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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

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Interview with Doug Bond: Cohen & Steers Closed-End Opportunity Fund

The Closed-End Opportunity Fund (FOF: NYSE) was launched on November 24, 2006, with an objective of total return. It seeks to achieve this objective by investing in common stocks of closed-end funds selected by Cohen & Steers, an investment firm located in New York. Cohen & Steers specializes in managing both closed-end and mutual funds that invest in real estate and utility funds.

This new fund invests significantly in a portfolio of closed-end funds in equity or income-producing sectors, strategies and securities. As of March 31, 2007, the fund was 98.7% invested. The total assets of FOF on April 19, 2007 were $530.8 million. FOF is jointly managed by Douglas R. Bond and William F. Scapell.

Douglas R. Bond

The top ten holdings on December 31, 2006 were Eaton Vance Tax Managed Global Fund (ETW), Calamos Strategic Total Return Fund (CSQ), Advent Claymore Convertible Securities & Income Fund (AVK), Eaton Vance Tax Managed Diversified Equity Fund (ETY), NFJ Dividend Interest & Premium Fund (NFJ), ING Clarion Global Real Estate Income Fund (IGR), Eaton Vance Enhanced Equity Income II (EOS), Eaton Vance Tax Managed Buy-Write Opportunity Fund (ETV), Blackrock Global Energy & Resources Fund (BGR), and Annaly Capital Management Fund (ALY), a real estate investment trust. This represents 29.9% of net assets.

At year-end, FOF was 80% invested in equity funds and 20% in fixed income-related funds. FOF will not invest in Cohen & Steers funds, as management decided that it would represent a conflict of interest.

The average annual returns for the market price of FOF for the first quarter was -0.18%., with +1.77% for its net asset value. Since inception, market return has been +2.78%. versus +2.09% for the S&P 500 Index. The largest sectors were Covered Call (25%), Tax Advantage Dividend (17%) and Real Estate Funds (12%).

We interviewed Doug Bond by telephone on April 20, 2007. Jon Chatfield also joined us for this interview. While visiting New York in early May, our editor met with Martin Cohen and Bob Steers of Cohen & Steers.

SL: Doug, what is your perspective on the closed-end fund industry, and what are some of the investment strategies you use?

Bond: FOF still trades near its net asset value and hasn't traded at much of a discount yet. The market makes the price, and we hope that it will reward FOF with a premium valuation over time. We are also students of the stock market, so we suspect others are rooting for it to trade at a discount. Time will tell. (On May 12, 2007, FOF closed at $19.60, at a discount of 1.7%, after its monthly ex-dividend date.)

Chatfield: Do you have any constraints on investing in funds that use leverage?

Bond: There are no formal constraints, but since leverage is one of the key risks in many closed-end funds, we constantly monitor the level of leverage in our funds. FOF is not leveraged, neither is the Cohen & Steers Total Return Fund. All of the other Cohen & Steers funds use some leverage. These leveraged closed-end funds typically borrow around 33% of their total assets. We evaluate, watch and measure the leverage of all closed-end funds in order to understand the leverage and investment philosophy of the funds we buy.

For example, we have investments in three leveraged Eaton Vance Tax-Advantaged Dividend funds, using "Auction Market Preferred" shares. Eaton Vance's philosophy,

with respect to leverage is that they believe over time earnings generated by the fund will more than offset any increase in borrowing costs as a result of increases in short-term interest rates. Each of these funds has increased their monthly dividends six times since inception.

Chatfield: How do you decide whether to invest in the equity market versus the bond market?

Bond: The investment committee makes a risk/return assessment potential of the various equity and fixed income asset classes. The asset allocation decision is assessed to help us achieve our long-term objectives for the funds. We prefer a combination of equity and fixed income fund exposure. Most of our fixed income funds sell at discounts to their net asset value and are leveraged. These discounts could narrow and share prices rise when the Fed eases later this year.

