared to the U.S. dollar), and this trend has been a positive factor for many European companies. A weaker euro helps the profit margins of European companies, which has been contributing to strength in that market, and we believe this trend may continue for a while.

The Europe Fund
As of June 30, 2005

Geographic Allocation of the $119.5 million fund as a percentage of total investments:

#	Country	%
1.	United Kingdom	34.8%
2.	France	20.1%
3.	Germany	13.6%
4.	Switzerland	5.7%
5.	Netherlands	4.9%
6.	Norway	4.0%
7.	Belgium	3.7%
8.	Ireland	3.1%
9.	Italy	3.1%
10.	Spain	2.7%
10.	Finland	1.8%
11.	Greece	0.8%

Five Largest Equity Holding:

#	Holding	%
1.	Total SA	4.4%
2.	GlaxoSmithKline Plc	3.8%
3.	Royal Bank of Scotland Group	3.4%
4.	UBS AG (Registered Shares)	2.8%
5.	HBOS Plc	2.7%

Five Largest Industries

#	Industry	%
1.	Commercial Banks	24.9%
2.	Oil, Gas & Consumable Fuels	12.5%
3.	Diversified Telecommunication Services	6.5%
4.	Insurance	5.3%
5.	Diversified Financial Services	4.6%

"All of these factors should help propel the European equity market in the months ahead, and we believe we have positioned the Fund to benefit from these trends."

– Gavin Corr, Portfolio Manager

Note: The dividend policy of the Fund is to "distribute to shareholders annually by the end of January an amount equal to at least 7% of the Fund's net asset value determined as of the beginning of the previous calendar year. If, for any calendar year, the aggregate of net investment income and net realized capital gains (if any) is less than 7% of the Fund's net asset value as of the beginning of that calendar year, the difference will be distributed from the Fund's paid-in surplus.

Editor's Note: As The Europe Fund is one of our largest holdings, we plan to interview the portfolio manager as soon as practicable.

Emerging Markets Begin to Show Signs of Volatility

It's a slow, tentative process, but for the first time in several years, the shadow of volatility – even nervousness – is creeping over emerging markets assets.

The first hint of trouble came from Brazil, where assets have sawed up and down over the last few weeks because of an on-going political scandal.

But this time, there's more concern. Record oil prices are causing worries about global growth, while steadily rising U.S. interest rates are draining the supply of easy money that has been flooding emerging markets in recent years. That's a double dose of bad news for the asset class.

"The liquidity premium is being taken out of the market," said Gene Frieda, head of emerging markets research at Royal Bank of Scotland in London. "This is when we see a start of what emerging markets are made of."

While there's no agreement on whether or how quickly the nervousness could spread and a few expect a rush to the exits, there's a sense that the tide may be turning on the emerging market boom.

Record-high global crude oil prices above $67/barrel have forced state-owned petroleum firm Pertamina to make massive dollar purchases to fund oil imports. Indonesia, the Asian region's sole member of the Organization of Petroleum Exporting Countries, is on track to be a net oil importer due to dwindling output.

These bouts of nervousness come after a broad rise in emerging markets assets over the past three years. The spread on J.P. Morgan's Emerging Markets Bond Index Plus closed at a record low recently. The Mexican peso, Brazil's real and the Chilean peso were all at multi-year highs in early August as well.

The emerging market boom hasn't just helped sturdier countries like Chile, Mexico and India; it has also lifted the assets of more troubled nations like the Ukraine and Ecuador. Now, the emerging markets asset class looks more sensitive to pockets of weakness.

– Laurence Norman
Dow Jones Newswires

Note: The full version of this report is available to *Wall Street Journal* subscribers at http://www.wsj.com.

Editor's Note: The first time I visited with the management of Franklin Templeton in Nassau and mentioned that there appeared to be more volatility in the emerging markets, I was told that the emerging markets have always been more volatile than those elsewhere.

Cohen & Steers Total Return Realty Fund, Inc.

In our last quarterly report, we suggested that negative sentiment in the market for REIT shares, as manifested in the peaking of short interest in the REIT index trading vehicles, was a bullish contrarian indicator and that REIT shares were trading at or below the value of their underlying real estate assets – not above, as Wall Street analysts had almost unanimously suggested. Additionally, at the same time, we have discussed our view that the risk-adjusted returns of real estate would continue to be relatively attractive in a low return environment.

