CLOSED-END FUND review

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Overview of 2012

Following a year (2011) when the average closed-end fund was up a respectable 5.37% on a share price total return basis, closed-end funds posted even better performance in 2012, with the average fund up 14.00% (according to Morningstar) on a share price total return basis. The strong performance was broad and deep with many categories posting double-digit total returns. The categories we focused on primarily in 2012 also posted very strong results with *senior loan funds up 22.63%, limited duration funds up 17.70%, domestic equity funds up 13.67%, high-yield funds up 12.11%, California municipal funds up 14.29% and municipal funds up 11.77%.*

There were many factors which contributed to the strong results posted in 2012 and while I have written and spoken about them before, I want to reiterate them here:

1. Exceptionally low short-term interest rates created very low leverage costs for many leveraged funds.
2. Low yields on traditional income-oriented investments such as CDs, money market funds and U.S. Treasuries caused investors to consider closed-end funds for part of their income needs.
3. There was strong demand for income-producing investments from retail investors.
4. Low defaults on credit-sensitive securities such as senior loans and high-yield corporate bonds helped to create strong returns.
5. Strong earnings per share growth, coupled with compelling valuations, led to a general increase in global equity markets.

The average discount to net asset value (NAV) of all 598 funds ended the year at 2.81% (somewhat narrower than the 10-year average discount of 3.82%) according to Morningstar. Reflecting the enormous appetite for fixed-income funds retail investors displayed in 2012, the universe of fixed-income funds finished the year at only a 0.56% discount to NAV, which is part of the reason I believe investors in fixed-income oriented funds should lower their expectations about the potential for capital appreciation in 2013 (more on that below). On the other hand, equity funds (as defined by Morningstar) finished the year at an average discount of 7.04% and this is part of the reason domestic equity funds remain one of the areas of the closed-end fund marketplace that I have the highest conviction level in for 2013 (see below).

2012 was a year of low volatility

While there were short periods of high volatility for closed-end funds, overall 2012 was a year of un-characteristically low volatility. In fact, the First Trust Closed-End Fund Composite Total Return Price Index (UPCEFT), which is a composite index of the municipal, taxable fixed-income and equity closed-end fund indexes, started the year at 1307 and at no point in 2012 did it fall below that level. It closed the year at 1501.

The same can also be said for the S&P 500 Index, which started the year at 1258 and never dipped below that point in 2012. While it certainly was a nice combination to not only earn double-digit total returns for most closed-end fund categories, this was also coupled with low volatility (at least by historical standards). Due to the fact that many closed-end funds are thinly traded, employ the use of leverage and are primarily owned by retail investors, I think it is unlikely to expect volatility to be as subdued in 2013 as it was in 2012.

Outlook for 2013

The good news, from my perspective, is that as 2013 commences all of these factors remain very much intact, which is why I am optimistic that 2013 could also be a good year for diversified closed-end fund investors, although I expect more of the potential total return (particularly for fixed-income oriented funds) to come from the distributions funds make (as opposed to meaningful capital

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appreciation). Investors looking for income, as well as the potential for capital appreciation, should focus on domestic equity funds as not only are fundamentals and valuations still compelling (in my opinion) for the underlying asset class of domestic equities, but the average discount to NAV of all 103 domestic equity funds remains attractive at 5.57% (according to Morningstar). This is more compelling than both the three-year average discount of 2.90% as well as the ten-year average discount of 5.02%.

Based on the five factors listed above, as well as our Economics team forecast for continued moderate economic growth and only a 25% chance of a recession in 2013, I am making no changes to my belief that the best approach for closed-end fund investors is to maintain broad exposure to domestic equity funds, credit-sensitive funds (including senior loan funds, limited duration funds and high-yield funds) and municipal funds.

I still have the highest conviction level in domestic equity funds and senior loan funds although I do not expect senior loan funds to deliver total returns north of 20% in 2013 as was the case in 2012. This is based on the fact that as 2013 begins, the average senior loan fund is at a slight 0.43% premium to its NAV. They began 2012 at a 5.89% discount to NAV. That said, moderate growth in the U.S. economy in 2013 should continue to keep defaults below historical averages for senior loans. Furthermore, yields remain compelling (average yield is 7.29% according to Morningstar), duration risk is low and the average senior loan is still trading at a slight discount to par at 96.09, whereas many other fixed-income asset classes are at premiums to par.

What could alter my investment outlook for closed-end funds in 2013?

There are two primary things I will be watching for in 2013:

1. Should the U.S. economy have two back-to-back quarters of annualized GDP growth of less than 0.5%, it would cause me to re-consider my view that investors should have overweight exposure to domestic equity funds and credit-sensitive funds as two quarters of sub 0.5% GDP could signal the potential for a significant increase in corporate defaults as well as a significant decrease in EPS growth. This could cause both of these categories to experience weakness. For now, I believe the moderate growth in the U.S. economy continues to create a good backdrop for domestic equity funds and credit-sensitive funds.
2. On the flip side of two weak quarters of U.S. GDP, should the U.S. economy experience two back-to-back quarters of GDP annualized growth north of 3.5%, it would cause me to re-consider exposure to leveraged municipal funds as two strong quarters could lead to a meaningful increase in long-term interest rates (which could be negative for leveraged municipal funds which have long durations). Under this scenario, I would advocate that investors lighten up on leveraged municipal funds and consider shorter duration non-leveraged municipal funds as well as shorter duration municipal ETFs (which would likely hold up better in that environment).

I am assuming that the Fed remains exceptionally easy all year and that the Federal funds rate stays at its current 0-0.25% level.

Of course, I will be monitoring valuations and fundamentals throughout the year as well.

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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