

# THE SCOTT LETTER: CLOSED-END FUND REPORT

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A Global View of the Closed-End Fund Industry

July/August 2010

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](http://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

## European Stress Tests Rally U.S. Markets

U.S. listed shares of European banks rallied, after the stress test results were announced July 23, led by Irish and Spanish lenders. The results of the region-wide stress tests showed most banks could withstand an economic downturn of the government-bond crisis.

The results of stress tests showed that only seven of the 91 banks failed to meet their capital requirements. However, investors signaled their distrust of the assumptions underlying the tests and the surprisingly small number of banks to fail the tests.

The stress tests, intended to restore trust in Europe's banking system, showed seven of the 91 banks – five from Spain, one from Germany and one from Greece – would raise new capital to fortify their finances and weather potential tough conditions.

The test involved modeling macroeconomic and sovereign debt stresses for 2010 and 2011, applying year-end 2009 capital levels. Germany's Hypo Real Estate and Greece's ATE were the only non-Spanish banks to fail, although there were near-fails in Italy, Ireland and Germany's Post Bank.

The euro buoyed because better-than-expected figures showed that German business rose more than expected. The U.S. dollar strengthened as well against the yen and Swiss francs. (Sources: *The Wall Street Journal*, *Financial Times*)

### The European Equity Fund

We interviewed the managers of The European Equity Fund. We prepared for this partly while on a riverboat tour of the Rhine, from Basel, Switzerland to Amsterdam. My wife and I were just a few miles from the

offices of Deutsche Bank, in Frankfurt, where this telephone interview took place. On this tour, we were fortunate to hear lectures on the euro by an economics professor from Oberlin College. We witnessed the vibrant economies of Switzerland and Germany.

The European Equity Fund, Inc. (NYSE:EEA) is a diversified, closed-end investment company seeking long-term capital appreciation through investing primarily (normally at least 80% of its assets) in equity and equity-linked securities of companies domiciled in European countries utilizing the euro currency. Any fund that concentrates in a particular segment of the market will generally be more volatile than a fund that invests more broadly.



Rainer Vermehren



Gerd Kirsten

Rainer Vermehren (42) is a German who was born in Venezuela. He attended Towson University in Towson, Maryland, and graduated with a B.A. in International Business in 1991. In 1990, he was a foreign exchange student at the University of Oldenburg, Germany, with a focus on Business Administration. He graduated from Fordham University, New York, with an MBA in Finance in 1996 after working as a financial analyst from 1994 to 1996 at Morgan Stanley on its Latin American team, learning fund management.

In 1997, he began his employment with DWS Investments and helped to expand the Latin American team into regionally dedicated and broader emerging markets funds. In January 2010, he was appointed Vice President to The Germany Funds (a family of three closed-end equity funds) and is now a Director and Portfolio Manager for these

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funds. He also manages emerging markets equity funds in Frankfurt.

Gerd Kirsten (47) joined DWS Investments in 2009 and is a Managing Director in Deutsche Bank's asset management division. He is responsible for alternatives in the German Equities and European Small and Mid-Cap team. From 2004 to 2009, he was partner and Managing Director of F&V Vermoögensverwaltung AG and fund manager of the innovative Dynamic Europe Fund.

From 1999 to 2004, during his 5-year tenure at Deka Investment, Germany's second largest mutual fund manager, Kirsten successfully launched and managed equity investment funds. Foremost, he built Deka's Small and Mid-Cap team from scratch and launched the Deka Europa Potential Fund which became a top-rated fund, growing it to be the largest such fund in Germany with over €1 billion in assets.

From 1990 to 1999, Kirsten worked on Wall Street. After gaining comprehensive experience as a mergers and acquisitions analyst, he developed, launched and managed the emerging market fund of HypoVereinsbank in New York which also reached top-rankings.

Kirsten has an MBA in Finance from Columbia University, New York, and a Diplom-Kaufmann in banking from the Technical University of Berlin.

We interviewed Rainer Vermehren and Gerd Kirsten by telephone on July 22, 2010:

**SL:** We have had a long history with the "Europe Fund" as it was called when it was managed by the Warburg London branch. When I researched my book on closed-end funds in 1990, they were very helpful in arranging appointments with the money managers of investment trusts in Edinburgh.

