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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.

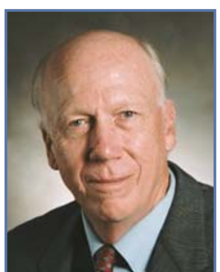
– George Cole Scott
Editor-in-Chief

IN THIS ISSUE:

First Trust Enhanced Equity Income Fund: Covered Call Strategy Hedges Market and Generates Consistent Income

The investment objective of First Trust Enhanced Equity Income Fund (NYSE: FFA) is to provide a high level of current income and gains and, to a lesser extent, capital appreciation. The Fund pursues its investment objective by investing in a diversified portfolio of equity securities. Under normal market conditions, the Fund has an integrated investment strategy that invests substantially all of its assets in diversified stocks of U.S. corporations and U.S. dollar-denominated equity securities of foreign issuers. In addition, on an on-going and consistent basis, the Fund will write/sell covered call options on a portion of the Fund's managed assets.

The Fund is managed by the sub-advisor, Chartwell Investment Partners, L.P. ("Chartwell"), an employee-owned investment advisory firm founded in April 1997 and located in Berwyn, PA. Chartwell is a research-based equity and fixed-income manager with a disciplined, team-oriented investment process.



Bernard P. Schaffer

Bernard P. Schaffer, managing partner, is a founding partner of Chartwell, has 39 years of investment industry experience and serves as senior portfolio manager for the firm's closed-end fund and hedged large cap equity strategies.

As the lead portfolio manager for the Fund since 2007, he focuses on securities in the energy, financials and consumer staples sectors. From 1990 to 1997, he was employed as a senior portfolio manager at Delaware Investment Advisers, managing two closed-end equity income funds that utilized option strategies to generate portfolio gains. Mr. Schaffer earned a bachelor's degree in economics from Villanova University and an MBA from the Wharton School, University of Pennsylvania.

Douglas W. Kugler

Douglas W. Kugler, CFA, principal, is a portfolio manager on Chartwell's large cap equity portfolio management team and has 13 years of investment industry experience. His areas of focus include the transportation and consumer discretionary sectors of the market. He has been a portfolio manager for the Fund since 2007. From 1993 to 2003, he held several positions at Morgan Stanley Investment Management (Miller Anderson & Sherrerd). Prior to joining Chartwell served as senior associate and analyst for the large cap value team. Previous to that, he was head of mutual fund administration and vice president and treasurer of the MAS Funds. Mr. Kugler holds the Chartered Financial Analyst designation and earned a bachelor's degree in accounting from the University of Delaware.

On May 2, 2011, our portfolio manager, John Cole Scott, had the pleasure of interviewing Bernard Schaffer and Douglas Kugler. In order to provide a more comprehensive interview, we also spoke to Jeff Margolin, closed-end fund analyst, and to Chris Fallow who is involved in advisor oversight with First Trust.

SL: What about your education and professional backgrounds do you think helps the most in the management of FFA?

Kugler: Bernie has 39 years of experience in the investment industry and has been managing funds using covered call strategies for the last 17 years. I have been involved in investing in higher dividend yielding stocks for the last seven years and have been working with Bernie on covered call strategies for the last 3½ years.

SL: Why do you like the closed-end fund ("CEF") structure for a covered call fund?

Schaffer: Under the CEF structure, the amount of capital the portfolio manager has to work with does not change on a daily basis, like it would under an open-end fund structure. This stable capital base makes it easier to manage the covered call portfolio.

SL: CEFs are known for equity income strategies. What is special about the covered call focus for the equity investor seeking an income-oriented portfolio?

Kugler: A properly run covered call program can be an additive to income generated by portfolio securities in most market conditions. In addition, the use of covered calls can lower the volatility of returns.

SL: When researching covered call funds, it comes down to NAV performance and what a realistic distribution level might be. There are currently 30 covered call funds with an average 9.1% distribution rate. In addition, it is rare to see a yield below 7%. I notice that FFA's distribution yield is currently 7%, in the lower end of the group's distribution range. How much of your strategy is writing calls for income and how much of it is the selection of equities for income and NAV performance?

