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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

– John Cole Scott, Contributing Author

IN THIS ISSUE:

General American Investors Company, Inc. Selects Individual Stocks with a Better Than Average Growth Potential

General American Investors Company, Inc. (NYSE:GAM) is an independent organization, one of the few remaining closed-end funds that is internally managed, keeping its expenses low.

GAM is classified as a diversified closed-end management investment company and is subject to the Investment Company Act of 1940 and Sub-Chapter M of the Internal Revenue Code.

The primary objective of GAM is long-term capital appreciation with lesser emphasis on current income. In seeking to achieve its primary objective, the firm invests principally in equities believed by its management to have better than average growth potential.

The firm's investment approach focuses on selection of individual stocks, each of which is expected to meet a defined portfolio objective. A continuous investment research program, stressing fundamental securities analysis, is conducted by the officers and staff of the firm under the oversight of its Board of Directors. The Directors have a broad range of experience in business and financial affairs.

Effective January 1, 2013, Jeffrey W. Priest became responsible for the management of the company. He was appointed Chief Executive Officer and Portfolio Manager, and has been President since February 1, 2012. Priest joined GAM in 2010 as senior investment analyst and has spent his entire career on Wall Street with over 25 years of investment and related experiences. From 1999 to 2010, Priest served as Managing Member and President of Amajac Capital Management, LLC, an investment advisory firm which he founded.

Previously, Priest served in a number of investment-related roles in disciplines including equity research and analysis, risk arbitrage, structural analysis, fixed income sales and trading and valuation analysis.

Priest received his B.A. degree from the College of Wooster in 1985 and later an MBA from Duke University's Fuqua School of Business in 1994. He has served on the Financial Accounting Standards Board of the Emerging Issues Task Force on acquisition accounting.

Priest succeeds Spencer Davidson who served as Chief Executive Officer and Portfolio Manager from 1995 through 2012 and now serves as Chairman of the Board of Directors. Priest is assisted in portfolio research by four analysts.

Jeffrey W. Priest

While shares of GAM usually sell at a discount to NAV, they occasionally sell at a premium over NAV. The stock sold at discount to NAV, ranging from 13.2% (May 14, 2012) to 16.4% (January 3, 2013). On June 30, 2013 the price of the stock was at a discount of 13.6% to its net asset value.

Since March 1995, the Board of Directors has authorized the repurchase of common stock in the open market when shares trade at a discount to net asset value of at least 8%. Through June 30, 2013, GAM repurchased 18.3 million shares of its common stock at a cost of $504.7 million. During the six months ending June 30, 2013, 37,470 shares of common stock were repurchased at a cost of $1,188,236, an average discount of 14.2% to net asset value.

On September 24, 2003, GAM issued and sold an underwriting of eight million shares of its 5.95% cumulative preferred stock, series B, with a liquidation preference of $25 per share ($200 million in the aggregate). The preferred shares are rated "A1" by Moody's Investors Service, Inc.

The preferred shares leverage the investment performance of the common stockholders. It may also result in higher market volatility for the common stockholders as well as also providing "permanent" incremental capital to enhance the efficient operation of the firm and a funding mechanism to support the aforementioned share repurchase program.

On December 10, 2008, the Board of Directors authorized the repurchase of up to one million preferred shares in the open market at prices below $25 per share, and that authority remains available to the firm. GAM's portfolio turnover is relatively low, averaging 19.6% over the last ten years.

GAM's portfolio uses a "bottom-up" approach. Its security analysts utilize numerous sources including publications and reports, conferences and meetings, industry trade group activities and their own independent research to identify the securities of companies with strong long-term growth potential.

Company visits and an understanding of management's goals and objectives are important aspects of the analytical process. The portfolio manager continually monitors economic conditions, the outlook of the securities markets, trends in multiple industry segments and the performance of numerous individual companies.

When a recommendation is made by an analyst, the portfolio manager evaluates the rationale for the recommendation provided and often solicits the input from other members of the research staff. Decisions to buy or sell securities are made based upon an on-going assessment of the prospects by the firm.

GAM approaches portfolio diversification by selecting companies individually, as described above, without specific reference to industry weightings in the Standard & Poor's Index. Management believes that adequate diversification can be achieved with a limited number of holdings in diverse industries. Individual security weightings depend upon GAM's assessment of the security's potential growth as well as the market liquidity.

