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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:

Advent Claymore's Convertible Securities & Income Fund (AVK): Convertible Bonds as Fixed Income Securities with Equity Upside for Rising Interest Rates

The investment objective of Advent Claymore's Convertible Securities & Income Fund (AVK) is to provide total return, through a combination of capital appreciation and current income. Under normal market conditions, the Fund will invest at least 80% of its managed assets in a diversified portfolio of convertible securities and non-convertible income securities. Also, under normal market conditions, the Fund will invest at least 60% of its managed assets in convertible securities and up to 40% of its managed assets in lower-grade, non-convertible income securities, although the portion of the Fund's assets invested in convertible securities and non-convertible income securities will vary from time to time consistent with the Fund's investment objective, changes in equity prices and changes in interest rates and other economic and market factors. The Fund expects to invest approximately 70% of its assets in lower-grade securities, however from time to time it is possible that all of the Fund's assets may be invested in lower-grade securities. The Fund may invest without limitation in securities of foreign issuers, and the Fund's investment in foreign securities may vary over time in the discretion of the Fund's investment advisor.

We interviewed Barry Nelson and Douglas Teresko, portfolio managers at Advent Capital Management, which manages the Advent Claymore Convertible Securities and Income (NYSE:AVK), on July 16, 2012.

SL: Please tell us what about each of your backgrounds helps you manage a convertible bond portfolio such as AVK?

Nelson: My background is diverse. I've been an equity analyst and an equity portfolio manager. I've run high yield bonds, government bonds and convertible funds. I've been a research director of three departments and on Wall Street for 40 years. I would say that everything I did over the years comes together in terms of managing convertible securities which have components of equities and fixed-income imbedded in them.

Teresko: I have 17 years of investment experience, the last 13 years as a portfolio manager specializing in convertible bonds, capital structure arbitrage and equity and credit derivatives. My background is very helpful as we sort out and trade ideas from our 11 fundamental analysts to put into the Fund. Looking at the whole capital structure and the different options we have on convertible bonds and derivatives, we are able to execute optimal trades based on our fundamental view of companies.

SL: Let's talk about the closed-end fund structure and how it applies to the portfolio management work you do at AVK.

Nelson: I would say the key advantage of the closed-end structure is that the cash flows are completely predictable. Unlike an open-end fund, we don't get whipsawed by unpredictable daily flows in or out of the funds which can be very destructive.

Open-end funds classically have more money than they know what to do with during the euphoria of their asset class, and then they get hit with liquidations in weak markets when it's very unfortunate to be forced into selling. We don't have those problems. Another favorable aspect of the closed-end fund structure is that you can use leverage. There is academic evidence that the best way to use it over time is to leverage a relatively conservative high quality portfolio. That's essentially our goal within AVK.

SL: As you think of how you manage the portfolio of convertible bonds, would you classify the strategy as fundamental, technical, tactical or value-oriented?

Nelson: Well, the basics of the fund are fundamental credit-driven, not just the high yield portion of the fund credit-driven, but we start with credit work on the convertibles that we buy. We're huge believers in credit research.

The other aspect of the Fund is in evaluating convertibles. We use various models to identify convertibles that are undervalued based on the creditworthiness of the companies and the volatility of the underlying stock. Our approach is fundamentals and credit-driven with an overlay of quantitative evaluations of the convertible securities.

A value-only approach is not essential to us. We'll take value if we can get it. We are really not technical and not tactical but bottom-up fundamental. It's not a sudden decision to invest in financials or get out of healthcare. We are looking for companies with good fundamental trends, with attractive convertibles or attractively priced high yield securities.

SL: What makes AVK's portfolio unique vs. other convertible bond funds?

Nelson: Relative to other leveraged convertible bond closed-end funds, it's our understanding that we are the Fund that's most weighted towards convertibles by prospectus. We have to be at least 60% invested in convertibles, and we've usually had more than that in convertibles.

We're at about 62% convertibles as of the end of May 2012 and, in the past, we've been close to 80% at different times. We perceive that the other leveraged closed-end funds with convertible in their name are not as heavily invested in convertibles.

SL: So you're a purer convertible play for a closed-end fund that is levered?

Nelson: Yes, we're at least 60% convertibles, making us a lot more religious about convertibles than other funds that are 50% or less and rarely push beyond their minimums.

