CLOSED-END FUND review

Jeff Margolin

Senior Vice President, Closed-End Fund Analyst

FIRST QUARTER 2012

First Quarter Overview

The first quarter was a very rewarding quarter for most closed-end fund categories. In fact, the rally was so broad-based, not only were domestic & international equity funds and credit-sensitive funds (such as high-yield and senior loan funds) positive for the quarter, but so too were high-quality municipal funds. Indeed, the average closed-end fund was up 6.34% on a share price total return basis for the first quarter, according to Morningstar. Buoyed by a 12% increase in the S&P 500 (the best first quarter for this index since 1998) as well as strong international equity markets, many of the best-performing categories for the quarter were equity-oriented ones. In fact, convertible funds were up 13.28%, domestic equity funds were up 11.10%, and the universe of all equity funds was up 10.14% for the quarter, according to Morningstar. Not to be outdone, the attractive yields, very low default rates and a renewed willingness on the part of investors to take credit risk led many credit-sensitive asset classes (such as high-yield and senior loan funds) to also post very impressive first quarter results. High-yield funds were up 8.03% and senior loan funds were up 10.79% on a share price total return basis, according to Morningstar.

Municipal Closed-End Funds

Coming off a year in which the average municipal closed-end fund was up 21%, municipal funds also had a strong quarter and were up 2.44% on a share price total return basis, according to Morningstar. Municipal funds continue to benefit from relatively low leverage cost, which is enabling the average fund to yield a compelling tax-free 5.85% (according to Morningstar). Furthermore, supply of individual municipal bonds remains below 2010 levels and that is helping to create demand in the secondary market for municipal bonds and municipal closed-end funds as investors search for places to generate tax-free income. Investors also continue to be concerned about the potential end of the Bush tax cuts at the end of 2012 and several states (including New York) have recently raised state income taxes, which also creates demand for municipal funds. California, another large state, could also potentially be increasing state income taxes later this year. Lastly, the overwhelming majority of municipal closed-end funds are investment-grade so investors are earning these yields from high credit-quality bonds.

Despite the fact that municipal funds had another solid quarter, there was a three-day period (March 14-16) when the share prices of municipal funds were down an average of 6% despite the fact that net asset values (NAVs) were only lower by 0.83%. (Please see Special Report from March 20th entitled, "*Municipal Closed-End Funds: Selloff overdue, but also overdone*".) While there was not one specific factor which caused this sell off, it was most likely related to the fact that long-term interest rates spiked during that particular week and many funds were trading at premiums to their NAV which caused investors to take some profits after a very strong 14-month period. Nonetheless, while I do continue to advocate investors maintain exposure to both leveraged municipal funds and non-leveraged municipal funds as well, I do think the volatility we saw during that three-day period does illustrate there is duration risk in municipal funds and should long-term interest rates trend higher at some point this year, that could put pressure on municipal funds. Therefore, I think it is important for investors in municipal funds to lower their expectations relative to the types of total returns these funds have posted over the past year and to expect more share price volatility. That said, municipal closed-end funds continue to distribute very attractive tax-free income and I think should continue to be part of a diversified income portfolio to create balance, which should also include domestic equity funds, senior loan funds and limited duration funds.

Categories of Highest Conviction in 2012 Remain Domestic Equity Funds and Senior Loan Funds

In my commentary piece from January of this year, I stated that the two categories of the closed-end fund marketplace in which I had the highest conviction level were domestic equity funds and senior loan funds. This was based on compelling fundamentals and attractive valuations. While I am very pleased with the share price total returns for domestic equity funds and senior loan funds in the first quarter (up 11.10% and 10.79% respectively) and continue to believe the fundamentals and valuations remain compelling for both of these categories, it is important for investors not to expect these types of results every quarter. These are two categories I like for income and total return investors for the next 12-18 months and should we see any periods of volatility or weakness in the coming quarter, I would encourage investors to add to these categories.

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Indeed, the fundamentals for senior loans remain compelling, with the default rate at only 0.61% as of the end of March (according to S&P LCD). The historical average is a much higher 3.28%. Furthermore, the average senior loan is still trading at a slight discount to par at 93.74 cents on the dollar as of 3/30/12 (according to the S&P/LSTA Leveraged Loan Index). Senior loan funds also provide investors with a compelling yield of 7.13% (according to Morningstar) and given the floating rate nature of the interest on a senior loan, provide that income with limited duration risk. While discounts to NAV are only 1.3% for senior loan funds, they are still wider than the five-year average 0.29% premium to NAV they historically trade at.

Our Chief Economist's outlook is that the U.S. economy will continue to grow this year, and as well, our Chief Investment Officer's outlook is that companies in the S&P 500 will continue to see positive year-over-year earnings per share growth in 2012. Couple this with the fact that the average domestic equity fund trades at a 4.56% discount to NAV according to Morningstar (more attractive than the five-year average premium to NAV of 0.8%), and domestic equity funds also remain a compelling category for closed-end fund investors, in my opinion. Plus, the average domestic equity fund pays a distribution yield of 7.52%, so investors are getting paid for the equity risk they are taking.

Outlook for Second Quarter 2012

I continue to advocate closed-end fund investors build diversified, blended portfolios with positions in several key categories including domestic equity funds, senior loan funds, limited duration funds and municipal funds for attractive current income and the potential for growth (particularly with domestic equity funds and, to a lesser degree, senior loan funds). I continue to believe it makes sound investment sense to combine equity funds which have equity risk (but have growth potential) with senior loan funds and limited duration funds (which have credit risk but provide attractive income with limited duration risk) with municipal funds (which have duration risk but earn very attractive tax-free income with limited credit risk, based on the historical default rate for investment-grade municipal bonds).

Lastly, while the first quarter was extremely fruitful, it is rare to experience these type of broad-based gains with such limited volatility (which is what we experienced in the first quarter) and therefore I do think closed-end fund investors should be prepared for more volatility in the coming quarter and be prepared to add to positions in the categories I just discussed, should discounts widen out and opportunities present themselves. 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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