# Closed-End Fund Review

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## First Quarter 2007 Results

Following a year when all 21of the broad categories of closed-end funds were positive and 18 of 21 were up double digits, closed-end funds continued their winning streak in the first quarter with 19 of the 21 categories we monitor up year-to-date. It was indeed another solid 3 months for most closed-end funds and we have now gone approximately 9 months without any meaningful and sustained weakness in the closed-end fund marketplace. While the past several quarters of strong performance from many closed-end funds is rewarding, it is important for investors not to get too complacent and ignore the short-term periods of volatility that closed-end funds often encounter.

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

Best Performers

| | |
|---|---|
| Intermediate Income Funds | up 5.37% |
| Senior Loan Funds | up 4.37% |
| Government Funds | up 3.91% |

Worst Performers

| | |
|---|---|
| International Equity Funds | down 2.10% |
| REITs | down 1.19% |
| General Mortgage Funds | up 0.38% |

The longer term results for closed-end funds are even more impressive, with all categories posting positive, average annualized share price performance over the past 5 year period. (Please note that the Covered Call category is a relatively new one and therefore data does not go back 5 years.)

## Review

Closed-end funds benefited from many factors in the first quarter. The Federal Open Market Committee (FOMC) met twice in the first quarter and both times elected to keep its target for the federal funds rate at 5 ¼%. At the very least, this benefited many leveraged funds as it meant that borrowing costs would be stable. As well, the number of dividend cuts continues to slow down relative to 2005 and 2006 when leveraged funds really started to feel the impact of the FOMC's tightening phase. Dividend cuts often negatively impact the share price of a closed-end fund. With borrowing costs relatively stable, investors are more comfortable buying leveraged funds, which has helped the performance of many funds. Furthermore, long-term rates as measured by the 10-year U.S. Treasury note were also very stable during the quarter helping to contribute to a positive interest rate environment for many fixed-income funds. The 10-year U.S. Treasury note started the year at a yield of 4.71% and ended the quarter at 4.65%. Despite a violent sell-off at the end of February, the performance of U.S. equities during the quarter also helped to provide a solid environment for the growing list of equity and equity income-oriented closed-end funds. The U.S. stock market as measured by the Dow Jones Wilshire 5000 index was up approximately 1.40% in the quarter.

## Positive Factors Have Continued

There were several other positive factors which continue to benefit many closed-end funds. There are approximately 78 million baby boomers who have either just retired or are getting ready to retire. Many of these investors have an insatiable appetite for yield and need to generate cash flow from their investments in order to have a dignified retirement. They are using closed-end funds to enhance yield in their portfolios and this is creating a wave of demand in the primary market and the secondary market which has helped the performance of the closed-end fund marketplace. Furthermore, with yields on traditional fixed-income investments still at relatively low levels (10-year U.S. Treasury 4.65%, Certificates of Deposit 4-5%, Municipal Bonds 3-4%) investors have a continued interest in closed-end funds, many of which offer attractive income. Lastly, the issuers of closed-end funds have done an admirable job of bringing unique asset classes and strategies (Dividend Capture funds, Structured Finance funds, Covered Call funds, etc.) to the closed-end fund structure, which has helped to create renewed interest in closed-end funds and has generated new demand in both the primary and secondary market.

All of this demand for closed-end funds has helped to narrow the average discount of all 650 plus funds to just -2.33%. Furthermore, 35% of all closed-end funds are now trading at a premium to net asset value (NAV). The increased interest in closed-end funds has not gone unnoticed by the sell-side brokerage community. In fact, two large brokerage firms recently added veteran closed-end fund analysts to their research departments to help meet the demand investors have for information regarding closed-end funds. I view this as a positive event. Furthermore, the number of websites and resources investors have for information on funds also continues to increase.

Institutional investors have started to become more active in the closed-end fund marketplace which might help to partly explain why discounts have narrowed over the past year. We note that many closed-end fund issuers have made the secondary support of their funds a top priority and are adding increased resources to help support their funds. While I view these trends positively, it could make the secondary market for funds more efficient and therefore likely make it harder for investors to find large discounts in the secondary market. The opportunities will still exist, but with more investors focusing on closed-end funds, they will be harder to identify. I will be monitoring this development closely.

The initial public offering (IPO) market for closed-end funds was on a torrid pace in the first quarter with approximately $13 billion raised in 10 new issues. This clearly indicates there is a huge appetite for income and income-oriented funds in not only the secondary market but also the primary market as well. To put it in perspective, there was $11 billion raised in the IPO market in all of 2006. Perhaps as impressive as the amount of money raised in the first quarter was the fact that the secondary market for funds held up so well considering all of the money that was raised in new issues. Historically, the secondary market experiences weakness and volatility when there is considerable money being raised in the primary market as investors often sell funds to purchase new IPOs. This phenomenon was not overtly apparent in the first quarter but is something we need to watch very closely as continued strength in the primary market could enhance downside volatility in the secondary market (as was the case in the second half of 2005 when the IPO market was also very active).

## Final Thoughts

Investors in closed-end funds should for the most part be very pleased with the performance of their funds over the past year. However, while I continue to see opportunities for investors in closed-end funds and am very much a believer in the long-term appeal of closed-end funds, I think it is probably a good idea for investors to temper their expectations a bit and not expect every quarter or every year to be as smooth as the past year and quarter were. Most closed-end fund categories have historically delivered attractive returns to investors. However, closed-end funds also often go through periods of downside volatility and investors need to be aware of those periods as well. 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.