

CLOSED-END FUND review

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Overview of 2010

After a year (2009) in which closed-end funds were up on average 51.15% (according to Morningstar on a share price total return basis), closed-end funds had another solid year in 2010 with the average of all 625 funds up 11.86% (according to Morningstar on a share price total return basis). Throughout the year, closed-end funds benefited from 3 primary trends:

1. Improvement in the global equity and credit markets helped the average net asset value (NAV) to increase 11.12% in 2010 on a total return basis, which helped to drive share prices higher.
2. Exceptionally low short-term interest rates helped keep leverage costs low, which in turn led many funds to boost their distributions during the year as well as helping funds to earn a nice spread between their borrowing cost and the return they could earn on their borrowed money. Approximately 70% of all closed-end funds employ the use of leverage.
3. With an average share price distribution yield of 6.90% (according to Morningstar) and a strong demand for income from retail investors due to the low yields available on traditional fixed-income oriented investments such as U.S. Treasuries, money market funds and CDs (certificates of deposit), investors gravitated to the closed-end fund structure throughout the year.

Indeed, not only was the average share price up 11.86% during the year, but discounts to NAV narrowed in 2010 to an average of 3.21% (according to Morningstar) on December 31, which is a narrower discount than the five-year average of 4.86% and smaller than the 3.97% average discount (as discounts were on January 1, 2010).

The palpable demand for income on the part of the retail investor community also led to a resurgence of the initial public offering (IPO) market for closed-end funds. In fact, according to the Closed-End Fund Association (CEFA) through November 2010, there were 16 new CEF IPOs and over \$7 billion raised. This is significantly more than the roughly \$2.5 billion raised in new closed-end fund IPOs in 2009.

Key Themes and Categories for 2011

As 2011 commences, many of the key trends which benefited closed-end funds in 2010 appear to be in place for 2011 and I continue to advocate that investors focus on a handful of what I believe are compelling categories in the closed-end fund marketplace. These include floating-rate senior loan funds, limited duration multi-sector bond funds, equity income-oriented funds, high-yield funds and municipal funds.

I believe that by focusing on these five categories, closed-end fund investors can attain a blended yield of approximately 6-8%; have protection against higher interest rates (should that occur in the next 12 months) with the exposure to senior loan and limited duration bond funds; have growth potential with the equity income-oriented funds (First Trust's Chief Economist and Chief Investment Officer both continue to believe U.S. equities remain undervalued based on an improving economy, improving corporate earnings and attractive valuations based on historical metrics); take advantage of improving credit conditions in the corporate high-yield bond market as the global speculative-grade default rate was only 3.3% at the end of November (according to Bloomberg Businessweek) & Moody's is now forecasting it will continue to decline to 1.8% by November of 2011; and lastly, be able to take advantage of some of the most attractive yields on municipal funds in the past 5 years. Indeed, according to Morningstar, the average yield among all 257 municipal closed-end funds was 6.97%, which is significantly higher than the five-year average yield of 5.67%.

While these are the five primary categories I favor and have favored the past several quarters, I do think there are 2 key themes closed-end fund investors need to be focused on in 2011.

1. **Getting closer to both short- and long-term interest rates moving higher:** Interest rates on both the short and long end of the curve have been exceptionally low for the past few years, but I believe we are getting closer to the end of this low interest rate environment and I believe closed-end fund investors need to begin (if they haven't already) focusing in on categories which have historically performed well as interest rates move higher. This is part of the reason I have and continue to advocate investors add floating-rate senior loan funds and limited duration multi-sector bond funds to their portfolios as a way to generate an attractive income stream from asset classes which historically hold up well as interest rates move higher.
2. **Expect most of the potential total return in a diversified portfolio of closed-end funds to come from income and not capital appreciation:** Historically, investors purchased closed-end funds because of the high income streams they have provided. Investors were more focused on the monthly or quarterly dividend check than they were about the potential for significant capital gains. However, coming out of the panic which engulfed the global financial markets in late 2008 and the beginning of 2009 which led to very wide discounts to NAV and very cheap prices for many asset classes (including equities, corporate bonds, senior bank loans and municipal bonds), investors in many closed-end funds were able to not only earn an attractive income stream but also earn significant capital gains. With the exception of the equity income-oriented funds where I do believe there is the potential for meaningful capital appreciation, most of the return that closed-end funds potentially provide in 2011 will be from the distributions they make. I think it is imperative that closed-end fund investors again look at a diversified portfolio of closed-end funds as a way to get a very attractive income stream as opposed to significant capital appreciation.

Spotlight on Senior Loan Funds and Municipal Funds

Two of the categories within the closed-end fund marketplace that I have advocated investors have exposure to the past two years are senior loan funds and municipal funds. As 2011 gets underway, I continue to like these two areas and believe they should be part of a diversified portfolio of closed-end funds (as mentioned earlier in this letter).