Recent events have validated all of these beliefs. During the third quarter of 2005, continued momentum in the recovery of real estate fundamentals and REIT earnings, and a flurry of merger and buy-out activity, drove REIT share prices to new highs.

There were seven buy-outs over the last year which were sizeable, totaling $27 billion in value across all four "core" property types: retail, apartment, industrial and office ... all of these deals were struck at prices above the commonly perceived value of the target company's real estate net asset value (NAV).

Investment Outlook

In the mid to late 1990s, real estate company share prices as a group consistently traded at large premiums to NAV – up to 30% for the REIT group as a whole. The public market's perception of the value and growth prospects of real estate assets was clearly ahead of that of the private market, and this enabled massive amounts of assets to flow from private to public ownership. The REIT market capitalization expanded dramatically through IPO's and secondary offerings of existing companies.

Today, the public market and private markets' views of real estate are much more closely aligned, as evidenced by the fact that most commentators see REIT valuations as closer than many had realized to private market NAV. This has profound implications for the way the real estate stock cycle will evolve, in our opinion.

We believe that assets will continue to flow from private to public hands as skilled

public players seek out selective, strategic acquisition and development opportunities. Additionally, we think that current strong investor interest in REITs investment attributes, as well as the improved outlook on the sector by analysts, offer an attractive environment for companies to utilize secondary stock offerings in order to finance these activities.

However, if private market values continue to be strong as well, as we expect, REIT equity issuance should not get out-of-hand as it did during the latter stages of the REIT cycle in the late 1990s. The large premiums to net asset values that resulted in many instances in undisciplined equity issuance contributed significantly to the severity of the downturn in REIT share prices in 1998 and 1999.

We have focused the portfolio on those sectors that we believe are benefiting most from the cyclical recovery in occupancies and rents: office, self-storage, hotel and certain segments of the apartment market (including student housing).

We have trimmed some retail holdings based on less attractive relative valuation, according to our property valuation model, as this sector's fundamentals stay steady while others improve. The rally in the second quarter, combined with the dynamics of the merger environment, has created many shifts in relative valuation for individual companies, and we continually rebalance the portfolio to capture those shifts.

– Martin Cohen, Co-Chairman
Robert H. Steers, Co-Chairman
Cohen & Steers

Editor's Note: We have scheduled an interview with Martin Cohen for the November 2005 Scott Letter. It will include discussion of the two closed-end funds we use in our portfolios, Cohen & Steers Total Return Fund (RFI-NYSE) and Cohen & Steers World-Wide Realty Fund (RWF-NYSE), and the mutual fund, Cohen & Steers Realty Shares (CSRSX).

Down with Mutual Funds

David Swensen is MAD at mutual funds, and I don't mean just a little sore. They're greedy, he says. They abuse investors. They milk you for fees. Their ads manipulate past performance to get you to buy. You're not only getting rolled, you're getting lousy investment results. When you're up against most mutual funds, you "lose in a first-round knock-out." Whew.

Who is David Swensen, and why should you pay attention to him? He's one of the most successful money managers in America today. In 20 years of running Yale University's endowment, he has averaged 16.1% a year, compared with 13.2% for Standard & Poor's index of 500 stocks. Together, his mix of investments – from stocks and bonds to real estate – has given him better returns with less market risk.

After the mashing the public took in the 2000-2002 market collapse, Swensen decided to publish a simpler version of his strategy that individuals could use themselves. So, he started examining the investments people commonly use – and that's when his anger rose. He found poor quality and high fees, especially among mutual funds.

Swensen's new book, *Unconventional Success: A Fundamental Approach to Personal Investment,* lays out the case against most funds and offers a smart alternative. His first book, *Pioneering Portfolio Management. An Unconventional Approach to Institutional Investment,* is what turned us towards asset allocation, which has paid off handsomely. Swensen's outrage focuses primarily on costs. Mutual funds run by managers tend to charge high fees. Funds sold by stockbrokers charge even more. Managers buy and sell stocks at a rapid pace, which runs up the brokerage expenses. The median cost to investors in 2002 came to 2.35% – and that doesn't count the upfront commission a broker might charge.

What's Swensen's answer? "Buy low-cost index funds instead."

– Jane Bryant Quinn

[Condensed from *Newsweek,* August 29/September 5, 2005]

Editor's Note: Our answer: We read Davis Swensen's first book and liked it so much, we decided to use a simpler form of his asset allocation for our portfolios. This strategy has increased our investment returns dramatically. He recommends index funds, but we wonder why Mr. Swensen, whom we admire tremendously, says nothing about closed-end funds in his new book.

