Closed-End Fund Review

Jeff Margolin, Vice President
Closed-End Fund Analyst

FIRST Trust ADVISORS L.P.

FOURTH QUARTER 2005

Third Quarter Results

While 14 of the 20 closed-end fund categories that we monitor posted a positive market price total return in the third quarter, much of those gains occurred in July and August as many categories traded lower in the month of September partly as a result of the Federal Reserve Open Market Committee (FOMC) raising the Federal Funds rate for the 11th consecutive time (from 3.50% to 3.75% on September 20th.) In fact, 16 of the 20 categories had a negative market price total return in the month of September. The continued rise in the Fed Funds rate is putting pressure on the earnings rates of many leverage funds, forcing these funds to reduce dividends which often leads to lower market prices. This phenomenon was evident in the month of September as several leveraged, municipal bond funds reduced their dividends. NAV performance was good in the quarter with 15 of 20 categories posting positive NAV performance. No category was lower by more than 1% on an NAV total return basis. Based on total return, the top performing categories in the third quarter were:

	Market Price	NAV
International Equity	up 16.81%	up 12.43%
Sector Specific Funds (including Energy)	up 6.78%	up 5.90%
Growth & Income funds	up 4.43%	up 1.82%
Convertible funds	up 3.03%	up 5.07%

The worst performers were Preferred funds (down 1.90% based on Market Price) and Investment-Grade bond funds (down 0.54% based on NAV).

Spotlight on Covered Call, Municipal and Senior Loan Funds

After having traded at an average premium to NAV of 2.41% over the past 52- weeks, **Covered Call funds** finally had a sell-off in the month of September declining 1.79% as a group, now trading at an average discount to NAV of 0.54%. I believe a minor sell-off in the Covered Call funds was to be expected considering that these funds had traded at premiums to NAV for the better part of the past year and considering that there has been a large supply of Covered Call funds brought public this year. At least 19 Covered Call funds have gone public in 2005 and often times when there are so many new issues coming public in one category it puts pressure on existing funds in the market place as some investors swap out of an existing fund and into a new one. This is particularly prevalent when the funds in the secondary marketplace are at premiums to NAV and have a positive total return as is the case with many Covered Call funds. Even with the sell-off in September, the average Covered Call fund was up 0.73% in the third quarter and is up 4.36% year-to-date.

While **National Municipal funds** were up 0.89% for the third quarter, they did begin to trade lower in the month of September (as did many state specific funds) with the category lower by 0.65%. New York municipal funds fared worse, declining 1.74% in September, and the category of "Other State Municipals" which includes funds from states such as New Jersey, Florida and Pennsylvania was lower by 1.44%. We believe the reason for the weakness is related to the continual increase in the Fed Funds rate which increases a leveraged municipal fund's borrowing cost. In an environment in which short-term interest rates are rising, portfolios that use leverage generally experience higher borrowing cost and consequently have less money to distribute to investors in the form of dividends. Therefore, many funds are forced to reduce their dividend, which often puts pressure on the market share price as was the case in September. Many municipal funds over the past several years had built up their U.N.I.I. balances (undistributed net investment income) which is essentially a reserve cushion that they could tap to help support dividends as borrowing cost increased. However, at this point, many funds have gone through their reserve cushions and have had to significantly reduce dividends, thus putting pressure on market prices. Municipal funds were also hurt by falling bond prices which put pressure on the NAV's of the funds in the month of September.

As we experience this volatility in the municipal funds, it is important to remember that the long-term track record of municipal closed-end funds is quite good with the average National Municipal fund up an annualized 8.6% over the past 5 years, and even with the dividend reductions, yields remain attractive. However, investors should be prepared for potentially more volatility because until the increase in borrowing costs abates, many municipal funds could continue to see pressure on their dividends and potentially the market price.

Even though the average **Senior Loan fund** was up 0.92% on a market price basis for the third quarter, the performance in September, as well as the year-to-date performance, has not been as good. In fact, the average Senior Loan fund was down 1.21% in the month of September and is lower by 4.62% for the year despite an average 4.31% year-to-date increase in NAV. The environment for Senior Loans remains solid, which makes the poor market price showing frustrating. Short-term interest rates continue to rise, dividends & yields continue to rise, default rates remain low and valuations are attractive with the average Senior Loan fund at a 7.95% discount to NAV versus a 52-week average discount of 2.04%. It is difficult to know why the market price of the Senior Loan funds has not performed well and kept up with the solid NAV performance. Two possible explanations are that investors have been moving money into the Covered Call funds from Senior Loan funds over the past year, thus putting pressure on the price of the Senior Loan funds and that investors believe the FOMC is not going to raise rates much further and therefore there is less of a need for exposure to Senior Loans. Either way, Senior Loan funds could potentially see a slight rebound over the coming months if the FOMC continues to raise short-term interest rates and the economy remains solid as valuations and yields are attractive (average yield 7.25%).

Final Thoughts

It is important to note that the fourth quarter is historically the most volatile for closed-end funds primarily as a result of year-end tax related selling. Discounts often widen at the end of the quarter only to narrow in January and February of the following year as investors purchase funds that have been beaten down at the end of the previous quarter. This historically makes January and February one of the best times of year for closed-end funds. Furthermore, if the FOMC continues to raise short-term interest rates when they meet again in November and December, it could put pressure on certain leveraged funds. We believe investors should be prepared for this volatility. However, once the FOMC has signaled it is nearing the end of its tightening phase, many Closed-end Fund categories could potentially benefit. Lastly, 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.