CLOSED-END FUND review

THIRD QUARTER 2010

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Third Quarter Overview

After a bruising May and (part of) June when many closed-end funds (CEFs) were lower due to volatility in the global financial markets (caused primarily by concerns about the sovereign debt of many European countries), most CEFs rebounded sharply during the third quarter. Indeed, the average CEF was up 9.83% on a share price total return basis (according to Morningstar). One of my core investment beliefs as it relates to investing in CEFs (and something I have written about before), is that when CEFs go through these periods of sharp downward price volatility, it often represents a very compelling long-term buying opportunity as discounts widen out and yields move up. The sell off in May and June, followed by the subsequent rebound for many CEFs in the third quarter, once again helps to re-affirm that belief. You might recall I mentioned in my commentary last quarter about the insider buying which occurred in several funds during the May and June sell off and how I believed those insiders were spot on by taking advantage of the weakness to buy CEFs. I continue to believe the most successful long-term CEF investors are the ones who build diversified portfolios across several categories and managers, have a long-term investment horizon as the compounding of CEF distributions can be quite rewarding over time, and who are tactical by taking advantage of sharp pull backs to add to positions.

There are several factors which continue to benefit many CEFs, including:

1. Improvement in the equity and credit markets.
2. Low-yielding investment alternatives which helps to get more investors to invest in CEFs due to their attractive distributions. (The average distribution yield of all CEFs was 6.80%, as of 9/30/10, according to Morningstar.)
3. Voracious demand for income in part due to the demographic shift occurring in America as more baby boomers retire or prepare for retirement.
4. Low leverage cost, which benefits many CEFs as they can earn a generous spread between their borrowing cost and their reinvestment rates.

Lower Expectations Due to Smaller Discounts to NAV but Opportunities Still Exist

While all of these factors continue to be prevalent as the fourth quarter commences, discounts have narrowed considerably for many CEFs the past year. In fact, the average discount to net asset value among all CEFs is only 0.36% as the fourth quarter gets underway, according to Morningstar. With discounts so small for many funds, I think it is important for investors to pick their spots carefully and lower future expectations as it relates to returns as investors can no longer count on discounts contracting to boost total returns. While I favor funds in several categories, including floating-rate senior loan funds, limited duration multi-sector bond funds, high-yield funds and municipal funds, I believe the best values exist in several equity income-oriented funds. Our Chief Economist and Chief Investment Officer believe that equities are undervalued based on an improving macro economy, rising corporate earnings and low valuations for equities based on historical valuations. Coupled with the fact that many equity income-oriented CEFs continue to trade at attractive discounts to NAV of 5-13% in certain cases, I believe CEF investors should include equity income-oriented funds in their portfolios as a way to generate high income, but also as a way to potentially attain capital appreciation.

The Fourth Quarter and CEF Tax-Loss Selling

A question that I get a lot this time of year relates to the fourth quarter and the seasonal volatility usually experienced during those months as a result of year-end tax-loss selling. My outlook for the fourth quarter and tax-loss selling is very similar to the viewpoint I had last year at this time, which is that I do not expect a lot of year-end tax-loss related selling. Tax-loss selling is usually most prevalent when two conditions exist:

1. Investors have a lot of losses to take in closed-end funds for that particular calendar year.
2. There are a lot of recent CEF IPOs below their IPO price.

As the fourth quarter commences, neither of those conditions exist in a meaningful way. The average closed-end fund is up 9.32% year-to-date as of 9/30/10 on a share price total return basis, according to Morningstar. This follows a year when CEFs were up an average of over 50%, according to Morningstar, and the majority of the CEF IPOs issued over the past year are either

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at or above their IPO price. While I do not expect a bad tax-loss selling season (as we experienced in 2005, 2007 and 2008), I do think it is prudent for CEF investors to always have a little bit more cash on hand in the fourth quarter as there could be some profit taking which occurs this quarter in CEFs. Even though I do not expect a lot of volatility as a result of tax-loss selling, the fourth quarter does tend to be the most volatile of the year for CEFs. I expect CEFs to trade more in sympathy with the broader equity and credit markets this fourth quarter as opposed to a quarter in which the trading patterns of CEFs are dictated by seasonal tax-loss selling.

That said, should the CEF marketplace experience some year-end volatility as a result of profit taking or tax-loss selling, as opposed to weakness in the underlying asset class a fund invests in, I think investors should use the weakness as a buying opportunity since this type of seasonal volatility is usually short lived and has historically represented a good long-term buying opportunity for investors.

In summary, I do not expect a particularly bad quarter for tax-loss selling. However, I do think it is a good idea for CEF investors to have some "dry powder" on hand should we experience some seasonal volatility. Be prepared to take advantage of that volatility and use it as a buying opportunity particularly in categories of the CEF marketplace I favor such as equity income-oriented funds, floating-rate senior loan funds, limited duration multi-sector bond funds, high-yield funds and municipal funds.

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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