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THE SCOTT LETTER:
CLOSED-END FUND REPORT

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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

IN THIS ISSUE:

Tom Dinsmore Elected President of Closed-End Funds Association

Tom Dinsmore, the manager of the Bancroft and Ellsworth Funds, has just been elected President of the Closed-End Fund Association (CEFA). Mr. Ober, Chairman of Adams Express, served as President since 2002, replacing Brian Smith, Executive Director. Ober was a strong advocate for the industry: under his leadership, CEFA developed a web site, an annual closed-end fund forum and a new booklet on the advantages of closed–end funds.

There are now over 600 equity and bond closed-end funds. They have a fixed capitalization, usually trade on stock exchanges and are distinguished by unique features and benefits. Each has its own investment objective: capital growth, current income or a combination of the two. Shares are created through a public offering (IPO) and trade on stock exchanges. Closed-end funds (CEFs) will have both a market price and a net asset value (NAV). The market prices fluctuate based on supply and demand, and typically trade above (premium) or below (discount) to the fund's NAV.

Tom Dinsmore

Mr. Dinsmore said: "It is my intention to build on this legacy and have the Association be a reliable source of objective information on closed-end funds, primarily through its web site."

CEFA annual forums are held in various locations to educate and inform advisors and investors about the latest opportunities and trends in closed-end fund investing. John Scott, Jon Chatfield (our new associate) and George Scott plan to attend this year's Chicago meeting.

Your editor has known Tom Dinsmore since the early 1990s. Closed-End Fund Advisors interviewed him by telephone on August 9.

SL: First, what is your overview of the industry and how do you plan to move the Association forward?

Dinsmore: We have achieved our initial objectives: we are educational and do some marketing and public relations. This may bring us out of the dark recesses of the investment industry that we were in a few years ago. We are getting noticed in publications such as *The Wall Street Journal* and *The New York Times* when we have something of importance to publicize with regards to the closed-end fund community. More is planned for the foreseeable future.

SL: How does it feel to step into Doug's shoes?

Dinsmore: Doug was the first "go to" guy for the Association. Brian Smith, the Executive Director, was a good first President when CEFA was founded in 1999.

SL: How will you expand CEFA?

Dinsmore: We want to expand membership – currently we have about 23 members, representing about 45 funds – in a cost efficient way. We also want new forums, now held in various parts of the country. Another option will be to increase our role at other shows and seminars. Only a handful of the funds have attended both the annual Money Shows and the Financial Planners symposia. Our Annual meeting will be held this year in Chicago. Details on how to sign-up for the free one-day seminar are on our web site, www.closed-endfunds.com. We also wish to continue our presence where investors and investment professionals can meet with funds and other members.

SL: What is the best way for investors to use your web site?

Dinsmore: While I liked the old Wiesenberger report, we determined that Lipper did the best job, so we chose them for the web site. It can be accessed from the internet or from services like Bloomberg. There, we can build links to all members who can get information from analysts and professionals. CEF shareholders can also get information, press releases and third party research without a fee.

SL: Good. What current issues concern you the most?

Dinsmore: The biggest one is a lack of sponsorship by the industry and insufficient research from the brokerage industry. We believe that they have to cover a wider variety of funds rather than just a few big names.

SL: How do you plan to resolve this?

Dinsmore: By continuing the regional forums to stir professional interest, making objective information more readily available and by taking positions on regulatory issues such as managed distribution plans. We want to be available to analysts, and contacts with the press are very important.

SL: The brokerage firms spend so much effort covering ETFs. Do you think they are ready to cover the closed-end funds better than they have?

Dinsmore: We hope that they will be able to combine a closed-end fund analyst with an exchange traded fund analyst. I used to think ETFs (index-tracking mutual funds) were real competitors, but it would be a good idea to expand to CEF coverage as well.

SL: Good point. At Closed-End Fund Advisors we now follow ETFs more closely, especially for the foreign markets. However, we still like the advantage of buying a CEF at a discount to net asset value. ETFs may be a better choice than using mutual funds, especially for the foreign markets, when the equivalent closed-ends are not available. Do you think that ETFs compete with us?

Dinsmore: As long as it remains index-driven, the passive investment ETF makes enormous sense, so I don't see where they compete with us directly.

SL: If these funds become actively managed, do you think that they would be fee-driven or what?

Dinsmore: These are some of the many questions we haven't answered yet. What will your fee structure be? How are you going to pay-off redemptions? Will it be a portion of an active portfolio or a passive index?

SL: These are good questions as ETFs seem to be on everyone's mind. What is your view of how closed-end funds differ from mutual funds in volatile markets?

Dinsmore: Because they sell at a premium or a discount, this means you can have a cushion or an extra fling in the wrong direction. We can't stress enough how discount protects the shareholder when markets head south.