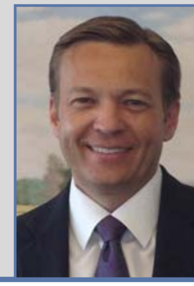
SL: How do you decide where to set the portfolio's exposure to convertibles and other categories to use in the portfolio?

F. Barry Nelson, CFA
Senior Vice President, Portfolio Manager

Mr. Nelson serves as Senior Portfolio Manager. Prior to joining Advent, Mr. Nelson was Lead Manager of Value Line Convertible Fund and Value Line Multinational Fund, and Research Director of Value Line Convertibles Survey. Under Mr. Nelson's management, Value Line Convertible Fund rose to #1 among 41 convertible funds monitored by Lipper Analytical Services. The Value Line Convertibles Survey was cited as the top-performing investment letter by Hulbert Financial Digest. His earlier experience includes international research at NatWest Securities, Research Director of Louis Nicoud & Associates, and Portfolio Manager of Value Line U.S. Government Securities Fund, named the #1 U.S. Government Bond Fund by Money magazine after five years, and Portfolio Manager of Value Line Aggressive Income Trust, a high yield fund. Mr. Nelson is a graduate of New York University and received his MBA in Finance from St. John's University.

Douglas A. D. Teresko, CFA
Vice President, Associate Portfolio Manager

Mr. Teresko serves as an Associate Portfolio Manager on Advent's closed-end mutual funds. Prior to joining Advent, Mr. Teresko worked in Global Proprietary Trading at Credit Suisse, where he managed portfolios of global convertibles, derivatives, and long/short equities. Before joining Credit Suisse, Mr. Teresko was a portfolio manager at Citadel and DKR. Prior to business school, he held various investment positions at Houlihan Lokey and JP Morgan. He is a graduate of Miami University and received his MBA in Finance from the University of Chicago.



Nelson: We have a better total return potential in convertibles than with some high yields. One can also make a good argument that due to credit spreads, high yield is quite attractive. Further, with low yields in general, you can infer that running an income fund is a lot easier to do with a higher allocation to high yields than to convertible securities in this market.

SL: When you're looking at convertibles, are there certain sectors that you generally avoid or plan to avoid in the future?

Nelson: Typically, it's not sectors. We often underweight convertible preferreds and especially mandatory convertible preferreds, which are really equity-like instruments and do not hold up well in a weak equity market.

We are going to be light on those except for either very attractive underlying equities or some other specific reason to make an individual convertible preferred appear attractive.

Teresko: We avoid most preferreds and mandatory preferreds. From a credit standpoint, we avoid companies that have deteriorating credit. We don't necessarily avoid a company because it's in an unattractive sector but more because of how it's performing within that sector.

One of the reasons that we underweight preferreds and mandatories is that they don't share the same asymmetric profile as convertible bonds.

SL: Though we have touched on it previously, who do you considered your closest peer competitor for convertibles?

Nelson: Our closed-end peers really don't look like us. The Calamos funds are less leveraged and typically have more in high yield. Other funds use synthetic convertibles that tend to be equity-like and usually don't provide good downside protection or not as good as we think we can get in the aftermarket for convertibles that were issued by companies as opposed to structured by investment banks. We really don't see that we have close peers. The other leveraged funds also have higher distribution rates than we do that drives them more toward investing in high-yield securities than in convertible securities.

[**Editor's Note:** Some of the other convertible bond closed-ended funds report part of their distribution yield as return of capital (RoC), which we typically avoid for our portfolios.]

SL: You have the lowest levered convertibles market yield in your peer-group, which is not a problem for us when we research funds for our clients.

Nelson: I've been a portfolio manager most of the time since the fourth quarter of 1981. Often a lower yield works best in terms of providing total return, and stretching for yield can be dangerous. In any case, our distribution rate partly reflects when we started in 2003, when there was less hunger for yield.

SL: What are the best indices to use to track your Fund?

Nelson: We prefer the Bank of America/Merrill Lynch indices because of transparency online. Every week, they tell us everything that's in the index. It's the most transparent. The broad convertible index is called the Merrill Lynch All Convertibles Index (ticker VXA0), and for high yields, we use Merrill Lynch High Yield Master II Index (ticker H0A0). Excellent transparency makes it easier for us to understand what's actually going on in these markets.

SL: How does the Fed's current policy impact the portfolio?

