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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 news-letter 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

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Flaherty & Crumrine Incorporated: Managing Preferreds as an Asset Class

Flaherty & Crumrine Incorporated, an independent investment advisor, specializes in the management of preferred and related securities. Founded in 1983, the firm is focused exclusively on managing preferred portfolios and associated hedges, and has a dedicated credit research team that performs comprehensive analysis of the risk faced by preferred securities holders.

On November 4, 2014, *The Scott Letter* interviewed two top officials of Flaherty & Crumrine Incorporated: **Chad Conwell** who serves as Executive Vice President, Chief Legal Officer and Chief Compliance Officer for the Advisor and Chief Compliance Officer, Vice President and Secretary of the firm's funds; and **Donald F. Crumrine**, CFA, who serves as Portfolio Manager of the Advisor and Chairman of the Board, Chief Executive Officer and Director of the firm's funds.

Chad Conwell joined Flaherty & Crumrine in 2005. In addition to his responsibilities for compliance and legal matters, Conwell also works with Donald F. Crumrine in fund management, client servicing and marketing efforts.

Previously, Conwell practiced at Paul, Hastings, Janofsky & Walker LLP, a global law firm, for more than six years in the areas of corporate finance and investment management regulation.

Conwell earned his B.A. from the University of California at Berkeley and his J.D. from the Georgetown University Law Center.

Donald F. Crumrine has managed portfolios of preferred securities since 1973. He co-founded Flaherty & Crumrine in 1983, after spending 12 years at Scudder, Stevens & Clark.

Crumrine earned a B.S. in Finance from the University of Southern California and his MBA from the Wharton School at the University of Pennsylvania. He has co-authored research papers presented to the committee for after-tax performance measurement of the CFA Institute. He has testified before the U.S. House Ways and Means Committee on matters related to the preferred securities market. (Source: www.flaherty-crumrine.com/FirmProfile/OurPeople.asp)

The Interview

SL: What is your basic approach to preferred equity investing? How is it like bond research and how is it like equity research? What do you do and what do you avoid?

Crumrine: We have long believed that the first step in managing a preferred securities portfolio is fundamental credit research at the preferred security level of an issuer's capital structure. To accomplish this, our research group, overseen in-person by one of our portfolio managers, is located close to the center of the action in suburban NYC. (Our main office is in Southern California.)

The rating agencies and many investors rate an issuer's preferred securities by simply "notching" down the senior debt rating. They'll rate the senior debt, then notch the subordinated debt and then they'll notch the preferred debt. So they're all rated on the same scale by all the published agencies. The analyst doesn't look at the preferred as a separate class of securities. Their focus is not in the preferred class, but rather their focus is on senior debt. They will reduce the rating by notching it, where a notch is interpreted as, for instance, from a BBB+ to a straight BBB or a BBB1 to a straight BBB – that would be a notch. So it's three notches down, and four notches would be a full rating category.

We disagree; we believe you must focus at the preferred security level.

Although our credit analysts are familiar with street expectations of an issuer's earnings and common stock performance, we are not equity investors. Instead, our focus is at the preferred level of an issuer's capital structure, primarily on those issuers whose senior debt ratings are at least investment grade, although their preferred securities may be rated below that threshold.

Conwell: I think the starting point is preferred equity issued by entities that have more leverage than other entities because they are considered to be safer by debt holders, e.g., the rating agencies, or by regulators. Those preferred equities exist primarily in regulated industries: insurance companies and banks.

The bank will issue subordinated debt which supports that debt. The bank will issue preferred stock which can support both the subordinated debt and the debt, and ultimately the bank issues common stock. I guess you can think of common stock one of two ways; it supports both senior debt and ultimately the deposit holder. Alternatively it is the equity investment from the investor's side that adds the most potential for return or for loss. Preferreds are really closer to debt than they are common stock, although they just sit immediately above the common stock in the capital structure.

Flaherty & Crumrine's investment process can be summarized as follows:

- Know your credits – the first step in successfully investing in preferreds
- Know your structures – critical because of the extensive variety of preferred issue terms
- Know your markets – trading execution is key in what continues to be largely a dealer-based OTC market

SL: What is your understanding of how the preferred equity security was created?