SL: We often see a fund run up in price just before it goes "ex-dividend" after which it often crashes. Comments?

Dinsmore: This is an example of why we are trying to get more information to investors so that they can act rationally. Often the price movements in closed-end funds are seldom rational. People over-react to news.

SL: This is just why we like investing in these funds. They are the best way to invest in inefficient markets.

Dinsmore: Some of these issues will be addressed at the September 18 Chicago conference. The sooner more information is available, the sooner people can make a more rational decision on whether to buy or sell based on objective information, rather than on heresay. If the most recent dividend information isn't on the web site, we will add it as well as other relevant information.

SL: Why do you think the same fund companies have both open-end and closed-end funds?

Dinsmore: If they have big selling organizations, it makes sense to have both. Some funds are good in an open-end format; for others, it makes sense to go the closed-end route. Open-end funds are market-driven; a closed-end fund can't massively expand or contract with dollar inflows as with an open-end.

SL: Some closed-ends have bigger distributions than the equivalent open-end funds, perhaps because they are allowed to leverage and mutual funds cannot. That can make a big difference in distributions, despite the higher risks.

Dinsmore: That's right. They may have higher yields, but they also have the possible downside inherent in these funds.

SL: There are an increasing number of leveraged funds. Have you ever considered leveraging your Bancroft or Ellsworth funds?

Dinsmore: No, but these funds serve a purpose as they can use a variable rate preferred stock to leverage. These shares are often highly rated because they are backed by a substantially larger diversified portfolio than the preferred issue. They not only get income as a trade-off to capital gains, but they also may invest in issues with a higher yield than the preferred. This is offset by an increase in risk and volatility.

SL: What are your thoughts on managed distributions?

Dinsmore: Managed distributions can provide investors with a predictable cash flow for a significant period of time, even if it means a reduction of principal. They make sense for people who require annual withdrawals of specific amounts or who simply have the need for periodic cash-flows. Secondly, if they are upset by the discount, a managed distribution can be seen as a "planned tender offer" at 100% of net asset value. It is a way of realizing the discount, if that is what is important.

I think such policies require an educated investor, but I don't think people should buy a managed distribution policy fund without investigating how they are generating that income. This is part of what CEFA is trying to do. If you look at our web site, we show what types of dividends are being paid and whether or not the fund has earned it.

To reiterate, the whole purpose of CEFA is education and to provide objective statistics from a variety of sources. We have sources such as brokers like Raymond James and banks such as Wachovia and others. People can now find research from those who don't have any axe to grind. We also give marketing and PR information from all closed-end funds as they are available. Our search engine has been improved, but we are still working on it.

We are also doing some advocacy. For example, some of our members have commented on proposed changes to NYSE Rule 452 in which the Exchange wants to change the definition of uncontested elections, such as for the board of directors. When the proxies have not been returned in a timely manner, Rule 452 allows brokers to vote clients' shares in routine, uncontested matters such as the election of directors or ratification of an auditor. This proposed rule does not consider any election of directors to be "uncontested" or routine. That would require all funds to spend money on an agent to solicit proxies directly from all shareholders to get a "hard" vote for a quorum. This might occur even if the shareholder has requested that they not be contacted.

Our comments had the effect of getting the Exchange to extend the comment period and to invite a member of CEFA to join part of their working group. We will continue to address these issues and others.

SL: Good work. When you recently changed the names of the Ellsworth and Bancroft funds so it excluded "convertible" in their names, didn't that require a "hard vote"?

Dinsmore: Yes, because it had a direct effect on what we could invest in. With the word, "convertible" in our name, we had to have 80% of our portfolio in convertibles at all times due to the SEC's "name rule." With the name change, we went back to our original charter standard of 65% convertibles. We asked for this change because in 2002 and 2003 convertibles became priced on their fixed-income value rather than their stock value. Thus, the convertible market as a whole was an unattractive equity alternative, while portions of the corporate bond and preferred markets appeared to be undervalued. We have, therefore, taken advantage of this disparity in valuations.

Today, convertibles have a substantial equity component, so the types of convertibles available now appear to be more attractively priced. Because a convertible has both an equity and a bond component, the interplay between the two is very important. This is where I can add value. When either component gets too large, it makes it harder to get the mix that makes it possible to reduce volatility and retain total return since you are buying either a stock or a bond equivalent.

SL: This is important to know because many investors still do not understand how the convertible market works.

Thank you for this and especially in helping our readers understand how CEFA can help them to navigate the difficult waters and to better understand how they can manage their hard-earned money. ■

International ETFs Surge in Popularity After Strong Returns

Investor interest in international funds has now tempered slightly, but that hasn't altered the picture for international ETFs, according to a report in *The Wall Street Journal.* Over the past year, ETFs, especially the internationally-oriented ones, have been raking in cash faster than their counterparts.