Nelson: I'd say that the primary way it's influencing us is with the repression of interest rates. On the one hand, our Libor-based auction rate preferreds provide us with non-expensive leverage. On the other hand, a problem within an income strategy when interest rates are low is it's difficult to produce high distributions other than by returning capital.

Secondarily, we seemed to be in a period of "market pessimism" that is discouraging issuance. I'm not seeing many equity IPOs, and we're not seeing a lot of new convertible bonds. Part of the reason for a lack of convertible issuance is low credit spreads. The amount of basis points saved when issuing a convertible relative to issuing a straight bond is not as great as when absolute rates on corporate bonds are higher.

I think we're in an era in which companies are not looking to aggressively grow. They don't need funding for capital expenditures, or for mergers and acquisitions, and historically, convertibles were issued by growth companies. We've traced convertibles back to 1837 when the then-new Erie Railway needed lots of capital to build the railroad from Chicago to the Hudson River opposite Manhattan. We're not seeing much corporate expansion like that in the current environment.

It will come back. When it does, we'll probably see higher interest rates permitted by the Fed. Plus, I think the Fed low rates imply an emergency condition that may be repressing optimism just as the Fed is suppressing interest rates.

SL: That is an interesting point, that the rates themselves being held low has tempered the equity and convertible upside for investors.

Teresko: One important thing to bring up about interest rates is that historically, convertible bonds have outperformed all other fixed income asset classes in a rising rate environment. We have multiple studies on high yields, long-term and medium-term Treasuries, as well as blended versions of these portfolios. This is something that we will have to be concerned about over the next one to five years when interest rates are backing up.

As an example, you have an on-the-run 10-year Treasury bond trading at 103, yielding about 1.49%. If the yield backs up 300 basis points or 3%, that bond will trade down to 89. If that bond yield backs up to 6%, that bond trades down to 68.5.

There is going to be a period of time when people focusing on capturing yields have significant principal loss as the yield curve backs up. Having a higher allocation of convertible bonds during that period will perform better than other fixed income asset classes.

This has happened several times over the last 20 years. Once Fed policy does relax, the yield surely will back up, but not until they decide to let it. That's why convertibles are very interesting for investors who are worried about a rising interest rate environment.

SL: Yes, that's exactly why we wanted to focus this interview on convertibles. Regarding staying diversified in AVK but not becoming over-diversified like an index, how do you decide on the size of a position and how many positions to hold?

Nelson: We are very broadly diversified. I think it's easier to tell you what we don't buy. We are usually light on mandatory convertible preferreds because of a lack of downside protection. We also don't ride the convertible bonds to the stratosphere.

Teresko: Regarding the size of position, we have a guideline to have no more than a 5% position in any particular credit. What you'll find in our funds is that the largest positions are about 3.5% and a lot of positions are in the 1.5%-2% range. Our goal is to beat the index at all times. We're certainly not indexing our portfolio; we're focused on creating alpha through good fundamental research.

Nelson: We'll buy anything that's attractive and liquid. It's really a situation of avoiding issues that we find dangerous either in terms of their structure or their current valuation or because of something wrong with their credit or the company.

We have a large team with 28 investment professionals and are global investors with a lot of good ideas. We can get very good insight into our portfolio companies, making it possible for us to hold diversified positions. Diversification can be helpful to liquidity when we change our minds on these situations.

If we own convertibles that rise too high above par, don't have appropriate downside protection, or if something goes fundamentally wrong, we will try to cut our losses or realize our gains and swap into situations that have better upside/downside potential.

SL: I am curious about the strength of convertibles bonds over preferred equity securities. How do they compare?

Nelson: First thing is an inherent suspicion of preferreds simply because they aren't bonds. They are equities, and while they are ahead of common equities from a risk perspective, they are not going to hold up on the downside the way bonds will, thus our prejudice against them.

The other thing is that being in convertibles over time provides equity-like returns, while straight preferreds are one dimensional yield instruments that have nothing like the upside potential of convertible securities. We are trying to avoid defaults and also want to avoid missed dividends. Preferred dividends can be passed, but if a bond misses a coupon payment, it's a default. We also manage some equities within Advent, and common stocks inherently have upside that's absent in straight preferreds.

SL: What do people misunderstand about convertible bonds?

