The Scott Letter:
CLOSED-END FUND REPORT©

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Welcome To **The Scott Letter,** a market letter designed to educate and inform you on a monthly basis about closed-end investment companies or closed-end investment trusts — a low risk form of investment.

Since the market crash of October, 1987, there are opportunities here not seen since the early seventies. If you buy a fund at a discount, sometimes as large as 50 percent of net asset value, you can capture a dollar's worth of assets for fifty cents. Once you recognize the values in closed-end funds, you are well on the way to a new world of investing. But first, what are the differences between closed-end and open-end or mutual funds?

Closed-End And Mutual Funds Compared

A mutual fund is open-ended — it constantly issues new shares; if investors want to buy into one, the fund sells shares to them. The value of those shares is determined by dividing the number of shares into the net asset value of the fund. If it is a load fund, the investor pays a sales commission above net asset value. He has to make up this amount in investment performance when he redeems his shares. A closed-end fund is different — the number of shares is fixed at the initial offering and after that it can be bought on one of the exchanges, like any other listed stock.

The price is therefore determined by supply and demand. This creates an advantage for the investor; he can buy at a discount to net asset value. This can reduce his risk and increase his return — if his timing and fund selection are good.

The Scott Letter will provide you with a monthly report at a reasonable price which will inform you about closed-end funds and feature detailed reports about one or more selections as well as other useful data.

Closed-end funds are better able to take advantage of market weakness because they can use their cash positions to buy stocks cheaply as well as to buy in their own shares when the discount widens. If they decide to maintain larger than normal cash positions, as Charles Allmon of Growth Stock Outlook Trust did during most of 1987 and does now, the fund can take advantage of market weakness to add to the portfolio or buy in its shares.

The Discount For Value

The discount in closed-end funds has narrowed since the first of the year, and we have been able to find some good values as markets have improved. Two recommendations fitting our criteria will be presented next month. The risks also appear to be lower in these funds as it is becoming clear that the October crash was over-done and value is out there.

The Scott Letter will emphasize a long-term approach to the market rather than try to trade it by guessing every hill and valley of the investment cycle. Therefore, look at your closed-end portfolios as building blocks in your financial asset-growth program or as a base around which to build a portfolio of different types of investments.

Tax Credits For You

There are definite tax advantages in buying some closed-end funds. This is because any year in which the company is taxed as a regulated investment company and the per share net long-term capital gains realized are material enough, the fund could retain long-term capital gains. It thereupon pays the tax for the investor and passes along a credit to lower his taxes due. We will explain more about this later. This is particularly meaningful to the larger investor.

Closed-End Bond Funds

We are aware that much of the closed-end fund industry contains income-oriented bond funds. They can produce more income than individual bonds as well as give you the benefits of portfolio management. But in buying these funds at the offering price, you pay underwriting fees and will see the net asset value drop after the offering. This also occurs in new offerings of equity funds. You do not know what the return will be because both are new funds.

Bond funds have a better chance of holding their premium than new offerings of equity funds, but you still have to be careful in selection. We recommend you pick an older fund and will help you do so; you will then know more what you are buying. It is important to note that the total returns on equity funds over the long term are much higher than on bond funds. Current tax laws favor the investor in equity funds because income and capital gains are taxed at the same rate.

History Of Investment Trusts

Closed-end funds were first created by King William I of the Netherlands in 1822; they were called investment trusts, a name preserved in the catalog of the Library of Congress today. The trust created by William was intended to invest in foreign government loans.

This concept was continued by the British who developed several investment trusts in 1863. Their goals were to diversify risk for the smaller investor. These trusts increased with the passage of the Joint Stock Company Acts of 1862 and 1867. In 1873, Robert Fleming, after visiting the United States, formed the first association in Scotland for investment in the U.S. No more than 10% of the capital could be invested in any one security. By 1909, Fleming had influenced some 56 trusts with resources of 114 million pounds.

Also in 1873, the Adams Express Company, first organized in 1854 by a group of men in the parcel express business, became a public company; the significance is that it became an investment company in 1929 and is today one of the few survivors of the Depression.

From about 1900 until World War I, British Investment Trusts increasingly invested in American securities, especially in the shares and bonds of railroads. All of these British trusts were of the closed-end type.

The first investment trust in the U.S. was created in Boston in 1893 and was closely modeled after its British counterparts. In 1904, the first U.S. closed-end fund to employ leverage or the ability to borrow on its assets was the Railway and Light Securities Fund; it open-ended as the Colonial Fund in 1954.

The history of J. & W. Seligman & Co. is part of our story. The firm was founded in 1864; by 1925, one of its partners proposed it sponsor an investment company similar to an earlier version sponsored by Dillon Read. It was defeated. Therefore, the fund which became Tri-Continental did not form until 1929; today it is the nation's largest closed-end fund — over $1.2 billion in assets.

The oldest fund we have found to be still operating is General American Investors, organized by two investment firms, Lehman Brothers and Lazard Freres on January 25, 1927. It immediately prospered and in 1928 it sponsored a second fund; the two merged in 1929. Lehman Corporation and Niagara Shares Corporation are other early funds which have survived.

Boom And Bust

During the 1920s, closed-end funds had phenomenal growth in the United States; hundreds were formed and thrived in the seemingly endless boom. By 1929 the ravenous public had invested over seven billion dollars in over 750 investment companies. When the market crashed in October of 1929, the biggest losers were the highly leveraged funds which had borrowed more than their assets. Massive numbers of investors took a beating as they sold out at whatever price they could get.