Schaffer: We first place emphasis on portfolio construction and security selection, and then we fit in the option strategy after that. We select securities based on total return potential. With the option strategy, we endeavor to supplement the income of our higher yielding equity portfolio and to also provide downside protection in a bear market. In addition, we also consider one of our goals to be competitive on the upside. That requires a different mindset than just writing options all the time. Basically, we are always active in covered calls, but we are very sensitive to total return in both up- and down-markets. The primary emphasis is on portfolio construction and security selection. The options are the tail, and the tail does not wag this dog.

SL: Have you ever held a position that you changed because of a challenge in writing calls?

Schaffer: No, I'd say not. As I mentioned earlier, we select securities based on their total return potential – the ability to write calls on the position, while reviewed, is not a significant consideration. We are always familiar with what we have in the portfolio and the depth of their options; some of the positions are not good for call writing.

You can overcome this through a variety of ways. You can hit your desired level of option writing through writing more on those stocks with readily available options. We can also use index options. You can pick and choose whether it is best to write calls on individual stocks or to write index options.

> **"We first place emphasis on portfolio construction and security selection, and then we fit in the option strategy after that"**

Kugler: Put another way, if we really like the stock from a total return perspective but it doesn't have what we would consider to be usable options, we will consider it to be a position to hold against index options that we could write. We will have a number, but not a majority, of the stocks in the portfolio that probably aren't the best "option stocks". However, we like them from a total return perspective.

Schaffer: Another consideration is that when writing on individual securities, we are very sensitive to price which, for options writing, is one of our evaluation parameters. For example, if you're writing calls on two stocks that have a history of trading between $25 and $30, we're not going to sell an option on the $25 dollar stock. It's too cheap.

Our typical approach would be to sell an option on the stock that is at $30 because we are at the top end of that range. For the $25 stock, we would be hesitant to sell options on it. That stock could be under the umbrella for which we would write index options. The real trap with writing calls is selling individual stock options against your whole portfolio because, in a strong market, you want to let your winners run. You don't want to sell options against stocks that you think are just too cheap.

SL: Closed-End Fund Advisors uses NAV versus peer groups as a way to quantify manager success. Your 2010 NAV return was better than peer averages, but you lagged in 2005, 2006, 2007, 2008 and with inception performance of +3.55% versus +4.65% for peer average. What is responsible for this? What do you expect will drive NAV performance in 2011 and 2012?

Kugler: Results for 2005 through 2007 were under the previous manager. In 2008, FFA's NAV outperformed the S&P 500 by over 6% and outperformed the group of comparable funds used by FFA to review performance. Any 2008 underperformance relative to another group of funds was most likely due to the strategies of the funds not being comparable. We expect NAV performance in 2011 and 2012 to be driven by our stock selection and our focus on high quality, higher dividend-paying companies which are performing well fundamentally.

SL: How much of your portfolio analysis is based on the ability to write large calls versus. the ability to get beta or performance over the stock market?

Schaffer: The bulk of our focus is on stock selection and maintaining a well balanced portfolio. We view the use of covered calls as a way to supplement the income derived by our above-market yielding portfolio of stocks and to mitigate volatility of returns. While selling calls is an important component of our strategy, stock selection is our first concern.

SL: You have a current distribution yield of 7% or 2% less than your peer group average, yet the fund has a NAV total return of +11.5% versus a peer group average of +8.1%, which is +3.4% better. Do you feel that you have had to trade off distribution yield for NAV total return?

Schaffer: No. We focus on providing the highest possible total return while generating sufficient income and capital appreciation to support a reasonable distribution yield over the typical market cycle.

SL: FFA raised the dividend 2.25% earlier this year. How does FFA decide to raise or reduce the dividend?

Fallow: Fund distribution policies get reviewed by a number of First Trust internal groups as well as with the sub-advisor before we make a recommendation to the board. Unless specified, we look to set the distribution rate based on recent income generation and NAV performance as well as forward looking sustainability.

SL: Do you feel pressure from the board to raise distribution yield levels or to keep the discount from getting too wide?

Kugler: No, we have never been pressured by the board to meet any distribution or discount levels.

