CLOSED-END FUND review

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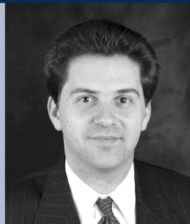

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FIRST QUARTER 2011

Overview of First Quarter

Following a year in which closed-end funds were up an average of 11.86%, closed-end funds had another solid quarter. Indeed, the average fund was up 2.63% during the quarter ("Q1") and many equity income and credit sensitive taxable fixed-income categories were up more than that. For example, the universe of 166 equity funds was up 3.51%; convertible funds were up 6.24%; senior loan funds were up 4.06% and high-yield funds were up 5.95%. (All data is from Morningstar and is on a share price total return basis.)

Closed-end funds continue to benefit from three primary trends, including:

1. **Strength in the global equity markets and credit markets**: The Standard and Poor's 500 Index ("S&P 500") was up 5.91% during Q1, according to Bloomberg, and the Euro Stoxx Index 50 Index was up 4.53%, according to Bloomberg. Finally, the Standard and Poor's Asia 50 Index was up 2.34%. The strong showing for several equity indices helped propel many equity income-oriented funds to a solid first quarter. Credit conditions, as measured by default statistics, also continue to improve and are expected to remain at very low levels for the remainder of the year and into next year, which is why (despite narrower spreads) I continue to advocate that investors have exposure to credit-sensitive categories such as high-yield funds, senior loan funds and limited duration funds. Moody's reported that the global speculative-grade default rate stood at 2.8% in February, unchanged from January. The rate stood at 11.7% a year ago. Moody's is now forecasting a default rate of 1.6% by February 2012. The U.S. speculative-grade default rate stood at 3.0% in February, also unchanged from January. The rate stood at 12.8% a year ago. Moody's is now forecasting a default rate of 1.6% by February 2012. The default rate on senior loans stood at 2.05% in February, down from 2.18% in January, according to Standard & Poor's LCD. Loan managers expect the default rate to average around 1.87% in 2011.
2. **Exceptionally low short-term interest rates**: Low short-term interest rates continue to benefit leveraged funds as borrowing cost remains very low. This is enabling closed-end funds to continue to earn a generous spread between their leverage cost and the return they can earn when they invest the borrowed proceeds. While I am concerned about the potential negative implications for leveraged funds when short-term rates move higher (which may not be until the beginning of 2012) and continue to advocate investors have exposure to limited duration bond funds and senior loan funds as a way to provide some protection against higher rates, for now low short-term interest rates continues to create a positive environment for leveraged funds.
3. **Low yields on traditional fixed-income oriented investments**: With yields on traditional fixed-income investments at paltry low levels and with the demand for income at a high level considering more investors are retiring with defined contribution plans (as opposed to defined benefit plans), more investors are using closed-end funds for part of their portfolios as a way to increase their overall yield. As of 3/31/11, the average distribution yield for all closed-end funds, according to Morningstar, was an attractive 6.85%.

Narrow discounts to net asset value (NAV); focus on income, less on capital appreciation

With many closed-end funds posting very solid total returns in Q1 and during the past two years, discounts to NAV have narrowed considerably for many funds, and as of 3/31/11 the average discount to NAV of all 627 funds in the Morningstar database was only 2.53% versus the 10-year average of 5.05%, **I believe it is important for closed-end fund investors to expect most of the potential total return from a diversified portfolio of closed-end funds to come from income and not capital appreciation as has been the case for the past two and a quarter years.** That said, I do believe there remain several compelling categories of funds for investors to focus on (see below); it's just important to keep total return expectations in check relative to the past 2 years.

For example, while I still like senior loan closed-end funds and believe they will hold up well when short-term interest rates move higher, the S&P/LSTA U.S. Leveraged Loan 100 Index closed 3/31/11 at 95.68. While this index is still at an average discount to par (100), it has been steadily narrowing recently. Furthermore, the average senior loan fund is now at a slight premium to NAV of 1.63%.