We interviewed Jeffrey W. Priest, CEO/President/Portfolio Manager and Eugene S. Stark, Chief Compliance Officer/Principal Financial Officer on August 28, 2013.

SL: Hi, Jeff and Gene. We have a long history with General American Investors Company. In the early 1980s, I conducted the first *Scott Letter* interview with Eugene L. DeStaebler. He held the post that Gene now holds and insisted I send a draft of the interview to GAM for review. We have done this ever since as a matter of accurate reporting. Fact-checking is what I learned from my earlier career in journalism.

Jeff, after graduating from Duke University's Fuqua School of Business in 1994, where did you go?

Priest: First, before I attended Duke in 1985, I started my career as a fixed income trader and analyst for a small firm, Miller Tabak and Co., LLC. There I focused initially on the short end of the maturity curve and then later on spread products like high yield bonds, hybrid and corporate bonds. Eventually, I became head of fixed income and trading.

Miller Tabak covered a lot of markets and was considered one of the first progenitors of equity futures arbitrage and program trading. Following my matriculation to Fuqua School of Business, I worked at Bear Stearns as a summer internship for Pat McConnell and Janet Pegg. These analysts were considered to be the best accounting researchers on Wall Street.

Given my age at that point and my prior experiences, I had a lot of really exciting projects to work on: a FASB group studying hedging and its accounting treatment, co-authored a research piece on FAS 114, and analyzed merger and acquisition accounting methods. At that time, it was hard to believe that accounting can be that fascinating, but it really can be.

After graduation, I returned to Bear Stearns, first as a special situations and accounting analyst for the equity research department, and later I was promoted to the equity arbitrage desk responsible for the valuation of domestic restructurings, mergers and acquisitions and other special situations for companies undergoing significant changes.

Subsequently, I went to a hedge fund in New York where I was the General Partner for a short period before starting my own firm, Amajac Capital Management, LLC. We were primarily an event-driven fund, but we also had broad capabilities in both debt and equity securities. The firm invested in both undervalued (long) and overvalued (short) securities positions.

We shut the firm down in 2009 because of client withdrawals to fund losses. We were fortunate because that was a year in which the firm experienced very little loss having foreseen, in part, the grave difficulties in the U.S. economy due to the enormous leverage in the financial system.

During that period, I met Spencer Davidson while seeking to raise capital in 2009 and 2010 for housing related investments.

SL: Please tell us more about your investment philosophy?

Priest: I have always been interested in pursuing many types of investments. As an opportunistic investor who looks for places where the potential returns are the greatest with the least amount of risk, it is a personality, for good or ill, with a certain level of risk aversion. This was borne out of my hedge fund history of pursuing absolute returns rather than a relative return model.

SL: Is risk management a part of your experience?

Priest: Yes, I have been around long enough to know that everybody needs to have risk management as a part of their skill set. I was around for the 1987, 1998, 2000 and 2008 market events that unfortunately come pretty regularly.

SL: In the 1990's the portfolio had a number of mid-cap companies. How did that evolve to your present holdings of primarily large cap stocks?

Priest: Your observation depends upon where our portfolio companies are on the valuation spectrum. For example, we have owned The TJX Company for approximately ten years. It is the largest international apparel and home fashions, off-price department store chain in the U.S. and owns T.J. Maxx, Home Goods and Marshalls. During that period, it went from a small/mid-cap company to a significantly larger cap company. This is true of many smaller companies we have owned that are now considered large cap companies.

The most important factors to finding really good investments is first class management that have a clear understanding of what drives profitability and how to allocate capital in their businesses.

SL: What was your analytical focus when you joined General American?

Priest: I focused on companies that other analysts were not currently covering which, at the time, happened to be industrially oriented organizations and a few selected special situations. I also worked with other members of the staff on their analytical projects in a supportive role. We functioned as a team, and though I make a number of decisions, it is generally with a lot of discussion among my colleagues about the pros and cons of a selected investment.

I am a great believer in the culture here at General American. When Spencer retired, the Board of Directors made and supported a series of changes that benefitted shareholders in 2012. For example, we went from 19 employees to 13 without diminishing our capabilities.