SL: In December 2008, the Fund's dividend was $0.40 per share versus its current $0.225 per share. How focused are you on getting the distribution back to 2008 levels?

Schaffer: The priority at the Fund is performance or total return, and if performance is good, that will have a positive impact on our ability to pay out an increased distribution. As you know, if you pay out more than you earn, the NAV declines. Our goal is to get the NAV in an upward cycle and to pay out what is considered to be a sustainable distribution. When we last cut the dividend, the cut was to a level we considered sustainable at that NAV. The most recent increase is reflective of the fact that the NAV had risen. Therefore, a higher level was considered sustainable.

SL: In reviewing FFA's 43.2% return of capital percentage, many investors don't realize how option premiums can impact that percentage. Option premiums on options that expire unexercised are categorized as short-term gains. These short-term gains are generally distributable only if they are greater than both current and carry-forward capital losses. Even if the fund receives enough current premiums to "cover" its distribution, losses from prior periods can impact how those premiums are characterized for tax purposes when distributed. We have found that some covered call funds intentionally include return of capital in their dividends to inflate a fund's indicated yield. Can you further clarify the difference between using the Fund's option premiums to support the dividend versus intentionally distributing return of capital?

Schaffer: I am not an accountant so we've got to be careful here. As you said, if you sell an option on a stock and it expires valueless, it is a short-term capital gain. If you distribute that income to shareholders, for tax purposes it is a short-term capital gain or ordinary income. We want to earn the distribution through dividends received, gains on stocks held in the portfolio and net options gains. When you look at it from a very simplified basis, return of capital occurs when more than what is earned is paid out. As Chris said previously, we look to set the distribution rate based on recent income generation as well as forward-looking sustainability.

However, as you know, whenever taxes are involved, things can get complicated. In many funds (FFA included), sales of securities at losses during the bear market of 2008 and 2009 generated tax loss carry-forwards which, for tax purposes, are used to offset other capital gains, including options gains, thereby reducing taxable income. The use of these tax loss carry-forwards to offset current year's gains can generate return of capital distributions even in years when the Fund has earned enough to cover that year's distribution. One way to look at this is that we have a built-in tax shelter because this fund has a loss carry-forward. When the Fund earns that income, any expired option premium gets returned to shareholders as a return of capital which is non-taxable. One way to think about it ... and most people don't ... but I do, is that there's a hidden asset in this fund. It's called the loss carry-forward. That is an advantage for a fund like this.

SL: What are your closest peer funds, and which funds are fundamentally different and should not be compared to FFA?

Kugler: FFA is fundamentally different from many covered call funds in that there is no requirement to maintain a coverage ratio of 80%. In addition, the portfolios of a number of our peer group funds are not actively managed or they are focused on growth companies which is another fundamental difference. We view BlackRock Enhanced Equity Dividend (NYSE:BDJ) to be our closest peer fund.

SL: As with all closed-end funds, you have to discuss the discount or premium of a fund as a significant factor in analyzing a fund's value or worth. What factors do you feel have the fund trading at a -9.48% discount versus a peer group average of -5.73% (as of April 29, 2011)?

Kugler: While it's hard to determine what exactly causes the Fund to trade at a discount, it's possible that a contributing factor could be our lower distribution yield in comparison to other covered call closed-end funds. However, we believe this gives us a long-term advantage in that the distribution is viewed as more sustainable.

SL: I know the Fund doesn't use leverage in the portfolio. Is this a manager or board decision? This could obviously help increase the ability to achieve a higher yield. Why don't covered call funds tend to use leverage when most closed-end funds or roughly 72% of all funds are currently levered in some capacity?

Fallow: The prospectus was written to not include leverage. With this strategy, we didn't want to increase the volatility by adding leverage.

Margolin: Almost all covered call funds are unleveraged. Issuers of covered call closed-end funds generally do not use leverage because a covered call strategy generates a lot of income already. Why make the portfolio have higher risk?

SL: Yes, very few covered call funds have leverage. I see four funds leveraged around the 20% level. When we do a presentation on CEFs, covered call funds always offer the highest average distribution yield available. If you're already the top group, you don't need to reach for higher yield.

