Closed-End Funds
Special Report

Tax-Exempt Closed-End Funds Weather Price Declines

Asset Coverage Remains Strong

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Related Research

Applicable Criteria
- *Closed-End Fund Debt and Preferred Stock Rating Criteria, Aug. 17, 2009*

Other Research: Closed-End Funds
- *Closed-End Funds: Evolving Use of Leverage and Derivatives, Sept. 27, 2010*
- *Closed-End Funds: Redemptions Provide Some Liquidity to Illiquid ARPS Market, Aug. 31, 2010*

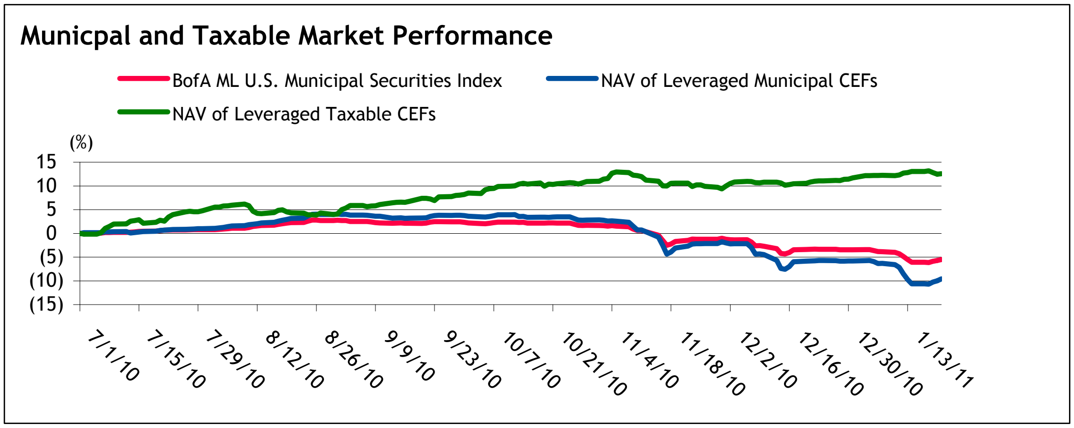
Other Research: Public Finance
- *U.S. State and Local Government Pensions (One Size Does Not Fit All), Jan. 7, 2011*
- *U.S. State and Local Government Bond Credit Quality: More Sparks than Fire, Nov. 16, 2010*

Summary

In the final months of 2010 and into 2011, the tax-exempt municipal bond market experienced meaningful price erosion, as evidenced by the 7.1% decline in the BofA Merrill Lynch U.S. Municipal Securities Index since Nov. 1, 2010. In fact, the municipal bond market declined steadily from August–October, with more pronounced declines through year-end 2010 and into 2011. Key drivers of the increased volatility included:

- Perceived financial weakness of certain municipal entities, including the perception that financial restructuring/bankruptcy risk may have increased.
- Market expectations of higher future inflation.
- The expectation that the Build America Bonds (BABs) program would not be extended, thereby increasing tax-exempt issuance in 2011 and the risk of supply/demand imbalances.
- Uncertainty over future tax rates.

Declines in municipal bond prices were, in turn, reflected in the net asset values (NAVs) of closed-end funds (CEFs) investing in tax-exempt securities, especially leveraged CEFs. Asset coverage ratios of leveraged CEFs also declined, although they remain at high levels.



Highlights

- Based on Fitch Ratings' review of 212 leveraged tax-exempt CEFs, the average CEF NAV declined 12% between Nov. 1, 2010 and Jan. 21, 2011. Conversely, the average NAV for 195 leveraged taxable CEFs increased 1.6% during the same period, reflecting more stable asset prices.
- The declines in municipal bond prices resulted in lower asset coverage available to debt and preferred shares issued by municipal CEFs. However, with respect to

Fitch-rated CEF leverage, existing asset coverage levels remain well above minimum levels deemed consistent with the assigned ratings.

- For municipal CEFs with leverage rated by Fitch, average asset coverage declined from 321% on Nov. 1, 2010 to 299% on Jan. 21, 2011, well above the 200% minimum threshold that would lead to active deleveraging to restore asset coverage.
- Among single-state CEFs, the worst NAV decline experienced was 21.4% in a CEF that invests primarily in bonds issued in California, reflecting the impact of credit stresses and market price declines in the state, as well as fund-specific asset selection and leverage.
- Fitch perceives higher risk, on average, for single-state CEFs relative to nationally diversified CEFs, particularly with respect to those single-state funds invested in states facing budgetary crises. As a result, Fitch's rating criteria call for higher asset coverage (lower leverage) for single-state CEFs.

