

# THE SCOTT LETTER: CLOSED-END FUND REPORT

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A Global View of the Closed-End Fund Industry

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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](http://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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## Why the U.S. Is No Bargain for Investors

“Even though the foreign markets remain cheaper than the U.S., ... the U.S. is not cheap by historical standards,” according to Charles De Vault, Manager of the First Eagle Funds. DeVault, a value investor who succeeded the incomparable Jean-Marie Eveillard (who retired last year), is troubled by insider selling of U.S. shares. He also points out that it is more and more difficult to find names overseas, even though the foreign markets remain cheaper than those in the U.S. Based on a price-to-cash flow basis, Europe and Asia sell at around 9½ times earnings, versus roughly 12½ times in the U.S. Therefore, the U.S. is not cheap by historical measures.

“We are very much valuation-driven, as opposed to outlook-driven,” he says. DeVault cites Barron’s insider transactions which show a list of the heavy insider buying and insider selling. In the past 12 months, insider selling has dwarfed insider buying by a ratio of 20:1. He sees companies listed across the board, “and that’s not encouraging.” Mr. De Vault

also points out that the P/Es discussed by most people are typically understated.

“Most companies do not yet expense stock options and have pension liabilities that are grossly understated. Most U.S. corporations assume their pension plans will have a return of 8½%. When you know that typically pension plans are 60% equities and 40% bonds, an assumption of 8½% is criminal.”

Other worries include huge (U.S.) budget deficits, a record high trade deficit and now the possibly of a slowdown in economic and corporate earnings growth in 2006. This could end interest rate increases soon, due to high energy prices and higher interest rates.

“If the housing bubble is not sustainable,” Mr. De Vault adds, “there will be a major correction in real estate prices over the next three years and, as a result, consumption by Americans will be cut back significantly, hurting the U.S. economy along with some of the export-oriented countries such as China. That is why we are not so sanguine about U.S. stocks in particular,” the report concluded. ■

## Record Sums of American Money Flow Into Foreign Stocks

Record sums of American money flowing into foreign stocks is starting to reshape overseas companies, encouraging more disclosure and investor friendly policies abroad, according to a report in *The Wall Street Journal*.

The Treasury Department has released figures showing that American net purchases of stocks outside the U.S. in the first ten months are on pace to smash their 2003 record of \$88.6 billion. At an average of more than \$9.5 a month, the 2005 total could hit \$115 billion.

American investor’s appetite for overseas stocks appears to be a long-term trend, not a passing fad driven by superior stock market returns in recent years. This trend has been

building for years, analysts say, as growth prospects in emerging markets has ripened. Financial consultants advise clients to have more than 20% in foreign shares, up from about 15% five years ago. A number of banks trusts and other institutional investors are following this trend, according to our research.

Long-term, the case for increased foreign holdings is compelling. Many of the fastest-growing markets and companies are overseas. Buying into these companies is easier and cheaper than ever before (especially by investing in closed-end funds), and there has been a drop in trading costs as well as an explosion of international mutual funds.

With so many money managers sending billions of dollars abroad every month, they

are increasingly bringing their activist tendencies to bear on companies, demanding bigger dividend payments and share buy-backs to shore-up prices as well as improved corporate disclosure.

The trend also has ramifications for U.S. companies, especially those without subsidiaries abroad, which may find they are facing more competition for U.S. investment dollars, increasing the cost of borrowing and other capital costs. That could pinch profits, making it tougher to compete against foreign peers.

The flow of American money is also likely to chip away at the difference

between U.S. and foreign stock prices. Investors historically have paid more per dollar of earnings for U.S. stocks than for shares elsewhere, a reflection of the higher risks seen in foreign stocks. That discount for overseas stocks has narrowed in recent years, and the trend is likely to accelerate as American and overseas companies increasingly play by the same rules.

For U.S. investors, greater exposure to foreign markets could heighten volatility in the near term. But, in the longer run, a portfolio that combines U.S. and international stocks tends to produce the best returns with lower risk.

We see the above report as confirming our view towards investment. We stress that investors should always diversify their risks and use closed-end rather than mutual funds, in most cases, for foreign diversification. We use some mutual funds when the equivalent fund managed by the same manager goes to a premium. In this case, we miss the advantages of buying at a discount to net asset value. ■

How CEFA allocates its portfolios will be explained further in the “Portfolio Manager’s Review” at the end of this letter.

## The Impact of Leverage on Closed-End Funds

In the last year, we have invested in two types of closed-end funds that employ leverage: The Lazard Global Growth and Income Fund (LGI-NYSE) and in several of the Cohen & Steers real estate funds. It is important for our clients and readers of *The Scott Letter* to understand that leverage comes in a variety of types and that there are both advantages and disadvantages in the use of leverage.