Nelson: Convertibles can be very confusing. I would say the most obvious issue we see is where you classify them. Asset allocation is a critical matter to advisors. They're telling their clients about fixed income and equity exposure that can effectively be obtained with convertibles. I see convertibles as being like a car with an automatic transmission. If the stocks perform, the convertibles tend to up shift and perform like the stocks. If the stocks don't perform, the convertibles tend to downshift and behave like bonds. Professional advisors often tell investors when to shift gears. If the vehicle has an automatic transmission, it's pretty convenient to just put one foot on the pedal.

Another factor that I think people don't appreciate is the influence of credit spreads on discount convertibles. That is convertible bonds that have dipped below par where the underlying stock has fallen into disfavor, and yet the credit quality is okay. These issues often trade at surprisingly attractive yields relative to the credit quality, and the underlying stocks often have huge recovery potential.

I think this reflects the fact that convertibles are often misunderstood, and we can exploit this. Discount convertibles are especially useful in an income strategy, but I don't think people think of convertibles that way. They look at a convertible simplistically, as a bond that can convert if the stock goes up. However, there can be a huge amount of gravy if you buy after the stock goes down, and the bond price makes it very attractive as a fixed income security. The stock is undervalued and should make a smashing recovery as well. Confusion is the rule with convertible securities among most market participants, and this provides an opportunity for those of us who specialize in convertibles.

SL: We've already touched on leverage. Your fund last reported being 40% levered, which is on the higher end for convertible closed-end funds. How do you decide to change the leverage, and how does the Fund make its leverage decisions between credit revolvers and auction rate preferreds?

Nelson: We're always on the lookout for opportunity. The only time when we redeemed our auction rate preferreds was during the panic in 2008, when our leverage hit 50%. We would have violated the 1940 Act leverage limits. It would have meant that we could not make any further distributions to the common shareholders, and here we are running an income strategy. We reduced some of the preferreds at that time in order to restore the leverage under the 50%. At 40%, it's off from its past height during panic conditions.

The fact that we are leveraged does drive us to be conservative. We are naturally conservative. We think that emphasizing credits and lower volatility, lower downside is especially appropriate with the significant leverage. Over time, the leverage should be additive particularly when the cost of leverage is so low.

SL: That transitions well into AVK's dividend policy. How does the Fund set its policy, and how much input do the managers have into that policy?

Nelson: I've been on The Street for 40 years, and I think the first company I ever called and asked about the dividend policy, the CFO told me, "Well, that's up to the directors" and essentially didn't answer the question. I do feel constrained about this and would just direct you to the record that we have cut the dividends a couple of times during periods in which our returns were low. You can also see how well we're doing in terms of earning the dividend, and I don't think we've ever had a return of capital in AVK.

SL: Yes, I haven't seen any return of capital in my research in on your fund since the crisis.

Nelson: How will we monitor what we've earned and what we haven't? Frankly, the first thing I emphasize is our actively managed strategy. Last fiscal year our turnover was a 100% or so.

We don't have to keep any material reserves for the distributions. AVK has a liquid, actively traded portfolio. We emphasize the more actively traded yield issues. What we have done in the past is to realize some losses to offset gains. The Fund would rather not distribute excess, giving shareholders back money when we think we can do better over time, and we certainly don't want to return capital.

SL: Return of capital is not always a bad thing but usually a bad thing, in our opinion. Since the 2008 crisis, how has the convertibles market changed?

Teresko: All sectors are really quite different today than before 2008. One of the biggest trends you saw prior to 2008 was that about 70% of the participants in the convertible bond market globally were hedged convertible participants. That would be a combination of hedge funds (levered between two and 10 times), dealer desks and investment-dealer desks that had large portfolios. These desks were levered over 30 times with the banks' capital.

Throughout 2008, there was a deleveraging of the overall financial system and especially convertible bonds. What you saw beginning in 2009 is that the percentage of convertibles owned by hedge funds dropped from nearly 75% prior to the Lehman collapsed to under 50%. The incremental buyers who bought what the hedge funds had owned were long-only low levered funds or unlevered long-only managers. That's taken a lot of leverage out of the system.

One other unfortunate item that happened in 2008 (when Lehman went bankrupt), was that a lot of hedge funds had used Lehman as their prime broker. When hedge funds prime broker their holdings with an investment bank, that investment bank repos those securities back out so the hedge funds didn't know exactly where the convertible bonds were. They weren't necessarily with Lehman. They went out as collateral to third parties that started selling those convertible bonds in the market that Monday morning after the bankruptcy because it was the only collateral they had. It was a very complex convoluted situation.