Municipal Market Dynamics

As mentioned, the key drivers of municipal asset price volatility over the past several months included increasing concern over the financial condition of various municipal entities, the impact of inflation expectations on bond yields, shifts in supply/demand dynamics, and tax uncertainty.

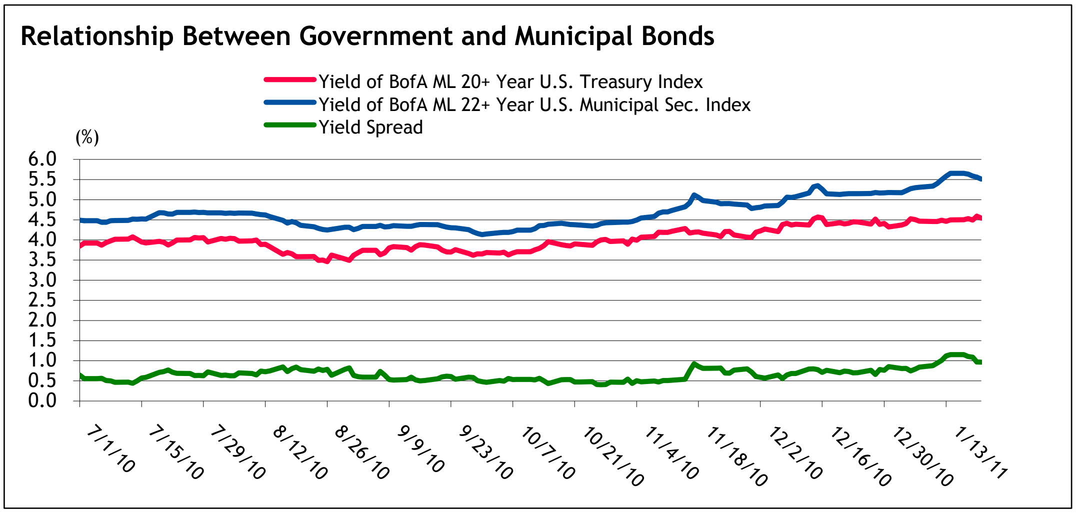
Uncertain Financial Condition of States and Municipalities

Concerns over the financial condition of certain municipalities also contributed to the recent sell-off in municipal bonds. Retail investors, in particular, have been influenced by increased media coverage of budget shortfalls and unfunded pension and other post-employment benefits (OPEB) obligations by states and municipalities. Another concern is whether the perceived stigma of bankruptcy or financial restructuring by municipal issuers has diminished, thereby increasing the risk of investing in tax-exempt securities of all kinds.

While recent legislative actions *(see below)* with respect to taxes and the BABs program add clarity (at least over the next two years) to the overall tax-exempt market picture, municipalities' fiscal problems may remain a source of volatility in the tax-exempt market going forward. Recognizing that not all municipalities should be painted with the same broad brush, the NAV performance and asset coverage of specific tax-exempt CEFs will be heavily influenced by the overall credit conditions of the state in which the fund invests, as well as the individual fund manager's asset selection and ability to identify municipal debt obligations backed by strong, stable, and predictable sources of revenue.

Inflation Expectations

Confidence in the recovery of the U.S. economy has increased over the past several months, raising the prospect of higher inflation and interest rates in the future. In response, yields on fixed-income securities, especially those with long maturities that are more sensitive to interest rate fluctuations, have risen, accounting for some of the decline in the prices of municipal bonds in recent months. The chart on the next page illustrates the strong correlation between yields on U.S. government securities, which are viewed as a benchmark for interest rates, and municipal bonds. The chart also highlights the widening yield spread between government and municipal bonds in the latter part of 2010 and early 2011, explained largely by the other municipal market dynamics discussed in this report.



