Closed-End Fund Review

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Second Quarter 2006 Results

In our closed-end fund commentary piece for the first quarter, I cautioned investors not to expect the robust returns for subsequent quarters that many funds displayed in the first quarter. I also warned that the closed-end fund marketplace faced some "head winds" in the form of higher interest rates which could put some pressure on many closed-end funds.

The aforementioned head winds did come to fruition with the Federal Open Market Committee (FOMC) raising the Federal Funds rate on May 10th from 4.75% to 5.00% and on June 29th from 5.00% to 5.25%. These increases continued to flatten the yield curve and dozens of funds were forced to reduce their dividends in the second quarter. These dividend reductions, which were particularly prevalent in the municipal category, helped to create market price weakness in many funds. Furthermore, long-term interest rates, as measured by the 10-Year U.S. Treasury note, crossed the psychologically important 5% mark on April 13th which also helped to create significant volatility in the closed-end fund marketplace. Lastly, some investors who purchased closed-end funds in the first quarter of the year and had meaningful profits by the beginning of the second quarter, elected to take those profits in the quarter, further pressuring many funds. All of these factors led to a difficult 3 months for closed-end funds. However, despite the tough second quarter, most closed-end fund categories are still in positive territory year-to-date as the gains achieved in the first quarter outweigh the losses in the second.

We break the universe of over 600 closed-end funds into 21 separate categories. For the quarter, sixteen posted a negative market price total return and five had positive market price total returns.

Based on market price total return, below are the best performers for the second quarter:

<u>Best Performers</u>

Covered call funds	up 2.90%
Senior loans	up 2.15%
Intermediate income	up 0.62%

Following a difficult 2005, senior loan funds continue to perform well in 2006 as investors have finally begun to appreciate their relatively stable net asset values (NAVs) and rising dividends. On average, senior loan funds are up 10.2% year-to-date and the average discount has narrowed to 4.7% versus the 52-week 7.2% discount to NAV.

Based on market price total return, below are the worst performers for the second quarter:

<u>Worst Performers</u>

Emerging market debt funds	down 5.12%
State municipal funds*	down 3.43%
International equity funds	down 3.39%

*includes single state municipal funds excluding California and New York

For the first six months of the year, seventeen categories have a positive market price total return and four are in negative territory.

The initial public offering (IPO) market for closed-end funds picked up slightly in the second quarter with eight funds coming to market versus the three funds which had an IPO in the first quarter. However, even with the slight increase in number of new funds, the IPO market continues to be much slower relative to the past four years both in terms of assets raised and number of new funds. We would not expect a dramatic pick up in activity in the IPO market for closed-end funds until the yield curve is steeper.

Final Thoughts

While it can be difficult to endure volatile quarters such as the one we just went through, which not only experienced market price volatility but also dividend weakness in many categories, I believe it is important to maintain a long-term perspective when analyzing the performance of closed-end funds. Indeed, all 20 closed-end fund categories which we actively follow (covered call funds do not have 5-year track records and therefore are not included) have posted a positive market price total return in the past five years. This statistic speaks to the benefit of owning closed-end funds for the long-term and the power of dividends compounding year after year. Furthermore, much of the weakness that we have seen in closed-end funds recently relates to the fact that the FOMC has now increased short-term interest rates 17 times, thus significantly narrowing the spread that leverage funds earn and therefore hurting their performance. While we do believe there still exists a potential head wind for closed-end funds in the form of higher short and long-term interest rates (and therefore investors should be prepared for more volatility), it also appears that the FOMC is likely much closer to the end of its tightening phase than the beginning. I believe that when the FOMC is indeed finished raising short-term rates and long-term rates stabilize that closed-end funds should perform better.

In the mean time, I would encourage investors to take advantage of the weakness we have endured and accumulate well-run funds that meet their investment objectives. Lastly, 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.

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