SL: We hope you are right about interest rates. Closed-End Fund Advisors also uses a similar combination of equity, preferred stock and bond portfolios to generate steady dividend income. What is your dividend policy?

Bond: Our goal is to grow the net asset value and the distributions. We want to deliver a 7% distribution rate, based on the offering price of $20 per share. We hope to grow shareholder capital by 3%-5% per year (as we have with our other funds). Our regular monthly distribution is $0.1175 per share. In 2006, we paid out a special distribution of $0.16 per share in addition to the regular distribution. At Cohen & Steers, we have only increased dividends, never cut them. We also have a dividend reinvestment program.

Chatfield: Do you ever take a shareholder activist role concerning discount/premiums or other issues?

Bond: Part of our due diligence is to discover value in the closed-end fund market. We maintain on-going dialogues with the investment managers who manage the funds in which we invest as part of our due diligence. A fund is constrained by the amount of shares we own. As a fund-of-funds, the Investment Company Act of 1940 prohibits us from owning more than 3% of the outstanding shares of any publicly traded closed-end fund.

[**Editor's Note:** Later in this newsletter, we will explain the differences between a fund-of-funds and a private investment manager which invests in closed-end funds.]

SL: At CEFA, we do not vote the shares of the funds that we own as we see it as the shareholder's responsibility. Do you differ in any way with this approach?

Bond: As a fund-of-funds, we are required to cast our votes according to the "proportionate" voting method. We vote the shares of the funds we own proportionately to how all other shareholders vote on any shareholder issue in the proxy. This means that we are not activists as our voting mirrors that of all other shareholders who cast their votes.

SL: How diversified is the Fund and how do you manage risk?

Bond: We see diversification as the centerpiece of any successful investment approach. Investing in a wide range of closed-end fund categories gives investors a broad cross section of securities. As a result, we invest in a broad range of different investment managers.

On December 31, 2006, we were invested in 64 different funds and in 15 sectors such as convertibles, covered call, energy, equity dividend, utility, preferred, high yield, limited duration, financial, healthcare, real estate, total return and even some equity non-dividend funds that offer promise based on their discount to net asset value.

We invest in 28 investment managers who bring a different corporate culture, investment process and philosophy. This yields a well-diversified portfolio to our shareholders. Some investors incorrectly think of closed-end funds as an asset class that all go down at the same time.

SL: You're right. Many investors often buy closed-end funds at a discount without considering the different sectors. Are most of your funds domestic funds?

Bond: No. For global exposure, our closed-end fund mangers invest in both domestic and international securities. Three of our top 10 holdings on December 31, 2007 were global funds, and many of our funds have significant positions in international companies and securities. We are doing increasing amounts of research on closed-end funds listed in London and elsewhere. There are some pretty interesting opportunities: For instance, after the global markets broke on February 28, 2007, you could buy shares in a Templeton Emerging Markets Fund in London managed by Mark Mobius at a 10.7% discount, while the same fund sold at an 8% discount in New York.*

When we launched RWF, the Cohen & Steers Worldwide Realty Fund in March of 2005, it was a great opportunity, and those who have stayed with it were richly rewarded. There are some pretty interesting opportunities in closed-ends outside the U.S. and, recognizing that, the closed-end fund business is global in scope with plenty of funds to choose from.

We own many funds that pay distributions in excess of 7%. That doesn't preclude us from buying funds that don't have a high monthly or quarterly dividend rate where we think there is an excellent total return opportunity.

SL: Have credit problems occurred that are often deterrents regarding investing in bond funds in the foreign markets?

Bond: We have not owned any funds that had credit problems in foreign markets. We think the way to minimize and defend against risk is to use bottom-up fundamental work on the individual funds and the managers as well as to maintain a well-diversified portfolio. Most of the funds pay very high monthly or quarterly distributions of income. We also own preferred funds, limited duration and high yield funds that invest in bonds. There are other factors we consider when choosing our funds, including interest rate risks, Federal Reserve interest rate policies and economic growth in the countries where we invest. Look at the high yield sector (in the U.S.), for example, of how this plays out in portfolio construction.