Crumrine: The structure originated back in the late 19th century with railroad preferreds. These securities were basically senior equity, junior to the railroad bonds that were issued at the time. Post-World War II, the primary preferred issuers were utilities and, to a lesser degree, pipeline companies.

A real transition in the market occurred beginning in 1993 with the creation of a new structure whereby payments to the holders were deductible from the issuers' perspective and became fully taxable to investors. In late 1996, banks were permitted to issue these taxable preferreds and receive equity credit from the rating services and their regulators. That really accelerated the growth of the taxable preferred market.

Now we've seen the reversal in growth of the taxable preferred market as many U.S. banks have redeemed those issues because of declining equity credit under Dodd-Frank and Basel III rules. These issuers are in the process of refunding those taxable preferreds with securities that are eligible as qualified dividend income ("QDI") to individual investors and are eligible for dividend-received-deduction tax treatment for domestic U.S. corporations. We've seen a lot of changes in this market, both from an issuance standpoint and from a tax treatment standpoint.

Much of the preferred market pays distributions that are considered as QDI to holders. I think that's probably what's going to be critical for most of your readers, financial advisors and clients.

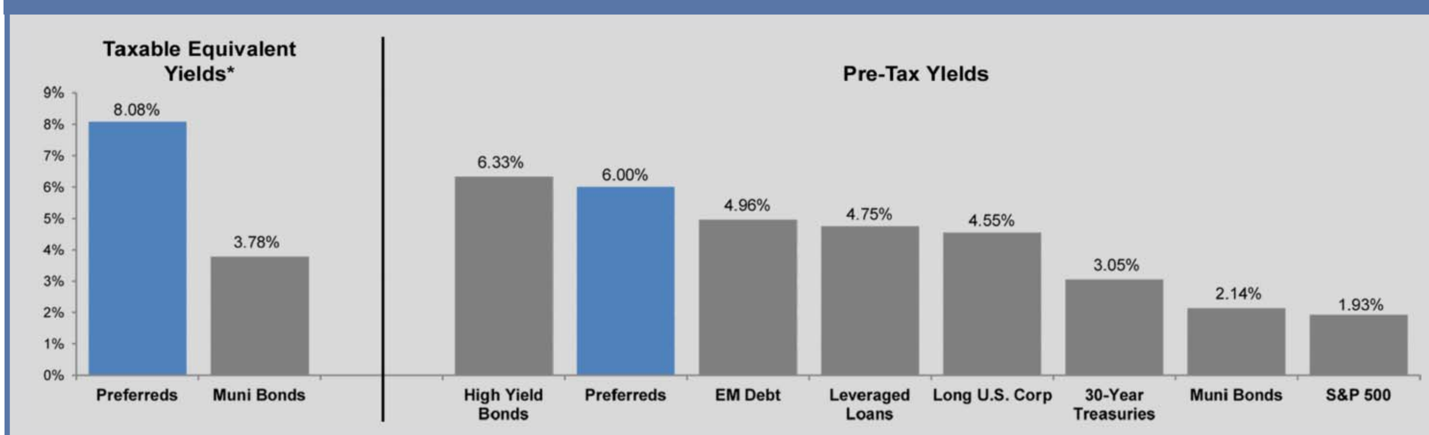
Conwell: In round numbers that means a preferred paying a 6% dividend is producing a taxable equivalent of around 8% for high income tax investors. You can see the tax advantage can be pretty meaningful for preferred investors. Depending on the fund, our funds produced between 50% and 60% 2013 distributions of QDI. So, a 7.5% dividend/yield on our funds was really closer to an approximate 9% taxable equivalent.

SL: As you think about the preferred equity sector and the difference in the companies that provide preferred vs. convertible equities, what is your commentary about owning preferred equities vs. convertible bonds?

Crumrine: It's going to be a different universe of issuers by and large. As Chad indicated, major issuers of straight (or non-convertible) preferreds are the banks, other financial institutions, utilities and REITs.

Convertibles are frequently issued by a whole different class. None of those industries I've just enumerated really issue much in the way of convertibles.

Taxable Equivalent Yields vs. Pre-Tax Yields
As of November 4, 2014



*Assumes a marginal income tax rate of 39.6%, a 3.8% Medicare surtax on investment income and a QDI rate of 20%.
Source: Flaherty & Crumrine Incorporated, Bloomberg, Barclays Live, Bank of America Merrill Lynch.

