CLOSED-END FUND review

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THIRD QUARTER 2012

Third Quarter Overview

The third quarter was yet another very solid quarter for the overwhelming majority of closed-end fund categories. Equity funds benefited from the overall rise in global equity prices during the quarter (the S&P 500 Index was up over 5%). Credit-sensitive funds, such as senior loan funds and high-yield funds, benefited from investors' continued appetite for high income-producing asset classes as well as default rates which remain below historical averages. Higher credit quality funds, such as municipal funds, benefited from a modest decline in long-term municipal bond rates as well as continued low leverage costs for funds which are borrowing at low short-term interest rates. Furthermore, as I have written about previously, with yields on traditional income-oriented investments (such as U.S. Treasuries, CDs and money market funds) at paltry rates of 0 to barely 3%, coupled with the demand for income-producing investments given the demographics in the United States, more investors are investing in the closed-end fund structure as a way to increase the overall yield in their portfolios. Indeed, at the end of the quarter, the average distribution yield of the 609 funds in the Morningstar database was 6.18%. I believe this is a very compelling relative and absolute yield compared to many of the income alternatives retail investors have.

Lastly, with the fed announcing a further round of quantitative easing, as well as announcing its intention to keep short-term interest rates low through mid-2015, I believe investors continue to be comfortable with the idea of owning leveraged closed-end funds as it doesn't appear that borrowing costs are going to be increasing anytime soon; therefore, funds which are borrowing at floating short-term rates should continue to earn a spread between their borrowing costs and the rates they can earn on the borrowed proceeds.

According to Morningstar, the universe of 609 closed-end funds was up 7.11% for the quarter and is up 14.81% year-to-date. The primary categories within the closed-end fund marketplace that I continue to advocate investors have exposure to also posted very solid total returns for the quarter. For example, according to Morningstar, municipal funds were up 5.51% for the quarter and are up 13.98% year-to-date. Limited duration funds were up 6.53% for the quarter and are up 17.62% year-to-date. Finally, the two areas of the closed-end fund marketplace that I have the highest level of conviction in were also positive for the quarter. Domestic equity funds were up 7.68% and are up 15.08% year-to-date and senior loan funds were up 8.93% for the quarter and are up 20.84% year to-date. (All returns are on a share price total return basis.)

Average CEF Now at a 0.46% Premium to Net Asset Value ("NAV"); Some Caution Necessary

While the performance of most closed-end fund categories in 2012 has been very rewarding, it is important to highlight the fact that (according to Morningstar) the average fund is now at a 0.46% premium to its NAV (as of 9/30/12). The three-year average is a 3.92% discount to NAV and the five-year average is a 5.40% discount. The many positive factors that I have written about previously (and which are mentioned above) have clearly contributed to the fact that the average fund is at a premium to NAV. I think it is interesting to note that Morningstar shows the average fixed-income CEF is at a 3.28% premium to NAV while the average equity fund is at a 5.15% discount to NAV (as of 9/30/12). I think this illustrates the apprehension retail investors still have about investing in equity funds, as well as their continued attraction to fixed-income oriented funds.

With the average closed-end fund is now trading at a slight premium to NAV I think it is imperative for investors to lower expectations about the future potential returns closed-end funds provide (particularly fixed-income oriented funds) and investors should be prepared for volatility as some investors could choose to take some profits after such a rewarding 3 quarters for 2012. That said, yields still remain compelling for many funds, the fed continues to buy bonds in its quantitative easing efforts, it continues to keep short-term rates exceptionally low, defaults remain below historical averages for both high-yield bonds and senior loans, yields remain very low on traditional income-oriented investments and demand continues to remain strong for high income-producing investments. For all these reasons, I firmly believe should we see any weakness develop as a result of funds moving to premiums to NAV, it would provide a compelling buying opportunity.