After a very strong year of performance for senior loan funds in 2009, senior loan funds posted another very solid year in 2010 with the average senior loan fund up 24.97% (according to Morningstar on a share price total return basis). There are 18 senior loan closed-end funds in the Morningstar database.

There are three primary reasons I continue to like senior loan funds:

1. **Still at Discounts to Par:** The S&P/LSTA Leveraged Loan 100 Index closed 2010 at 92.91, indicating that the average senior loan is still below par or 100. Therefore, I believe that as credit conditions continue to improve and demand for senior loans increases (as investors look to diversify into asset classes which historically perform well when short-term rates move higher), I believe there is the potential for modest appreciation in the NAVs of senior loan funds as the average price moves closer to par.
2. **Defaults Declining Among Senior Loans:** After hitting the low double digits in early 2009, defaults in the senior loan marketplace have declined meaningfully with the rate down to 2.25% in November, according to S&P LCD.
3. **Attractive Yields With Very Limited Duration Risk:** According to Morningstar, the average senior loan closed-end fund yield was 6.48% as of December 31, 2010. Due to the fact that the interest on a senior loan is re-set every 60-90 days based on short-term interest rates, there is very little duration risk in senior loans. I believe investors in senior loan closed-end funds are earning a very attractive income stream of 6.48% with very limited duration risk and that, coupled with the fact that credit conditions continue to improve and there are still discounts to par available among senior loans, they are a compelling investment, in my opinion.

After rising 44.93% (on a share price total return basis according to Morningstar) in 2009 and being up approximately 14% through the first three quarters of 2010, municipal closed-end funds sold off 9.96% during the last three months of the year and finished the year up a modest 3.95% (on a share price total return basis according to Morningstar). There were several reasons for the significant sell-off the last three months of the year, including a significant supply of new individual municipal bonds flooding the market which put pressure on existing municipal bonds, a general increase in long-term interest rates, disappointment that the Build America Bonds program was not extended, concerns about credit conditions in the municipal bond market and outflows from open-end municipal funds put pressure on prices of existing municipal bonds.

Despite the sell-off in municipal closed-end funds during the fourth quarter, I believe municipal funds are poised to perform better in 2011 for the following 3 reasons:

1. **The Municipal Yield Curve Remains Very Steep:** With short-term interest rates still at exceptionally low rates, leveraged municipal funds continue to benefit significantly from the steep municipal yield curve as they are able to borrow at low interest rates and then earn a meaningful spread on the longer-term bonds they invest in with the leverage proceeds. While I am concerned about the potential for short-term rates to move higher, for now I believe investors should continue to own municipal closed-end funds in order to take advantage of the very steep yield curve which has enabled many municipal funds to increase distributions the past two years.
2. **Steep Yield Curve Has Created Very Attractive Yields Among Municipal Closed-End Funds:** In large part as a result of this steep municipal yield curve, municipal closed-end funds are able to earn (emphasis on earn) very attractive tax-free yields. According to Morningstar, the average leveraged municipal closed-end fund yields 7.17%. This is significantly higher than the three-year average of 5.46% and the five-year average of 5.76%. Furthermore, I believe dividends for most municipal closed-end funds remain secure and we could potentially see even more dividend increases in 2011 as many municipal funds continue to over earn their monthly dividends and have built up a significant amount of undistributed net investment income (UNII) which could be used to raise dividends.
3. **Credit Conditions Remain Solid for Most Municipal Bonds:** While many states and municipalities face stress in their budgets, it might surprise investors to know that defaults have actually been trending down the past 2 years in municipal bonds from the record set in 2008. Indeed, according to Bloomberg, in 2010 (through October), defaulted securities fell to \$2.48 billion. This is less than the \$7.28 billion in 2009 and the record in 2008 of \$8.15 billion. To put those numbers in perspective, according to Forbes Magazine, there were \$157.7 billion worth of corporate bond defaults alone in 2008. Also, bear in mind the total municipal bond market is enormous, with over 50,000 different issuers of municipal bonds (according to T. Rowe Price) and over \$2.8 trillion outstanding. While there is always the potential for defaults to move higher, it is important to note that the historical default rate on municipal bonds remains exceptionally low. Moody's recently released a default study covering the period from 1970 to 2009. During that time, only 54 of the 18,400 municipal issuers rated by Moody's had defaulted. Of those, 78 percent were in the hospital and housing project finance areas. Only 5 of the 54 defaults, or 5 out of 18,400 municipal bonds involved General Obligation debt. Furthermore, it is important to note that most municipal closed-end funds are invested in well over 100 individual municipal bonds and most municipal closed-end funds focus on the highest-quality municipal bonds.

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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