Total ETF assets have risen 38% to $335.1 billion in the past 12 months, while during the same period, global ETFs nearly doubled to $82.8 billion. Some financial advisors say that they have begun to favor international ETFs over traditional mutual funds because they offer a wide range of options, easy trading and lower fees.

A major drawback of exchange-traded funds, however, is that they only offer index-based investment strategies. They can't hire a money manager to pick stocks. They are instead limited to replicating stock market returns of the country or region they are designed around. That makes ETFs cheaper than other funds but typically eliminates the chance for better-than–market returns. This is what investors in closed-end funds hope to do.

Our view of ETFs is cautious. We have a few of them and continue to study how best to use them, only as alternatives to closed-end funds where we can't find a CEF to fit into the portfolio. ■

Buy Closed-End Funds

"Income investors need not be slaves to the Federal Reserve Board," writes Richard Lehmann in the August 14 *Forbes Magazine*. "You can get steady cash from a portfolio without owning treasury bonds. Diversify across stock market, real estate, and oil and gas. A good way to accomplish this is with closed-end funds."

Lehmann first recommended closed-end funds to get their high income, derived in part from leverage. The funds borrowed short-term and invested the money long-term at high rates, pocketing the difference. A year later, he recommended selling these funds because the Federal Reserve's rate hike policy was punishing funds relying on leverage.

Now he says it is time to get back into leveraged closed-end funds rather than ETFs because the yield curve is flat and is expected to "steepen" over the next 12 months. This is especially true for those seeking income because ETF offerings in the bond sector are limited, and they generally don't use leverage.

"Besides," he says, "you can't get an ETF at a discount as the whole point of an ETF is to keep the shares trading almost at precisely at its net asset value. The discount, on the other hand, enhances yields, offsetting the fund's expenses, which are higher than those of ETFs."

Lehmann recommends several closed-end convertible funds (see www.forbes.com/lehmann). ■

Learning: It's a Lifelong Process
You can get all A's and
still flunk life.

— Walker Percy (1916-1990)
Writer

Jonathan Chatfield Joins Closed-End Fund Advisors


Jonathan L. Chatfield

We welcome Jonathan L. Chatfield, CFA, to our firm as co-portfolio manager and contributing editor of *The Scott Letter.*

Jon brings many years of experience in managing portfolios for a large firm where he oversaw over $800 million in assets. In this capacity, he managed both the "aggressive growth" strategies and the firm's "conservative core" portfolios. Jon also served as a member of their investment policy committee, primarily selecting mutual funds for client portfolios.

Jon is excited to be able to manage closed-end fund portfolios again. He was one of the original employees of Closed-End Fund Advisors which was founded in 1988 in Santa Barbara, California. Since rejoining the firm, he has helped us develop a new Hybrid Income Portfolio for clients interested in steady income (see details below).

We have stayed in touch with Jon over the years, hoping he would eventually make the jump to a firm specializing in closed-end funds. In his new role, Jon will serve on our investment policy committee and assist in portfolio management. He will also help the firm to grow its assets, particularly in California and the West.

Jon (age 39) is located near San Diego. Click here to download Jon's bio. ■

The New CEFA Hybrid Income Portfolio

In order to provide our clients investment alternatives, CEFA has decided to add depth to our product line by introducing a **Hybrid Income Portfolio** in response to requests for an income alternative that has less volatility.

The portfolio will be diversified across sectors and have exposure to dividend-paying equity and bond portfolios, REITs, and high-yield corporate bonds, both domestic and foreign. To keep our exposure to currency fluctuations low, we may emphasize domestic portfolios.

The new portfolio is expected to have a current yield of approximately 8%. For more information, download the following Fact Sheet (as of July 2006). ■

Portfolio Manager's Review

During August, we completed purchases for clients of Allied Capital, because of its steady performance and consistent quarterly dividend over 8%. We also initiated new buys in Berkshire Hathaway B shares, as we see it as a good long-term holding to participate in other kinds of investments, with little downside risk.

We also increased our exposure to our holdings in the two Latin America regional funds, LAQ and LDF. This was funded by sales of Templeton Global Income Fund (GIM) which has been selling at a premium. In addition to its normal run-up for its September dividend, GIM has also been a good hedge against the decline in the U.S. dollar. We may purchase it once again in small amounts, if a discount appears.

Overall, we are positive for most markets, especially the foreign ones and continue to downgrade U.S. holdings (except for real estate funds and REITs) because of continued expected higher returns in the emerging markets and Europe. ■ George Cole Scott

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