SL: We hope that GAM can continue its culture of excellence with fewer analysts.

Priest: Yes, it can. This significantly reduced the overhead, which goes directly to benefit shareholders.

Stark: There were three retirements and two departures, and we were saddened by the passing of one individual. With this confluence of events and the adoption of additional technology, we were ready to take advantage of the opportunities.

Priest: We also implemented a new software system for our accounting and back office areas which benefits our shareholders through its ability to provide management and our Board of Directors with a number of analytical tools and reports that can be generated more efficiently and effectively.

SL: We are most interested in discussing your sector allocations rather than your individual stock selections. I am particularly interested in the fact that you have environmental control companies in the portfolio.

Priest: We have spent a lot of time looking at a number of areas in the environmental control area, including water companies, as well as the science behind the environmental companies. To the extent that we find a viable investment from our perspective, that is, high cash-on-cash profitability, strong free cashflow, future growth prospects and management teams who are effective at allocating resources, we will pursue the opportunity. These are the primary factors that dictate whether or not we will be an investor.

SL: Environmental sustainability, according to EPA's definition includes: "Sustainable practices and approaches that include labeling green products and promoting green chemistry and engineering, managing materials rather than creating waste, using green infrastructure to manage storm water runoff and supporting the sustainable design of communities." Would you consider using a more exact term for this category?

Stark: The Standard Industry Classification ("SIC") included "environmental controls." The current Global Industry Classification Standard ("GICS") does not contain that category. Nevertheless, we still own the companies.

SL: There are investment risks in choosing a few stocks in this category. We have invested in Brown Advisory Winslow Sustainability Fund.

Priest: Solar is great when the sun is up, wind is good where it is windy, and hydro power is fabulous when there are no droughts. You can construct them without negatively impacting fish stocks, and geothermal requires you to have a source point to capture the energy. There are others for sure, but they all have their drawbacks.

I would not advocate stopping our pursuit of alternatives by any means, but I think a reasoned approach to understanding the trade-offs would be useful. For instance, utilizing alternative energy does elevate the direct cost of energy to the consumer. For those on a limited budget, these costs can be significant.

SL: That is true, but the cost of alternative energy is coming down. Where are you on the energy issue?

Priest: How is the water and energy use better or worse than that of shale gas or oil with the many complaints about that industry's use of water and potentially hazardous chemicals? The great question concerning free and vast energy reserves is our inability to store it. Lead acid batteries are horrific at storing energy in terms of efficiency. Other battery technologies still lack the required efficiency and longevity for sustainability.

When it comes to choosing between coal, oil, natural gas or more clean technologies, no one really understands the trade-offs. We need energy to heat our homes, grow our crops, obtain potable water and facilitate commerce, telecommunications and a host of other activities. Coal, along with nuclear power, is and has been the backbone of the power grid.

From an industry perspective, our primary focus is on natural gas and oil production, which is in response to the relatively recent discovery of recoverable domestic reserves of shale oil and gas and the servicing companies.

SL: We appreciate that you understand the importance of these trade-offs.

Has General American ever owned closed-end funds?

Stark: Yes, several years ago we owned Central Securities, but typically, closed-end funds are not a significant element of the portfolio. However, we have owned them from time-to-time.

Priest: We do not try to mirror the indices in their sector allocations. We are driven to those investments that we believe offer the most compelling investment return in a portfolio that seeks diversity with the least number of investments possible.

SL: We see you have expanded the healthcare sector.

Priest: Yes, but it depends upon the opportunities. Recently, there are some more science-based companies that leave us more favorably disposed to this sector. Some of those that we have purchased have become real power houses. In these cases, it is really the individual circumstances that will dictate our asset allocation.

SL: We have invested in some of the closed-end funds managed by Hambrecht & Quist, which include many start-ups such as Gilead Sciences and others that are or might now be in the GAM portfolio.

Priest: We really are geared towards focusing upon the individual investment; the secondary consideration is the concentration of the portfolio. In our analyst meetings people do not say, "We really need more energy," but rather are more interested in a certain energy company for its growth model, free cashflow, future prospects or management team.