Has the investment style of the Fund changed since you've taken it over?

**Kirsten:** No, we are a research-driven house, bottom-up style. We are very aware of global trends so we incorporate a top-down view into our investment approach. I am the Fund's stock picker, and Rainer oversees the macro issues. When I took

| The European Equity Fund, Inc. (EEA) |              |        |         |        |         |                                 |
|--------------------------------------|--------------|--------|---------|--------|---------|---------------------------------|
| Performance as of June 30, 2010      |              |        |         |        |         |                                 |
| Total Return                         | Year-to-Date | 1-Year | 3-Year  | 5-Year | 10-Year | Since Inception (Aug. 27, 2003) |
| Market                               | -21.71%      | 4.00%  | -20.25% | -2.25% | -4.44%  | 5.17%                           |
| NAV                                  | -20.16%      | 3.34%  | -18.25% | -1.61% | -3.91%  | 5.84%                           |

  

| Geographic Distribution as of June 30, 2010 |     |             |     |
|---|-----|-------------|-----|
| Germany                                     | 43% | Netherlands | 5%  |
| France                                      | 17% | Denmark     | 3%  |
| Spain                                       | 9%  | Ireland     | 3%  |
| Switzerland                                 | 9%  | Other       | 11% |

over as management advisor to the Fund a year ago, the prior portfolio manager had about 60 holdings; we now have about 45.

We are less constrained as compared to the benchmark to find the best stocks and then weigh them in the portfolio in the order in which we have the highest level of confidence. That gives us much better performance on a long-term basis, rather than looking too closely at the benchmark.

**SL:** We see that the Fund has most of its investments in Germany, France and Switzerland.

**Kirsten:** The Fund is currently very concentrated and has a large overweight (about 17%) in Germany. The two largest off-benchmark country allocations are Switzerland and France, but these result more from stock picking than from a conscious country allocation. We select stocks from a "bottom-up" approach because we don't necessarily look at "countries" but at companies.

**SL:** How is the team that you and Rainer worked to structure?

**Vermehren:** Our entire portfolio management platform, both in New York and Frankfurt, reports to Klaus Kaldemorgen, the global head of equities at DWS. In my role as portfolio manager and vice president for The Germany Funds, I oversee the management of the three funds (which include The New Germany Fund, The Central Europe and Russia Fund and The European Equity Fund) as well as all the funds managed in Frankfurt for our U.S.-based clients. Gerd is Management Advisor to The European Equity Fund and responsible for picking its stocks.

**SL:** How many analysts are there, and who visits the companies?

**Vermehren:** In addition to my role as vice president of The Germany Funds, we have both a primary as well as individual deputy fund manager for each of the three funds. Overall, we have about 60 equity fund managers based in Frankfurt, managing more than 100 mutual funds. We make about 2,000 company contacts per year.

The equity portfolio management team here in Frankfurt is split into different regions and sectors. Regionally, the teams cover Europe (ex-Germany), Germany, the U.S., emerging markets and global equities. We constantly discuss our market views and single companies with our colleagues from the respective regional team. Alternatively and additionally, input is provided by the individual sector teams.

**SL:** What will happen when the newer eastern Europe countries join the euro in the coming years? Will there be any overlap with your other Fund, Central Europe and Russia Fund?

**Vermehren:** The Central Europe and Russia Fund (CEE) is primarily focused on five countries: Turkey and Russia being the larger ones, plus Poland, the Czech Republic and Hungary. We are allowed to invest in other countries but are concentrated in those I mentioned.

**SL:** What is your economic and market sentiment for the euro zone now?

**Vermehren:** From a technical standpoint, things are looking pretty positive. Our economy is doing very well; Germany has an unemployment rate of 7.7% which is the lowest in about 18 years.

**[Editor's Note:** Since we spoke to Rainer, the *Financial Times* reported that German business confidence has reached its highest level in July, a 3-year high as employers reported a steady recovery.]

**Vermehren:** When we look at Europe, it is very much North versus South, core versus periphery. We like the North but are less hot on the South, and we like the core, such as Belgium, Germany, France and The Netherlands.