As many of our readers know, closed-end funds are not popular with brokers because of the small NYSE commission, hence there is little incentive for brokers. Our clients like our low turnover and don't mind paying us a fee for our expertise in picking closed-end funds to diversify their portfolios around the world.

Closed-End Funds May Open Up

According to a report in the *Wall Street Journal,* mutual fund shareholders have recently gained more power to control the destiny of their funds when the New York Stock Exchange blocked brokers, who often favor management, from casting ballots on behalf of shareholders who don't state a preference. The move, the report continues, has been hailed by shareholder activists, led by Elliot Associates, a hedge fund. This could also weaken the negotiating power of shareholder activists as it puts the onus on individual shareholders to take a more active interest in their funds. [CEFA strongly approves of any moves in this direction.]

A ruling in September involved plans by Citigroup to transfer management of its

closed-end funds to Legg Mason, Inc. as part of a larger asset swap worth $437 billion. The dissidents are frustrated by "chronic discounts" of most of Citigroup's 24 closed-end funds. They want the company to adopt measures that will improve performance and reduce or eliminate the discounts, which averages 14% from the beginning of 2002 through the end of August of this year, before they approve any new advisory contracts.

The NYSE recently said that approval of an advisory contract wasn't a routine matter, and, therefore, so-called broker votes would no longer be allowed. It added in a SEC filing that it concluded that such a matter "could affect substantially the rights or privileges" of fund shareholders. The American Stock Exchange soon followed suit.

During a vote this month, dissident shareholders at six Legg Mason funds urged other shareholders to vote against the transfer of management of the funds as a way to pressure management to do something to lift share prices and narrow the gaps between prices and the underlying values of the fund's portfolios. This broker-vote policy applies to all mutual funds but will have the most impact on closed-end funds because they trade on exchanges at discounts to net asset value. Citigroup's move will likely be the first test of this new policy.

Broker votes are under greater scrutiny amid a broader push to improve corporate governance in the financial services industry. The NYSE recently formed a working group to see if broker votes are still appropriate. Broker votes originally were allowed to vote shares held in street name as a way to help achieve a quorum on routine matters. Unlike mutual funds, closed-end funds have a higher percentage of outstanding shares held in broker names.

"It could put some dissidents at a disadvantage. It takes away the leverage if they want to do a proxy contest," said Cody Bartlett, of Karpus Investment Management. Karpus has set in motion proxy contests on five of the Citigroup closed-end funds. Mr. Bartlett added that he was surprised by the NYSE rule change.

One potential negative for shareholders will be, in the absence of broker votes, funds might have to spend more to reach out to investors to get the votes they need. The additional costs will, undoubtedly, be passed along to shareholders, increasing operating expenses of the funds.

– Angela Pruitt
Dow Jones Newswires

Editor's Note: We are aware that many closed-end funds have made a strong case to do everything they can to keep expenses as low as possible in order to increase returns for their shareholders. To continue this discussion, we telephoned Tom Dinsmore, Chairman of the Ellsworth/Bancroft Convertible funds. He is also on the Board of Directors of the Closed-end Fund Association.

Dinsmore: Some people are making an argument that you can't buy and sell the management contract of a fund. I have real problems with that; it seems that we are moving back into an era when you can't get a quorum for the vote. Some of them do not call. People are also trying to stop the funds from calling shareholders on issues, which can be critical in a close vote. This is a prescription for gridlock that does not help shareholders. If the stock exchanges aren't going to allow shareholder votes, as is being proposed, I don't see how they are helped at all. This move will also raise the cost of running the business and make it impossible to make any changes. Why would you want to prevent the sale of the management contract? In this case, Legg Mason is one of the world's premier money managers, so why can't the firm sell its funds if it wishes to do so? It doesn't make sense.

SL: We agree. Now, regarding a related issue, we have been talking to the publication, *Investment News,* which is soon to publish a story about how a shareholder of closed-end funds can make a decision regarding how to vote on a proposed open-ending. When the fund is trading at significant discount to its net asset value and you are offered a chance to cash out, it can be tempting to do so. How would you answer that question?

Dinsmore: Basically, what you are saying is that there is no place in the world for the small money manager who doesn't have a big selling organization. We wouldn't be able to survive these activists unless we have a large organization to fight them off. The smaller funds could disappear.