For example, in the financial services space, one of the most interesting trends or developments underway involves mobile payments and who are building real businesses with the prospect of making significant returns in the future.

[**Editor's Note:** Mobile payments include mobile money transfer operating under financial regulation and performed via a mobile device instead of paying by cash, check or credit cards. Only recently has the technology to support such systems become widely available.]

SL: You only have a small percentage of the portfolio in metals, materials and mining sectors.

Priest: We have a very low allocation in the metals, materials and mining sectors because there are few companies in these sectors with good long-term prospects. There is also a lot of excess capacity in the materials sector, but we have increased our allocation to energy companies.

Many of the natural gas companies were priced as if natural gas would remain at $2.00 per MCF, when they were not profitable at anything less than $3.50 per MCF. Therefore, we acquired what we believe to be the lowest cost producers. We much prefer to own first rate companies with first rate businesses than to own companies that only enjoy a cyclical tailwind. That does not mean that we will not invest in mining; it is just that we do not yet see the opportunity for a sustained rise in valuations and business fundamentals.

SL: That is important. Have the issues surrounding the major banks been resolved?

Priest: Many of the government issues have been resolved. Everything that we currently see in the media is the result of things that occurred in the past for which these banks have probably reserved in prior periods. The moat for large institutions is getting deeper as a result of Dodd-Frank which means that margins over the cycle will likely grow as competition with smaller banks recedes.

SL: I see that you own some shares of Berkshire Hathaway.

Priest: Yes. we believe insurance analysis is one of our strengths. Many of our insurance companies are really offshore reinsurance businesses. If you take them together, they represent the majority of our investments that are only impacted by exogenous events. We diversify in this area to protect against individual underwriting events. There are a number of great companies in this industry.

SL: Regarding your dividend policy, we notice a trend for most closed-end funds we follow is they are paying more frequent distributions. Nearly every closed-end fund now pays quarterly. GAM has a record of paying its distributions once a year.

Priest: Our policy is to pay dividends and distributions annually in accordance with the requirements of Sub-Chapter M of the Internal Revenue Code. Additionally, last year we paid a special dividend and distribution. GAM's objective is not oriented toward current income. Our preference is to only distribute that which we actually earn without the imposition of additional constraints. Why would a long-term investor want their money back if they trusted the managers of the company?

A fixed or stated dividend/distribution policy could potentially mean the firm is in the position of paying-out capital gains before they are recognized or distributing the paid-in capital of the firm unnecessarily. Such a policy places undue focus upon the payment of regular distributions versus our principal priority of applying sound economic and security analysis.

[**Editor's Note:** A regulated investment company can either retain or pay realized capital gains. Most elect to pay capital gains distributions to shareholders rather than retain them. Funds do so to build up their assets. If a fund retains the capital gains, it must pay the tax on them at the corporate capital gains rate on behalf of its shareholders. If you are a taxpaying shareholder, you include your share of realized but undistributed gains. This information would be contained in IRS Form 2439 issued to you by the fund. You then file IRS Form 2439 with your tax return and receive a tax credit on your behalf.

(Source: *Investing in Closed-End Funds: Finding Value and Building Wealth* by Albert J. Fredman and George Cole Scott, 1991)]

Priest: I come from a world where share buybacks, sound economic analysis, and judicious tax management are the best means to generate returns for our shareholders over the long term. We would be more aggressive buyers of our stock if we could, however, we have to abide by the rules regarding buybacks.

General American Investors Company, Inc.
Performance as of June 30, 2013

Period	NAV (average annual return)	Stock Price (leverage annual return)	S&P 500 (with dividends reinvested)
1 Year	23.1%	25.7%	20.6%
3 Years	17.4%	18.5%	18.4%
5 Years	3.1%	2.8%	7.0%
10 Years	6.8%	6.7%	7.2%
20 Years	10.6%	10.4%	8.6%

For the first six months ended June 30, 2013, the net asset value per common share increased 13.1%, while the investment return to GAM stockholders increased by 14.8%. By comparison, the Standard & Poor's 500 stock index (including income) increased 13.8%.

For the 12 months ended June 30, 2013, the return on the net asset value per common share increased by 23.1%, and the return to GAM shareholders increased by 25.7%. These compare with an increase of 20.6% for the S&P 500. During both periods, the discount at which our shares traded continued to fluctuate and on June 30, 2013, was 13.6%.