Let me add that we are straight preferred investors by and large. We will buy busted convertibles, if we can buy them cheap enough to where the preferreds trade, and where there may be opportunity to recover. But we're basically straight preferred investors.

Conwell: It is important to note that convertible bonds have equity upside in addition to equity downside. In other words, you can't convert them into common stock and your investment can appreciate. However, your expected return in preferreds is really the income that you receive from owning the security minus any changes in principal that are impacted due to interest rate changes or credit spreads.

SL: How is your background helpful in managing the portfolio? How do you group or organize the investment team?

Crumrine: Founded in 1983, Flaherty & Crumrine is the most experienced firm specializing in the management of preferred securities portfolios.

Our internal credit research is the beginning and key to both our investment process and performance results. Relying upon our internal rating system, we manage our client portfolios directly on our trading desk. Two of our four portfolio managers, assisted by additional personnel, trade these portfolios in a relatively inefficiently priced market where only approximately half the preferred market is listed on an exchange. Our portfolio management structure facilitates rapid decision-making and execution, critical in such a market environment.

SL: Why did you IPO the fund? What are IPO assets? What was the initial strategy? How has it changed over time?

Crumrine: Prior to 1991, all of our clients were separately managed institutional accounts focused on preferred securities. Flaherty & Crumrine had the opportunity in January 1991 to distribute its first closed-end fund (Preferred Income Fund, NYSE:PFD) to retail investors. Since that date, we have done seven additional closed-end funds (including two in Canada) and one open-end or mutual fund – all focused on preferred securities.

Our most recent fund, Dynamic Preferred and Income Fund (NYSE:DFP) was launched in May 2013. As of September 30, 2014, the combined funds totaled just under $3 billion. The strategy and objectives of these funds have not changed over time.

SL: I was a little curious that you have two closed-end funds in Canada. When were they IPO'd? Are they similar to your U.S. funds or are they of a different type of strategy?

Conwell: There's actually only one Canadian fund now; the two original funds merged. They were both launched in 2004 with slightly different strategies at the time, but now obviously they're the same. I would say the one fund that exists has basically the same strategy as our newest closed-end fund (Dynamic Preferred and Income, NYSE:DFP) in that it can own different kinds of preferred securities and even debt. However, it doesn't tend to invest in the more equity-focused preferreds issued in the United States.

SL: We have some friends that run a couple of Canadian closed-end funds. It's a much smaller market. We haven't tackled it yet. We're still busy with the U.S. closed-end fund market.

Crumrine: In terms of scale, the Canadian market is roughly one-tenth of the U.S. market in the size.

SL: What do you like about the CEF structure to meet the portfolios' objectives?

Conwell: Not having to maintain a liquidity buffer to fund redemptions (as a mutual fund must); this boosts both portfolio yield and total return of a CEF. Of course, all funds also permit issuer diversification that would be difficult for individual to achieve. Finally, the LIBOR-plus leverage permitted in the CEF structure combined with relatively high yields on our underlying portfolios meaningfully enhance distributable income to shareholders.

SL: What are the frustrations of running a CEF?

Conwell: Like all client relationships, we must invest in accordance with each fund's investment guidelines. Since each of our closed-end funds employs leverage in the form of LIBOR-plus borrowing, managing pledged collateral is important. Finally, it can be frustrating when market expectations (as reflected by market prices) deviate somewhat irrationally from the underlying value of a fund reflected by its NAV.

SL: How would you classify the fund's management style? What changes have you made to the fund in the past year, if any?

Conwell: It's difficult to classify our funds' management style in terms typically used to categorize other fixed income or other equity managers. Although our funds' results are compared against preferred security benchmark indices, we're certainly not market-timers, since our mandates are to be relatively fully invested. Preferred market issuance is concentrated in a just a few industries that

Flaherty & Crumrine Incorporated Manages Five U.S. Closed-End Funds

Flaherty & Crumrine Preferred Income Fund (NYSE:PFD), January 31, 1991 inception
Flaherty & Crumrine Preferred Income Opportunity Fund (NYSE:PFO), February 11, 1992 inception
Flaherty & Crumrine Preferred Securities Income Fund (NYSE: FFC), January 29, 2003 inception
Flaherty & Crumrine Total Return Fund (NYSE: FLC), August 26, 2013 inception
Flaherty & Crumrine Dynamic Preferred and Income Fund (NYSE:DFP), May, 23, 2013 inception

