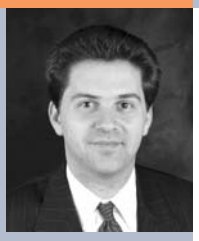
CLOSED-END FUND

SPECIAL REPORT

Jeff Margolin



Senior Vice President,
Closed-End Fund Analyst

MARCH 20, 2012

Municipal Closed-End Funds: Selloff overdue, but also overdone

In previous communications, I mentioned that investors should expect more price volatility in municipal closed-end funds (CEFs). However, I certainly did not expect that the YTD gains would be wiped out in three days. While I believe some profit taking in the muni CEFs was perhaps overdue (municipal closed-end funds have essentially been on a straight line up the past 14 months), I also believe last week's selloff was overdone. When looking at this type of volatility in such a short time period, I immediately ask myself two questions (among others):

1. Has there been a dramatic change in the fundamentals to warrant this type of violent selloff in share prices?
2. Has the category had a big move upwards recently and, therefore, valuations are not as attractive and profit taking could be occurring?

In regards to the first question, while long-term interest rates did tick up last week, and perhaps did spook some investors, the increase only caused the net asset values (NAVs) of all municipal closed-end funds to decrease 0.83% last week, according to Morningstar. Share prices on the other hand were lower by a much more significant 5.95%, also according to Morningstar. This indicates to me that investors overreacted to the weakness in muni bonds and NAVs as is often the case with CEFs. Dividends for most muni funds remain stable. There were roughly 15 muni CEF dividend increases this month and roughly 15 muni CEF dividend decreases this month, but most of the 254 muni funds have had stable dividends recently, according to Morningstar.

With regard to the second question, there is no doubt that municipal closed-end funds have been on a tear the past 14 months. With the average muni CEF starting last week at a 2.4% premium to NAV, according to Morningstar, there was less value in muni funds and investors were likely taking some profits after a significant move upwards. As is often the case with CEFs, the selloff in funds is often overdone relative to the weakness in the underlying NAV. I think that was evident last week by the mini-panic, which fed on itself from Wednesday through Friday and gained steam as the week went on.

When there is not one obvious reason for this type of meaningful selloff, investors are often hungry for reasons why it occurred. I think there are a handful of reasons which caused the selloff, but it is hard to pick just one. Here are several which likely caused the weakness:

1. The selloff in long-term bonds on Wednesday gave investors a reason to take some profits in muni CEFs, many of which were up over 20% in the past year, according to Morningstar.
2. The fact that average premiums to NAV were over 2%, according to Morningstar, also gave investors a reason to take some profits.
3. With the Dow Jones Industrial Average firmly over 13,000 for several days, there was likely a rotation out of bonds and into equities.
4. A prominent analyst with negative views on the credit conditions for municipal bonds reiterated those views mid-week on CNBC.
5. Selling pressure feeds on itself and creates even more selling among retail investors. This is particularly true with CEFs (most of which are owned by retail investors) and because a lot of muni CEFs are thinly traded. The downward share price moves can be quite severe even if the NAVs are not down nearly as much.

While a selloff in muni CEFs was overdue, I also think it was overdone. Indeed, the average discount to NAV among all muni funds is now an attractive 3.14%, as of 3/16/12, according to Morningstar. The five-year average discount to NAV is 1.25% and the ten-year average discount to NAV is 1.83%. It was a 2.4% premium to NAV to start last week. Furthermore, the average yield on the universe of national leveraged funds is now 6.46%, according to Morningstar. It was 6.02% a week ago. I believe these are compelling tax-free yields and valuations. I expect buyers to return early this week to take advantage of these newly formed opportunities.

Domestic equity CEFs and senior loan CEFs continue to be the areas of the CEF marketplace in which I have the highest levels of conviction. I also continue to advocate that income investors maintain exposure to muni CEFs for the high tax-free income they provide, the high credit quality characteristics they maintain and the balance they can provide in a portfolio, which should also include equity funds and credit sensitive funds like senior loan funds.

First Trust
First Trust Advisors L.P.
1-630-915-6784
www.ftportfolios.com

All opinions expressed constitute judgments as of the date of release, and are subject to change without notice. There can be no assurance 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.