SL: If you were invited to address any of the closed-end fund meetings in New York to discuss share buybacks, you would be telling a story that they are not used to hearing. What are your views on tender offers for CEFs?

Priest: I am not sure what they accomplish. If the purpose is to only temporarily tighten the discount, then I am not sure that tender offers are a good idea. But, if there is a strategic reason for doing it, why not?

SL: We agree and participate in some of them, but you have to wonder if the Boards of these funds really understand that liquidating the fund may not be good for shareholders.

Priest: General American is not a mutual fund complex or a closed-end fund group with many funds whose orientation is focused upon distribution and growing assets through subscription.

Our goal is to minimize the discount by building a real business and delivering superior risk-adjusted returns to our shareholders over a long period of time.

The discount can be used to benefit the remaining shareholders. It is anti-dilutive and, if repurchased in the open market at a significant discount, accretive to net asset value.

You have to ask: "Who is the true investor?" Is the entity subject to taxation or is it a non-taxable organization? This is one of the questions arising from stated distribution or tender offer policies.

SL: What are your views on leveraging your portfolio?

Priest: Leverage can and should be used judiciously. We have not experienced high volatility in the last two years, but leverage can present investors with some additional risk.

It also affords opportunity. In 2008 and 2009, investors with undrawn letters of credit or margin accounts faced fairly draconian alternatives when the banks pulled their credit lines.

I look at our preferred stock as a source of capital to deploy when significant opportunities present themselves, as it did in 2009, or to be utilized to buy back our common shares at attractive discounts. These are two examples of using leverage.

SL: Yes, this helps the common shareholder and yields 5.95%. Do you know of other funds that have preferred shares?

Priest: Yes, there are a few, mostly in Canada, e.g., Canadian General Funds. Preferred shares provide flexibility in the capital structure that give a benefit to common shareholders.

SL: It might interest you to know that, after Bergstrom Capital was liquidated in 1992, I had several consulting engagements with closed-end funds, including the management of Canadian General.

Do you use puts and calls in your portfolio?

Priest: Yes, for very specific situations. For example, we may purchase a common stock after doing a lot of work and find volatility is high. In that case, we may sell the put option. If the volatility is low, we may buy the call option. Writing put options provides an opportunity to acquire a stock at a price and valuation we are interested in. If it turns out that we don't acquire it, we get paid for our waiting time. We will also use warrants, which are essentially call options issued by the company.

> ***"... we are primarily seeking long-term capital gains rather than short-term trading gains."***

SL: Do you take short positions?

Priest: Yes. We can short stocks and are not restricted from doing so. I believe we did it in a few instances during Spencer's tenure. However, we are primarily seeking long-term capital gains rather than short-term trading gains. Our short positions must first be for economic reasons; hedging benefits should only be a byproduct of our primary focus.

SL: Are you invested in the emerging markets directly or indirectly?

Priest: Yes. A lot of the companies we own are big beneficiaries of the trends that have taken place in the emerging markets. This is a significant part of the story for our Unilever holding, which does a lot of business in these markets.

SL: It would interest you that I will interview Mark Mobius for the December issue of *The Scott Letter*. I have known Mark for many years. He founded the first emerging markets closed-end fund in 1987 and now manages two closed-end funds and a frontier markets mutual fund.

From this conversation, we see that GAM has more flexibility than many other funds to do whatever it takes to grow the portfolio.

Priest: We use our flexibility for the long-term benefit of our shareholders. However, we clearly understand that that comes with responsibility. We seek to employ best practices in our organization. It is the only way we operate.

All of these capabilities that we have talked about today are available through the firm's prospectus and existing operating policies. Spencer had access to these same capabilities as well as his predecessors. Nothing in the toolbox is new, so to speak.

I believe investors find General American compelling, both as an investment and as an employer that has such a broad mandate and a complete toolbox that helps us accomplish its objectives. We seek long-term capital appreciation through timely and well researched investments.

SL: Does Spencer Davidson still help manage or research the portfolio?

Priest: Spencer served as a very dedicated and engaged Chairman of our Board, but he is no longer involved in the day-to-day management of the company.