We think the U.S. is in the latter stages of the credit cycle. High yield bonds are being issued in record numbers. This has been followed by rising default rates and other credit issues, concerns that are reflected in some of the high yield funds

we have been buying at discounts. Even though we have identified issues with a high yield as a sector, we find value in being selective.

We buy funds to get a nice income stream and capital appreciation potential for our shareholders. If a closed-end fund is selling at a wider than average discount to its net asset value, it may be in a group surrounded by investment concerns. That may present an investment opportunity. In the high yield area, some funds have reduced their distribution rates. (We look at that as a risk.) On a top-down basis, we keep ourselves informed, but on a bottom-up basis, we try to make a daily determination about whether the various fund share prices already reflect some of those risks.

Most of the funds we buy sell at discounts to NAV, but we currently hold some funds selling at premiums to NAV. When we either buy or hold positions at a premium to NAV, our work has to give us a high conviction that the manager can sustain or grow its distribution rate and net asset value over time – in order to continue to earn that premium to NAV valuation.

Chatfield: Is there is any reason to hold a closed-end fund at a premium, especially if there are others in the category at discounts? Do you ever buy funds selling at premiums?

Bond: The short answer is yes. We are always looking for the discrepancies between how the fund manager is doing with the money and how the market price is evaluating the fund. We call that the "performance spread." We look at the performance spread on a 1-day, 1-week, 1-year, 3-year or 5-year basis. We look at all of these factors in our evaluation process. We look at the yield, level of coverage of the distribution amount and the historical performance of the manager relative to a benchmark over time periods.

We are not traders or market timers of closed-end funds, but we do think hard work can reveal times that are better for buying and times that are better for selling.

To summarize, we are very excited about the investment opportunities in closed-end funds. The market is growing dynamically, and there are many new issues which create a larger selection universe. There are also more investors every day considering closed-end funds as part of their portfolio strategy. They are attracted by the same things we see: high current income, a wide range of strategies that can complement just about any portfolio, growth potential that comes from net asset value growth and the narrowing of discounts. There is an incredibly talented group of investment managers in the universe of closed-end funds. If you are patient and do your homework, there is a lot of money to be made. ■

***Note**: When researching material for the book, *Investing in Closed-End Funds: Finding Value and Building Wealth* (New York, 1991) with Professor Fredman, I visited the closed-end funds (known as Investment Trusts in the U.K.) in London, Edinburgh and Dundee for the part of the book dealing with the history of investment companies. I then became aware that the discounts on London-traded funds were much deeper than in the U.S. After some consideration, I decided not to invest in any of these foreign-listed funds because they are difficult to buy, and there were plenty of opportunities in the U.S. It was a good decision.

Good News for Global Investors: U.S. and Global Stock Markets Increasingly Take Separate Paths

"For the first time in years, foreign stocks are behaving less like they are joined at the hip with U.S. shares," says a recent report in *The Wall Street Journal.* That is good news for global investors worried that U.S. economic growth is slowing. Many investors, including us, are preoccupied with the relationship between U.S. and foreign markets. Correlation is the key word, and it is the tendency of how markets move in different directions. It appears that the correlation of the U.S. and foreign markets are decreasing, because economic and earnings growth are diverging. This is nothing new for those of us who follow the U.S. and foreign markets, but it may be for most *Wall Street Journal* readers.

Textbook theory versus the real world was tested at the annual meeting of the CFA Institute in New York, which your editor attended in early May. This theory suggests that investing abroad helps to diversify a portfolio because overseas stocks are influenced by local economic conditions and interest rates. This debate has been a focus of much of our research and attention for many years.