Why are we not as hot on periphery countries as we are on Germany?

There are a couple of reasons. One is the so-called “Kurzarbeit” or “short work” which is a partnership between the German government and businesses developed in 2008 when we were at the peak of the crisis.

Companies, instead of laying off employees, simply reduce their employees’ work week (maybe to a 70% level), as may be required by the prevailing business environment and pay them only for the hours worked. Concurrently, the government steps in as a partner to the company and picks up a portion of the costs of employment so that employees in “Kurzarbeit” continue to receive 85%-95% of their net weekly pay. This way, companies save payroll costs while employees continue to receive close to their full pay package.

**SL:** Wow! If this is only in Germany, no wonder they recovered faster than the other European countries.

**Vermehren:** Yes, it worked very well and resulted in Germany bouncing back in 2009-2010. These companies were able to ramp up very quickly because they were not out looking for people to run their plants. This program will be phasing out over the next quarters, so, for them, that stimulus is going away. The expectation is that by now the domestic economy is strong enough to continue with reduced or no government aid.

Another thing adopted by other countries was what you called “cash for clunkers”. Germany was the first to introduce this. Of course, the program was criticized at the time as being only a short fix: “You are pulling sales forward into this year from next year and will then fall into a big hole,” they said. The downstream attached to the auto industry, however, is so far and wide ranging that it carried the industry very well in 2009, and thus far in 2010. They are going full steam ahead,

clearly a surprise for us. In hindsight, we have done a few things well, and Germany, being a big exporter, is now benefiting from low interest rates.

At the pace Germany is moving, if we had been currency independent, we would have had much higher interest rates. Because of the problems in the periphery countries, we are enjoying relatively low rates versus our neighbors. However, many of the periphery countries have been able to raise money in the capital markets. This has strengthened the euro in recent weeks.

**SL:** We have the same situation in the U.S. and anticipate rising interest rates once our recovery moves along.

**Vermehren:** In our portfolio positioning, that is our outlook: Core versus Periphery, North versus South. Keep it simple.

**SL:** Germany is clearly the leader and the strongest European country, but that means it’s carrying many of the weaker ones. Have any of the other peripheral countries, besides Spain, been able to raise capital?

**Vermehren:** Last week there was a large number of sovereign issuances to raise money. From that end, the markets are, at least, still open to them. However, the overall debt burden continues to be a concern in Europe. The announced austerity measures will take some months to implement. The pressures on them are to maintain low rates, but if rates start going up, the savings from the austerity measures may disappear very quickly.

For example, the public debt in Greece is about 160% of its 2011 gross domestic product (GDP). In Italy and Portugal, the ratio is about 130% and in Ireland, 120%. The figure for Spain is not that high and even lower than in Germany, but Spain has other problems such as an unemployment rate of 20% and other things they are struggling with.

**SL:** Yes. Among the OECD countries, the average government debt-to-GDP ratio was 44% in 2006 and is expected to rise to 71% in 2010. The ratio including intra-government obligations reached 79% for all the countries of the Euro region in 2009. Do you see this continuing to rise, and if so, what are the consequences?

**Vermehren:** We expect the overall debt to keep increasing. Germany has introduced a hard and fast debt ceiling into their constitution, but it will not go into effect until 2016. Constitutional amendments are usually difficult to achieve because they need approval of 75% of the voters. I am assuming that debt will continue going up here as well as in the other regional countries. Germany is at the forefront of trying to get that stopped. Some of the smaller countries, such as Denmark and Austria, have done more in the past to contain their level of debt.

The auto industry is going full steam ahead. Germany, being a big exporter, is clearly at an advantage and is benefitting from this development driven by low interest rates. Had Germany been “currency independent” within this crisis environment, interest rates in Germany would have had to rise more quickly than what is now the case. Critics argue that the common currency and problems in the periphery are providing Germany with lower rates than would otherwise be the case.

**SL:** At CEFA, we focus on regional and global funds, rather than on a single country fund.

Our investment philosophy is to find the best funds that give us both regional and global exposure to diversified economies. For that reason, we diversify into many countries. Diversification, as you know, is one of the ways to reduce investment risks.

This takes into account not only your “bottom-up” approach of picking strong, sustainable companies, but it also enables us to use a “value” approach by buying funds that are beaten down.