The lesson of this kind of collapse and the crash which occurred in October of 1987 is that it is more prudent to be a buyer than a seller in panic situations.

In the restructuring of the market which followed the 1929 crash, the stronger funds purchased shares from the weaker ones. Control was obtained and the "raided" company was either dissolved or liquidated.

In 1934, The Securities and Exchange Commission was created and stepped into the act to reform and regulate the abuses of the 'Twenties. Out of this came the Investment Company Act of 1940, the basis for regulation of investment companies, protection sadly needed before the Depression. Highly leveraged funds were prohibited; capital structures and dividends of funds were strictly regulated. Funds were also prohibited from paying profits from dividends without disclosing these distributions. At the same time, the Investment Company Institute, a trade group which records the weekly net asset values from some seventy closed-end funds, was founded.[1]

1. For this historical information we are indebted to Thomas J. Herzfeld, *The Investors Guide to Closed-End Funds*, McGraw-Hill, 1980. Also to *Over the Long Term . . . the story of J. & W. Seligman & Co.* by Ross Muir and Carl J. White, J. & W. Seligman & Co., 1964. The fiftieth anniversary brochure of General American Investors was also helpful as was the centennial piece from Adams Express Company.

After the widespread speculation and abuses of the 'Twenties, closed-end funds, with a few exceptions, became unpopular. Open-end funds developed as better stock markets appeared in the fifties and the small investor returned to the market. Closed-end funds didn't really become popular again until the 1982 Bull Market. New bond funds as well as the popular "country" funds such as the Korea Fund or the more recent Taiwan Fund are the only way to invest in a those economies. But, due to currency risks and the large premium one has to pay over net asset value, one has to be particularly careful in investing in these funds.

Choosing Your Fund

The best closed-end funds are the ones which have superior compound growth rates and fully disclose information to the investor. For example, we found that while many funds disclose the individual cost of their securities, many do not; we think this should be a uniform practice.

Closed-end funds are good at dividend reinvestment plans, sometimes done automatically: unless you notify the fund you receive the dividend in new shares. What does confuse the investor is the different practices of brokerage houses in handling the capital gains from closed-end funds when the stock is held in street name; you often get cash when you want new shares. We will cover this issue prior to the December payments so you'll be ready to make the right choice.

Even if you are an investor who is good at picking your own stocks, this letter can help you. All investors can use closed-end funds, a low-risk place to invest your hard-earned cash with professional money managers at a discount to net asset value. We will only recommend you purchase closed-end funds when they sell at a discount unless the fund does so for the wrong reasons, particularly for poor performance.

We do not believe, as some do, that you should trade the funds based simply on the narrowing of this discount. Remember, we are long-term investors. My approach, having advised investors for nearly twenty years, has been to buy to hold for capital gains, but as the investment appreciates, take your profit.

The prices of closed-end funds are based on supply and demand in the open market just as are the shares of other public companies. Sellers push down the price; buyers bid it up. These price changes occur regardless of net asset value per share.

The appearance of many new funds in recent years has created a problem of oversupply. Brokers have little incentive to recommend them as the commissions are so much lower than on a newly-created fund, unit investment trust or open-ended fund.

Watch for the amount of income and capital gains paid out by the fund — the higher this amount, the narrower the discount. But don't buy a fund based on this alone; the five and ten year performance record is crucial to buying any fund. If it is a newer fund, you analyze the manager's investment record.

Book Selection

High-Return, Low Risk Investment. Combining Market Timing, Stock Selection and Closed-end Funds, by Thomas J. Herzfeld and Robert F. Drach, New American Library, 1983. This book, revised and updated from earlier versions, is nearly out of print; it is the only known book on closed-end funds. It was written as a primer for those not familiar with closed-end fund investing. The authors review the psychological barriers confronting the investor and give rules for selecting and buying stocks. They also get into some of the discipline involved for a technical approach including market timing and advice for what is called "The Herzfeld Hedge." The book is difficult to find, but we wanted to make you aware of this guide for the closed-end fund investor.

Looking Forward To Next Month's Letter

In our next issue we will recommend two funds which fit the criteria for this report. One is an older fund which has an excellent long-term record and the other is a special-situation dual fund we are excited about; both should be worth looking at for the value-oriented investor.

In summary, The Scott Letter will:

— Review the previous month in the market and update economic and market data. We will write an essay on an investment issue as it affects the closed-end fund investor.

— List the latest net asset values on publicly-traded funds provided to the financial press by the Investment Company Institute as well as ICI news relevant to you as a fund investor.

— Analyze, in detail, one closed-end fund for you to consider each month and special situations we feel have merit.

— Recommend new and classic books on fund investing as well as general investing.

— Answer your questions, as space permits, and try to respond to your individual investment needs.

We have an affiliation with a brokerage firm which not only provides quick execution of trades, but at prices comparable to discount brokers. If you subscribe to The Scott Letter and become an active client your subscription will be extended free. Contact us about details.

We are open to suggestions. Help us make this reasonably priced letter a guide to your investment goals. We look forward to serving you. Trust us!

George Cole Scott

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Editor

George Cole Scott has been an investment broker since 1969 and a free-lance writer since 1965. He became interested in closed-end funds in 1976 when he joined the board of Claremont Capital, a closed-end fund based in Seattle. He has specialized in this form of investment since that time.