Fund Performance as of October 31, 2014

	1 Year		3 Year		5 Year		Since Inception	
Fund	NAV	Market	NAV	Market	NAV	Market	NAV	Market
PFD	16.3%	20.8%	14.9%	11.4%	17.1%	19.3%	10.2%	9.9%
PFO	16.4%	19.2%	15.5%	10.1%	17.6%	19.6%	9.5%	9.1%
FFC	17.2%	19.7%	16.5%	15.3%	18.8%	20.9%	8.5%	8.2%
FLC	16.9%	19.6%	16.1%	14.0%	18.4%	20.0%	8.5%	7.6%
DFP	17.8%	20.3%	N/A	N/A	N/A	N/A	11.3%	2.1%

Source: Flaherty & Crumrine Incorporated are generally regulated businesses and currently exhibit favorable credit momentum. Although we may overweight or underweight any of these industry groups based on our expectations, the majority of our outperformance has been based on security selection, reflecting both credit analysis and execution.

Right now, we're at the point in the credit cycle where common stock equity is continuing to increase, which means there's a greater cushion underneath that to absorb any shock that banks may suffer. In addition, banks generally are improving in other ways. The quality of their loans are getting better, though still not good, but it's getting better. Their expected losses, their litigation – all of these issues are reduced over time. as we get further and further away from the 2008-2009 time period. That will change at some point. Banks will take on additional risk, but right now banks are still de-risking. Finally, banks are not allowed to do the same kinds of things as they used to do.

That generally is going to be a good thing for preferreds. It means that it's less likely that the common equity cushion underneath us will come at risk because the banks won't be engaging in as much risk-taking behavior, as they did back in 2005 for example.

Right now, spreads (the difference between the preferred coupon and interest rates) are really very wide. We think that's a good thing by the way. We're getting paid a lot to own excess risk, and over time we think you're going to get paid more than fairly for taking on that risk.

We have not made any material changes to any of our funds over the past year.

SL: Where do you spend the most money and time as a team? Where do you spend the least that might surprise you?

Crumrine: We devote virtually all of our resources to credit research, portfolio management and trading. We spend the least amount of our time soliciting new business. Generally, potential clients are either referred to us or independently discover our identity after concluding preferreds are an attractive but highly specialized asset class.

SL: As portfolio manager, how do you balance the need for NAV performance with payments of dividends to shareholders, i.e., income vs. total return growth?

Crumrine: Although our funds' absolute total returns based on NAV as well as their NAV performance relative to other closed-end preferred funds have been excellent, high current income through the payment of dividends to shareholders is the primary objective of all but our most recent fund.

While it's not necessarily the objective of any our funds, we also consider the tax-status of the preferreds we're investing in at the margin. For example, last year at least 50% of the distributions from each of our CEFs were taxed at the lower QDI rate (of 0%, 15% or 20%).

SL: Why do you make changes in the portfolio – portfolio companies, allocation or sector changes?

Conwell: Because of the limited availability of many issues, it wouldn't work to create a model portfolio and then go buy it in the market. That's why it's advantageous for us to have our portfolio managers also act as traders. They take our views on credit and structure and find attractive trading opportunities based on what's available in the market and compared it with what we own in our portfolios.

SL: Have you had a dog in the portfolio? How did you handle it?

Crumrine: We're not perfect. However, when we've made a mistake judging an issuer's credit momentum, we attempt to cut our losses as soon as possible. Although we generally purchase securities of issuers in regulated industries where their credit momentum is positive, recovery is minimal for preferreds in the event of default. However, since our firm's inception, our clients' annualized cumulative default rate is low and is entirely reflected in our performance results.

SL: What types of companies, sectors, regions, do you prefer to invest in?

Conwell: The preferred market is concentrated in financial issuers (e.g., banks, finance companies and insurance), which comprise a little more than 80% of preferred issuance. We focus on U.S. dollar-denominated ("USD-denominated") preferred securities issued by U.S., European or Asian corporations. We don't have a sector/region bias, other than some of our funds are limited in the percentage of their portfolios that may be invested in foreign securities. Although we do take into account macro factors affecting industries or regions, our investment process is driven by a bottom-up fundamental approach where we target companies that we believe have good credit quality with attractive spreads.

