CLOSED-END FUND review

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SECOND QUARTER 2012

Second Quarter Overview

Following a quarter in which the average closed-end fund was up an impressive 6.34% on a share price total return basis (according to Morningstar), the majority of funds continued their winning streak with the average fund up 1.43% in the second quarter. Supported by declining interest rates, still below historical levels of defaults for below investment-grade corporate bonds, low leverage costs and still insatiable demand on the part of retail investors for fixed-income funds, the 425 funds classified by Morningstar as "fixed-income" led the way with a 4.36% average share price total return. The 172 funds classified by Morningstar as "equity" funds were lower on the quarter with an average share price total return of a negative 4.14%. Despite rallying 1.88% during the month of June, it was not enough to make up for the very weak and volatile month of May when the global equity markets were hit hard. Indeed, the Standard & Poor's 500 Index was lower by over 6% in the month of May. Despite the weak second quarter, I still believe some of the best opportunities for closed-end fund investors remain in the 98 funds Morningstar classifies as "domestic equity" funds which are still up 8.48% year-to-date on a share price total return basis (according to Morningstar) despite being lower by 2.16% in the second quarter. For more on domestic equity funds and other categories I continue to favor, please see below.

Discounts to NAV Have Narrowed

As I have written about previously, there are many factors which continue to contribute to solid total returns for many categories in the closed-end fund marketplace, including the ones listed above. There are other factors, such as baby boomers retiring and needing more income-oriented investments in their portfolios; more investors retiring with defined contribution plans as opposed to defined benefit plans; and more investors turning to the closed-end fund structure for a portion of their portfolios to increase the overall yield they earn since interest rates on traditional income investments remains exceptionally low (i.e. 0-3% yields available in money market funds, U.S. Treasuries and Certificates of Deposits). It is precisely these factors which have not only contributed to the solid total returns many funds have experienced the past three years, but also to the fact that the average fund is only at a 0.84% discount to net asset value (NAV) as of 6/30/12 (according to Morningstar). This is much narrower than the 5.95% discount to NAV funds have averaged over the past three years. I think it is important for investors in certain categories (such as high yield and municipal funds) to realize that going forward, most of the potential total return is going to come from the income these categories distribute as opposed to capital appreciation. That said, there are two categories, namely domestic equity funds and senior loan funds, which I believe offer not only attractive income but also the potential for capital appreciation over the next 12-24 months.

While the average discount to NAV for all funds was 0.84% at the end of the quarter, there continues to be a noticeable bifurcation in the valuation of fixed-income funds compared to equity funds. Indeed, even though the U.S. stock market (as measured by the Wilshire 5000 Index) is up over 107% since the recent low on March 9, 2009, retail investors continue to be apprehensive about investing in equities. I believe that is reflected in the universe of 98 domestic equity funds ending the second quarter at an average discount to NAV of 4.91%. This is significantly wider than the 5-year average discount to NAV of only 0.79% and part of the reason I believe domestic equity funds represent a compelling value now. By comparison, the universe of 425 fixed-income funds ended the quarter at an average premium to NAV of 1.8% (significantly wider than the 5-year average discount to NAV of 2.26%). I believe this reflects the voracious appetite retail investors have for fixed-income funds and part of the reason there is simply less value in many fixed-income funds now relative to the past 5 years.

Still Advocating a Balanced, Three-Pronged Approach to Investing in CEFs

I am making no changes to my firm belief that the best approach to investing in CEFs now is to maintain a balanced, three-pronged approach, including:

1. Domestic Equity Funds
2. Credit Sensitive Funds (particularly senior loan funds and limited duration multi-sector funds)
3. Municipal Funds

The benefits of being disciplined and diversified in these three primary areas is that all three continue to distribute very attractive income. In addition, the share prices of equity funds and credit-sensitive funds tend to trade lower during periods of "risk off" like we experienced in May with the S&P 500 Index off roughly 6%.