SL: Are you familiar with Daniel Yergin's excellent book, *The Quest: Energy Security and the Remaking of the Modern World?* It tells the story of the great questions of energy and security that face our nation in this risky world.

Priest: I have not read it but will add it to my reading list.

SL: I read a lot of biographies about builders of our great nation. The last was about Henry Flagler whose life's ambition was to build a railroad from Miami to Key West, which he did, but it was blown away by the 1935 hurricane.

What books have you read lately?

Priest: Did you bring up Flagler to raise the Blue Devil in me? I believe he is the namesake for the Kenan-Flagler Business School, that other North Carolina school – just kidding, of course.

I read a lot of books, but my reading passion has always been for socio-political and history books about significant periods. I recently enjoyed reading the biography of Andrew Carnegie by David Nasaw. One of my favorite books is *The Law* written in the mid-1800's by Frederic Bastiat, a socio-political economic philosopher.

SL: That is a good way to end this highly informative interview. We thank you for your patience. As you know, as an RIA, by law, we have to put the interests of our clients first and make sure that your comments only contain public information.

Priest: There is nothing that has been discussed in this interview that is not publicly available. More information about the firm is available on our web site, www.generalamericaninvestors.com or by calling 800-436-8401. ■

Disclosure: CEFA's clients and employees as well as family members of George Cole Scott own shares in Brown Advisory Winslow Sustainability Fund, Berkshire Hathaway and General American Investors Company, Inc. Closed-End Fund Advisors will not trade in these securities for 72 hours after the release of this *Scott Letter* has passed.

The First Investment Trusts in England and Scotland

Investment companies became popular in England and Scotland when the first public investment trust, The Foreign and Colonial Investment Trust PLC, was formed in London in 1868 by Lord Westbury, a former Lord Chancellor. He and four of his colleagues decided to form a "common law trust" to invest in government bonds overseas.

These companies resembled closed-end funds in the U.S. and issue securities to the public. They use the proceeds to acquire a managed portfolio of securities that trade at a discount or premium that could be greater or less the value of the portfolio.

British investment trusts were organized differently. They did not have employees; management of the trust and its financing was performed by either a management company or fiscal agent, or by both. In this way, a number of trusts could be grouped together under the control of one fiscal agent, providing small investors with the same diversification and professional management available to wealthy investors.

There were a number of abuses involving many investment trusts, including a lack of disclosure to investors, insufficient portfolio diversification and excessive leverage by borrowing through the issuance of senior securities. These funds engaged in underwritings and other non-investment activities as well as issuing "founders' shares" to the funds promoters.

By the late 1880s, a speculative bubble caused one fund after another to come to market. There was a major crash in 1890. To regain confidence, British investment trusts adopted more conservative policies.

Investment companies first became popular in the U.S. during the bull market of the 1920s. All of these funds, like their British antecedents, were closed-end funds whose shares traded at premiums or discounts from the value of their portfolios.

During the late 1920s closed-end funds were far more popular than open-end mutual funds. They could redeem shares upon request on the current value of the fund's portfolio and continuously offered new shares based on that price.

There was a fierce rivalry between mutual funds, located primarily in Boston, and closed-end funds centered in New York.

The 1929 crash proved to be near disastrous for closed-end funds, spurring public acceptance of mutual funds, and led calls for government regulation of all types of investment companies.

Many closed-end funds of the 1920s had characteristics that proved important for the future of the industry.

First, their shares traded at premiums above the actual values of their portfolios. These funds, like their British antecedents, traded at premiums or discounts from their net asset values.

The first mutual fund was launched in Boston in 1924, but soon many closed-end funds became more popular as high speculative demand pushed them to premiums above the actual values of their portfolios.

Since the trust also purchased securities on margin, the speculator often piled margin on margin. Trust equities were often so small that the slightest rise in stock prices would be magnified many times over.

Closed-end funds engage in leveraging by borrowing or by issuing preferred shares that leverage the investment of their shareholders. In the 1920s, however, it went too far. Some leveraged further through pyramiding, whereby a leveraged fund invested in another leveraged fund that invested in another leveraged fund and so on. In addition, many investors were deeply in debt to purchase fund shares.