Could you tell us something about price-to-earning (P/E) ratios in your region?

**Kirsten:** We look at valuations both on a historic basis (versus a market’s own history) as well as on a dynamic basis, comparing the yield differentials of other asset classes, for example, bonds versus equities. We also use P/E bands over long-term time frames.

As you look at various country indices, such as the DAX (Germany) and other

individual euro stocks, you now see that they are all selling near their valuation lows because company earnings are seeing dramatic improvements. Based on this measure, European equity markets look cheap.

Secondly, by comparing dividend yields to interest rates, stocks are also very attractive, at least as compared to rates in the southern countries whose rates are generally higher than those in Germany, France and the Benelux countries.

**Vermehren:** We look at the valuations in countries we invest in, but, of course, we find that a lot of the emerging markets such as the BRIC countries (Brazil, Russia, India and China) have higher valuations than Europe and Germany. Are you familiar with the BRIC countries?

**SL:** Yes, very familiar. We interview Mark Mobius of Franklin Templeton every year to keep up with them.

We see that you are overweight in Germany as of June 30, 2010. At the end of the 2010 second quarter, it was 43.36% versus just over 36% on March 31 of 2010. Has this weighting continued?

**Kirsten:** We are 18% overweight in Germany and are overweight in Switzerland as well. These are the countries that are doing relatively well in this crisis because they are exporting. They have had the benefit of the weak euro, and much of the exports are machinery products. We export to the U.S., where prices have been lower because of the weaker euro, but Asia is definitely driving growth.

**SL:** After the stress tests were announced, the euro strengthened. Do you see this continuing?

**Vermehren:** I think that the current strength of the euro is more a result of the U.S. slowdown than an improvement in the European outlook.

**SL:** That may be true, but the U.S. has been reporting an increasing improvement in corporate earnings. Over 80% of 2010 second quarter earnings have been higher than the estimates, despite lagging high unemployment. What new positions have you been buying lately for EEA?

**Kirsten:** We have decreased the cyclical companies in the portfolio but are still looking at some companies like Lufthansa

Airlines, Aareal on the financial side and Xtrada of Switzerland, a company that owns mines all over the world.

**SL:** What is the current status of mergers and acquisitions (M&A) and other restructuring that have powered EEA well in past years?

**Kirsten:** We expect M&A to pick up as corporate balance sheets are strong. The focus is on the more stable countries in northern Europe where there is generally a consolidation within industries in the more fragmented consumer sectors or within technology. The big deals usually come later, in materials and mining.

**Vermehren:** For example, with the problems that BP is having in the Gulf, they will be selling about \$10 billion of their assets.

**SL:** Historically, EEA has owned oil, gas and other energy companies, which are good sources of dividends. Is that still true?

**Kirsten:** We have little exposure to the energy sector. Our only major oil company is Total, a French company. We don't really like the oil majors because they are structurally weak and have to keep spending more money to find oil. Oil will get a lot more expensive now after the Gulf of Mexico spill. We focused more on the oil service companies last year but sold these companies as everything will be delayed now, because of the spill.

**SL:** What interest do you have in alternate energy companies?

**Kirsten:** We have invested 1% in Vestas Wind Systems, a Danish company. The wind cycle was ahead, had a slump, but is now accelerating again. We also hold Wacker Chemie, the worldwide leader in production of silica for solar panels. Those are two direct plays. Indirectly, we play the whole energy conversion trend for energy efficiency through industrial companies. It is tough to find pure plays in Europe.

**SL:** Turning now to corporate governance, is EEA concerned with its discount which is running about -13% now?

**Vermehren:** The concern has been here for many years. Unfortunately, some closed-end funds trade at a discount.

**SL:** We see discounts as what distinguished us from ETFs and mutual funds which have perennial problems with

redemptions. We like the discount advantage because of their leverage and downside protection, as long as they don't widen too much after we purchase shares. Lately they have been narrowing throughout the whole spectrum of closed-end funds, especially those that are bond funds or growth funds that pay out much of their capital gains. We also favor continued share repurchases.

