Closed-End Fund Review

Jeff Margolin, Vice President
Closed-End Fund Analyst

FIRST Trust ADVISORS L.P.

SECOND QUARTER 2007

Second Quarter 2007 Results

I break the universe of approximately 650 closed-end funds into 20 categories. In 2006, every category registered a positive market price total return. In the first quarter of this year, 19 were positive and I cautioned investors in my first quarter closed-end fund commentary that we had now gone approximately 9 months without any sustained weakness in the closed-end fund marketplace and it was important for investors not to get too complacent and forget the short-term periods of volatility that closed-end funds often encounter. Many closed-end funds encountered exactly this type of volatility in the month of June.

While April and May were both solid months for the performance of most categories, June was a difficult month for closed-end funds and in fact every category, with the exception of International Equity funds, was lower in June. For the quarter, 7 categories exhibited a positive market price total return and 13 categories were lower.

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

Best Performers

International Equity Funds	up 10.11%
Sector Specific	up 3.67%
Domestic Funds	up 3.51%

Worst Performers

REITs	down 5.30%
Preferred Funds	down 4.79%
Multi-Sector Bond Funds	down 4.19%

In my opinion, several factors contributed to the weakness in the quarter. Again, most of the weakness occurred in the month of June. Perhaps the biggest contributor was the sharp increase in interest rates in June which put pressure on many fixed-income funds which often hold intermediate and long-term bonds. Municipal, preferred and multi-sector bond funds are particularly vulnerable when interest rates move higher. The yield on the 10-year U.S. Treasury increased from 4.67% on May 11th to 5.25% on June 12th. Furthermore, below investment-grade bond funds were hurt by concerns over the weakness in the sub-prime mortgage securities market. Weakness and volatility in the equity markets contributed to the negative returns many equity funds posted in June. The S&P 500 Index was down 2% in the month of June. Furthermore, 7 new funds had an initial public offering (IPO) in June and oftentimes when there is a robust IPO market for closed-end funds it puts pressure on the existing funds in the secondary market as investors sell secondary funds to buy the new issues.

Lastly, I believe after a very solid period of performance for many closed-end funds, including most of 2006 and the first 5 months of 2007, investors were also likely taking profits in funds as valuations had gotten a little high. In fact, at the end of May nearly 40% of all closed-end funds were trading at a premium to their NAV. At the start of the second quarter, the average discount to NAV for the entire closed-end fund universe was only 2.3%. At the end of the quarter the average discount widened to 4%, reflecting the weakness many funds had in June.

While it is never fun to endure these periods of weakness across many closed-end fund categories, they do occur periodically and it is probably a good idea for closed-end fund investors not to expect every quarter to be a smooth and positive one. Periods of short-term volatility are normal for closed-end funds and I believe most investors should ride out these periods of volatility instead of selling into the weakness. The long-term performance results of closed-end funds are quite good despite these periods of volatility. In fact, all 19 categories have a positive average annualized market price total return over the past 5 years. I believe this statistic speaks, in part, to the power of high dividends and distributions (which many closed-end funds have) compounding year after year. (Please note the Covered Call category does not go back 5 years and therefore is not included.) In my experience, the closed-end fund investors who are most successful are the ones who are contrarians and buy funds during these periods of weakness and take advantage of widening discounts.

It is also crucial for me to note that this period of weakness for closed-end funds was consistent with other periods of weakness in that the market prices of most funds got hit much harder than the underlying NAVs. This leads to a widening of discounts to NAV and therefore more opportunities for investors, in my opinion. The reason the market price often goes down more than the underlying NAV is because many funds do not have a lot of share volume and so it only takes a little bit more selling to cause market prices to decline more rapidly than NAVs. Also, investors often overreact and sell funds without fully examining what is happening with the underlying portfolio which also causes market prices to decline more than NAVs.

Municipal Bond Funds

This phenomenon of selling was most evident in the municipal bond category. Municipal bond funds had a very difficult month of June as rising long-term rates put pressure on the underlying long-term municipal bonds that most municipal funds invest in. Furthermore, concerns about a strengthening economy and higher inflation led some investors to believe that the Federal Open Market Committee (FOMC) might actually increase short-term rates by the end of the year, thus increasing borrowing costs for leveraged municipal funds and potentially leading to more dividend cuts. This change in sentiment also negatively impacted the share price of municipal closed-end funds. However, as was the case in many other periods of weakness for municipal closed-end funds, share prices declined much more than underlying NAVs. In fact, one of the largest California municipal funds had a 6% decline in share price in the month of June despite the fact that the underlying NAV was only down 1%. I believe that during these periods of volatility in the municipal funds it is important to maintain a long-term perspective and realize that the municipal category has historically been a very attractive category for long-term investors who seek high, tax-free income. In fact, according to Lipper, as of July 6, 2007, the 5-year average annualized return of the 55 National Leveraged municipal funds was 6.4%.

Radar Screen

As the second half of the year begins there are several issues I will be monitoring very closely. The first relates to the increasingly active IPO market for closed-end funds. There has already been more money raised in closed-end fund IPOs in the first half of 2007 than there was in all of 2006. There were 21 closed-end funds IPOs in 2006. There have been 27 in 2007 including 7 in the months of May and June. I will be actively monitoring the performance of these new issues because if they should experience losses by the time the fourth quarter begins it could lead to a potentially volatile fourth quarter tax-loss season for the closed-end fund marketplace. This is what occurred in the fourth quarter of 2005 and while there was a lot of downside volatility during the fourth quarter of that year, it also created some excellent buying opportunities as well. As I did in 2005 and 2006, I will issue my forecast for the fourth quarter tax-loss season in early October. As you recall, last year was a very benign year for tax-loss selling as there were simply few losses for investors to take.

I will also be closely monitoring interest rates, both short and long-term. As closed-end fund investors saw last month, any meaningful increase in interest rates puts pressure on many categories of funds including Municipal, Preferred, REIT and Multi-Sector funds. However, if interest rates were to stay relatively stable or decline, it creates a more positive environment for many categories of funds. It is also important to note that many of the funds which have been brought to the market over the past 3 to 4 years are very much impacted by the performance of the equity markets (for example Covered Call, Equity Income and Dividend Capture funds) and therefore if the equity markets continue to trend higher these types of funds should perform 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.