Closed-End Fund Review

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THIRD QUARTER 2007

Third Quarter 2007 Results

The third quarter of 2007 was the most volatile quarter for closed-end funds in 2 years and rivals some of the most volatile periods in the past 10 years (such as the fall of 1998 when Long-Term Capital imploded; year-end tax-loss selling in 1999 & 2000; and even September 11th). In fact, discounts on August 16, 2007 were over 9% for the entire closed-end fund marketplace, which is wider than at any point in the past 7 years. (They were approximately 10% at the end of 2000.) Many funds traded lower in July and the first half of August, only to rebound from mid-August through the end of the quarter. Still, even with the bounce back in the last half of the quarter, 17 out of 20 categories finished lower on a share price basis during the quarter. Part of the reason discounts widened to such attractive levels is because net asset value (NAV) performance was much better during the quarter relative to share price performance. In fact, only 6 out of the 20 categories were lower on an NAV basis.

Based on market price total return, below are the best and worst performers for the second quarter:

Best Performers

International Equity Funds	up 7.97%
U.S. Government Funds	up 3.42%
Investment-Grade Funds	up 0.21%

Worst Performers

High-Yield Funds	down 8.84%
Growth & Income Funds	down 8.25%
REITs Funds	down 7.79%

There were many culprits for why closed-end funds had such a brutal July and first half of August including an over supply of new issues in the spring, volatile equity markets, and most important, the credit crisis which developed as a result of concerns over the sub-prime mortgage market. As the month of August began, many closed-end fund investors had entered full-fledged panic mode and were selling closed-end funds regardless of the underlying asset class the fund was invested in. Even high-quality municipal funds were weak. In fact, as usual, when closed-end funds go through these periods of widening discounts and weakness, share prices got hit much more than underlying NAVs and that is why discounts widened and many good buying opportunities were created. In my opinion, when share prices of closed-end funds are getting hit much more than underlying NAVs (2 to 5 times more on average in July and August), it is often a good time to be a buyer of closed-end funds, not a seller.

While it can be painful to endure these periods of volatility and July and August were about as volatile as it gets for closed-end funds, they have been through periods like this before (as recently as the fourth quarter of 2005). Closed-end funds historically do bounce back from these difficult periods of broad weakness as investors begin to realize that the sell-off in share prices has been overdone relative to NAV weakness and so they begin to become attracted to the wide discounts and high yields which have been created as a result of the panic and often irrational selling.

August 17-The Turning Point

This is precisely what occurred on Friday, August 17th, after the Federal Open Market Committee (FOMC) cut the discount rate 50 basis points from 6.25% to 5.75%. Closed-end funds had one of the biggest one day advances I can remember as many funds were up over 5%. Investors jumped back into closed-end funds as they became more comfortable that the Federal Reserve was going to be aggressive in helping to alleviate some of the issues in the credit markets which had become quite worrisome by Mid-August. Furthermore, investors finally began to realize that many closed-end funds were trading at or near some of the widest historical discounts they had ever traded at and represented a compelling investment opportunity. Many of the sell-side closed-end fund analysts also began publishing research reports which discussed how there were a lot of opportunities for closed-end fund investors. The positive share price momentum continued through the end of August and into September. Closed-end funds also got another boost on September 18th when the FOMC again cut the discount rate by 50 basis points and also reduced the Federal Funds rate from 5.25% to 4.75%.

The reduction in the Federal Funds rate was important for closed-end funds because many funds employ the use of leverage to enhance their yield. The drop in the Federal Funds rate should lower financing costs for most leveraged closed-end funds which could, over time, lead to a higher earnings rate for many funds. I believe if the FOMC had not reduced the Federal Funds rate, it could have meant a significant amount of funds would have had to cut their distributions as financing costs had increased markedly in August with investors demanding higher yields on Auction Rate Preferreds and other types of short-term instruments closed-end funds use to leverage their portfolios. In my opinion, the interest rate cut creates a more positive environment for many leveraged funds and at the very least should prevent a fresh wave of dividend cuts as borrowing costs should begin to come down.

Insider Buying

It is interesting to note that during much of the period of high volatility in closed-end funds this summer, there was a substantial amount of insider buying–not selling–among insiders at many large closed-end fund companies. The insider buying was meaningful both in terms of the number of insiders who bought closed-end funds in July and August but also in terms of how much money they invested. The insiders at these closed-end fund complexes clearly recognize that much of the selling and weakness in the share prices of funds was overdone and represented an attractive long-term investment opportunity.

Fourth Quarter-Tax-Loss Selling

While many closed-end funds have bounced back solidly from their lows on August 16th, as we enter the fourth quarter it is important to note that historically this quarter is the most volatile one of the year due to tax-loss selling. Tax-loss selling is when investors sell securities to realize losses in order to offset gains within their portfolios. Due to the fact that there have been a large number of closed-end fund IPOs so far this year (37 as of 9/30/07) and many of them are lower heading into the fourth quarter, I conclude that we will see a fair amount of tax-loss selling this quarter. While I think that some of the selling which occurred in August also may have been tax-loss related, I still think there will be more tax-loss selling in this last quarter of 2007 and investors need to be prepared for it. Tax-loss selling for closed-end funds usually begins in November and lasts through the first 3 weeks of December. I would not be surprised if tax-loss selling commences a bit earlier this year as some investors may try and get out ahead of other investors.

The downward volatility which is often associated with tax-loss selling can create some uneasiness for closed-end fund investors. However, it is important to keep in mind that this type of selling is generally a short-term, seasonal technical factor which leads to discounts widening out at the end of the year only to narrow again as the calendar switches over to the new year. In fact, if we do have tax-loss selling, which I suspect we will, I believe it creates an excellent buying opportunity for investors as I would expect many funds to recover in January and February of 2008. As you may recall, the fourth quarter of 2005 had a lot of tax-loss selling and discounts got as wide as almost 7% for the entire closed-end fund marketplace. Many closed-end funds got hit hard that quarter only to snap back solidly as the new year began in 2006. At the end of the year investors and their financial advisors often look at their portfolios and say, "Where can I take a tax-loss?" However, at the beginning of the next year investors and their financial advisors say, "Where are the opportunities in closed-end funds that got beat up at the end of the previous year and are now trading at attractive discounts and yields?" It is this phenomenon that usually leads to closed-end funds performing well in the first quarter of the year. 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.