**Vermehren:** We have had a share buy-back in place for quite some time and really haven't seen great results. We talk to investors and listen to their needs and desires. We just had a board meeting and decided that we will continue with the buy-backs and, in addition, have decided to change direction. We proposed that, in addition to continuing the buy-backs, we will do two semi-annual tender offer lots, with a measurement period of 12 weeks. If the discount remains at 10% or more, we will buy 5% of the Fund's outstanding shares at a price of 98% of NAV.

**SL:** I saw that – and a number of funds are doing this – but there are expenses involved as well as other disadvantages. Most funds have repurchase programs, but most of them are more flexible rather than setting a certain percentage of shares. They continually repurchase, and if they see a block of shares appear, they buy the shares, sometimes to use for the share distribution as a dividend.

We also think repurchases are a good idea as it puts a floor under the price of the stock and can keep the shares from falling in weak markets. However, the worldwide economic recovery has raised net asset values and narrowed discounts for months as more and more investors seek protection and cash distributions.

If we like a fund, we oppose tenders because our clients could lose out in being able to buy shares because we are competing with the company for them. The irony is that we are the long-term shareholders that you need the most, rather than those who are in for quick gains.

**Vermehren:** What is your experience with activist shareholders?

**SL:** We don't like them. Since you announced your tender, there have been noticeable large buyers for your shares, but

they are not in for the long term. What is your experience with them?

**Vermehren:** We try to keep all channels of communication open and our entire investor base in focus, not just those screaming the loudest. While we actively respond to requests that are brought to us, we need to ensure that any measure taken is to the benefit of all shareholders. There are still a number of those activists around.

**SL:** We couldn't agree more with you for looking out for all of your shareholders. These activists have succeeded in destroying many of the smaller funds for short-term gains. When a fund is opened to eliminate the discounts, everyone redeems their shares. We can't see this happening with a complex fund as large and as sophisticated as yours, however. It still goes on, but the funds have gotten better at protecting themselves, so I wouldn't worry about it too much. We have been watching this for over 20 years.

We think that good performance, such as what you have, is always the best way to narrow the discount. Now that EEA is performing well and market fundamentals are strengthening, you shouldn't be concerned about discounts and ways to close them. We wonder if the timing is right for you now.

**Vermehren:** European markets are indeed coming into focus again. A combination of improving equity markets, a steady and disciplined discount management program, as well as increased "awareness-building" for the Fund should all contribute to reducing the funds share price discount to NAV.

**SL:** Some funds make a fixed distribution policy that automatically pays out a certain amount of distribution – and this can narrow discounts – but that is probably not for you because of the danger of paying a return of capital. Paying out more in distributions is what draws the long-term shareholders to you, but this is tough for a

growth fund. Many pay out as much as they can. Are there any changes in your distribution policy?

**Vermehren:** There are no changes.

**SL:** You might remember that cash distributions are dear to the hearts of closed-end fund investors, especially in the difficult times we have seen in the last few years. Your discount will narrow more once shareholders see that you are making capital gains, realizing some of them and are still giving them the choice to keep the cash or reinvest it in new shares.

Good performance is the bottom line, as I said. We just want to be able to buy enough shares so we can participate in the expected increase in your net asset values and not be blocked by the traders just in for the short-term gains.

EEA appears to be on the right track, and we hope to continue to be long-term shareholders. What conclusions do you have about investments in your region?

**Kirsten:** We think that the whole investment environment is changing globally again. For the last two years, the investment view was very macro-driven. It was more a matter of a broad earnings collapse and a subsequent earnings recovery across the board. It was much more important to see how much beta you had in the fund and whether you had cyclical versus defensive stocks.

Now, our job is getting much tougher because we must identify the macro trends within each sector and subsector, as well as the stocks which are going to grow and outperform going forward. The market has become much more of a stock picking game again. Earnings are recovering, but it is important to focus on companies with sustainable earnings growth. These must be identified.

**SL:** Is a low portfolio turnover part of your philosophy?

**Kirsten:** That is the basic philosophy, but risk management is also very tight. If it

doesn't work out, we won't sit on a stock and wait for it to happen. Instead, we would sell the position.

Assuming the tender offer for fund shares takes place, the investor would be able to put his shares to the fund and receive 98% of NAV, which would be something more than 8%, assuming the then prevalent market price discount from NAV is still above 10%.

