

CLOSED-END FUND review

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THIRD QUARTER 2009

Overview

In the words of Midwest rock legends R.E.O. Speedwagon, “Keep on Rolling” ... and that is exactly what closed-end funds did in the third quarter. Of the 626 closed-end funds tracked by FundData, the average fund was up 17.25% on a share price total return basis. Indeed, every category tracked by FundData was positive during the third quarter and is positive year-to-date. This follows the 21% positive return funds earned on average in the second quarter. 2009 is shaping up to be a stellar year for most closed-end funds with the average fund up an impressive 45.18% year-to-date. The average fund is also up 25.31% over the past 12 months, which means that funds are even starting to make up for the negative returns which occurred in the first 9 months of 2008.

Several factors contributed to closed-end funds having another excellent quarter, including:

1. Continued improvement in the global equity and credit markets.
2. Very low leverage cost, which enhanced yields and returns for many funds.
3. Low yielding alternative income-oriented investments made closed-end funds and their attractive yields more appealing to investors.
4. An increased willingness on the part of investors to take on more risk in their portfolios.

While I am extremely pleased that closed-end funds have bounced back dramatically so far year-to-date and am particularly pleased that the 4 areas we have been focusing on (municipal funds, equity-oriented funds, senior loan funds and investment-grade corporate and multi-sector bond funds) have all posted very solid returns, I would caution investors not to expect 45% plus total returns over the next nine months like were earned over the prior nine months.

Part of the reason I do not think investors should expect these types of oversized gains is because discounts to net asset values (NAVs) have narrowed dramatically this year, which means that investors can no longer count on capturing extra returns because of discounts contracting. Closed-end funds ended the third quarter of 2009 with an average discount to NAV of only 2.48%. They started the year at an average discount of 11.15% and have averaged 14.31% over the past 12 months. Due to the fact that discounts have narrowed significantly over the past 12 months, I believe closed-end funds investors need to choose the funds and categories of funds they invest in more carefully as they can no longer count on discount contraction to boost returns. However, just because discounts have narrowed considerably does not mean an investor cannot make money in closed-end funds over the next 6 to 12 months. Rather, it means closed-end funds investors need to focus on funds and categories where there is still value in a fund’s underlying asset class. While discounts are no longer in the double digits for most funds, if the underlying asset class performs well and the NAV moves higher, ultimately the share price should also move higher and investors can still earn a decent total return in their funds.

The four main categories of closed-end funds that I believe investors should continue to focus on include:

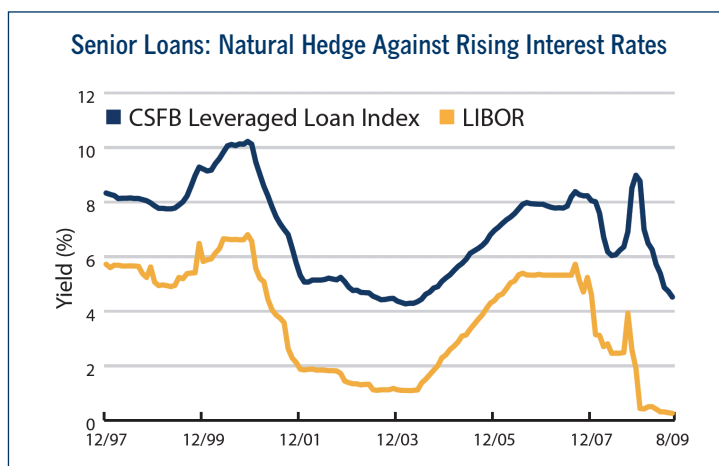
- municipal funds
- equity-oriented funds (including covered call, convertible and tax-advantaged equity income funds)
- investment-grade corporate and multi-sector bond funds
- senior loan funds (see below for more information on senior loan funds)

I believe that if investors focus primarily on these 4 areas of the closed-end fund marketplace they can earn a blended yield of approximately 7-8%, have some protection against rising interest rates due to the exposure to floating rate senior loan funds, have growth potential with the equity-oriented funds and can take advantage of some of the very attractive tax-free yields available in the municipal funds.

The Case for Senior Loan Funds

Despite the fact that the average senior loan fund was up 23.81% on a share price total return basis during the third quarter of 2009, it continues to be one area which I believe offers investors the potential for solid total returns over the next 12 months (especially if the economy continues to improve and interest rates move higher next year). Senior loan funds are compelling for the following 3 reasons:

1. Senior loans pay an interest which re-sets every 60-90 days based on short-term interest rates. With the Federal Funds rate and other short-term interest rate metrics such as LIBOR (London Interbank Offer Rate) at historically low levels (and with the potential for them to move higher next year), senior loans and senior loan funds should provide investors with a nice hedge against rising interest rates due to the floating rate nature of the interest the loans pay. Furthermore, most retail and institutional investors have plenty of fixed-income securities which perform well when interest rates come down, but fewer income-related securities which do well when rates move higher. I believe more investors will look to add to an asset class such as senior loans and senior loan funds when rates move higher.
2. As I mentioned in my introduction, discounts have narrowed considerably in closed-end funds this year. However, discounts in the senior loan category remain attractive and wider than historical averages. At the end of the third quarter, the average discount for all senior loan funds was 6.09%. This number is not only wider than the average of all closed-end funds but it is significantly wider than the historical average for senior loan funds. Indeed, over the past five years, senior loan funds have traded at an average of a 4.1% premium to NAV and over the past ten years they have traded at an average of a 3.3% discount to NAV.
3. I also believe there is value in the underlying loans. As of 9/30/09, the S&P/LSTA U.S. Leveraged Loan 100 Index had an average loan price of 85.86, which is significantly below par. Historically this index trades very close to par, and therefore I believe there is upside potential in the loans.



Fourth Quarter Outlook and Tax-Loss Selling

The fourth quarter for closed-end funds tends to be the most volatile due to tax-related transactions which generally occur during this three-month time period. While I do expect some tax-related transactions and enhanced volatility this quarter, I do not expect it to be nearly as severe or as pronounced as in prior years (such as 2005 or 2007). There are simply fewer losses for investors to take this year in closed-end funds. Furthermore, should the equity and credit markets continue to perform well in the fourth quarter as they have most of the year, I believe there would continue to be buyers of closed-end funds in the secondary market which could offset some of the tax-related transactions during the quarter. Having said that, it is always a good idea to have cash available to invest during the fourth quarter should closed-end funds be hit with seasonal tax-related selling and as opportunities present themselves. As always, 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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