Harvard professor and economist John Kenneth Galbraith in his book, *The Great Crash 1929,* emphasized the downfall of these early funds due to their excessive leveraging.

This 1955 book was the first book that I read about the stock market after starting to build my own portfolio in 1953. I recently reread it after 60 years in the stock markets. My first reading scared me, which was probably a good thing.

He wrote "Leverage was achieved by issuing bonds, preferred stock, as well as common stock to purchase more or less exclusively a portfolio of common stocks. When the common stocks so purchased rose in value … the value of the bonds and preferred stock of the trust was largely unaffected. Houses of issue, brokers and securities dealers sponsored and undertook the distribution of securities of investment companies … accounting for over 60% of management investment companies in 1929."

Many observers warned that securities firms might be tempted to dump slowmoving or questionable securities held in their portfolios. That proved to be near-disastrous for closed-end funds as, by mid-1929, the average investment trust was selling for 47% above the liquidation value of its portfolio.

Despite calls that noted "conditions were fundamentally sound" and others recommending the selling of stocks and buying gold, by October 23, 1929 there were heavy losses, and soon thousands of speculators decided to get out or were told that they had to post more collateral because an unprecedented volume of margin calls. Panic began on October 24, 1929, and soon the beginning of the Great Depression was upon us.

The abuses were different in recent years. In 2003, New York's crusading Attorney General Eliot Spitzer filed actions against four major mutual fund management companies, charging Bank of America's "Nations Funds" had allowed a hedge fund to "late tread" after the markets closed. This spread rapidly, ultimately becoming a black eye for an industry that had long touted its ability to cater to individual investors. This was reminiscent of the 1920s and exposed a breach of trust.

The initial fallout, implicating a dozen firms for various front-running, market timing and insider trading violations was swift and severe. Spitzer also filed civil actions charging that these companies had conspired with and even aided and abetted certain preferred investors to undertake illegal acts. This included some 400 hedge funds that identified their strategy as "mutual fund market timing" well after the U.S. market had closed. These funds were able to buy and sell mutual fund shares in funds that were investing in non-U.S. securities, trading at prices already set in foreign markets hours before the trades took place.

This exposé came to light in 2011 and again in 2012, and included "sell side" activities of security analysts that colluded with their investment banking colleagues, giving high ratings to stocks underwritten by their investment banking firms. Over the next year, the number of participating firms grew to 23, with total assets nearing $1.2 trillion – almost 25% of the industry's then $5 trillion total. Share liquidation of the firms involved in the scandal leaped upward. They suffered well-deserved, if not grossly inadequate, financial penalties. (Source: *Investment News*)

John Bogle, founder of The Vanguard Group of mutual funds, saw these scandals as a blessing in disguise. It awakened investors to shoddy, illegal and unethical practices of mutual fund managers who conspired with hedge fund managers and used extreme forms of "market timing" to dilute the returns of – and even defraud – long-term investors in the funds. He saw these activities as a situation in which marketing superseded management.

Bogle added that 12b-1 fees are still controversial because of how they compensate financial advisors for promoting mutual funds. That's forbidden for closed-end funds to do.

A study by the Investment Company Institute found in 2004 that 40% of the 12b-1 fees went to financial advisors and others for assisting investors to purchase funds and 52% for on-going shareholder services.

More recently, financial planning groups have been trying to determine who is a fee-only advisor and who isn't. There are different definitions between fee-only brokers and those who charge both a commission and fee. ■

What Are the New Emerging Markets?

Mark Mobius, founder of the first emerging markets fund for Sir John Templeton, wrote in his blog (mobius.blog.franklintempleton.com/) that smaller, fast-growing economies may be the next big thing.

"Several emerging and frontier markets – including the Philippines, Indonesia, Thailand and Vietnam in Southeast Asia – have seen strong returns in recent months. And there are several other notable emerging market performers where local macroeconomic developments have attracted strong returns in recent months.

Global economic growth hasn't been terribly inspiring so far in the first half of the year, but some investors have nonetheless been inspired to pour more assets into the equity markets, some of which have surged to record highs."

As we hit the mid-year point, now seems like a good time to take a pulse check of emerging markets and assess our progress.

Given that yields on some assets seen as "safe" are close to record lows, the attraction to potentially higher-yielding, but riskier assets such as emerging market equities has continued to grow. Of course, we have seen some disappointments too.

