CLOSED-END FUND review

Jeff Margolin

Senior Vice President, Closed-End Fund Analyst

SECOND QUARTER 2010

Second Quarter Overview

After four consecutive quarters of positive share price total return performance for the average closed-end fund, volatility came back with a vengeance in the second quarter of 2010. However, even though the S&P 500 was lower by 12% in the second quarter, May was the worst month for the Dow Jones Industrial Average since 1940, and there was a palpable flight to safety which pushed yields on the 10-year U.S. Treasury to below 3%, **the average closed-end fund was only lower by 3.28% for the quarter and is still up 2.38% year to date and 25.01% over the past 1 year.** (Information derived from Morningstar. All figures are share price total return.) The primary reason for the sharp decline in equity prices during the quarter, as well as for the significant flight to safety, was the sovereign debt concerns of several countries in Europe including Greece, Spain and Portugal. Indeed, during the quarter both Spain and Greece had their credit ratings downgraded. It is interesting to note that even though there was a flight to safety in the quarter and many credit-sensitive funds were lower, there were 2 meaningful positive data points which were overlooked by the credit markets, in my opinion, but could help credit-sensitive funds such as senior loan funds and high-yield funds as the year progresses.

1. According to Bloomberg, for the first time since the second quarter of 2007, U.S. credit ratings upgrades exceed downgrades. Standard and Poor's lifted the ratings of 244 U.S. issuers and downgraded 211. Moody's Investors Service upgraded 205 borrowers and downgraded 131. Again, this has not occurred in 3 years.
2. During the month of June, for the first time in 2 ½ years, not one senior loan represented in the S&P/LSTA Index defaulted (according to Standard and Poor's). The lagging 12-month default rate fell to an 18-month low of just 4.02% (by principal amount) from 4.64% in May for senior loans.

During periods of extreme volatility in the global equity markets and credit markets, positive data points such as the 2 significant ones I just discussed tend to get overlooked by the market. However, I believe that ultimately as the fundamentals continue to improve in the credit markets, particularly in the senior loan market, the closed-end funds which focus on these asset classes will benefit. Even though senior loan funds were down an average of 7.73% during the quarter, it continues to be a category within the closed-end fund marketplace that I believe investors should have exposure to, as I believe these funds will offer good protection against rising interest rates. Even with the weakness in the quarter, senior loan funds are up 5.29% year-to-date and are up 45.07% during the past one year (according to Morningstar. All figures are share price total return).

Municipal Closed-End Funds Continue to Shine

One category within the closed-end fund marketplace that we have been writing about extensively over the past 2 years and strongly encouraging closed-end funds investors to have exposure to is municipal closed-end funds, which continue to perform very well. Municipal closed-end funds were up an average of 3.95% in the second quarter and are up 9.38% year-to-date and 25.75% over the past one year (according to Morningstar. All figures are share price total return). There are presently 255 municipal closed-end funds trading domestically and it is by far the largest category by number of funds on the market today. There are 619 closed-end funds trading domestically as of June 30, 2010 (according to Morningstar).

Municipal closed-end funds continue to benefit from a steep municipal yield curve, which is enabling many of them to over earn their monthly dividends and build up significant amounts of undistributed net investment income (UNII) which should help keep dividends stable for several months (if not longer) and I can't rule out the possibility of even more dividend increases later on in the year for municipal funds. During the quarter, several dozen municipal closed-end funds increased dividends again. This represented the 5th dividend increase for some municipal funds in the past 15 months. The average Leveraged National Municipal closed-end fund yielded a compelling 6.50% at the end of the quarter (according to Morningstar). Municipal closed-end funds also continue to benefit from the likelihood of higher Federal taxes in 2011 (many states have already raised their income taxes) which increases the taxable equivalent yields of municipal funds and makes them even more in demand as investors try to earn a high tax-free income and shelter income from the government. Lastly, continued issuance of taxable municipal Build America Bonds has meant much less supply of traditional long-term tax-free municipal bonds and that has helped the performance of secondary tax-free municipal bonds and municipal closed-end funds.

As we begin the third quarter of 2010, I continue to like municipal closed-end funds and believe income-oriented investors should continue to have exposure to them as all of the positive factors I addressed above remain very much intact. However, it is important to state that while I am extremely pleased that the municipal closed-end fund category has delivered very high tax-free income the past year and a half as well as meaningful capital appreciation, I don't expect significant capital appreciation going forward as the average municipal closed-end fund is now trading at an average of a 0.56% premium to net asset value (NAV) (according to Morningstar). I believe, rather, that most of the total return will likely come from income. That said, I did go back and look at all of the municipal closed-end funds which were trading the last time marginal federal taxes increased in this country,

First Trust

First Trust Advisors L.P.
1-630-915-6784
www.ftportfolios.com

and found that in 1993 when President Clinton raised taxes, several of the largest municipal closed-end funds went to high single digit premiums to their NAV during that year. Some even went to double digit premiums to NAV. Of course, past performance is no guarantee of future results.