Leverage is one characteristic that sets apart many closed-end funds from their open-end counterparts, which are prohibited from using leverage. Barron’s *Dictionary of Banking Terms* defines *leverage* as “money borrowed to increase return on invested capital.” That borrowing allows a fund to take the proceeds received and reinvest those proceeds in additional securities. During certain interest rate environments, the spread between the borrowing costs and the reinvestment of proceeds may serve to increase dividends paid to common shareholders of leveraged closed-end funds. This strategy is becoming increasingly popular with these funds.

While the Investment Company Act of 1940 limits closed-end fund leverage in the form of senior securities to 50% of total net assets, most funds vary their leverage to between 25% and 50%. Lazard leverages 33 1/2%, while the Cohen & Steers real estate funds leverage their portfolios at 35%.

Leverage comes in a variety of types:

- a. Borrowing through the preferred stock market, either in the form of fixed or auction-preferred shares. (This strategy is most commonly used by closed-end municipal bond funds as a way to increase dividend yield.)
- b. Commercial Paper (CP) allows a fund to issue short term unsecured promissory notes in the open market to finance short term funding needs. CP rates are comparable to auction market preferred stock yields.
- c. A Revolving Credit Line is an agreement between a fund and a bank that allows the fund to borrow a specific amount of money which, when repaid, can be borrowed again. The interest rate paid on the revolving credit line is linked to some specific benchmark (i.e., the consumer price index) plus additional interest for credit risk.
- d. A Bank Loan is the money advanced to the funds by a lender, which usually obliges the fund to pay interest.

Most fund companies that do not employ preferred stock or CP are now using revolving credit lines for leveraging. When short-term interest rates rise, expectations are that these funds will switch back to bank loans and lock-in lower rates for their longer term time horizons.

As it appears that the next move by the Federal Reserve will be to increase interest rates. *Moody’s* believes that there will be

some erosion in share prices of fixed-income and preferred stock funds, as investors seek to add risk to their portfolios in the form of leveraged equity funds. As a result, they expect share prices of leveraged equity to continue to rise. ■

Source: Moody’s Special Comment  
(December 21, 2005)

**Editor’s Note.** Closed End-Fund Advisors’ view is that we have been cautious on using leverage funds. In the case of Cohen & Steers, we first limited our exposure to their oldest fund, The Cohen & Steers Total Return Fund (RFI-NYSE) because it does not employ leverage. Then, after analyzing Cohen & Steers’ 20-year record with real estate funds, we started cautiously using some of their leveraged funds, such as the new global fund, Cohen & Steers World Realty Fund (RWF-NYSE) because it not only fits our global mantra but also because the firm has a long outstanding record (since 1985) in picking winners in real estate investments.

In the case of the Lazard Fund, we waited a full year after the fund was launched to analyze its record. This paid off, as they had a good year so we had some history on which to base an investment decision.

**If you spend your life waiting for the storm, you will never enjoy the sunshine.**

– Morris West (1916-1999), Writer

## Ellsworth Convertible G&I Fund Announces Annual Shareholder Meeting Results

Ellsworth Convertible Growth and Income Fund, Inc. (ECF:ASE) reported financial highlights and statements for the Company's Annual Report to Stockholders for the 12 months ended September 30, 2005:

1. Two directors were elected.
2. The new Investment Advisory Agreement was approved.
3. The fundamental investment restriction limiting investments in unseasoned issuers was eliminated.
4. The selection of Tait, Weller & Baker, LLP as independent auditors for the 2006 fiscal year was ratified.
5. The proposal to amend the Articles of Incorporation was defeated, having

received a vote of only 16.5% of the total number of shares outstanding.

Share-holders voted on a proposal concerning the reorganization of the Fund to a Delaware statutory trust on February 13.

At the meeting, Tom Dinsmore, Chairman of the Fund, discussed the proposal to eliminate a fundamental investment restriction that limits the Fund's ability to buy securities of issuers with less than three years of operations ("unseasoned issuers"). Dinsmore stated that, even if the Fund purchased securities of unseasoned issuers, any such securities that are illiquid will be subject to the Fund's limitation on investing in illiquid securities.

Dinsmore also said that certain of these securities may increase the risk profile of the Fund, but it was not management's present intention to change the Fund's risk profile. He then noted that the Fund's investment program is subject to oversight by the Fund's Board of Directors.

Effective January 31, 2006, the Fund's name was changed to Ellsworth Fund, Inc. This will provide the Fund with greater flexibility to invest in non-convertible debt and preferred stock if management determines it is advantageous to do so. He noted that under normal circumstances, the Fund will continue to invest at least 65% of its total assets in convertible securities and common stock received on conversion or exchange of securities. ■

## 2006 Phoenix Closed-End Forum

The Closed-End Fund Association's Fund Forum will be held this year in Phoenix, Arizona on March 6 at the Pointe Hilton Squaw Peak Resort. The Forum is designed to help educate and inform investors about the latest opportunities and trends in closed-end fund investing.