Two Areas of Highest Conviction Still Domestic Equity CEFs and Senior Loan CEFs

All year my two areas of highest conviction have been domestic equity funds and senior loan funds and I still have that belief. I also continue to advocate investors maintain exposure to limited duration multi-sector bond funds and municipal funds for income and to create balance in a diversified CEF portfolio. Domestic equity funds continue to be compelling for 2 primary reasons:

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1. At First Trust we continue to believe the S&P 500 Index remains undervalued based on an economy that continues to grow (even if only modestly), valuations still remain below historical averages, corporate profits remain near all-time highs for the S&P 500 Index and cash positions remain at record highs for companies in the S&P 500 Index.
2. Unlike most CEF categories, the average domestic equity fund can still be bought at a discount to NAV of 3.3% (according to Morningstar) and many well-run funds with admirable track records can be bought at even wider discounts.

Senior loan CEFs continue to be my favorite category on the fixed-income side of the equation. However, with the average senior loan fund now at a slight 2.38% premium to NAV (according to Morningstar as of 9/30/12) I think it is important for investors to expect most of the total return potential to come from the compelling 7.07% yield the average senior loan CEF distributes (as opposed to meaningful capital appreciation as they earned thus far in 2012). My thesis for continuing to favor senior loan CEFs remains intact and has been consistent all year:

1. Credit conditions remain sound and defaults remain low for the senior loan asset class (see below).
2. Senior loan CEFs yield on average 7.07% (according to Morningstar as of 9/30/12) with limited duration risk. I believe this is a very compelling income stream on both an absolute and relative basis to most fixed-income alternatives.
3. The underlying asset class of senior loans is still one of the only broad-based fixed-income asset classes trading below par at 95.90 (according to S&P as of 9/30/12). While not a big discount, it is still a slight discount nonetheless at a time when almost every other fixed-income asset class is above par.

There were no defaults in the S&P/LSTA Leveraged Loan Index in the month of September. In fact, between July and September, there was just one S&P/LSTA issuer which defaulted. As a result of there being just one default in the month of September, the senior loan default rate declined to just 1% by principal amount from 1.07% in August and to 1.06% by number of loans from 1.21% in August. To put these numbers in perspective, the historical default rate is approximately 3.4%.

According to S&P, it appears as if the default rate will remain low for the foreseeable future in large part because S&P's "shadow default rate" (which is a measure of loans to issuers that have either missed a bond payment, entered a forbearance agreement or engaged bankruptcy counsel) stood at a record low in mid-September at 0.16%. Barring an unforeseen shock to the economy or recession in 2013, senior loan defaults will likely remain below the historical average.

Fourth Quarter Tax Loss Selling and November Presidential Election

The fourth quarter is often the most volatile of the year for closed-end funds as a result of year-end tax related transactions which can often lead to volatility toward the end of the quarter. In my experience, tax-loss selling is usually the worst in years when closed-end fund investors have losses to take. However, with the average fund up an average of 14.81% year-to-date (as of 9/30/12) and up 20.95% over the past one year (on a share price total return basis according to Morningstar) there are not a lot of losses to take. This would normally lead me to predict that we would not see a lot of tax-loss selling and volatility in the fourth quarter. However, given the fact there is a Presidential election on November 6th and a lot of uncertainty about not only the Presidential election, who will control Congress and what tax rates will be next year on capital gains, dividends, ordinary income etc., it could cause some closed-end fund investors to take profits and sell some of their funds which are at premiums to NAV and which they have made money on. In other words, "tax-gain selling" as opposed to "tax-loss selling."

Given the uncertainty regarding the election, the so called "fiscal cliff" and the implications for taxes, I think it is reasonable to expect volatility as we get closer to the election and closer to the end of the year and the "fiscal cliff." I think the best approach for closed-end fund investors over the next few months is to dollar-cost average into the categories I have advocated having exposure to (domestic equity funds, senior loan funds, limited duration multi-sector funds and municipal funds) in order to take advantage of the potential volatility which could occur as the quarter progresses.

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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