It looks like almost 30% of your portfolio is concentrated in the top 10 holdings. I find some funds with hundreds of positions. Conversely, there are some funds out there that might only have 15 to 20 positions. For FFA, is it more your manager style coming through, or does the covered call strategy drive this result?

Schaffer: We think it's more the nature of the strategy and what the shareholder is looking for from us. There are funds that own hundreds of securities. Certainly they can have their reasons, but that's not our style. We think owning between 50 and 60 at the low end and 70 to 85 on the high end makes sense because this is a lower risk strategy. Typically more diversification means lower risk. When we have strong convictions, we take positions over 3% as you've seen in the past. Diversification is a virtue although you can overdo it.

SL: Please discuss how your turnover ratio changed over recent market cycles. What was normal turnover as you navigated through the three distinct periods: pre-financial crisis, the bear market and the recent recovery?

Kugler: Looking at the annual report for FFA, the turnover rate was 41% in 2010, 74% in 2009 and 121% in 2008. The higher level of turnover in 2008 was a result of rebalancing the portfolio from the previous manager and reacting to the turmoil in the market at that time. The 74% was another instance of repositioning as we saw the markets turn during March of 2009. We repositioned the portfolio to be more cyclical in nature and that generated a higher turnover. The 41% for 2010 might be on the low end because we've been so comfortable with the holdings in the portfolio. Our stocks have been performing well, and we just didn't feel any changes were needed. I'd say our normal turnover would be between 41% and 75%.

SL: I noticed that the turnover figures reported by CEF Connect are inaccurate. Is this something the Fund audits or reviews regularly? In addition, how do you monitor the accuracy of the data being presented on external sites like cefconnect.com or cefa.com versus your site?

Margolin: I am familiar with this issue as someone who regularly looks at information for many closed-end funds. We use cefconnect.com, and other paid research resources. However, I always find for my own research and from my experience, if you need to drill down into one specific fund's information, the best place to go is the fund's own web site.

SL: Yes, it takes some extra time, but this can help you make more accurate decisions on CEFs.

It came up at the recent CEF Association meeting in NYC that CEFs sometime try to hide behind Regulation FD when communicating with shareholders. What has FFA done to improve their communication to shareholders, and where do you see it improving in the near-term?

Margolin: First Trust has set up sub-advisor calls with the public and provides information on the web site.

SL: We have a few questions from closed-end fund investors on LinkedIn and Morningstar CEF discussion groups which we wanted to share.

[**Editor's Note:** Questions from the above mentioned discussion groups are presented in *italics*.]

First Trust Enhanced Equity Income Fund
(as of December 31, 2010)

Performance*		1-Year Ended 12/31/2010	Average Annual Total Return 5-Years Ended 12/31/2010	Average Annual Total Return Inception (8/26/2004) to 12/31/2010
Fund:	NAV	15.50%	2.59%	3.73%
	Market Value	16.37%	3.81%	2.26%
S&P 500		15.06%	2.29%	4.19%
BXM Index		5.86%	2.81%	3.64%

Total 10 Holdings	% of Total Investments
Occidental Petroleum Corp.	3.60
Exxon Mobil Corp.	3.33
International Business Machines Corp.	2.79
Intel Corp.	2.68
Bristol-Myers Squibb Co.	2.62
SPDR KBW Bank ETF	2.60
JPMorgan Chase & Co.	2.37
Microsoft Corp.	2.12
Target Corp.	2.06
Coca-Cola (The) Co.	2.00
Total	26.17%

Sector Classification	% of Total Investments
Financials	17.76
Information Technology	16.03
Industrial	13.05
Energy	13.04
Consumer Staples	10.81
Consumer Discretionary	10.26
Health Care	7.44
Materials	5.96
Telecommunications Services	3.55
Utilities	1.86
Other	0.24
Total	100.00%

*Investment involves risk, and past performance figures shown above are not indicative of future performance.

Options CEFs publish their moneyness policy, but does this vary significantly based on the portfolio manager's short-term market outlook? How important is stated moneyness in comparing or choosing a covered call CEF?

