Closed-End Fund Review

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FOURTH QUARTER 2006

Fourth Quarter and 2006 Results

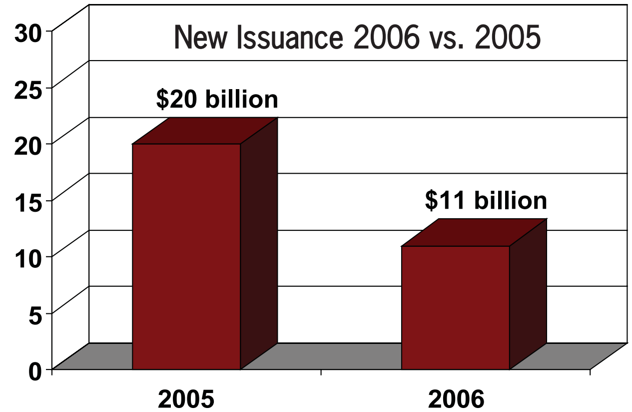
A Remarkable Year. The performance of closed-end funds in the fourth quarter was emblematic of how most funds performed during the entire year. We break the universe of over 630 funds into 21 categories and all 21 categories were positive for the final quarter and full year of 2006. In fact, not only was every broad category positive for the year, but 18 of the 21 categories were up double digits. The year was characterized by solid results and low downside volatility. In fact, only the second quarter of the year had any meaningful broad-based weakness and that was short lived. 2006 was a truly remarkable year for the performance of closed-end funds.

Own for the Long-Term. While the one-year total return statistics are impressive for the 21 major categories, I believe it is important during good times (i.e. 2006) and difficult times (i.e. fourth quarter of 2005) to examine the longer-term results of closed-end funds. To this end, all 20 categories have a positive market price total return over the past five-years (please note that the Covered Call category is a relatively new one and therefore data does not go back five years). This fact illustrates the benefit of owning closed-end funds for the long-term.

The Year in Review. Many factors contributed to the solid year closed-end funds had in 2006. Certainly the strong underlying performance of the equity and fixed-income markets had a positive impact. However, because of the structure of a closed-end fund where the share price trades independently of the net asset value (NAV), there were other factors which helped.

After a brutal fourth quarter of 2005 which saw discounts increase to over 10% for many funds, investors embraced these bargains with a vengeance in the first quarter of 2006 which helped set the tone for what would become a very solid year. While there was a slight pull-back in the second quarter as the Federal Open Market Committee (FOMC) continued to raise short-term rates (thus leading to higher leverage costs and the threat of more dividend cuts), by the summer after 17 straight increases in the Federal Funds rate the FOMC decided to "pause". I believe this "pause" convinced many closed-end fund investors that despite the possibility that the FOMC would increase short-term interest rates again, it appeared that the Fed was likely closer to the end than the beginning of its tightening phase. This encouraged investors to feel more comfortable with leveraged funds as it meant that borrowing costs would be more stable.

Another factor which helped the secondary market of closed-end funds was the fact that the initial public offering (IPO) market for funds slowed down markedly in 2006. There were 21 new issues last year raising approximately $11 billion. This compares to the 47 new funds and over $20 billion raised in 2005. The slow-down in new issues re-focused investor's attention on the secondary market and the many opportunities that exist there. (See my "Outlook for 2007" for more information on IPOs on the second side of this report.)



Attractive Yields. A common theme which gets a fair amount of attention from investors is the aging of the population and all of the baby boomers who either just retired or are getting ready to retire. Certain sectors (i.e. healthcare) are often viewed as potential beneficiaries of the aging of the population. I believe another potential beneficiary is the closed-end fund marketplace. As baby boomers retire they are likely going to need more income from their investment portfolios and even with the 17 increases in the Federal Funds rate, yields on traditional income-oriented investments remain low by historical standards. Money market funds and certificates of deposit are generally in the 4%-5% range. The 10-year U.S. Treasury Note yields only 4.65%. These relatively low yields have caused investors seeking income to gravitate to closed-end funds as a way to increase yields within their portfolios. This trend was evident in 2006 as investors were attracted to the yields offered by many funds and I expect it to continue.