There will be something else that happens in the next crisis, but this won't happen again because of the way participants have changed. It is the way long-term leverage has been reduced and the way that prime broker unwindings are set up now.

There are some pretty dramatic differences.

Nelson: Another change is really what I said before about a lack of optimism.

SL: The Fund has a negative undistributed net investment income (UNII) balance. I know that's a life-to-date balance for the Fund. The earnings reported don't fully cover the distribution. How do you look at the trend in the UNII and the trend of investment income to make decisions? How should we be analyzing convertible funds from these data points?

Nelson: We track UNII, and usually our aim is to make sure that we earn those distributions and that we don't overdo it. AVK, as you said, has the lowest distribution yield among any leveraged closed-end convertible fund so it's not the biggest challenge for us. I would also point out that ultimately the distribution at year-end is driven by IRS rules that differ from GAAP and that our earnings for tax purposes typically are higher than for GAAP purposes.

SL: How do you balance the need in the portfolio to produce income and net asset value (NAV) total return?

Nelson: I would say the goal is total return. We like having significant yield on our assets, but we're really trying to optimize the Fund for total return, not reach for yields and have a portfolio that has excessive credit risk and a lack of upside potential.

What we focus on is what we are earning for tax purposes and to aim to earn enough to cover the distribution but not so much as to have to make a large extra distribution.

SL: Some funds change their distributions regularly, in small increments, and some funds change distribution in large increments. Your fund seems to fall into the second group, with the last dividend change in early 2009. What's happened since you last set the policy?

Nelson: Well honestly, Doug and I are not directors. I've been around since day one at AVK. Maybe if I retire, I can become a director. You can look at the points where we've reduced the distribution and then use the word "crisis" – that's typically when it's happened. I think our record is actually similar to the other convertible funds.

SL: Regarding the turnover at the Fund being around 100%, can you help our readers understand some of the changes you have made recently?

Teresko: The interesting thing about convertible bonds is that you always want the upside option to convert into stock at higher prices than where the convertible bonds were issued. There are often catalysts that can't be predicted leading to long volatility. We can benefit from those catalysts. Just a week or so ago, there was a very short-dated bond (less than a year to maturity) trading very close to bond floor. It was right around par, and we were very comfortable with the credit risk earning a relatively small yield on the security.

Last Monday the company was taken out. The bonds were trading fairly close to par and shot straight up to 155. We unwound the position that morning. We wish we could have an event like this every Monday morning.

Nelson: This sort of thing happens all the time. Recently a high yielding convertible preferred trading at a discount for a number of years was finally called at $50 or par. It's really fantastic to know that for the 15 years it was outstanding, the convertible preferred provided a total return of 75% while holders of the common lost 43%.

You know we're always losing convertible bonds to favorable events. As I said before, we sell them if they get too high. We also sell them if they look dangerous. We had the convertible preferred of a telecom equipment company. The company began to look shaky due to economic problems in their key market. We were in the convertible preferred, and the company had a short maturity convertible bond that had a better risk-reward ratio. We took a capital loss on the preferred and swapped into the bonds with very high confidence that with a year and a half to go, they were going to redeem that discount convertible bond at par, giving up some risk. We made a double digit return on the bond.

SL: What does a normal default look like in the convertible sector? What is the normal recovery rate?

Teresko: Convertible bonds are typically senior unsecured obligations of a company, equal in right of payment to all other senior unsecured debts. The debt that would rank in front of convertible bonds would include bank debts or any secured debts.

If you look at the average recovery rate for convertible bonds, it's going to be very similar to the recovery rates for all senior unsecured debt that has a similar credit rating. There certainly have been defaults over time.

A normal recovery rate would have a wide range because it depends on the industry and the hard assets of a company. There are certain circumstances where a convertible might be a subordinate – not a senior unsecured – so in that case the recovery would be much lower.

An average recovery for senior unsecured debts with a BB rating is 40 cents on the dollar, but there is wide fluctuation. I hate to say what a normal recovery rate is as there are a lot of different factors.

Nelson: Defaults are pretty rare for convertibles. We have never had a default in AVK, although we did have a small position in a Lehman convertible preferred that went to zero.

We had securities on loan to Lehman Brothers on that Monday morning. Doug mentioned people with Lehman collateral, well hallelujah! Our collateral at Lehman in New York was Treasury bonds. The convertibles that we had lent to Lehman did not go during the post-Lehman market panic on Monday morning, but the Treasuries did. We got out and in a sense got a gain from Lehman.

