2008 was a painful year for closed-end fund investors. The worst one-year performance for the Dow Jones Industrial Average since 1931, coupled with an extremely difficult year for credit sensitive fixed-income securities, created a very challenging environment for closed-end funds. The list of events which also contributed to a difficult environment for closed-end funds in 2008 includes: the failure of the auction rate preferred securities (ARPs) market; funds having to reduce their dollar amount of leverage in order to maintain the required asset coverage ratios which led some funds to reduce distributions; the bankruptcy of Lehman Brothers which created a heightened and palpable amount of fear and panic in the financial markets; and finally a dramatic flight to safety which helped to push yields on U.S. Treasuries to historical lows. All 34 Lipper categories of closed-end funds were lower for the year.

For the year, the 3-worst performing categories on a share price total return basis were:

- Real Estate Funds -59.38%
- Emerging Market Funds -54.41%
- Pacific Ex Japan Funds -52.38%

The 3-best performing categories on a share price total return basis were:

- Non-Leveraged Municipal Funds -7.70%
- Intermediate Municipal Funds -10.85%
- Investment Grade Bond Funds (non-U.S. Govt) -11.51%

Despite an extremely difficult year for closed-end funds, there was a sliver lining which occurred toward the end of the year.

Throughout the year I had remained cautiously optimistic there would be stability in the financial markets and investors would jump in to take advantage of the large discounts and yields available in the closed-end fund marketplace. Unfortunately, as the third quarter progressed and as we headed into the fourth quarter, the global financial markets continued to be extraordinarily volatile and discounts on closed-end funds widened to a ten-year high of 26% percent on October 27. Bear in mind the 10-year average discount for all closed-end funds is only 4%. However, the silver lining to a very tough year did begin to occur as the month of December commenced and many closed-end funds staged a very powerful rally. Indeed, a basket of convertible closed-end funds that I monitor was up just under 30% from November 25 to the end of the year. Another basket of municipal closed-end funds was up 20% from December 16 to the end of the year. While one very strong month cannot make up for the rest of the difficult year, if some of the ingredients which helped cause the rally to occur at the end of 2008 remain present in 2009 (which I think some will) this year could be a better year for closed-end fund investors than 2008.

Several of the positive contributing factors which helped closed-end funds toward the end of the year included:

1. An end to year-end tax loss selling pressure.
2. Stabilization in the equity markets.
3. A reduction in the overall level of fear and panic in the global financial markets.
4. Bottom fishing on the part of investors to take advantage of the historically deep discounts.
5. Relief after some closed-end funds which had to postpone distributions due to asset coverage ratio issues, were slowly announcing they would be paying them again.
6. Very low borrowing cost for leveraged funds which helps the earnings power of a fund.

As we begin 2009, discounts remain attractive with an average discount of 14%, according to Lipper, which should be enticing for investors looking to taking advantage of the values which exist in the closed-end fund marketplace. Borrowing costs remain low and should be for the foreseeable future. I think the most important ingredient to a better 2009 for closed-end funds and (as I stated in my last commentary) the biggest wildcard will be if the equity and credit markets continue to stabilize and perform better. If this occurs, 2009 should be much better for closed-end funds.
Two of my favorite categories for 2009 are leveraged municipal funds and equity-oriented funds. Leveraged municipal funds are particularly attractive for two reasons:

1. The municipal yield curve is very steep right now, so leveraged municipal funds are able to borrow money at exceptionally low rates of approximately 1.5% and invest in high quality, long-term municipal bonds with yields between 5.5% and 6.5%. Due to the large spread between what a leveraged municipal fund is borrowing at and reinvesting at, I believe it is likely that leveraged municipal funds will be able to increase dividends in 2009.

2. I also believe that as an asset class, municipal bonds are extremely attractive due to their historically high yields versus U.S. Treasuries. Despite their generally high credit quality characteristics, municipal bonds have not benefited from the dramatic flight to safety we saw in 2008, which pushed yields on U. S. Treasuries to record lows. Therefore, I believe municipal bonds remain undervalued and very attractive for investors looking for steady tax-free income.

I also find equity-oriented funds compelling for investors who want high income but also the potential for growth, which equities historically provide. Equity income-oriented funds currently provide investors with:

1. Distributions, on average, above 10%.
2. Average discounts above 10%.
3. With most major equity indexes lower by 40% over the past year, the opportunity to get "paid to wait" for the equity markets to recover in the form of very high distributions is compelling for the appropriate investor looking for income but also exposure to equities.

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.

All opinions expressed constitute judgments as of the date of release, and are subject to change without notice. There can be no assurance any forecasts will be achieved. The information is taken from sources that we believe to be reliable but we do not guarantee its accuracy or completeness.