The agenda includes the industry's leading experts discussing investment strategies for closed-end funds. Attendance is FREE so register now to ensure a seat for this one-day event, developed to allow personal interaction between closed-end fund companies, investment advisors, brokers

and investors while providing valuable information on closed-end funds investment trends and market outlooks.

More information and how to register is available on the Closed-End Fund Association's website, [www.closed-end-funds.com](http://www.closed-end-funds.com). ■

## Real Estate Funds and International REITs: The Global Property Securities Market Is Growing Rapidly

"The global property securities market over the past year has begun to grow in size and importance," according to a report from the manager of the Alpine International Real Estate Fund.

"The creation of REIT legislation in a number of different countries has led to the listing of new real estate companies and a broadening of the investor base for real estate securities. Activity in 2005 is concluding with a flurry of IPO's investing in diverse markets such as Hong Kong, Hungary, Malaysia and Turkey as well as Germany and Japan.

"It is quite possible that the next two or three years will see a dramatic expansion of global market capitalization for real estate securities on a scale similar to what we enjoyed between 1992 and 1995. During that period, the number of companies doubled, and the merchant capitalization rose by a factor of 4.5 times. Even now the world's largest public real estate company is no longer in a major developed nation. Emaar Properties in Dubai experienced explosive petro-dollar fueled growth to achieve a market capitalization of \$43.5 billion!

"Much of the growth in property markets has been brought about, not only through increased demand for real estate investments, but also by significantly higher prices for properties and property companies around the world ... Investors have made bets on a premier property's ability to generate rental growth over the duration of the property cycle. We agree that in many cases rental growth should accelerate over the next two to three years; however, the pace and strength of the rent and value growth could vary dramatically across global markets.

“Throughout the 16 years we have managed this Fund,” the report concluded, “there has never been so much interest or activity in and among international property stocks. REITs are part of the story, as is the global yield shift.

Perhaps the most important elements are the perceptions that foreign real estate markets may offer greater potential upsides

than our own and that real estate is well positioned for solid performance in this business cycle. That’s our view, as well.” ■

– Samuel A. Leiber, Portfolio Manager  
Alpine International Real Estate Fund

In Alpine International Real Estate Fund’s Annual Report of October 31, 2005, investments in the Fund were allocated into the following regions: Asia, 29.8%; Europe, 45.1%; South America, 9.8%; North America, 15.2%.

## Central Europe and Russia Fund Announces Expiration of Rights Offering

The Central Europe and Russia Fund, Inc. announced that its rights offering which commenced on December 22, 2005 and expired January 20, 2006 was over-subscribed. In accordance with the terms of the Offer, the subscription price of \$40.19 was determined based upon 90% of the average of the last reported sales price per share on the New York Stock Exchange for the five trading days ending January 20, 2006. Shares were distributed to stockholders following any pro rata allocation of over-subscription requests at the end of January.

Deutsche Asset Management Americas, Inc., the Fund’s investment manager, intends to invest the proceeds from the Offer to pursue investments in primarily equities and equity-linked securities in Central Europe and Russia that the investment manager believes represent investment opportunities.

We plan to interview the managers of The Central Europe and Russia Fund, The European Equity Fund and The New Germany Fund for the March issue of *The Scott Letter*. The three funds are managed and advised by wholly-owned subsidiaries of the Deutsche Bank Group. ■

## Portfolio Manager’s Review

During January, we completed the annual asset allocation adjustments by purchasing Adams Express Co., Diamondrock Hospitality Co. (a REIT), Ellsworth Convertible Growth and Income Fund (now Ellsworth Fund), because the latter has been acting better and is less volatile than TCW Convertible Securities Fund, which was sold.

Because our 2006 focus shifted from Western Europe (in 2005) to the Emerging Markets for 2006, we sold nearly all of the positions in The Europe Fund, but held and added to the European Equity Fund because it now has exposure to the emerging markets of Eastern Europe. We also added to H&Q Healthcare Fund to concentrate our declining U.S. exposure. In the

foreign sector, we added to Asia Pacific Fund, Lazard Global Total Return & Income Fund, Swiss Helvetia Fund in the equity sector and Templeton Emerging Markets Income Fund and Templeton Global Income Fund to the bond fund sector.

We also invested much of the cash available into the mutual fund, Templeton Developing Markets Trust, after sales of the Templeton Emerging Markets Fund (EMF). Further purchases in these two funds managed by Dr. Mobius will be limited to the mutual fund mentioned above unless a discount appears again. ■



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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