CLOSED-END FUND review

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FIRST QUARTER 2010

First Quarter Overview

Following a year in which closed-end funds were up 51% on a share price total return basis, closed-end funds had another very solid quarter. Indeed, the average fund was up 5.87% for the first quarter of 2010 and is up 56.9% over the past 12 months. Clearly, investors who were patient during the turbulent market of 2008 and who were adding to positions in their closed-end funds during that volatile time period have been rewarded. Closed-end funds continue to perform well for a number of reasons, including:

- Improvement in the global equity markets.
- Improvement in the global credit markets.
- Exceptionally low short-term interest rates which is drawing money out of money market funds and other short-term cash investments and into higher-yielding ones like many closed-end funds.
- These very low short-term rates are also keeping leverage costs down for many closed-end funds, which is also helping the approximately 70% of funds which employ the use of leverage.

I also think investors are gravitating towards closed-end funds because of the very attractive yields and cash flow they provide. As investors become increasingly more willing to move money out of cash into more credit-sensitive securities or equities, they are using closed-end funds because, if they are going to take on more credit or equity risk, they want to get paid an attractive dividend for taking this added risk. Given the fact that the average distribution yield for the universe of closed-end funds is 7.09%, (according to Morningstar) closed-end funds provide the cash flow I believe investors are looking for as they move money out of cash equivalents. This is helping to move prices higher for many funds. As prices move higher and outperform net asset values (NAVs), as was the case during the first quarter, it helps to narrow discounts. At the end of the quarter, the average discount was only 0.78% among all funds. This compares to the 5-year average of a 5.04% discount to NAV. The small average discount to NAV tells me four important things based on my experience following closed-end funds:

1. Investors should lower their expectations about future returns as they can no longer count on big discounts contracting to boost total returns.
2. More of the total returns will likely come from income as opposed to capital appreciation.
3. There is still potential for investors to make money in closed-end funds, but they have to pick their spots more carefully and focus on funds where the underlying asset class is positioned to do well. If the underlying asset class performs well, so should the share price over time.
4. Even with discounts contracting to less than 1%, there are still many well-run funds at high single-digit or low double-digit discounts available for investors. I am currently finding many of these high discounts in the equity income category.

That being said, several of the categories highlighted in past newsletters continue to post solid results. In fact, the number one performing fixed-income category in terms of share price total return performance was the **senior loan category**, posting a very solid total return of 15.09% (according to Morningstar) during the first quarter. The only category which performed better among all closed-end funds was the small category of (four) finance equity funds which were up 19.57% for the quarter. While senior loan funds have had a very big move the past three months (and past year) and are now trading at an average premium to NAV of 4.09%, I continue to like the category due to the fact that I believe they will provide a nice hedge against rising short-term interest rates because the interest on a senior loan is a floating interest rate and re-sets every 60-90 days based on Libor (London Interbank Offer Rate). Furthermore, the underlying loans senior loan funds focus on are still at discounts to par. The S&P/LSTA U.S. Leveraged Loan 100 Index was at 91.76 as of 3/31/10 and is still below par, implying modest capital appreciation potential left in the NAVs of senior loan funds.

While I am usually against paying a premium for a closed-end fund, I am willing to pay one for a senior loan fund because senior loans are a difficult asset class for investors to get exposure to, and with the exception of a small number of open-end funds and the universe of closed-end funds, it is virtually impossible for retail investors to get exposure to this asset class. Retail investors cannot buy senior loans individually and there is not an ETF which offers investors exposure to them. I believe because the asset class is positioned to continue to perform well, coupled with the uniqueness of the asset class and the difficulty investors have in getting exposure to it, senior loan funds will likely trade at premiums to NAV for an extended period of time.