Kugler: Yes, "moneyness" should vary significantly based on a portfolio manager's market outlook, and it is a factor in comparing funds as "moneyness" can affect total return. We employ a flexible approach to FFA's options use in which the "moneyness" of the options employed is adjusted based on our market outlook. The more positive we are, the less "moneyness" and vice versa.

SL: *I like to know up front if a fund ever buys or sells puts.*

[**Editor's Note:** From CEFA's internal research, I have yet to find a fund in the sector that deals with puts.]

Could you imagine the environment where puts were a useful and marketable strategy for a covered call fund?

Schaffer: We have not used puts within FFA, although the Fund has the capability to use them. Buying puts would have been a useful strategy during the bear market, but our strategy was to be super aggressive on the covered call side and not being afraid to be close to 100% covered during that period. We did not employ puts, and as you can imagine during that time period, they just seemed to be too expensive. Premiums were also just as elevated on calls, so the strategy we employed was to be optioned throughout most of the bear market, at rates exceeding 80%-90%, and occasionally we were literally at 99%. That's the strategy we employed, and we were successful in doing that. To pay the prices that puts were trading for in order to protect the portfolio was not economical so we employed a very aggressive call over writing strategy.

Margolin: The only fund I'm aware of that was aggressive in using puts was Eaton Vance Risk-Managed Diversified Equity Income Fund (NYSE:ETJ). Their NAV was only down 1% in 2008. The problem is they clearly never changed direction in the portfolio because, for the last 2½ years, they dramatically underperformed. In the recent bull market, the strategy obviously hasn't helped them.

SL: *Fussier details that some may be interested in are whether the call options are in or out of the money. Do stocks get called away or the options bought back if they are about to exercise?*

Kugler: Within FFA, we generally write out of the money options. Options are bought back if we judge the remaining appreciation in the stock to be of sufficient size to warrant the repurchase of an option that is in the money.

SL: *With covered call funds, I am usually interested in some details on how they actually manage the options, such as what percentage of the portfolio is covered with call options, are they single stock or index options, and is all income actually "earned" income on an annual basis.*

Kugler: For FFA, the percentage of portfolio covered varies over time and will generally range between 50% and 100%. A mix of index and single stock options is used. We attempt to "earn" the dividend through a combination of dividends, options gains and stock appreciation (capital gains).

SL: *As equity prices have recovered from recession lows, FFA and other covered call funds have dramatically underperformed the market. Further, as equity prices declined during the crash, FFA and peers also appeared to underperform the market. In light of this performance, what is the future of the covered call strategy?*

Kugler: As a group, covered call funds will likely underperform un-hedged market returns when those returns are as strong as they were coming out of the collapsed market. However, FFA's NAV return was greater than that of the S&P 500 in 2010, returning 15.50% versus 15.06% for the S&P 500.

FFA also outperformed the bear market during the 12-month period ending June 30, 2009 by over 7%. We believe that the future of the covered call strategy is strong because, over a complete cycle, they can provide market matching or even beat returns with significantly lower volatility.

SL: As you stated, is it a reasonable expectation for the portfolio to lag the markets in a bull cycle?

Schaffer: Yes, typically a hedged portfolio can underperform in a very strong equity market. That's not surprising. I believe that compared to our peer group we have outperformed. The reason probably is the portfolio has done well, and we've been writing mostly out-of-the-money calls, trying to let our winners ride.

SL: When you say you let your winners ride, is it more likely a strategy that you will take profits, reduce exposure or set downside stop orders?

Kugler: We believe that each stock is unique and should be analyzed separately, without any hard and fast sell rules. Within the context of reasonable valuation, we want to own the stocks of companies that are performing well and will sell the stocks of those that on a fundamental basis are performing poorly. Therefore, if a company is doing well and valuation is reasonable, we will let the stock run. We take profits as valuation reaches the upper end of our range for the stock.

SL: Focusing on the equity selection process, how did you shift your management mindset during the bear market from the fall of 2008 into early March 2009?

