CLOSED-END FUND review

THIRD QUARTER 2016

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Third Quarter Overview

The third quarter was another solid period for diversified closed-end fund ("CEF") investors. The average CEF was up 2.37% for the quarter and is now up 13.01% year-to-date. Equity CEFs were positive on average by 3.79%, taxable fixed-income CEFs were up on average 5.04%; municipal CEFs, on the other hand, were lower on average by -0.84% for the quarter. (Source: Morningstar. All data is share price total return data). As I mentioned last quarter, after grinding through a challenging 2015 (particularly the back half of the year), diversified CEF investors have been rewarded with very strong total returns year-to-date (YTD). Many of the factors which benefited several categories of the CEF marketplace the first half of 2016 were also present during the third quarter including: higher equity prices (particularly U.S. equities), continued "Plow Horse" (as our Economics Team phrases it) economic growth in the U.S. economy (which helps to create a positive backdrop for many credit-sensitive CEFs), and high distributions and attractive discounts to net asset values (NAVs). This was particularly true for equity and credit-sensitive categories, which also helped to attract buyers to the secondary market during the quarter.

According to Morningstar, average discounts to NAVs narrowed slightly during the quarter to -4.42%. They ended the second quarter with an average discount of -4.65%, which was down from -5.83% at the end of the first quarter and -7.86% from the start of the year. As average discounts to NAV continue their narrowing process closer to their long-term average, we believe it is important to focus on categories where valuations still remain attractive and also where the fundamentals and valuations of the underlying asset class also remain attractive. This is precisely the reason I continue to favor equity income, senior loan and limited duration multi-sector taxable fixed-income funds. (More on that below).

Senior Loan CEFs Finally Getting the Respect They Deserve

For much of 2015, senior loan CEFs seemed like the "Rodney Dangerfield" of the CEF marketplace. They just couldn't get any "respect" from investors. Despite very sound fundamentals (i.e. defaults well below historical averages), attractive valuations (i.e. on average loans at discounts to par and senior loan CEFs at high single-digit average discounts to NAV), distribution yields in the mid- to high-single digits and very low duration risk, investors did not seem interested in these very positive attributes. The tide has clearly turned in 2016 as senior loan CEFs are now one of the top-performing CEF categories YTD and investors are clearly starting to recognize these positive characteristics.

After rising on average 8.24% during the third quarter, the average senior loan CEF is now up 16.39% YTD and up 14.43% over the past one year. (Morningstar, on a share price total return basis). After double-digit total returns so far in 2016, a question I am now receiving from investors is "Do I still like senior loan CEFs going forward?" My answer is "Yes!" In addition to the attractive fundamentals and valuations mentioned above, I believe there are still two more additional key catalysts which could propel senior loan CEFs next year.

With LIBOR (London Interbank Offered Rate) moving higher this year, coupled with the likelihood the Federal Reserve ("Fed") will raise the federal funds rate in December, it's possible senior loan CEFs could be poised to slowly increase distributions later next year. Now to be clear, this might not occur until the second half of 2017 as it might require one more additional increase in the fed funds rate during the first half of 2017 for the income senior loans pay to begin to meaningfully reset higher, but nevertheless, this could be a positive catalyst next year. One final catalyst which could boost senior loan CEFs, in my opinion, is the potential for a significant amount of money to rotate out of long maturity bonds (many of which are at significant premiums to par) and move into the senior loan asset class. I would expect this to happen if the Fed signals it intends to continue to raise rates in 2017, long-term rates slowly creep higher and investors seek to reduce duration risk in their fixed-income portfolios.

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Outlook for Remainder of 2016 and 2017

As the fourth quarter commences, the backdrop for categories I have favored this year (particularly equity income, senior loan and limited duration multi-sector) continue to look attractive to me. As mentioned previously, with our Economics Team continuing to forecast more "Plow-Horse" U.S. economic growth, higher domestic equity prices and a slow but gradual move higher for both short- and long-term interest rates, I continue to favor equity income-oriented CEFs, senior loan CEFs and limited duration multi-sector CEFs, which not only have attractive valuations and strong fundamentals, but should also benefit from the macro environment our Economic and Equity strategists are forecasting.

As mentioned in the senior loan CEF discussion above, LIBOR has moved higher this year and with the Fed poised to raise the federal funds rate in December, it is likely LIBOR will continue to move higher into next year. This directly impacts leveraged CEFs, many of which have their borrowing cost tied to LIBOR. I am particularly concerned about the negative impact higher LIBOR, and therefore higher borrowing cost, will have on levered fixed-income CEFs that are invested in fixed-coupon bonds such as municipal CEFs. As LIBOR and borrowing cost move higher, the coupons on the bonds they own are fixed and cannot reset higher to keep up with higher borrowing cost. This is much less of a concern with a floating-rate asset class, such as senior loans, as higher LIBOR will eventually lead to higher income among the floating-rate senior loans whose reset is also tied to LIBOR (therefore making up for the increase in borrowing cost).

In addition to the significant duration risk levered municipal CEFs have, given the uptick in LIBOR, I believe many levered municipal CEFs are at risk of distribution cuts in the 5%-10% percent range over the next several months. For investors looking for exposure to the municipal bond asset class, I still favor non-levered municipal CEFs, which have slightly less duration risk and are also less impacted by the increase in LIBOR and borrowing cost.

Lastly, during this time of year, I always get inquiries related to what my views are as it relates to tax-loss selling season in CEFs, which is usually at its peak in late November and December. Given the fact the average CEF is up 13.01% YTD and that the gains were broad and included most categories of the CEF marketplace, I am not expecting a particularly rough season of tax-loss selling during this year's fourth quarter.

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