I continue to advocate the closed-end funds investors should focus on include senior loan funds, limited duration funds, high-yield funds, equity income-oriented funds and municipal funds. I believe by building diversified closed-end fund portfolios across these categories, investors can generate a blended income stream in the 6% to 7% range; have protection

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against higher interest rates with senior loan and limited duration funds; take advantage of improving credit conditions in the high-yield market; have some growth potential with equity income-oriented funds and take advantage of the most attractive yields available in municipal funds in several years (for more on municipal funds see below).

The one broad category within the closed-end fund marketplace that I continue to believe offers the potential for income and meaningful capital appreciation remains equity income funds. It remains one of the only broad categories within the CEF marketplace where investors can still buy funds at mid- to high-single digit discounts to NAV. For example, according to Morningstar, the average domestic equity fund is at a discount to NAV of 4.68%, as of March 31, 2011. Furthermore, the underlying asset class of equities remains very compelling for investors looking for income, but also the potential for capital appreciation due to attractive equity valuations, an improving corporate earnings picture and continued improvement in the broad economy.

An update on municipal closed-end funds

While municipal bonds and municipal closed-end funds had a very difficult first two weeks of the year, it might surprise some investors to know that municipal funds (as measured by the First Trust Municipal Closed-end Fund Index) were up 10 out of the last 11 weeks of Q1. Indeed, the index has risen from 1125 on Jan 17 to 1215 on March 31. This represents an increase of 8.0%. The index was up 1.18% for the quarter. While still below the highs set in the late third quarter of 2010, the index has clearly rallied nicely and steadily since the lows set in January.

You might recall municipal bonds and municipal closed-end funds were weak during much of December through the first 2 weeks of January, mostly due to what I believe were overstated fears about the potential for widespread municipal bond defaults. Please see my report dated January 18, 2011 where I discuss why I believe concerns about a significant wave of municipal bond defaults was overstated and where I discuss why I think municipal bonds and municipal closed-end funds were very compelling investments.

There are several reasons why municipal bonds and municipal closed-end funds have had a solid and steady rally over the past 2 months including:

1. Investors (particularly institutional investors and cross-over buyers) beginning to recognize and take advantage of the attractive yields and prices available in municipal bonds.
2. A recognition on the behalf of investors that despite fears about municipal bond defaults, the reality is that municipal bond defaults are down this year relative to 2010, according to Bloomberg, and many states and municipalities are starting to see an increase in revenue as the economy improves.
3. Solid fundamentals continuing to exist for many municipal closed-end funds including stable dividends and attractive yields for most investment-grade leveraged municipal CEFs in the 7% tax-free range, a steep yield curve which will likely stay steep for most of 2011 due to the apparent unwillingness of the Federal Reserve to change its very easy monetary policy and large undistributed net investment income (UNII) balances averaging 2-3 months for most leveraged municipal closed-end funds.
4. A slowdown in the issuance of new municipal bonds after a significant increase of supply of municipal bonds in the fourth quarter of 2010 has helped the secondary market for municipal bonds. (30-day visible supply of municipal bonds remains light but will likely increase sometime in the April/May timeframe around the time O'Hare Airport issues approximately $1 billion in bonds.)

While there is always the potential for near-term volatility in municipal bonds and municipal closed-end funds, I believe that until the Federal Reserve begins to raise short-term interest rates, investors (in the context of a diversified, balanced portfolio) should use weakness as opportunities to dollar cost average into municipal closed-end funds. I believe leveraged municipal funds are the one area within fixed-income where investors are being rewarded for the duration risk they are taking and periods of weakness enable investors to buy leveraged municipal closed-end funds with very compelling yields of approximately 7% tax-free and municipal bonds at attractive historical valuations relative to U.S. Treasuries. Bear in mind that a 7% tax-free yield for someone in the highest tax-bracket is a taxable equivalent yield of over 10%. Investors who want exposure to municipal bonds but don't want the enhanced volatility associated with leveraged municipal closed-end funds, should consider diversifying into non-leveraged municipal closed-end funds or non-leveraged municipal Exchange Traded Funds (ETFs).

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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