Schaffer: We run the portfolio with a top-down rule, a very simple rule. It's a rule that asks what we believe will be the toughest benchmark to beat. Is it going be the S&P 500 or is it going to be the CBOE S&P 500 BuyWrite Index (BXM)? These are the two benchmarks we are viewed against by the FFA board.

During the bear market, it was obviously the BXM which is 100% covered at all times. It is a tough benchmark to beat in a down market. The market bottomed in March 2009, and by April we shifted gears. Our view was that we wanted to perform against the S&P 500 index. It isn't that we are great market forecasters. We just felt that the market had shifted, and we wanted to outperform the S&P 500.

This drove us to make two shifts. The first was in the portfolio construction and security selection. We sold defensive stocks and bought more aggressive stocks like industrials. Secondly, we changed the way we wrote options against the Fund. We wrote further out-of-the-money options and wrote fewer of them. We made that decision about a month after the bottom, and our view remains that the S&P 500 is going to be the index we want to focus on and try to beat because we remain bullish on the market.

SL: As you previously mentioned, in 2010 you beat the S&P 500 in an up year. Could you share with our readers how your strategy accomplished this?

Kugler: Yes, one thing that we're really proud of is we beat both the S&P 500 and the BXM last year. The BXM was easy because of the strong market, but our returns, both gross and net, were ahead of the S&P and that's hard to do while running a hedged portfolio. We did it through strong stock selection in the financial, consumer discretionary, industrial and materials groups while also having the proper sector weightings throughout the year. In addition, we managed the options strategy in the portfolio in such a way as to not have it be a material drag on performance. We believe it shows the strength in our tactical and flexible approach to writing options.

Margolin: I'm on my Bloomberg terminal right now, and from December 31, 2010 to May 2, 2011, Bloomberg shows the S&P up 8.87% on a total return basis and the NAV on FFA is up 8.38%. While not quite beating the S&P like it did like last year, the Fund continues to perform well versus the index. That's impressive for a fund that employs covered calls.

[**Editor's Note:** Of course, like you, CEFA uses NAV performance to judge manager success, but to make sure our readers understand, investors can only buy a closed-end fund at market prices which, for an equity fund, is often below NAV, although it can be above NAV or at a premium to NAV in certain situations.]

SL: What is the one thing you wish shareholders knew about FFA when deciding if they should buy, sell or hold the Fund in their portfolio?

Schaffer: We believe that NAV growth with a distribution that is sustainable over the long term is the best way to create shareholder value. Because of this belief, we focus on owning a well-balanced portfolio of stocks with a higher than the market yield which can provide solid returns over time. We believe our strategy is very suitable for conservative investors.

SL: Thank you to all four of you for being able to give us and our *Scott Letter* readers such an in-depth window into the operations and management of a unique CEF strategy.

Margolin: Thank you as well; we enjoyed the opportunity to tell our story. ■

For more information on First Trust's Enhanced Equity Income Fund, please call 800-621-1675 or visit their web site (www.ftportfolios.com).

To learn more about Chartwell, visit their web site (www.chartwellip.com) or call 610-296-1400.

Funds Now Earning More Dividends

Even though discounts are mildly narrow compared to year-end, there are still opportunities in the closed-end fund industry. We have used the recent weakness to increase the equity exposure for many of our clients and have found a few new funds in order to help provide consistent income as well.

As of May 20, 2011, the average equity closed-end fund was trading at a -5.32% discount versus -6.16% at the start of 2011. The average bond closed-end fund was trading at a -1.64% discount versus -1.96% at the start of 2011.

Bond funds are showing an average Relative UNII or dividend surplus of 14.2% versus 14.7% at the beginning of 2011. Dividends have contributed to our clients' total return. The average closed-end fund is currently paying a 6.8% distribution yield versus 6.9% at the start of 2011.

The average equity fund is showing a 20.1% return of capital (ROC) in their distribution history, noticeably down from 28.2% at the start of the year. For equity closed-end funds, there have been 21 dividend increases versus only three decreases since their last dividend announcement.