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The universe of 255 municipal closed-end funds, which is the largest category among all closed-end funds, also had another very solid quarter, increasing 5.16% on a share price total return basis. These funds are up 31.20% over the past year. Municipal closed-end funds continue to benefit from the three factors I have written about previously, which include:

1. An exceptionally steep municipal yield curve. This yield curve is helping municipal funds to over earn their dividends and to either raise them or build up undistributed net investment income (UNII). They will be able to tap these funds when borrowing costs move higher and should help to keep dividends stable for at least the next year, in my opinion.
2. The likelihood of higher federal marginal tax rates in 2011 increases the attractiveness of tax-free bonds and municipal closed-end funds. Many states have already raised state and local taxes.
3. A scarcity of long-term traditional tax-free municipal bonds due to the increased issuance of taxable municipal Build America Bonds. This is helping to push up the prices of traditional long-term municipal bonds and municipal closed-end funds as investors seek high tax-free yields.

While I continue to like municipal closed-end funds for investors looking for high tax-free monthly income, I think it is important to note that I do not expect the same type of outsized double-digit total returns in the next 12 months as was earned in the past 12 months. However, with average tax-free yields of 6.34% (according to Morningstar) and the likelihood that dividends are stable over the next 12 months and that taxes move higher, I still believe they are compelling for income-oriented investors.

Investing for Income in a Rising Interest Rate and Rising Inflationary Environment

As I travel around the country talking to advisors and investors, perhaps the question that I have been getting most recently is the following: "How can I invest for income in an environment in which interest rates and inflation are moving higher?" Part of the reason I have focused so much attention on the senior loan funds over the past year is because I firmly believe they will perform well as interest rates and inflation move higher over the next couple of years. By paying a floating interest rate (as opposed to having a fixed coupon), senior loan funds can provide not only attractive income but also protection against rising rates. While I am very pleased senior loan funds have performed well recently and I still like the category, there are other options which I believe can also provide income as well as some protection against rising interest rates and inflation, including funds which focus on: convertibles, TIPS (Treasury Inflation Protected Securities), MLPs (Master Limited Partnerships) and dividend-paying stocks.

Convertible securities are an attractive category for investors looking for income in a rising interest rate and rising inflationary environment because they have characteristics of both common stocks and bonds and are convertible into common stock at a specified price. The hybrid nature of convertible securities makes them less sensitive to interest rate changes than bonds of comparable quality and maturity. Furthermore, convertibles perform well when the stock market is moving higher because they can be converted into common stock. During the last interest rate cycle when the Fed was raising its Federal Funds rate from 1% to 5.25%, the Merrill Lynch Convertible Index increased at an annual rate of 8.87%, making convertibles an attractive asset class during that period of rising rates.

I believe closed-end funds which invest in TIPS are also an important asset class to have exposure to as inflation is likely to pick up over the next couple of years. TIPS protect an investor against higher inflation because the principal value of TIPS is adjusted according to inflation over the life of the bonds, therefore protecting an investor's purchasing power as inflation moves higher. In fact, the Barclays Capital U.S. Treasury Inflation Notes Index had an average annualized total return of 4.72% from 6/30/04 to 8/31/06, which was during the last time the Fed was raising short-term interest rates.

MLPs have also historically been an attractive asset class during periods of rising interest rates and there are currently nine closed-end funds which focus primarily on MLPs. MLPs are high cash flow businesses that pay out a majority of their cash to investors. MLPs as an asset class have a very admirable track record of increasing dividends which can be an effective way to protect a portfolio against rising interest rates and inflation. Indeed, over the past 10 years, MLPs have increased dividends at an annual rate of 7.0% (according to the Alerian MLP Index). During the last Fed tightening cycle, MLPs had excellent total return performance with the Alerian MLP Index producing an average annualized return of 19.78% from 6/30/04 to 8/31/06.

Lastly, I think investors should also have exposure to closed-end funds which invest in dividend-paying stocks as they too have historically performed well during periods of rising interest rates. They can provide a rising income stream but also growth potential, which is essential in order to stay ahead of inflation.

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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