Correlation is measured on a scale of 1 to -1. When markets are moving in perfect unison, the theory goes that they have a correlation of 1; and when they move in exact opposite directions, there is a correlation of -1. (At zero, there is no relationship.) During the 2-year period that ended in February 2007, this "decoupling" is expected to continue, but some markets will diverge more than others. During this same period, correlation between U.S. and other developed markets was 0.63, according to ING Asset Management. That is a big decline from 2003 to 2005, when they nearly moved in lockstep, at 0.93. These figures are based non-monthly movements in the Standard & Poor's 500 Index (which is one of the benchmarks we use to compare our performance) and the Morgan Stanley International EAFE indexes. Many analysts now see economic and corporate profits growing in the U.S. at about 1.8%, while non-U.S. economies are still expanding in much of Europe, Japan and the developing world. It is the latter that is our focus, and our portfolios have benefited in the last few years.

Growth in much of the developing world, particularly in Europe, is poised to continue expanding faster than the U.S. economy. This is because stock prices outside the U.S. look cheaper relative to earnings. Warren Buffett and others think that the dollar probably will continue to weaken, making returns on foreign stocks

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higher when translated into dollars. A report from a unit of Bear Stearns Asset Management says that European stocks will continue to outperform their U.S. counterparts because of cheaper valuations, noting that higher correlations between markets doesn't mean that they demonstrate identical returns, just that they are prone to move in the same direction.

There are signs that as economies around the world decouple from the U.S., stock market performances will diverge even further. If true, this is great news for investors in overseas funds. Profit growth in the U.S. is expected to be at the lowest level in five years, J.P. Morgan wrote in a recent report. Foreign companies may also depend less on the American consumers than in the recent past, while emerging markets are increasingly selling commodities and other goods to China and India, lessening their historical dependence on the U.S.

In short, the U.S. is losing out to foreign competition, which is not a new thought. There is a growing middle class, especially in Brazil, China and other parts of Asia. China's continuing demand for iron ore, steel and beef means that the foreign companies are well insulated from a U.S. slowdown or dip in its stock market, according to Wall Street sources.

Another reason for the continuing divergences are differences in monetary policies in many countries. The European Central Bank hasn't yet finished raising interest rates. It has followed central banks in India, New Zealand and possibly China, where there is speculation that interest rates will have to be raised to slow its booming economy. All of this could mean a continued decoupling between the U.S. and other economies. It is also important to note that in analyzing these markets, we are talking about indexes, not individual stocks.

We have seen that most of the closed-end funds in our portfolios outperform their benchmarks. We hope that this will continue, but past performance is no guarantee for future results. For many years, we have continually done research on the correlation between different types of closed-end funds, particularly in markets where we are invested. It is this inefficiency that intrigues us in using closed-end funds for overseas investing. ■

Sources: *Financial Times,* Market Watch (Dow Jones)

A Fund-of-Funds vs. Private Investment Advisor

"A fund-of-funds has some important advantages and disadvantages that you need to be aware of: It is exactly what it sounds like – a mutual fund (or closed-end fund) that invests in other mutual funds. Here are some big advantages to investing in a fund-of-funds:

1. Double diversification. A mutual fund diversifies across many different stocks. A fund-of-funds diversifies among many different funds.
2. Simplicity. Instead of investing in many different funds to achieve the same result, you can invest in one fund. That allows for much less paperwork.
3. Less expensive for beginning investors. It is tough to diversify when starting out because of account minimums. A fund-of-funds allows for an investor to diversify amongst hundreds or thousands of stocks in one small account.
4. Institutional advantages. A fund-of funds can often invest in desirable institutional accounts that are off limits for retail investors. They also have the ability to invest in some load funds without paying the load.

Here are some of the disadvantages:

1. Extra fees. Some funds-of-funds will charge fees at the parent level that should entice investors to create the same portfolio by buying the different mutual funds themselves.
2. Expense ratios. Most funds-of-funds carry high expense ratios that will drag down your returns over time.