In my third quarter commentary piece (published in October), I discussed my belief that the fourth quarter of 2006 would not have nearly as much tax-loss selling as the fourth quarter of 2005. The main reason for this assertion was due to the fact that there were simply fewer losses for investors to take relative to 2005. This turned out to be the case and the fourth

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quarter did not have any significant amounts of tax-loss selling. The absence of this selling helped to contribute to a solid fourth quarter and 2006. The fact that the fourth quarter was so strong and there was very little tax-loss selling likely means we will not have quite as big of an upside move in the prices of funds in the early part of 2007 as we did in early 2006.

Outlook for 2007

While 2006 was a great year for many closed-end funds, I think it is unlikely that a year from now, when I write my 2007 year-end review, that all 21 categories will have been positive for the year with an average gain in the mid-teens as we had in 2006. There are many factors which we need to monitor throughout the year which could greatly impact the performance of closed-end funds.

As previously discussed, in early 2006 the share price of many closed-end funds benefited from the massive amount of tax-loss selling which occurred at the end of 2005 and created extremely attractive discounts and opportunities for investors. However, due to the fact there was hardly any tax-loss selling in 2006 and it was such a strong year for many funds, there are simply fewer bargains and deep discounts for investors to take advantage of as the year begins. For example, at the end of 2005 the average senior loan fund was trading at a discount to NAV of 11%. At the end of 2006 the average discount is only 2%. This does not imply that senior loan funds are not solid long-term investments with attractive yields, but rather it illustrates how valuations are simply not quite as attractive as they were a year ago. That fact could temper the buying we see in not only senior loan funds but other categories as well.

The Interest Rate Question. Perhaps the biggest question mark for closed-end funds in 2007 is interest rates and the FOMC. If the Fed were to continue to leave the Federal Funds rate stable at 5.25%, it would likely be viewed as a slight positive for closed-end funds as it would mean that borrowing costs would be stable which would lead to fewer dividend cuts. However, if the FOMC were to begin to raise short-term interest rates again I believe it would be a big negative for many closed-end funds as we would once again see many dividend reductions (which often lead to market price weakness). Conversely, a reduction in the Fed Funds rate would be viewed positively and benefit many leveraged funds, particularly investment-grade funds. It will be vital to monitor the FOMC closely in 2007 to see where rates are headed and the impact it will have on closed-end funds.

The IPO Market. While the IPO market for closed-end funds slowed down relative to 2005 and previous years, the last 2 months of the year saw a noteworthy pick up in the amount of money raised in IPOs. In fact, in November the largest closed-end fund IPO ever was launched with over $2.6 billion raised in one fund. This impressive showing, coupled with a few other successful launches at year's end, indicates that the IPO market is not dead for closed-end funds and we will likely see a pick up in the number of IPOs and amount of money raised in 2007 relative to 2006.

In addition to the largest closed-end fund IPO ever, there was also the first closed-end fund "fund of funds." This is significant and impacts the secondary market because approximately $500 million was raised in this fund at the end of November. The managers of the fund were likely investing some of the proceeds from the offering in December which helped the performance of certain funds at the end of the year as the increased buying lifted share prices. It is probable that the managers will still be putting money to work at the beginning of 2007 which could provide a boost to certain select funds. The creation of the first closed-end fund "fund of funds" could prove positive for the secondary market as it creates a new large buyer of funds, and if there are more funds like this, it could provide further support for many funds in the secondary market as money gets invested.

Summary. Investors should be thankful for an impressive 2006 showing for closed-end funds. However, it is probably a good idea not to expect this type of across-the-board solid performance in 2007 as some of the ingredients for these excellent returns (i.e. relatively stable short and long-term interest rates, slow IPO market, strong global equity and bond markets etc.) may not all be present in 2007. I continue to see value in the tax-advantaged equity funds which I originally highlighted in the first quarter commentary piece of 2006. Our Chief Economist Brian Wesbury expects 12%-15% equity price appreciation in 2007, which means equity income funds could potentially continue to be a solid place for investors who are seeking attractive tax-advantaged income as well as the potential for growth. We will continue to provide guidance in this quarterly commentary. 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.