SL: Are there any trends unfolding for the convertible bond market?

Teresko: One thing that we want to keep an eye on is the political uncertainty in the United States and everything that is going on in Europe. At some point, Europe will stabilize, and interest rates will start back up. That's going to be a pretty interesting time in the bond market.

It is important to start thinking now about how you want to position your portfolio because when that happens, like I said, I don't think it's something that happens before Labor Day, but it's going to happen at some point in time. The market move could be pretty substantial especially given how low rates are and the fact that the Fed is keeping them artificially low.

At the end of the day, these things will get settled, and life goes on. There will be growth in the global economy, and there will be hiccups. One thing that's going to be very interesting to keep our eye on for the next 9 to 24 months is the yield curve and how assets will react. This could be one of the main driving factors in the next couple of years.

SL: Regarding the issuance markets being slow to recover since the financial crisis, has it picked up this year?

Teresko: We see a couple of catalysts that will come into play helping the new issue market. The first one being when interest rates back up. Second, there are a lot of banks in Europe that need to roll over their loans. They want to have those loans where there's a natural demand to pre-issue a different convertible bond.

The third thing that tends to happen when mergers and acquisition activity picks up, which has started to happen, is that there tends to be a need for convertibles to finance that activity. There are some signs and some catalysts where the issuing is picking up.

There was a rush of new issuance of convertible bonds when the equity markets started to run and people needed to refinance. There are signs and catalysts for the future that we think will lead to new issuance.

Nelson: Healthcare is a major sector among convertible issuers, and just getting through the national election should be a help. Is Obamacare good or not? Uncertainty, I think, is worse. The federal government is most likely going to radically step up spending on healthcare. It sounds to me like it is good for healthcare companies and the potential for lots of healthcare convertibles.

Financials as well have been major convertible issuers, historically, and a lot of them are at a point where they're going to benefit. They are not on life support anymore and even with near zero cost of funding, they need some higher yielding loans and mortgages to earn a higher interest rate margin. These things are coming. However, the election in November is certainly the most visible catalyst.

SL: How do you keep investors updated on AVK's portfolio?

Nelson: We report everything properly and promptly as required. Guggenheim has an elaborate website with all the details. Once in a while, we talk to people like you, and sometimes we visit branches and talk to advisers, accompanied by licensed Guggenheim personnel.

SL: Is there anything that I failed to ask that you'd like to share with our readers?

Nelson: I would suggest stepping back. We are in a period of great uncertainty, a period of low absolute yields. As Doug says, here's an asset class that historically has done well. It has had positive returns when Treasury rates go up during a strong economic recovery that causes the Fed to back off a bit.

Credit spreads are at least going to stay tight rather than widen. Convertibles are a good way to make a decent return over time when it is almost inconceivable that you can make a high return with yields so low in traditional fixed income. The prices of the underlying stocks are not as rich as the prices of Treasury securities.

SL: With closed-end funds, we find that the market price often tracks the net asset value movement, but sometimes it can be highly uncorrelated. How have you seen this impact on AVK?

Nelson: You're right. I see this just like the equity markets. Having been an analyst for so long, it's freakish when the Fund's pricing has no rhyme or reason.

If you look back at the chart that's on the Guggenheim page for AVK, it shows that at one time, we had a 30% discount. Those are closing prices at the end of the day. At intraday, we had a 50% discount not long after Lehman went under, and there wasn't anything wrong with the Fund, but people didn't believe anything that day.

SL: As I often ask, what is the last book you read, and what is one thing you learned from it?

Nelson: The last book I read was *The Most Important Thing* by the famous convertibles manager, Howard Marks. What I got out of this was a reinforcement to rely on fundamentals and to try, on one hand, to take advantage of market opportunities during frightened markets, and on the other hand, to avoid getting carried away in euphoric markets. Stick with the principles, the fundamentals and the evaluations.

Teresko: I just finished reading *A Colossal Failure of Common Sense* by Larry McDonald. It talks about the inside story of the collapse of Lehman Brothers and brought me back to the crisis, the actual events that happened inside Lehman, and how it unwound. There are a lot of interesting things to take away because it's always important to look at history, learn from history, learn from other people's mistakes and trying not to make the same mistakes because history does tend to repeat itself.

Nelson: I would add that Doug and I love our work. It is no accident that both Larry McDonald and Howard Marks are convertible guys.