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Municipal funds, on the other hand, tend to see their share prices move higher during these volatile periods. This is exactly what we saw in May and illustrates the benefits of this approach. A CEF investor who maintains this balanced, three-pronged approach should currently earn a blended income stream of roughly 6.0%-6.5%. Because the share prices of equity funds and credit sensitive funds often move in a different direction than municipal funds, investors may experience less volatility by being diversified across these three primary areas. I believe investors should consider domestic equity funds, credit-sensitive funds and municipal funds if they don't have exposure to those areas already. I firmly believe that this balanced, three-pronged approach achieves the goal of distributing compelling monthly income and also can help to reduce some volatility because of the different characteristics of the asset classes.

Update on Two Categories of Highest Conviction

At the beginning of 2012, in my CEF commentary piece I stated the following *"In addition to maintaining exposure to municipal closed-end funds, as 2012 begins, the two categories of the closed-end fund marketplace in which I have the highest conviction level in are domestic equity funds and senior loan funds, based on compelling fundamentals and attractive valuations."* I continue to believe this as I write this commentary in early July.

Although municipal funds ended the quarter at a premium to NAV of 2.02% (according to Morningstar) and are up an impressive 8.28% year-to-date (as of 6/30/12) on a share price total return basis, I continue to advocate investors maintain exposure to this category based on the very compelling average tax-free yield of 5.56% (according to Morningstar as of 6/30/12), significant demand retail investors continue to have for high quality tax-free income, low defaults experienced in 2012 (according to Barron's the number of defaulted municipal issuers is down by 32% to 39 issuers from 57 over the first half of 2011, and down to $800 million in defaulted municipal bonds versus $1 billion over the same time period in 2011), relatively low borrowing costs many funds continue to have, concern about higher taxes in 2013, relative value municipal bonds offer versus U.S. Treasuries and the balance municipal funds provide in a portfolio when coupled with equity funds and credit sensitive funds. However, while I continue to advocate a three-pronged approach including municipal funds, given the fact that many municipal funds are now at premiums to NAV, I believe it is likely most of the potential total return these funds provide will come from the high income they distribute and not capital appreciation. Domestic equity funds and senior loan funds remain the areas of highest conviction I have for the rest of 2012 and into 2013 due to the high income they provide and the potential for capital appreciation given the compelling valuations and fundamentals for both categories.

Senior loan funds continue to offer compelling average yields of 7.14% (according to Morningstar as of 6/30/12). Moreover, fundamentals also remain strong for senior loans. Indeed, as of the end of June (according to S&P) the default rate for senior loans was 1.08%, which remains significantly below the historical average of 3.40%. Not only are yields and fundamentals solid for the senior loan asset class, but valuations remain attractive for the loans themselves as well as the senior loan CEFs, in my opinion. Indeed, as of 6/30/12, the S&P Leveraged Loan Index was at 93.19, which is still below par (100) and the average senior loan CEF was at a discount to NAV of 2.36%, according to Morningstar. Over the past five years, the universe of senior loan funds has traded at an average premium to NAV of 1.15% and I think this illustrates the value that continues to exist in this asset class and these funds.

At an average discount to NAV of 4.91% versus a five-year average discount to NAV of only 0.79%, the universe of 98 domestic equity funds remains one of the only broad-based categories within the closed-end fund universe still trading at a meaningful discount to NAV as well as a meaningful discount to its historical discount to NAV. While these attractive discounts are a plus in my opinion, it is not the only reason domestic equity funds remain one of my areas of highest conviction for 2012. I am drawn to domestic equity funds because the valuations in the closed-end funds are compelling, but so too are the attractive valuations that exist among companies in the S&P 500. Indeed, with a forward P/E ratio of approximately 12 times next year's earnings, according to Bloomberg, the S&P 500 continues to trade below its historical multiple of 15 to 16 times forward earnings and therefore I believe remains a compelling asset class. Lastly, according to Morningstar, the average domestic equity fund has a distribution yield of 7.76% as of 6/30/12, and therefore, investors are receiving a compelling income stream for the equity risk they are taking.

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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