In September 2013, Dr. Mobius wrote that the Indian equity market will recover, adding that he thought the worst was over.

"Investors," Mobius wrote in his blog, "were looking forward to September 18, 2013 when the Fed could decide to taper imminently, although some analysts fear that emerging markets will suffer more … but much of this has been discounted."

"The big story would be, of course, to take the shoulder from Bernanke, and if funds do come in, there could be quite a dramatic shift towards direct financing and very rapid increase in money supply, which will be quite bullish for markets around the world," he added.

As we go to press, the world markets were rejoicing that Lawrence Summers pulled out of the contest to succeed Ben Bernanke as Chair of the Federal Reserve, leaving Janet Yellen, the Fed's current Vice Chair, as the leading candidate.

This withdrawal significantly clarifies the President's choice and enhances his ability to reach a consensus in Congress. The markets thinks or hopes that any stimulus will be small and data-dependent. This is why stocks are "crouching expectantly just below all-time highs." reported Barron's.

We never try to predict markets but we will see what happens. ■

Portfolio Managers' Review

U.S. GDP growth is up, inflation is low, crude oil has weakened, and car loan demand is soaring. On top of this was the news that the U.S. jobless rate fell to 7.3% from 8.1%, when the current round of quantitative easing by the Fed began.

Russia and South Africa held the biggest sale of emerging-market debt this year. World commodity demand strengthened as a Chinese manufacturing index rose to a 6-month high in September, signaling that a rebound in the world's second largest economy is gaining momentum, especially in exports. Russia and South Africa have also issued large amounts of government debt that brought many investors back into the developing economies after months of turmoil.

During the quarter, we added to Templeton Emerging Markets Fund (NYSE:EMF), and Templeton Dragon Fund (NYSE:TDF) while reducing some bond fund holdings. We also participated in Liberty All-Star Equity Fund's (NYSE:USA) tender offer and reduced some of our holdings in Adams Express (NYSE:ADX) as well as in Tri-Continental Corporation (NYSE:TY). We sold some of our holdings in Cohen & Steers Closed-end Opportunity Fund (NYSE:FOF), partly due to its bond exposure. We added to Cohen & Steers Quality Income Fund (NYSE:RQI) and Alpine Global Premier Properties Fund (NYSE:AWP) in the real estate sector.

Treasury bonds rallied in September as a better U.S. jobs report hinted that the Federal Reserve may pare its monthly bond-purchase program soon. After some clarification, the markets rallied because the Fed hinted that it might continue purchasing U.S. Treasuries. We made strategic trades in our municipal and high yield debt exposure based on earnings coverage, relative pricing and NAV performance.

Barron's wrote on September 23, 2013: "Bernanke and Co. decided against being painted into a policy corner, even though the markets had inferred that it meant a reduction of at least $10 billion in monthly bond buys."

Over the summer, both taxable and municipal closed-end bond funds reverted to wider discounts. They are now generally priced below NAV. Many of the CEF specialty equity funds also experienced discount widening, as their holdings are primarily yield-oriented. In addition, they often have above-normal distribution levels as elected by their boards. Because of this, we found that specialty-equity CEFs trade closer to bond CEFs than the U.S. equity and non-U.S. equity CEFs.

Discount levels in the CEF universe have widened on average to -7.5% for equity and -6.9% for bond funds. One-year average Z-Stats, which adjusts for the volatility of a discount or premium, the average equity fund is -0.7, while the average bond fund is a -1.5 Z-Stat. This means that bond funds currently are priced about twice as far below their average discount vs. equity funds. This widening can be seen in the YTD NAV returns of +7.1% for equity funds and -4.6% for bond funds, as compared to market price YTD total returns of +5.8% for equity funds vs. -11.9% for bond funds. Equity funds are lagging NAV movements by -1.3% and bond funds by -7.6% as discounts have dramatically widened giving investors a nice entry point back into the bond sectors. (Source: CEFA Universe Report, September 13, 2013)

We are optimistic about future NAV growth for most CEF sectors. We continue to make changes to client positions based on relative value – trying to buy when the funds are relatively cheap and selling when they are relatively expensive. ■

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