SL: Good. You both have been very generous with your time. I have learned a lot more about convertible bonds, and I am glad to share it with our readers.

Teresko: All right. Thank you very much.

Nelson: Thanks a lot. ■

AVK's fund sponsor is Guggenheim Investments and is distributed by Guggenheim Funds Distributors, Inc. ("Guggenheim Funds"), both of which are subsidiaries of Guggenheim Partners, LLC. Guggenheim Funds and its affiliates provide supervision, management and/or servicing of assets.

Guggenheim Partners, through its affiliates, provides investment management, investment advisory, insurance, investment banking, and capital markets services. The firm is headquartered in Chicago and New York with a global network of offices throughout the United States, Europe and Asia.

The Closed-End Fund Analysis Trifecta

At CEFA we consider three important details when doing a primary review of a closed-end fund ("CEF"). We track almost 50 data points per week per U.S.-listed CEF with "[CEFA's *Closed-End Fund Universe Report*]" (CEFU). The key areas we suggest investors and investment professionals to monitor are: *Entry Point Risk, Dividend Risk* and *NAV Performance*.

Entry Point Risk: The NAV vs. Market Price for a CEF

We find it is important to not only understand the current discount or premium (disc/prm) on an absolute basis (amount ± from zero) but also historically compare the disc/prm to itself as well as to it peers. CEFA uses a 90-day relative discount or the current disc/prm vs. the previous 90-day average disc/prm. We also compare funds on the 1-year z-statistic (Z-Stat), which is the current disc/prm vs. the 52-week average disc/prm then divided by the volatility (or standard deviation) of the discount. A third relative measure of a disc/prem would be the discount range, essentially plotting the current disc/prm as a percentage between the 52-week discount high and low. The goal for these data points is to help determine if a fund is currently over or under priced.

Rules of Thumb

• We generally like an absolute discount over an absolute premium but recommend close reviews of Dividend Risk and NAV Performance before simply buying a dividend yield or deep discount.

• Having a negative 90-Day Relative Discount means buying a fund at a lower than average discount. This is often a good place to buy into a fund as long as it has positive fundamentals, but CEFA again suggests you have an understanding of the dividend's security and the manager's NAV performance before making any buy/sell decisions.

• A 1-year Z-Stat between -1 and +1 is within one standard deviation of the disc/prm range for the previous year is a relatively normal place for a disc/prm to fall. When the Z-Stat gets over ±1.5, the current relationship starts to gain statistical significance. Z-Stat exceeding ±2 are rare occurrences. However, a wide Z-Stat does not scream a buy or sell without a review of possible dividend policy changes and NAV performance. For perspective, our CEFU report* shows that out of 614 CEFs, there were only 41 CEFs with a Z-Stat over +2 and four CEFs with a Z-Stat below -2.

• When looking at a fund's disc/prm, we find it useful to compare it against its peer-average disc/prm as it can be a way to identify a fund with modest downside protections and above-average upside potential. However, no data can guarantee future performance, relative or absolute.

Dividend Risk/Security

The average closed-end fund is currently showing a 6.3% annualized forward-looking distribution yield,* making it clear that the dividend is often a significant component for a CEF's total return. For the 614 current CEFs, 79% have distribution yields over 5%. There are more than a few CEFs that have dividend levels CEFA considers ridiculous (usually +10%) and unsustainable going forward.

Rules of Thumb

• No single data point can guarantee a dividend increase or decrease. It only can suggest where risk or opportunity might lie. Only a fund's Board of Directors/ Trustees can make dividend changes.

• Even if UNII or earnings are negative or lower than the dividend level, look at how peer funds are doing for the same data points to give a more realistic analysis.

• The current level of a fund's discount or premium can also help identify how much anticipated risk is built into a fund's distribution policy or level.

• Do not forget that performance is a combination of "yield" and "capital appreciation or loss". Both factors need to be combined for any accurate comparisons.

• Another important concept to note with UNII data is that it shows a fund's life-to-date balance and can be impacted by accounting and IRS adjustments over time. The older a fund, the more important the trend is vs. the absolute level of UNII.

Net Asset Value Performance

A closed-end fund is best described as three things:

1. A near permanent number of shares without daily in/out flows (open-end funds) or the involvement of creation units (exchange-traded funds).

2. Active portfolio management involving portfolio managers and a team of analysts vs. a passive index or a pre-determined formula.

