CLOSED-END FUND review

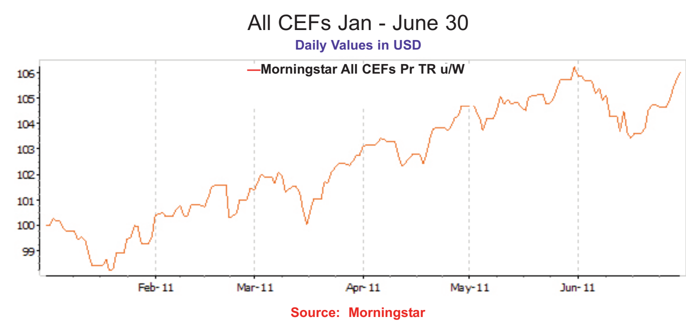
Jeff Margolin

Senior Vice President, Closed-End Fund Analyst

SECOND QUARTER 2011

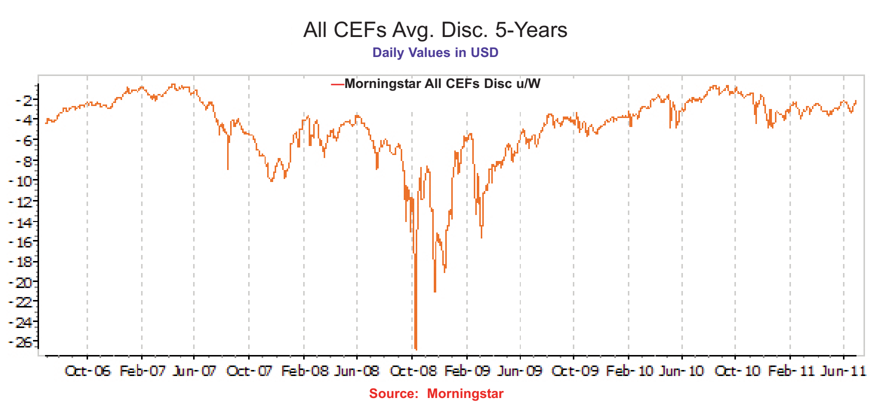
Overview of Second Quarter

The universe of 631 closed-end funds had another solid quarter, with the average fund up 3.2% on a share price total return basis (according to Morningstar). Closed-end funds (CEFs) are now up an average of 6.03% through the first two quarters of the year on a share price total return basis (see chart below). Many of the categories we continue to favor for investors looking for income are also having a good year with municipal CEFs up 6.75%, senior loan CEFs up 4.91%, high-yield CEFs up 10.42%, limited duration CEFs up 8.51% and equity CEFs up 3.86% (through June 30, 2011). Despite a sell-off in equities at the end of the quarter and a flight to safety (the 10-year U.S. Treasury ended the quarter at a yield of 3.15% after beginning the quarter at 3.45%), many categories of the CEF marketplace continue to benefit from higher domestic equity prices, improvement in overall credit conditions, very low short-term interest rates and therefore very low leverage cost (roughly 70% of all closed-end funds employ the use of leverage) and high demand for income-oriented funds, given the very low interest rates on traditional fixed-income investments (such as U.S. Treasuries, Certificates of Deposit and Money Market Funds).



Outlook

While I continue to believe that CEF investors should focus on the categories discussed above for high current income, given the fact that average discounts to NAV are only 2.08% for all CEFs (see chart below), versus a 5-year average discount to NAV of 4.33% (according to Morningstar), there clearly is less value in the marketplace today than there was 12-24 months ago; therefore, investors should expect most of the potential total return they earn to come from income and not capital appreciation from narrowing discounts. However, with the average CEF with a distribution yield of 6.81% at the end of the quarter (according to Morningstar), I believe investors can still achieve potentially attractive total returns. Furthermore, the data continues to show that defaults are very low for both corporate bonds and senior loans (Moody's reported that the global speculative-grade default rate stood at 2.4% in May, up slightly from 2.3% in April, according to its own release the rate was 7.6% a year ago). Moody's is still forecasting a default rate of 1.5% for December 2011. The U.S. speculative-grade default rate stood at 2.7% in May, up slightly from 2.6% in April. The default rate on senior loans stood at 1.50% in May, no change from April, according to the S&P LCD. Interest rates remain very low (Fed Fund futures now predict the Fed may not begin raising short-term interest rates until the second half of 2012). And our First Trust Chief Economist (as well as our Chief Investment Officer) continue to forecast higher equity prices over the next 12-months based on an improving economy, improving corporate earnings and low valuations on equities based on historical averages. Therefore I continue to believe that the backdrop for investors who are diversified across the categories mentioned above remains a good one. The one broad category within the CEF marketplace that I favor where there are still mid-single digit discounts to NAV, or even high single digit discounts, remain equity income-oriented funds. In fact, according to Morningstar, the average discount to NAV among equity funds is 4.88% through June 30, 2011.