**SL:** We have a few shares, but we hope that your Board will see that tenders should not be necessary as good performance will take care of widening discounts. Closed-end funds are efficient, giving their shareholders great advantages over mutual funds, ETFs and other forms of investments. Our long experience has proven that many times over.

Just keep up the good work in building the portfolio, now that market sentiment is improving, talk of a "double dip" recession is fading, and world growth is starting to accelerate in a low interest rate environment. We hope that you will be flexible about your proposed rights offerings; they may not be necessary as good performance is the best way to narrow discounts and is also the best way to go as earnings recovery continues.

Remember, the optimists always win. We see EEA as a good choice to be able to participate in the growth and development of the euro region. We are strong supporters of the whole idea behind breaking down the barriers in an increasingly globalized world.

More information on EEA and the other funds managed by Deutsche Bank Group (DWS) is available by visiting [www.dws-investments.com](http://www.dws-investments.com) or calling 800-349-4281. ■

## Wall Street Anticipates a Recovery

While much of the country remains fixated on the bleak employment picture, hiring is beginning to pick up on Wall Street, the place that led the recession.

The shift underscores the remarkable recovery of the biggest banks and brokerage firms since Washington rescued them in the fall of 2008 and follows the huge

rebound in profits for members of the NYSE, which totaled \$61.4 billion in 2009, the most ever. Since employment bottomed out in February, New York securities firms

have added nearly 2,000 jobs, a trend that is also playing out nationwide at financial companies, commodity contract traders and investment firms.

“Though the figures are small in comparison to overall Wall Street employment, executives, economists and headhunters say that they expect growth to

pick up steam in the coming months,” said Rae Rosen, a regional economist at the Federal Reserve Bank of New York.

“Wall Street typically hires in anticipation of the recovery, and there is a sense that the economy has bottomed out and is slowly improving,” he said. ■

Source: *The Wall Street Journal*

## Portfolio Manager’s Review

As U.S. investors have noticed, there has been a close stock market relationship between the European markets and those in the U.S. Now that the European stock markets are behaving better and the economic problems in some peripheral countries are subsiding, we hope that the economic fundamentals there will translate to our stock markets. We have been adding to funds that are leading the charge for the next bull market, with an emphasis on cash distributions because that is what closed-end fund investors want. We are more patient in the emerging markets that are well on their way to recovery.

In spite of better news on economic recovery, the U.S. stock markets are still focusing on short-term and continuing high unemployment figures while ignoring the better news that underlies the economic fundamentals. A lot of this comes from a revival of world trade. Investors entered earnings season tentative but hopeful. Analysts have been surprised by better-than-expected U.S. earnings for the second quarter, and stocks are trading at historically cheap levels, despite prevailing negative investor sentiment.

According to Thompson Reuters, however, of the S&P 500 companies that have reported through July 16, 75% of them beat the estimates, compared with the historical average of 62%. Some 13% missed estimates, compared to fewer than the historical average of 2005. Thompson Reuters adds that, on the whole, companies are beating estimates by 16% this quarter, compared with an average of 2% since 1994.

Since our interview, there have been many comments in the press about both a “double dip” recession and deflation fears which could erode profits and is bad for stocks. On top of that, sentiment is eroded by press reports that focus on the short-term blips in recovery that is taking longer than expected, in light of improving economic fundamentals. The last deflation scare was in 2000 which turned out to be a false alarm; instead we got soaring asset prices that aren’t in the cards now.

We will certainly have more inflation than deflation because of massive U.S. and European debt. That is more reason to be in stock markets, as it is the best way to beat inflation. Another reason is that commodity prices are rising due to world recovery and high oil prices.

In this environment, we need to watch the Federal Reserve. Both former Chairman Greenspan and Chairman Bernanke discount deflation fears. With a few policy moves, the Fed can banish the fears of deflation, and we will all be talking about inflation again.

Using closed-end funds is still the best way to invest, and there are funds for investors with all types of risk tolerances, as we have found in bear markets. The present good performance of the European Equity Fund is just one example. There are many others on both the equity and bond side of the spectrum. ■

*George Cole Scott*

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