In order to open-end a fund, you have a number of requirements. There is usually a "super majority" vote, that is, two-thirds of the shares have to be voted affirmatively to pass a measure. Unfortunately, a large chunk of the shareholder votes never get voted at all, because many shareholders mistakenly think that their broker or money manager can vote for them. [We are sent the proxies but do not vote them for our clients. That is their responsibility.]

How the shareholder should vote may depend on his assessment of the long-term performance of the fund. Just because you can get a quick percentage gain – the obvious 14% or 15% on a close-up – it doesn't always work out that way because of the expenses involved. The costs of liquidation can be high, including legal expenses. There are also the rights of the minority shareholders for the fund to consider as well, assuming 50% of the shareholders want to liquidate. There are also either tax or other reasons to oppose liquidation so this change may not be a great benefit to them. The SEC focuses on that one factor more than all the others.

SL: That's very interesting, and I hope we have informed our readers about this issue. We are also interested in your views on Exchange Traded Funds, ETFs. Nuveen calls them "exchange-traded closed-end funds". We have followed their growth and acceptance but have told our readers that we are not ready to use them yet.

Dinsmore: I think they are coming along, are reasonable and are a great alternative for investors. The big issue is how one of them will be able to create an "actively managed ETF." I can't see how it can happen. You will have to come up with an entirely different design that could require a full SEC review. In order for it to work, you have to be completely open, perhaps form some kind of hybrid fund. With all the brilliant brains on Wall Street, I wonder why they haven't come up with

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them by now. It is possible there is not a formula that works within the current structure.

SL: Thank you for your thoughts, Tom. We appreciate your insights.

The September issue of *Investment News* contains a report that Managed ETFs has asked the SEC for an exemption so it may launch a broad range of actively managed "enhanced" index ETFs, which could be converted into traditional mutual fund shares after a 2:30 p.m. cut-off. The report cautions that "actively managed ETFs face significant hurdles, especially when it comes to transparency." One big question will be whether the SEC will accept the less transparent nature of the actively managed funds; the other is acceptance among investment advisers.

Letter to the Editor

Dear Mr. Scott,

I am delighted to keep receiving your newsletter! It is always an interesting and enlightening reading that makes more and more sense with every other economics class that I take. Over the summer, I had the chance to intern with both BNP Paribas and the Bulgarian National Bank. One day, I had printed your newsletter and my boss (head of treasury and fixed income at BNP) asked me what I was reading. I explained how we met and that I have been receiving your newsletter ever since. He asked to read it, and he was really impressed by its content and even more impressed that I am receiving this. I wanted to say a big thanks for both the knowledge that I receive from reading your newsletter and the good impression it helped me make!

I also have two questions for you as a person who has long experience in international economics. I have decided to devote my time to economics, and I'll be an Econ major here at Kenyon.

Thank you very much for your time! Please let me know if you are coming to campus anytime soon.

– Mario Strahinov

Mr. Strahinov is a student at my alma mater, Kenyon College. I met him last year on a visit, and he subsequently subscribed to *The Scott Letter*. We encourage any other subscribers, young and older, to write as we are always interested in feedback, comments or questions about *The Scott Letter,* now celebrating its 15th year. Please address your correspondence to The Editor, The Scott Letter, P. O. Box 1100, Richmond, Virginia 23218 or by e-mail.

– Editor

Portfolio Manager's Review

During September, we purchased Cohen & Steers Realty Shares Fund (CSRSX), a mutual fund, as RFI is selling at a premium. We also made a new purchase of Diamond Rock Hospitality Co., a hotel REIT, partly owned by Marriott Hotels.

In our focus region, Western Europe, we added to The Europe Fund, The Germany Fund of Maryland, Lazard Global Total Return Fund and Templeton Global Income Fund. Sales were also made of some shares of Allied Capital, Cohen & Steers Total Return Fund, The Swiss Helvetia Fund and TCW Convertible Securities Fund.

As it is rebalancing time, we have decided to increase our exposure to the global markets to 35%. Therefore, we sold some shares of Latin American Equity Fund, because of its sharp run-up, as well as Allied Capital, which is not a closed-end fund and it is difficult to track its net asset value. We are delighted to have such stellar performance for the first nine months.

None of the information contained herein should be construed as an offer to buy or sell securities or as recommendations. Performance results shown should, under no circumstances, be construed as an indication of future performance. Data, while obtained from sources we believe to be reliable, cannot be guaranteed.

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