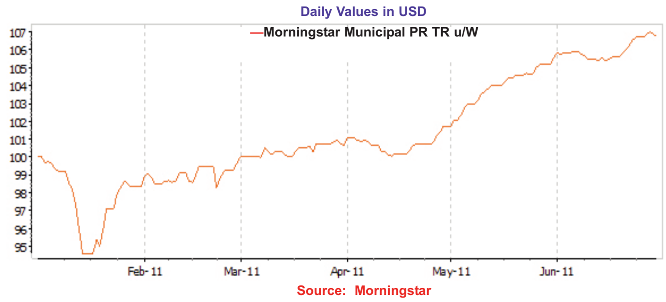
First Trust

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

Municipal Closed-End Funds

Owing to the fact that municipal CEFs are the biggest category within the CEF marketplace (of the 631 CEFs, 254 are municipal CEFs according to Morningstar) and due to the fact that municipal CEFs were very volatile at the end of 2010 and beginning of 2011, I get the most amount of questions from advisors about municipal CEFs. Please see the CEF Commentary page on www.ftportfolios.com for previous comments I had on municipal CEFs on 11/11/2010, 12/10/2010, 1/4/2011, 1/18/2011, 2/14/2011, 4/19/2011 and 5/25/2011. Despite the fact that municipal CEFs started the year on average lower by 6.2% through January 14, 2011, as measured by the First Trust Municipal CEF Index (MNCEFT), due to what I believe were overstated concerns about the potential for municipal bond defaults in 2011 (please see report dated 1/18/11 entitled "Misconceptions Currently Hurting Municipal Bonds"), they have roared back and through the first half of 2011 are up 6.75% on a share price total return basis (see chart below).

All Muni CEFs Jan 1 - June 30



Municipal bonds and municipal CEFs continue to benefit from a limited supply of new issue municipal bonds (which helps the secondary market of municipal bonds and municipal closed-end funds), low borrowing cost for most leveraged municipal funds (which is helping many municipal funds to earn yields of 6% or more tax free) and an extremely low municipal default rate. In fact, despite the dire predictions of some, according to Bloomberg the number of municipal bond defaults totaled 25 ($752 million) in the first half of 2011. That was well below the 60 defaults, valued at $2.87 billion, registered in the first half of 2010. Bear in mind, the entire municipal bond market is worth nearly $3 trillion. Even the state of California (which is hardly a model of fiscal responsibility) had its $71.7 billion of A- rated outstanding general obligation bonds upgraded from a "negative outlook" to a "stable outlook" from S&P recently. The positive revision to California's outlook means a downgrade is less likely. Municipal bonds posted the best return of the major debt categories in the first half of 2011. The following 6-month index returns are provided by Barclays Capital (June 30): Municipal Bond: Long Bond 22+ (+5.88%); Global Emerging Markets (+5.84%); U.S. Corporate High Yield (+4.97%); Global Aggregate (+4.38%); GNMA 30 (+3.56%); Intermediate Corporate (+3.26%); U.S. Aggregate (+2.72%); and U.S. Treasury Intermediate (+2.20%).

I continue to believe that until the Fed starts to raise short-term interest rates, the environment for leveraged municipal CEFs remains a good one. In my opinion, income-oriented investors in the context of a diversified balanced portfolio should have exposure to municipal CEFs and I believe investors are being rewarded for the duration risk they are taking from primarily investment grade bonds (i.e., the average yield was 6.94% as of June 30, 2011, for National Leveraged Municipal CEFs, according to Morningstar.) While I don't believe we will see a meaningful amount of dividend increases among leveraged municipal CEFs in the near-term, I do expect that the majority of leveraged municipal funds will maintain dividends at their current levels for much of the year.

Although the environment remains favorable for leveraged municipal funds, in my opinion, investors should begin the process of preparing for higher interest rates by incorporating some non-leveraged municipal CEFs, non-leveraged municipal ETFs or a diversified portfolio of individual municipal bonds into their portfolios. They all tend to have shorter durations than leveraged municipal funds and will likely hold up better relative to leveraged municipal CEFs if interest rates do move higher next year. Finally, a word about valuations. Since municipal bonds have rallied, most yield less than comparable maturity U.S. Treasuries on most parts of the yield curve (with the exception of long-term municipal bonds of 20 years or more). This is an indication that municipal bonds are not nearly as undervalued as they were six months ago. Therefore, I believe, it is unlikely that the underlying asset class of municipal bonds will repeat the significant upside move it had in the past five months.

As always, due to the fact that CEFs 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