CLOSED-END FUND review

SECOND QUARTER 2009

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Overview

The second quarter was an excellent quarter for closed-end funds and investors who have been patient and/or were buying as discounts widened to historic levels at the end of 2008 and into 2009. These investors were finally rewarded with meaningful positive total returns during the quarter. Any way you slice and dice the quarterly and year-to-date total return numbers, they look very good. Of the 633 closed-end funds tracked by FundData, the average fund was up 21% on a total return share price basis during the second quarter and is up 24% year-to-date. Not only was the average gain very impressive during the quarter, but the breadth of the gains was also impressive: every major category and sub-category tracked by FundData was positive for the quarter with the exception of the small category (consisting of 2 commodities funds) which was lower by only 0.26%. It truly was a very broad, deep and powerful rally for closed-end funds.

What Led the Performance Rally?

There were several factors which led to the significant improvement in performance for closed-end funds, but I believe the biggest contributing factor was simply more stability and healing in the overall equity and credit markets as well as some stability in the overall macroeconomic environment during the quarter. This is an issue I have commented on in several of my previous newsletters as being extremely important in terms of seeing improvement in the performance of closed-end funds.

Closed-end funds are an investment structure which is primarily owned by retail-oriented investors and many closed-end funds are thinly traded. Therefore, it does not take all that much extra volume on the up or down side to really move the share price of many funds. As fear and paralysis took over the financial markets and economy last fall and winter, closed-end funds got hit especially hard and investors sold funds, aggressively pushing average discounts to over 25% in October, 2008. However, as stability slowly comes back to the financial markets and economy and as the fear level subsides, closed-end funds are benefiting as investors are once again willing to assume risk. During the second quarter, investors finally started to recognize the tremendous yields and discounts available in the secondary market and that helped the average fund to increase by 21%.

With average share price total returns north of 21% for closed-end funds during the quarter and outpacing net asset value (NAV) total returns, discounts narrowed considerably. According to FundData, the average discount at the end of the second quarter was 4.11%. This is essentially in line with the 10-year average discount to NAV of 3.98%. Now that discounts have narrowed to levels which are more in line with historical averages, I believe closed-end fund investors will have to dig a little deeper among the universe of over 600 funds to find attractive opportunities. However, I do firmly believe there continues to be several attractive categories and individual funds which still represent a compelling value and investment opportunity for investors. (Please see Outlook for Remainder of 2009 for more information).

Other Developments During 2Q09

After a dramatic slowdown in the number of new issue closed-end funds in 2008, the initial public offering (IPO) market for closed-end funds is starting to revive a bit in 2009. There were only 2 IPOs in all of 2008 versus 40 in 2007. So far in 2009 there have already been 8 and 6 of those were in the second quarter. 7 of the 8 new IPOs have been municipal offerings, reflecting the many attractive opportunities available in municipal bonds as well as a very steep municipal yield curve. One fund was an investment grade taxable offering. While all 8 of the new issues have been relatively small in size, (all under $300 million) I believe the opening of the IPO window for closed-end funds is a positive sign not only

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for closed-end funds but also for the broader markets in general as it shows that investors are once again willing to look at new investment opportunities and are willing to again assume some risk. I also believe that it is healthier in the long run to see one or two smaller new issues come public each month instead of having 4-7 new, larger issues each month which I believe has been proven to be too much for the market to absorb and ultimately leads to cannibalization and enhanced volatility in the secondary market.

Another development which was particularly pervasive during the second quarter was the number of dividend increases in the municipal closed-end fund category. Readers of this newsletter know that the municipal category is one of my favorite categories and one which I still find very compelling. One of the reasons I have been so attracted to the municipal closed-end funds is because these funds continue to benefit from an extremely steep yield curve. This has enabled the municipal funds to borrow at exceptionally low rates of 50 basis points or less in some cases and re-invest in longer term municipal bonds yielding 4%-6%. This environment has led municipal funds to significantly over-earn their monthly dividends and that is why over 100 municipal closed-end funds increased their dividends during the second quarter. The environment remains good for leveraged municipal funds and I expect more dividend increases in the municipal funds during the remainder of 2009. Despite the fact the average municipal fund was up 9% on a share price total return basis during the second quarter and is up 26% year to date, it remains one of my favorite categories and one I think investors should have exposure to.

Outlook for Remainder of 2009

While having total returns of 21% during a 3-month time period is very rewarding, particularly after such a difficult 2008, I don't think closed-end fund investors should expect these types of returns every quarter going forward. While most of the positive performance was the result of improvements in the underlying asset classes many closed-end funds focus on, some of the performance was a result of discounts narrowing and share prices catching up to NAVs. Now that average discounts have narrowed close to historical levels, I believe there will be less of a contraction in discounts, and therefore I believe investors need to look harder to find value and need to focus on funds which invest in asset classes that have upside total return potential. I still believe there are many very attractive opportunities in several funds and categories for closed-end fund investors and I believe they should focus on the following 4 categories for attractive income and total return potential over the next 6 months and into 2010:

– municipal funds
– equity-oriented funds (including covered call, convertible and tax-advantaged equity income funds)
– investment-grade corporate and multi-sector bond funds
– senior loan funds

As I have stated in previous newsletters, continued stability in the broader financial markets will go a long way toward helping closed-end funds continue to 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.

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