Supply/Demand Dynamics

The expiration of the BABs program at year-end 2010 created temporary supply/demand imbalances, as municipal borrowers sought to utilize the program prior to expiration and investors anticipated a return to traditional municipal issuance via the tax-exempt market in 2011. BABs were issued on a taxable basis, with a portion of the interest subsidized by the federal government to maintain low financing costs for municipalities. These features attracted investors who traditionally did not buy tax-exempt municipal bonds, including out-of-state and foreign investors, moving a large portion of the municipal market's supply into the taxable bond market. According to the Bond Buyer, $117.3 billion of BABs were issued in 2010, accounting for 27% of the municipal bond market. With the BABs program ended, Fitch expects municipalities to return to their traditional avenue of financing via the tax-exempt market. Yields for municipal bonds increased at year-end 2010, due in part to investor concern that this shift back to tax-exempt issuance may overwhelm investor demand for these securities in 2011.

Tax Uncertainty

On Dec. 17, 2010, new tax legislation was signed into law in the U.S., ending market speculation as to the tax environment in 2011 and 2012. The new law avoided an increase in current individual income tax rates, which would have otherwise occurred after Dec. 31, 2010. Tax rates are an important factor in determining the yield paid by municipalities on their bonds, since income from these securities is exempt from federal and state taxes (in the state in which the bond is issued). Given the temporary nature of the legislation, volatility related to tax considerations is expected to continue to some extent, especially as the extension to current tax rates gets closer to the expiration date (year-end 2012).

2010 Closed-End Fund Performance

Bond prices have been driven down as some investors fled the tax-exempt municipal bond market due to the factors described above. This trend is evidenced by recent record redemptions from open-end mutual funds investing in municipal securities. According to a report by Lipper FMI, $4.0 billion and $29.3 billion was redeemed from the funds in the one- and 10-week periods ended Jan. 19, 2011, respectively. While average municipal bond prices tracked by the BofA Merrill Lynch U.S. Municipal Securities Index increased 2.7% between January 2010 and October 2010, performance quickly turned negative, with the index falling 7.1% between November 2010 and January 2011.

Tax-exempt CEFs performed in step, with the average NAV for leveraged tax-exempt CEFs declining 12% between Nov. 1, 2010 and Jan. 21, 2010. The average common stock price for these funds fell 13.5% during the period. Conversely, taxable CEFs, including funds backed by taxable bonds, loans, convertibles, preferred stock, and common equity, did not experience the same negative performance. Specifically, the average NAV for 195 leveraged taxable funds increased 1.6% during the past two-and-a-half months. The chart on page 1 illustrates these trends.

Performance of tax-exempt CEFs also varied based on the credit strength of the individual state where the fund focused its investment. For example, CEFs investing primarily in municipalities in California (general obligation bonds rated 'A–' by Fitch, the lowest rating among the 50 states) experienced an average NAV decline of 14.1% from November 2010–January 2011, compared with an average NAV decline of 8.5% for CEFs investing in municipalities in North Carolina (general obligation bonds rated 'AAA' by Fitch).

Additionally, the characteristics of each fund and the capabilities of the manager play important roles. Within municipal California CEFs, the worst performing fund lost 21.4% of NAV between Nov. 1, 2010 and Jan. 21, 2011, while the best performer in the state lost only 5.9% over the same time frame. Factors influencing these differences in performance include the credit quality, duration, and diversification of the portfolio, as well as the degree to which a fund is leveraged.

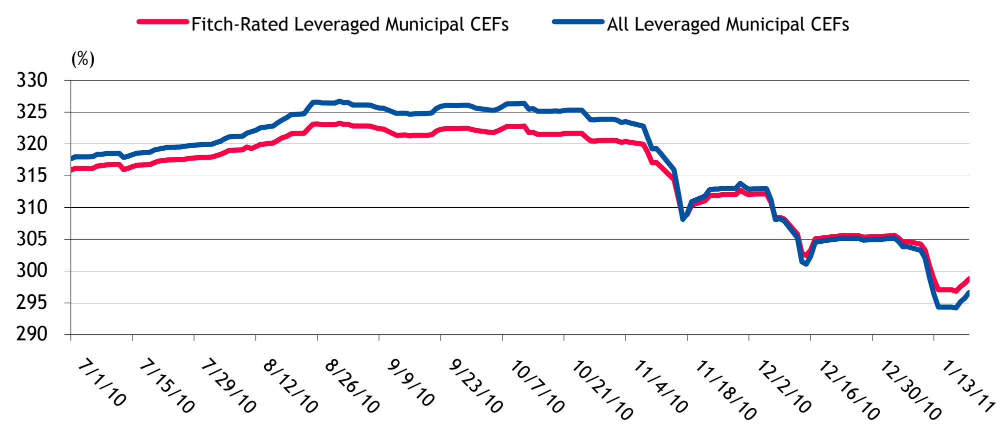
Asset Coverage

Price declines in the municipal market affected asset coverage levels available to investors in leverage issued by CEFs, but existing structural protections are intended to provide safeguards through market cycles.

