Closed-End Fund Review

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Second Quarter Results

After a difficult first quarter when 16 out of 20 categories that we monitor posted negative total returns on a market price basis, closed-end funds rebounded solidly in the second quarter. In fact, 19 categories had a positive total return on a market price basis. Only the senior loan category was lower for the quarter with the average senior loan fund down 5.01%. All 20 categories achieved positive net asset value (NAV) total return performance.

In the second quarter, closed-end funds benefited from attractive valuations as many funds were at deep discounts to their NAV after the difficult first quarter and investors were eager to purchase funds at enticing discounts. Equity funds benefited from rising overall stock prices. The S&P 500 Index was up 1.4% for the quarter. Many fixed-income funds benefited from rising bond prices and falling yields. The yield on the 10-year U.S. Treasury Note fell from 4.50% at the beginning of the quarter to 3.95% at the end of the quarter. Several leveraged fixed-income funds were forced to lower their dividends as leverage costs moved higher due to the Federal Reserve Open Market Committee (FOMC) increasing the Federal Funds rate two times in the quarter. Rates increased on May 3rd from 2.75% to 3.00% and on June 30th from 3.00% to 3.25%. The Initial Public Offering (IPO) market, while strong, was not as robust as in the first quarter. Seventeen funds had their IPOs in the quarter raising over $5 billion. A slight decrease in the amount of money being raised in IPOs is to be expected after the torrid pace of 2004 and 2003.

The best performing categories in the quarter on a market price total return basis were real estate investment trusts (REITs) up 13.6%, followed by New York municipal funds up 8.4% and National municipal funds up 7.7%. As indicated by the solid total return numbers for these categories, clearly investors remain attracted to the high tax-free yields of the municipal funds (New York avg. yield 5.2% and National avg. yield 5.9%) and the 7.6% yield the average REIT fund is paying. REIT funds were also the best performing category on a NAV total return basis increasing 15.3%. Emerging market debt (up 6.5%) and sector funds including utility and financial services funds (up 5.5%) rounded out the top three performing NAV categories.

Senior Loans

As previously mentioned, senior loan funds was the only category that posted a negative market price total return. The average senior loan fund was lower by 5.01% in the quarter despite a 0.59% increase in NAV. While there is no single reason why senior loan funds traded lower in the quarter, it is likely a combination of several factors, such as investors shifting assets away from senior loans and into the covered call funds, frustration that dividends have not increased as much as anticipated, and a growing belief that the FOMC might not need to raise rates as much as previously predicted. Nonetheless, the average senior loan fund is now trading at a deep 6.2% discount to NAV versus the previous 52-week average of a 1.1% premium. Furthermore, the last two FOMC increases in interest rates are just now starting to be felt by the loans that the funds own, and therefore, we could see rising dividends from the senior loan funds which already yield an average of 6.6%. These factors could potentially lead to a rebound for the senior loan funds over the coming months.

Where Do We Go From Here?

While it is always hard to predict how the various closed-end fund categories will trade, the last half of the year has the potential to be a positive one for many asset classes if the FOMC signals it is nearing the end of its tightening cycle and the economy continues to grow at a moderate, non-inflationary pace. Due to the fact that closed-end funds can exhibit periods of high volatility, investors are encouraged to maintain a long-term time horizon and exposure to different types of funds when investing in closed-end funds.