For closed-end bond funds, there have been 17 increases versus nine decreases since the last dividend announcement. With the economy and markets improving, funds are over-earning their dividends. We expect there to be similar increases going forward for investors' benefit. ■

Delegates Told Inflation Spike Is Temporary

The Chartered Financial Analysts Annual Conference was held May 8-11 in Edinburgh, Scotland. This was the first time the educational gathering has been held in the U.K. in its 64-year history. The 2012 meeting will be held in Chicago and its 2013 meeting in Singapore.

The focus was macroeconomics: a study of the movement and trends in the economy as a whole rather than on factors that affect the decisions made by firms and individuals. This included discussions about inflation, employment and other measures versus microeconomics which looks at the smaller picture, studying how individual businesses decide on how much to produce and what to charge for it.

Former Bank of England maverick David Blanchflower warned the delegates that the Bank of England will be forced to prop-up Britain's economy through further quantitative easing this year, amid signs of another economic slowdown. He had correctly predicted the last downturn, long before his colleagues on the Bank's Monetary Policy Committee. He also said interest rates in the U.K. should not be raised until 2012.

Professor Blanchflower also raised the social and economic implications of the wage curve – the unemployed "lost generation". He also discussed why austerity is not the road to recovery, the spreading sovereign debt crisis and the future of the euro. Although concerns persist over inflation, he argued that the inflation spike, now at a 29-year high in the U.K., is only temporary, driven by a higher value-added tax (VAT) that is now 20% (30% in Ireland) as well as higher exchange rates and oil prices.

The primary mission of the CFA Institute is to test people and provide them with CFA designations to practice as financial analysts. It is considered the gold standard of the investment analysis field. The non-profit association awards Chartered Financial Analyst (CFA) designations worldwide as well as certificates in investment performance measurement (CIPM) after a series of tests held worldwide. The Institute now has over 100,000 members and is based in Charlottesville, Virginia. More information is available at www.cfainstitute.org.

Athough George Cole Scott is not a CFA charterholder, he has held an associate membership since 1972. He has attended local meetings in Richmond as well as CFA annual conferences in New York, Philadelphia, Boston, Zurich and other cities to update himself on the evolving knowledge he needs to understand world economies in order to better manage his client's portfolios. All members are required to sign the CFA Code of Ethics pledge each year.

This year's four-day conference opened with a session by Pulitzer Prize-winning author Liaquat Ahmed, whose book *Lords of Finance,* pointed out that people at the center of the crisis that impact world events play an important role in economic decisions. He also gave insights from the Great Depression and explained what forces cause global financial crises. He pointed out what history can (or cannot) tell us about the right medicine for a sick economy and how people at the center of a crisis impact world events.

"Non-economic factors play an important role in economic decisions," he said. He also spoke of the need for political will in today's economy, and the actions that individuals needed take to avoid repeating history.

The speakers covered a wide range of topics, and some held wealth management workshops. Many raised questions about the post-crisis global economy, asking why it happened and questioned its consequences.

In break-up sessions, attendees participated in diverse discussions such as alternative investments, behavioral finance, equity and fixed income investments, leadership, risk management and standards, communication skills, portfolio management, private wealth management. ethics and regulations were a key part of the subjects covered.

The Evolution of Risk Management: What Is Risk?

A hot topic for money managers: "Is risk just uncertainty about the expected investment outcome? Why are we so hooked on standard deviation as a measure of risk?" We were told that upside uncertainty isn't risk; it is a positive surprise. In terms of behavioral finance, our perception of risk is very fluid, a function of changes in wealth. People may prefer the riskier alternative when choosing between negative outcomes.

Other speakers predicted the outlook for employment, inflation and economic measures that drive economies. Some questioned whether the crisis was really over and asked what we can learn about investor behavior. Others discussed "managing unquantifiable portfolio risks."

There were roundtable discussions on the post crisis global economy including lively discussions about how "Markets Are Not Created Equal" and "Opportunities in Emerging Markets and Beyond". We learned how risk managers better understand their firms' overall exposure in the longer term and macro trends that serve as enduring performance drivers. One speaker asked us to try to understand the broader portfolio questions related to security analysis.

We were asked about other topics such as a re-evaluation of asset allocation strategies after the global financial crisis. This included defining, measuring and hedging risks – moving from asset allocation to exposure management.