We've been decreasing exposure in Europe because they're issuing newer types of preferred rights now, and we haven't yet found them to be more attractive than the rewarding opportunities in the United States. As a result, we have reduced our exposure to European banks. We still own European insurance companies.

SL: As you might know, we have organized CEFs into major and sub groupings and collect over 180 data points weekly on all CEFs. How would you classify and organize your fund in the world of other preferred equity funds?

Conwell: We think that preferreds should be classified in an investment

Flaherty & Crumrine Fund Holdings Generating QDI as of August 31, 2014

Fund	Fund holdings generating QDI	2013 distributions eligible as QDI
PFD	60%	59%
PFO	59%	59%
FFC	55%	50%
FLC	58%	52%
DFP	61%	56%

Source: Flaherty & Crumrine Incorporated category all their own. Preferreds are a distinct asset class with low correlation to both equities and other fixed-income assets, providing effective diversification. There should be more of a distinction between more dedicated preferred funds and funds that are income-focused which simply include preferreds among other asset types.

SL: What sectors do you see or hear investors replacing with preferred equity CEF?

Crumrine: Viewed historically, preferreds continue to be attractively valued, relative to historic relationships with other fixed income asset classes. We believe most investors in our preferred CEFs are doing so because of the higher distribution rates we can offer.

SL: Who are your closest fund peers?

Crumrine: The USD-denominated preferred market is relatively small compared to other fixed income asset classes, with the total par value of issuance at just over $400 billion. Consequently, we have a relatively small group of competitors that include preferred funds from John Hancock and Nuveen, and more recently Cohen & Steers and First Trust. There are other CEFs that dabble in preferreds, but these are the funds focused entirely on preferred securities.

SL: What are the best indices to track your funds' relative performance?

Conwell: With our input, Bank of America Merrill Lynch recently created a set of preferred indices that include both retail and institutionally structured preferreds. In the past, retail and institutionally structured preferreds have always been segregated in preferred indices from other providers. We think these new indices are the most reflective of the entire preferred universe.

All of us active managers and all of our peers can trade in listed preferreds and bond-like preferreds. That's proven to our advantage. An article published last year observed that preferreds were the only space where every single active manager beat the ETF (Source: "For Preferred Shares, Active Management Has Paid Dividends," Cara Esser, Morningstar, May 28, 2013). In another words, we can all provide value relative to ETFs because ETFs just have these artificial constraints in our space. It's a long winded way of saying that indices are not a great metric for us, and it is proven by those investors who try to invest with an index like an ETF.

SL: How does the current Fed policy regarding tapering, rising rates and deflation risk impact the portfolio?

Crumrine: Our portfolios have been increasing their allocation to securities with fixed-to-float coupons, which have less interest rate risk. These securities pay dividends at a fixed rate for 5 or 10 years and then transition to a floating rate dividend.

It's roughly 57% fixed-to-float now. That really shortens the duration on our portfolios pretty dramatically.

Furthermore, although we think the economy can support higher interest rates, long term interest rates are likely to rise only gradually, given low inflation and a moderate economic growth environment. Since preferreds are the highest yielding asset from investment grade issuers, their relatively high yield tends to dominate capital losses over most time horizons. Of course, ultimately rising short-term rates will impact our cost of leverage and the level of our distributions.

Nonetheless, you've got an asset class which has a perpetual maturity, yet because of the fixed-to-float nature of it – securities converting to adjustable rates within 10 years generally, and in some cases even five years – that shortens durations. I think it's probably the best defense against increasing rates which are going to occur at some point; it's just a matter of time. So what happens in the future? I don't know. We're talking coupon or coupon-minus returns.

Conwell: I think coupon-minus means that while we may suffer some slight price decline in long term interest rates when intermediate and long term interest rates rise, it's not going to be very much. The reason it's not going to be very much is that we don't expect, certainly over the next year and really over the next couple of years, long term and intermediate term interest rates to rise significantly.

So, if the long bond rises from 3% to 4%, that's within expectations; in fact, it did that last year. But we don't currently anticipate that going much higher. That forms our coupon-minus opinion to some degree. There could be some price declines from long or intermediate bonds rising, but not a lot.