"Depending on your situation, investing in a fund-of-funds may make sense to you. It is an attractive option for new investors. Before investing in a fund-of-funds, I suggest taking a closer look at the expense ratios to make sure they are not too high. If you are interested in learning more about funds, try visiting the Fund of Funds Association home page." ■

Source: Dustin Woodward, *Your Guide to Mutual Funds*

Advantages of a Private Investment Advisor/Specialist

Closed-End Fund Advisors, Inc. has more experience investing in closed-end funds than most funds-of-funds managers. Its portfolio manager has been buying closed-end funds since 1973. George Cole Scott has served on the Board of Directors of Bergstrom Capital, an award-winning closed-end fund. This fund was selected by *Forbes Magazine* for its "Honor Roll" of mutual and closed-end funds for 10 years in a row in the 1990's because of its superior investment performance and low expense ratio. The experience has made us acutely aware of such issues as the investment value of low expenses, the dividend policies of funds, asset allocation, and the value and use of sub-advisors to take advantage of expertise (such as in venture capital investments). Bergstrom Capital, a fund that was responsible for getting us into this specialty, employed numerous sub-advisors to manage much of its portfolio until it was liquidated in 2003.

How Closed-End Fund Advisors Differs from Funds-of-Funds

1. Our managed accounts are suitable for many investors, especially those who need services in structuring of a personalized asset allocation model in closed-end funds that will actively maintain a balanced approach to a

client's individual objectives with daily account reviews.

2. As part of our research, we conduct in-depth, one-on-one interviews with portfolio managers all over the world. This gives us unique access to the best managers who have exhibited superior investment returns over long periods. For this reason, we avoid new funds until they have developed a track record. As a result, this helps us decide which funds best fit a client's portfolio.
3. We are also able to evaluate many funds in comparison to the others we research. These interviews are published in *The Scott Letter* so our readers may become educated about closed-end funds.
4. In our opinion, the best way to invest in the global markets is through using closed-end funds.
5. The Closed-End Fund Advisors web site (www.cefadvisors.com) gives in-depth information about the firm, including our investment philosophy and portfolio allocation models.

As an aside, your editor attended the 60th annual meeting of the CFA Institute, an international not-for-profit organization based in Charlottesville, Virginia. It is a community of more than 90,000 members in 133 countries with a mission to lead the investment profession globally by setting the highest standards of ethics, education and professional excellence. During this conference, one speaker told the crowd of 1,600 that many money managers are skeptical of company visits [as well as Wall Street research], as publicly-traded companies always have "axes to grind."

Interviewing closed-end fund managers regularly since he started *The Scott Letter* in 1989, George is acutely aware that sometimes even the portfolio managers of closed-end funds try too hard to promote their particular fund, causing them to lose their objectivity. On the other hand, he has nothing but the highest regard for the portfolio managers and senior-level executives of the 500+ closed-end funds that the firm follows. They exhibit superior ethical conduct and give easy accessibility to us when we contact them. We also find that we are often given clear answers to our questions when we see them at meetings.

The closed-end fund industry also has had a trade association since 1998, its web site can be accessed from the web at www.cefa.com. ■

> *"I think the greatest thing in the world is to believe in people"*
>
> – John Galsworthy (1867-1933), writer and playwright

Portfolio Manager's Review

April was characterized by continuing concerns about the U.S. economy, which is growing slower (1.8%) than most overseas markets. Towards month-end, however, the Dow made new highs, and most of the foreign markets, especially in Asia and Latin America, strengthened.

Most of our portfolios have been behaving very well. We are now invested in a total of 45 closed-end and four mutual funds, some of which are real estate funds. We have added to The European Equity Fund, ING Clarion Global Real Estate Fund, First Trust/Aberdeen Global Opportunity Fund, Nuveen Global Value Opportunities Fund (the latter two mostly for the Hybrid Income portfolio) and a major new position in Washington Real Estate Investment Trust, (WRE), a Washington, D.C.-based diversified REIT.

Sales were made in a few shares of Adams Express because of its sharp run-up. We also lightened our holdings in Calamos Global Total Return and in two of the Cohen & Steers funds. One of our largest holdings, Templeton Emerging Markets Income Fund, was reduced for better opportunities, although it is still a major position and a superb performer. ■

George Cole Scott

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