Are the Emerging Markets Safer Today than Developed Market Equivalents?

The risks of global imbalances in the emerging markets, which came up in our discussions with Mark Mobius and other portfolio managers regarding the emerging markets, were addressed by William H. Buiter, chief economist, Citi Investment Research & Analysis: He spoke of the next stage of the financial crisis and how investors should prepare for it. He offered a proposal for preventing a distintegration of the euro area and an analysis of country-specific risks. He also spoke of the risks and opportunities in emerging markets.

Raghuram G. Rajan of the University of Chicago asked "Why did the crisis happen? Why now in the most sophisticated financial in the world?" He then said that the emerging markets have never been able to manage substantial domestic demand expansion well, pointing out what happened in the East Asian crisis (1997) and the Latin American debt crisis for consumption (1980s).

These events resulted in a relative loss of position in industrial countries and focused on the dangers of fighting change rather than adapting to it. This leads to global competition for capital and financial repression in industrial countries. If the change is not smooth, there is worldwide political backlash. The speaker does not want trade restrictions and is bullish on globalization.

Three sessions went right to one of the prime educational focuses of the CFA Institute – "Financial Market Integrity and Ethical Issues" and Keynesian Classical Economics – leading to discussions of what was relevant in today's markets?

There were three very informative sessions about Wall Street and portfolio management: "Wall Street Revealed," "Next Generation Asset Management" and "Asset Allocation and Risk Strategies".

The conference featured many networking sessions and a new feature, "CFA Conference Connect" which offered an on-line attendee directory and discussion forum to help attendees communicate with each other. We were shown how to log-on through our cell phones, computers and iPads in order to stay in touch now and later.

The Rest of the Trip

While in Edinburgh, CEFA's President George Cole Scott revisited Charlotte Square where in 1990 he interviewed money managers for his closed-end fund book (with Professor Albert Fredman) *"Investing in Closed-End Funds"*, published by Simon & Schuster in 1991.

Since there is so much to see, he took time to visit Edinburgh Castle for a sponsored breakfast, St. Andrews College and the medieval cathedrals. Afterwards, he traveled to Bath, England and to Ireland during the week the Queen made the first royal visit in 90 years for reconciliation. The world stock markets are long overdue for reconciliation as well. ■

Portfolio Manager's Review

What is the best inflation hedge with the threats facing investors that massive U.S. budget deficits and the Federal Reserve's easy money policy will lead to significant inflation?

Dr. Jeremy Siegel, a professor at Pennsylvania's Wharton School has a few answers: "Stocks are claims on real assets, which appreciate in value as overall prices increase."

First and foremost, don't abandon the stock market. As long as inflation doesn't ramp up to the double-digit levels of the early 1980s – a scenario I consider extremely unlikely – stocks will act as an excellent hedge.

The reason is simple: Stocks are claims in real assets, such as land, plant and equipment, which will appreciate as overall prices increase.

1. History supports this: Over 30-year periods, the return on stocks after inflation is virtually unaffected by the inflation rate.
2. Over shorter periods, however, it is a different story. Although stocks do well when annual inflation is in the range of 2% to 5%, their performance begins to falter when inflation exceeds 5%. Some analysts theorize that stocks lose their hedging ability because inflation sparks higher interest rates, and interest rates are a key variable in calculating current stock prices.
3. Interest rates certainly rise when investors foresee inflation, but inflation also boosts future revenues and earnings. In a world where the prices of raw materials and finished goods rise at the same rate, the increase in future cash-flows should exactly offset higher interest rates. In practice, companies can't always pass along increased costs, especially in the case of an important raw material, oil.
4. To best insulate your stock portfolio from inflation, you must diversify internationally. If inflation kicks into overdrive, the dollar will fall, and foreign stocks can act as an automatic hedge as money invested in foreign currencies is translated into more dollars back home. But don't run to speculative assets (such as gold and silver) that will deflate in price when inflation slows.

For long-term investors (which closed-end fund investors should be), stocks will be an excellent hedge against rising prices.

Source: *Kiplinger's Personal Finance,* June 2011

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George Cole Scott

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