We're not expecting to see an inverted yield curve unless long term interest rates decline significantly for quite some time. Expectations of Fed policy don't call for a rise of short term interest rates above 3% until the end of 2016. As a result, we're not as worried about an inverted yield curve today as we have been at other points in the past.

On the cost of leverage, of course, we care about short term interest rates because that's where most of our benefit comes from. We borrow very cheaply in the short end of the market and invest in much higher yielding securities, passing on the benefits of the leverage.

SL: What is your approach on keeping the portfolio diversified but not over-diversified? What is considered "too many positions" for a fund of your focus and size?

Conwell: We don't typically have positions of more than 6% in any one issuer, and our credit research group sets exposure limits to issuers based on their credit opinion, which are typically much lower than that level.

Our funds will generally hold over 100 securities in order to achieve the diversification and maximum exposures that we want. We tend to have core holdings that we own for extended periods and other holdings that we look to trade more opportunistically.

SL: Our studies show that all major CEF groups and subgroups with preferred equity funds had the roughest time when rates rose by 4% during March 2004 and September 2007.

With your experience in the sector and memory of this time period, can you say anything that will help us understand the data better? What is different now with the probable rise of rates vs. before, and what changes have you put in order to navigate through it?

Crumrine: The return you cited in the article was return based on market price. The return on NAV during this period was quite a bit better at over 12% (using returns from Morningstar's preferred CEF category), as market price results trailed NAV performance during this time period. While the market price of CEF funds can deviate from their NAV for various reasons, the NAV performances of our funds were respectable given the rise in rates. The difference today is that our funds have a greater weighting in fixed-to-float securities, with over 50% of each of the fund portfolios currently holding either floating or fixed-to-float coupons.

SL: What is the one item advisers and investors always seem to misunderstand about your fund/sector?

Crumrine: Although preferreds either have long-dated or perpetual maturities, their interest rate sensitivity is much closer to that of intermediate maturity debt instruments. Features of preferreds such as issuer call options and currently either floating or fixed-to-float coupons make preferreds less sensitive to changes in interest rates. The unlevered effective duration (a measure of interest rate sensitivity) for our client portfolios is currently akin to intermediate bond portfolios.

SL: Can you put the fund's use of leverage into perspective? How has it changed over time? Give us a breakdown of the type of leverage you employ and why. What would cause you to increase/decrease your leverage? Did you use to have auction rate preferreds or did you always have a debt leverage?

Conwell: All of our funds use debt leverage for which we pay a spread above 3-month LIBOR. The funds are allowed to borrow up to one-third of their total assets, and we have been managing the funds fully leveraged at this level.

Given the existing wide spread between our cost of leverage and our portfolio yield, the use of leverage makes sense and enhances returns to shareholders. From a distributable income perspective, this is true except in the rare case of an inverted yield curve.

In terms of auction preferreds for our two largest funds, we had actually refinanced the bulk of the leverage by early 2008. With leverage markets freezing up in the months leading to the financial crisis, our funds were finally were out of auction preferreds by mid-2009, and we were glad to be done with it.

Crumrine: We do have the flexibility to modify/change the leverage. Currently we can't take any additional leverage on if more than one-third of total net assets is leveraged, but it allows us, in effect, to manage the liability side of the funds, which we couldn't do before.

Conwell: In fact, we are starting to consider ourselves somewhat more active managers of leverage. We really think about the overall balance, how it fits the risk profile of the fund – whether it makes sense to take on more leverage within the rules or whether it makes sense not to. We've made both of those decisions.

Since their inception, all of our funds have paid monthly dividends and have had a dividend reinvestment plan ... for shareholders.

SL: We look at leverage adjusted NAV yield to get a sense of what a fund manager has to do to meet the dividend policy. At 6.2%. vs. 5.8%-5.7% "peer funds % market" yield, do you look at the same info? How is the data/holdings different?

Conwell: It's difficult to pinpoint exactly why our portfolio yield is higher than our competitors, but we'd like to think it's because we've done our homework on credits and structures, and selecting securities with better return profiles. And, our higher yield hasn't come at the expense of taking on more risk because our risk-adjusted returns are favorable compared to competitor funds over most time periods.