3. Investor liquidity or the ability to have the shares trade on a U.S. exchange.

While all CEF shareholders buy and sell at market prices on exchanges, we find it best to track a portfolio manager using NAV performance. This takes their cost into account vs. the investments. Even though there are funds with large differences in how the market price trades vs. the NAV movement, our CEFU report* through its 90-day NAV/Market Price correlation figures, indicate that over the long-term a CEF's market price eventually follows its NAV trend.

Rules of Thumb

• We suggest comparing a CEF's NAV performance to their peer funds and a tracking index. This is a way to confirm the fund is a good investment vs. reacting to a discount or dividend hype market catalyst.

• CEFA doesn't dwell on expense ratios, as growing capital from its current level is far more important than a reasonable expense. NAV calculations adjust for a fund's operating and management costs by comparing funds on a net basis.

• We do not completely ignore expense ratios, but it is a secondary factor in our CEF research process.

Conclusion

A closed-end fund is a structure around an investment objective. For more information on CEFs, we suggest you attend any of our live or on-demand webinars (beginner to advanced levels) or visit our web site (www.cefadvisors.com). ■

*CEFU Report as of August 10, 2012.

Portfolio Managers' Reviews

During the second quarter, we did not have the same market strength of first quarter. Investor worries dominated with little progress made in the Eurozone until the end of the quarter. The U.S. economy also showed disappointing growth..

The markets have improved substantially in July and so far in August. As of August 10, 2012, the average closed-end fund is up +12.9% year-to-date on a total return market price basis.

Recently, CEFA's *Closed-End Fund Universe Report* has been tracking the 90-day correlation between each fund's net asset value movement and their market price movement. We only have about six weeks of data to review, but we have been surprised at the noticeable difference in the level of correlation between equity funds vs. bond funds and their sub-peer groups.

In June, we took a defensive stance in clients' portfolios. We are positive about Asian growth and increased our holdings in Templeton Dragon Fund and Asia Tiger Fund due to some positive developments.

Asia Tiger Fund completed its biannual tender offer during July. We submitted all of our shares for their 10% redemption at 98% net asset value for gains in all of our portfolios. We plan to repurchase the shares if the discount drops sufficiently. Alpine Premier Properties Fund, a large holding, held a tender offer for 90% of its shares in June.

As we saw the markets oversold, we eliminated some of our global bond funds and purchased equity funds that we think will provide more growth going forward.

We also added to The Templeton Frontier Markets Fund for globally diversified accounts. The $385 million fund, launched in October 2008, is managed by Mark Mobius who believes that bargains have no borders and searches for the best investment opportunities as they arise across the globe.

We recently sold our position in Wells Fargo Adv Global Dividend Opportunity as we have some concerns on the future of the dividend level. We have held the proceeds as cash for the time-being, waiting for a high dividend opportunity. We swapped our muni-bond exposure from Eaton Vance Municipal Fund to Nuveen Enhanced Municipal Value Fund on earnings and discount variances.

While there are over 100 national muni-bonds funds, we find it hard to identify more than a few we feel comfortable with at any given point in time due to relatively high premiums and under-earning trends we are beginning to see in the data.

There are strong signs of recovery in real estate markets. Although new home construction fell in the U.S. in July, the number of building permits jumped to the highest level in four years, indicating the industry will continue to improve in the second half of the year.

Commercial property has been on an upswing as the industry landmark was 6.5% higher in April than it was a year earlier. This produced a 2.8% gain in the Vanguard REIT index in the three months through June, while the S&P 500 stock index was down 3.3% during the period. We added to our Real Estate allocation as a result of these good figures and note that REIT funds pay large distributions.

Despite the slowly advancing stock markets, corporate earnings and balance sheets are stronger than they have ever been. Once corporations stop being so risk-averse and short-term in their thinking, we should see more robust U.S. markets. Globally, however, we have seen improvements in the Asian and Latin American markets which we believe will continue. ■

George Cole Scott
Founder and Editor-in-Chief
Portfolio Manager

John Cole Scott
Contributing Author
Portfolio Manager

Leslie Jane Daniels
Copy Editor

Mamie Woo McNeal
Production Editor

The Scott Letter Online
is published by

Closed-End Fund Advisors
Global Investment Counsel
7204 Glen Forest Avenue, Suite 105
Richmond, Virginia 23226
(804) 288-2482
www.CEFAdvisors.com

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