Calculating Asset Coverage
In assigning ratings to CEF debt or preferred shares, Fitch calculates asset coverage based on the Fitch overcollateralization (OC) tests, as well as coverage tests mandated by the Investment Company Act of 1940 (1940 Act tests). The Fitch OC tests take into account portfolio asset discount factors, diversification framework, and senior fund leverage, as outlined in Fitch's rating criteria.

Given that Fitch does not rate the entire universe of CEFs reviewed for this report, as well as the limited availability of publicly reported data on certain senior liabilities of CEFs, Fitch relied on the 1940 Act tests to calculate asset coverage levels for this report. For the purposes of calculating the 1940 Act test for preferred shares, Fitch incorporated each fund's NAV and common shares outstanding, as well as the total amount of preferred stock outstanding as of the most recent publicly available financial report, which may not be inclusive of total leverage.

Avg. Asset Coverage Ratios Available to Preferred Shares Issued by CEFs



Reduced Coverage Levels

Despite the observed asset price declines, Fitch-rated municipal CEFs continue to maintain asset coverage for debt and preferred shareholders consistent with the assigned ratings, albeit with less cushion than previously maintained. For municipal CEFs with outstanding leverage rated by Fitch, average asset coverage declined from 321% on Nov. 1, 2010 to 299% on Jan. 21, 2011. The average asset coverage level for all leveraged municipal CEFs similarly fell from 324% to 297% during the same period. Put another way, on Nov. 1, 2010, funds had, on average, $324 in market value of assets to support every $100 of fund leverage, but, by Jan. 21, 2011, this value declined to $297. As the chart above shows, the initial coverage levels provided a large cushion for CEFs to weather subsequent declines in municipal bond prices. In fact, based on the average level of asset coverage as of Jan. 21, 2011, Fitch-rated municipal funds were positioned to withstand, on average, an additional asset price decline of 33% before breaching the preferred share asset coverage of 200% and, thus, be required to deleverage.

Structural Protections

Leveraged municipal CEFs primarily utilize preferred stock as leverage, as well as, to a lesser extent, inverse floating-rate securities issued by tender option bond (TOB) trusts. Leveraged CEFs implement structural protections for note and preferred shareholders that require mandatory redemption of preferred stock and other leverage if the market value of assets declines below certain levels, compared with the amount of leverage outstanding. For Fitch-rated CEFs, Fitch reviews the fund's structural protections and compares them with the rating stresses outlined in the agency's rating criteria, while also monitoring the funds' asset coverage using Fitch's overcollateralization (OC) tests. In the event asset coverage ratios breach minimum required levels, Fitch expects CEFs to sell assets to redeem outstanding leverage or reposition portfolios more conservatively to restore appropriate coverage levels. Fitch OC tests may provide additional protections beyond those offered by the Investment Company Act of 1940, as they incorporate higher discounts to more volatile assets like nonrated and below investment-grade securities and contemplate forms of leverage, such as TOBs, that may not be captured by the 1940 Act tests.

Outlook

While there appears to be more clarity on certain tax and supply dynamics, perceived credit conditions and, to a lesser extent, inflation concerns are expected to exert material price influence on municipal securities over the near term.

With respect to ratings assigned to CEF leverage, Fitch will continue to monitor the impact municipal market developments may have on asset prices and coverage levels. At present, Fitch does not anticipate negative rating actions, even in the event of additional asset price declines, given the excess asset coverage funds currently maintain, as well as the deleveraging mechanisms in place to ensure that asset coverage is restored, should it decline below threshold amounts.

Moreover, Fitch continues to regularly assess the appropriateness of its rating criteria in light of market developments. Particular scrutiny has been placed in recent months on the risk associated with the concentration of a CEF's portfolio holdings in a single state.