SL: How does the Board of Directors go about setting the dividend policy? What is the portfolio's manager's input on this factor? Have you ever really used return of capital?

Crumrine: Periodically each fund's board considers a continuing dividend resolution proposed by its management. Since our portfolio managers also serve as each fund's management, we're the ones doing the analysis necessary to communicate and justify to the boards any recommendations for changes in each fund's existing dividend policy.

Conwell: We did very slightly, in the midst of the financial crisis, use return of capital because we just couldn't hit the target. The highest level in one of our funds was under 5%, and most of them were 1%-2%. Ever since then, we have tried to err on the other side; we tend to retain some earnings. In other words, we haven't quite distributed all of our distributable income each year.

SL: Please talk about the dividend and any policy for share buybacks. If there were changes in the dividend and/or share buyback policy, was it activist-directed or activist-defensive.

Conwell: Since their inception, all of our funds have paid monthly dividends and have had a dividend reinvestment plan (allowing dividends to be reinvested for additional shares) for shareholders. These policies were not necessarily implemented with activist shareholders in mind. We don't otherwise maintain any policy for buying shares of the funds on the open market. Overall, we believe the best response to premiums and discounts is as clear and consistent a communication strategy as possible.

SL: What is the biggest strength of the boards? How have you used them to better manage the fund?

Crumrine: The biggest strengths of the funds' boards are their stability, tenure and knowledge of the preferred securities market. The same four independent directors serve on all five of our U.S. funds. Two of those directors have served since the inception of PFD back in 1991.

The two more recent directors have served since 1997 and 2005, previously having extensive experience in the preferred securities market.

SL: Please help us understand how the fund monitors its earnings/net investment income and unrealized capital gains/losses. How should this data point be viewed by investors?

Crumrine: As discussed above, our portfolio managers also serve as each fund's management team, ultimately responsible for monitoring its finances, including earnings and net investment income. Although the funds' administrator, Bank of NY/Mellon, has primary responsibility to calculate these numbers, we have long utilized internally generated software to verify their calculations.

These fund statistics are available periodically on our various fund websites and should be considered along with other fund factors, including historic results, distribution yields and the relationship of both current and historical market price to NAV. We would note that our older funds have meaningful capital loss carryforwards that should mitigate potential future capital gains.

SL: How often do you update investors on the funds' financials/ holdings? What is your investor/public relations strategy? Do you go to any conferences?

Conwell: We send quarterly reports to shareholders and provide commentary on the funds and the preferred market through our funds' websites. On a monthly basis, our funds publish summary information on their websites about their portfolios (e.g., top issuers, industry and foreign breakdown).

We also publish quarterly economic updates as well as occasional white papers on topics of interest in the preferred market (e.g., changes in bank capital regulations, bank stress test results) which are available on our funds' websites.

For our three largest funds, Destra Capital serves as shareholder servicing agent and is actively marketing the funds with financial advisors throughout the country and directly with market analysts. As a small shop, we don't do much marketing ourselves, but we do speak at conferences and with analysts as the opportunity arises.

SL: Talking about CEF data/analyst coverage, who offers the best insight and shares research with individual and investment professionals?

Crumrine: There a few good analysts that we track at the sell-side firms. We also follow third party resources, such as CEF Advisors and Morningstar. In our view, the issue is more about scope. Not enough people are aware of our relatively small corner of the investment products universe and the high income we can offer.

SL: What is next for the funds and teams?

Our outlook for preferred securities remains relatively optimistic.

Conwell: We will continue Flaherty & Crumrine's tradition of delivering best-in-class results for our fund shareholders and separately managed institutional clients, making no changes in our key steps of credit research, portfolio management and trade execution. Of course, at some point we might bring to market the next closed-end fund. In the meantime, for those investors more comfortable with an open-end, mutual fund structure, we'll continue to communicate the attraction of our sub-advised fund, the Destra Preferred and Income Securities Fund.

SL: What is your market outlook for 2014 and beyond? Where might you take the portfolio's allocations or what will drive investment decisions?

Crumrine: Our outlook for preferred securities remains relatively optimistic. Moderate U.S. economic growth in a sluggish global economic environment should provide a constructive atmosphere for preferred security investors.