Limited Duration Multi-Sector Bond Funds Hold Their Own During Second Quarter

Another category within the closed-end fund marketplace I have been recommending investors have exposure to has been limited duration multi-sector bond funds, and they continue to perform well. The average limited duration multi-sector bond fund was up 0.88% during the quarter and is up 10.27% year-to-date and 33.07% over the past 1 year (according to Morningstar. All figures are share price total return). These funds generally have an average duration of 3 years or less, have exposure to several different taxable fixed-income asset classes such as floating rate senior loans, high-yield corporate bonds and low duration mortgage backed securities. They also tend to have average investment-grade credit ratings of BBB or higher. I continue to like these funds because not only do they have attractive yields of an average of 7.94% (according to Morningstar), but I believe because they have relatively short durations they should hold up well should interest rates move higher later this year and next year. Furthermore, because they tend to invest in at least 3 different segments of the taxable fixed-income markets, the portfolio managers have a wide degree of flexibility to shift the portfolios around depending on market conditions.

Don't Ignore Equity Income-Oriented Closed-end Funds

During a quarter in which the S&P 500 was lower by 12%, it can be easy to lose sight of the fact that some of the best opportunities exist in equity closed-end funds and even income-oriented investors should have exposure to equity income funds, in my opinion. Equity income closed-end funds not only provide a steady, attractive income stream but they can also add growth potential to a diversified portfolio (which I believe is essential in order to help keep up with inflation over long periods of time). With the S&P 500 trading at only 11 times next year's consensus earnings estimates (according to Bloomberg), coupled with the very attractive discounts to NAV presently available in many equity income-oriented closed-end funds, I believe there are many attractive long-term opportunities in these funds.

Not only are valuations inexpensive for the S&P 500 relative to historical figures, but according to Morningstar the average equity income closed-end fund which focuses on dividend-paying stocks, is trading at an average discount to NAV of 7.08% versus a 3-year average of 2.9% and a 5-year average of 5.4%. This represents an opportunity, in my opinion. Furthermore, many companies are electing to use some of the significant cash positions they have to increase their dividends. Indeed, during the second quarter of 2010 the number of companies that increased their dividends was 355. This is significantly higher than the 233 which increased dividends during the second quarter of 2009.

Final Thoughts

As I have the privilege of traveling around the country talking to advisors and investors about opportunities available in the closed-end fund marketplace, I always try to stress the importance of building diversified portfolios with exposure to many different asset classes in order to create an attractive blended yield of 6%-8%. For example, while I currently favor (and have for some time now), 4 categories within the closed-end fund marketplace, namely municipal funds, floating rate senior loan funds, limited duration multi-sector bond funds and equity income-oriented funds, I would not recommend investors have 100% of their portfolios in any one of these specific categories. Rather, I would suggest investors have a blended mix of all 4 of these categories because they each have different specific risk and reward characteristics. For example, municipal funds have some interest rate risk but very low credit risk, in my opinion. Floating rate senior loan funds have little interest rate risk (in fact they tend to perform better when interest rates are moving higher) but they do have credit risk. Therefore, I believe investors who blend these asset classes (as well as the others I have mentioned) can create a more stable and balanced portfolio which will have some categories performing well while others may not.

I also firmly believe that investing is a marathon and not a sprint and too often investors get caught up in the day-to-day, week-to-week and even minute-to-minute volatility in the markets. Based on my experience, I believe the most successful long-term closed-end fund investors are the ones who build diversified portfolios designed to last years (not days or weeks) across different categories in solid, well-run funds. It is interesting to note that during the volatility the global equity and credit markets had in May and June, there was some significant insider buying in several closed-end funds during the second quarter. I believe the insiders who were buying aggressively during the quarter are spot-on because some of the best long-term opportunities are created during periods of weakness as funds sell-off, yields increase and discounts widen out. While it is extremely difficult to predict short-term movements in the financial markets, I firmly believe that investors who build diversified portfolios across good funds in favored asset classes and who buy during periods of weakness and volatility ultimately will be rewarded in the long term.

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.

First Trust
First Trust Advisors L.P.
1-630-915-6784
www.ftportfolios.com