Furthermore, improving fundamentals and wide yield spreads on preferred securities – as their prices have not participated in much of the recent U.S. Treasury market rally – should at least partially absorb some of the impact, even if interest rates move gradually upward over the next few years.

We expect the USD-denominated preferred market to continue to produce attractive returns for investors, with total returns in a "coupon" or "coupon-minus" environment. On the whole, a moderate-growth and low-inflation economic environment continues to be favorable for preferred securities – one of the few pockets of both yield and good credit quality available today.

Although we believe that the fund portfolios are currently well structured and diversified, as discussed previously we anticipate continuing to add to positions in fixed-to-float preferreds as those prices are less sensitive to possible changes in interest rates. Preferreds do fit real well into where America is going in the next 10 years or so.

SL: Good, you've given me a mental workout. I appreciate it, you guys. As a last question, what is your most recent non-financial book that you've read?

Crumrine: I'm reading two biographies on James Madison. Of all the founding fathers, there's the least amount published on him. I've read a number of books on all the others, but I've just recently focused on him. He was the primary drafter of the Constitution and Bill of Rights, and that is very interesting to me. ■

For more information about Flaherty & Crumrine Incorporated, please visit their website (www.flaherty-crumrine.com) or call 626-795-7300.

Disclosure: Clients and employees of CEFA as well as its family members own shares of DFP at the time of this interview. We will wait three business days after publication before executing any buys or sells in DFP, FFC, FLC, PFD and/or PFO.

Portfolio Managers' Review

As of November 21, 2014, year-to-date on a market price total return basis:

- Equity CEFs are up +10.4% at an average -7.7% discount to NAV.
- Taxable bond funds are up +4.5% at an average -7.1% discount.
- Municipal bond CEFs are up on average +15.5% at a -7.5% discount.
- BDCs are down -1.3% YTD at a -7.3% discount.

Discounts to net asset values are still common, with 89% of CEFs trading below their NAV. The current 11% of funds above NAV compares with 24% of CEFs trading above NAV at some point in the previous 12 months.

We continue to recommend investors focus on *The CEF Trifecta* when selecting and monitoring their funds. In simple terms this means:

1. Seek an attractive entry point in order to help reduce some of the potential market risk of your investment. We often call a good discount level "up-gravity," and at some point when investors potentially shift their interest to a fund you own, you have the opportunity to experience the narrowing of the discount. When this occurs, there is additional alpha on top of any NAV performance for the fund.

2. Seek funds with a high potential to maintain or even increase their distribution rates. We generally pivot out of funds with what we consider risky policies. We are also mindful of what level is normal for a peer group and understand when a CEFs next anticipated dividend announcement date should occur.

3. Lastly, we care about what a manager does for their shareholders after expenses as compared to peer funds. We analyze a CEF's NAV performance on an absolute basis and against peer funds over the previous 6-month and 12-month time periods. While investors will be unlikely to ever buy or sell a CEF for its NAV, it is the anchor point for its market price and, in our opinion, an indicator of its ability to grow over time for good long-term performance.

In November 2014, Standard & Poor's headed higher, with a gain of nearly 3% during that period. During this month, we swapped some of our BDC exposure to other funds of higher quality at more favorable entry points for client accounts.

Stock market history has shown that seasonal factors during the last two months of the year are among the strongest for U.S. stocks. This often includes the global and emerging markets which have continued to underperform U.S. markets this year.

We have added to Templeton Emerging Markets Fund (NYSE:EMF) which has been trading near its midpoint market price over the previous year. The emerging markets have recently been propelled by China's move to cut its interest rates for the first time in two years.

Due to recent stock market volatility and to potentially protect our portfolios in a possible equity market downswing, we have added exposure to two global bond funds which pay investors monthly dividends: Templeton Global Income (NYSE:GIM) and Deutsch Global High Income Fund (NYSE:LBF).

This issue of *The Scott Letter* is being published in the middle of tax-loss selling for the closed-end funds sector. CEFs are often caught in the retail investors practice of selling losses to offset gains taken during the year to avoid tax liabilities. We have already started this process for taxable accounts so we can have cash on-hand for potential discount widening.

The January/February 2015 issue of *The Scott Letter* will include an interview with Dr. Mark Mobius, the manager of Templeton Emerging Markets Fund and Templeton Frontier Markets Fund. ■

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