CLOSED-END FUND review

Jeff Margolin

Senior Vice President, Closed-End Fund Analyst

FOURTH QUARTER 2011

2011 Overview

It was a mixed year for closed-end funds in 2011. According to Morningstar, the entire universe of 631 closed-end funds was up 5.37% on a share price total return basis. While not a bad overall total return by any means, reflecting the flight to quality in 2011 among many investors, most of the gains occurred in higher credit quality categories such as municipal funds and investment-grade taxable bond funds. Despite very solid fundamentals and compelling valuations for both equity-oriented funds (i.e. double digit EPS growth for the S&P 500 Index and a below average historical P/E ratio for the S&P 500) and credit sensitive funds (i.e. defaults at roughly 4 ½ year lows), investors (particularly in the 3Q) were quite risk averse and shunned the compelling fundamentals of categories such as domestic equity funds, convertible funds and senior loan funds.

As 2012 commences it is my firm belief that because of these very solid fundamentals and valuations, closed-end fund investors should continue to have exposure to areas of the closed-end fund marketplace that, despite being out of favor in 2011, remain very compelling, such as domestic equity funds and senior loan funds. (More on both of these categories below.)

There were 18 new closed-end funds launched in 2011, representing net proceeds of roughly $5.5 billion. This was slightly less than the 21 new funds (representing approximately $8.4 billion) launched in 2010, but nonetheless represents a healthy but not saturating amount of new funds brought to the marketplace. According to Morningstar, average discounts to net asset value (NAV) ended 2011 at 2.59% for the entire universe of 631 funds which is essentially in line with the 10-year average discount to NAV of 2.83%. That said, many categories (particularly domestic equity and senior loan) are trading at wider discounts than they historically trade at and continue to have solid fundamentals.

Municipal Closed-End Funds

The standout category for closed-end funds in 2011 was municipal funds. In fact, according to Morningstar, the entire universe of 254 funds was up 20.03% on a share price total return basis. Leveraged national municipal closed-end funds were up 21.84%. California municipal funds, which are the largest state-specific category with 34 funds, were up 22.79%. Throughout 2011, municipal bonds and municipal closed-end funds benefited from several factors including: a flight to safety, attractive yields relative to U.S. Treasuries, lower supply of new municipal bonds, higher state income taxes in several states (including Connecticut & Illinois) and significantly lower defaults than some analysts had predicted. Many leveraged municipal funds also benefited from low leverage costs which has enabled many funds to not only distribute tax-free distributions in excess of 6%, but also to maintain significant undistributed net investment income (UNII) balances.

As 2012 commences, I think it is important for municipal closed-end funds investors to lower their expectations relative to the 20% plus total returns many funds earned in 2011. Indeed, given the fact that, according to Morningstar, the average municipal closed-end funds begin 2012 at a 1.22% premium to NAV, I think it is extremely unlikely municipal funds will post the same type of total returns this year as they did in 2011. That said, I still believe closed-end fund investors in the context of a diversified balanced portfolio (which should also include equity-oriented funds and credit sensitive funds such as senior loan, high-yield and limited duration funds), should maintain some exposure to the municipal asset class. As a continued result of relatively low borrowing costs for many leveraged municipal funds, the average national leveraged fund yields a very compelling 6.4%, according to Morningstar as of 12/31/11, and has built up roughly 2 months worth of UNII per share. Furthermore, primarily as a result of austerity measures in many cities, counties and states, issuance of new municipal bonds remains below 2010 levels. Many investors also remain quite concerned about the threat of higher state and federal taxes which also creates demand for municipal bonds and municipal closed-end funds. Finally, municipal closed-end funds (the overwhelming majority of which are investment-grade) not only provide investors with very compelling current tax-free yields of roughly 6%, but also are generating that income from high credit quality bonds and, therefore, I believe can create a nice balance in a portfolio which includes more credit sensitive funds and equity income-oriented funds.

Categories of Highest Conviction Heading into 2012

In addition to maintaining exposure to municipal closed-end funds, as 2012 begins, the two categories of the closed-end fund marketplace in which I have the highest conviction level in are domestic equity funds and senior loan funds, based on compelling fundamentals and attractive valuations. I believe domestic equity funds are compelling because despite an overall flat year for the S&P 500 in 2011, earnings grew at approximately 15% (final results won't be in for a few weeks) and valuations on the S&P 500 remain below historical averages. Indeed, as 2012 commences, the S&P 500 is only trading at approximately 11 times next year's earnings estimates which is below the longer-term historical average of approximately 15 times forward year's earnings estimate. Moreover, not only are fundamentals sound for domestic equities and valuations cheap relative to historical averages, but according to Morningstar the average U.S. domestic equity fund is trading at a discount to NAV of 8.37% as of 12/31/11. This is far wider than the 5-year average premium to NAV of 0.60% and the 10-year average discount to NAV of 4.52% and, therefore, I believe represents a very compelling opportunity for investors.

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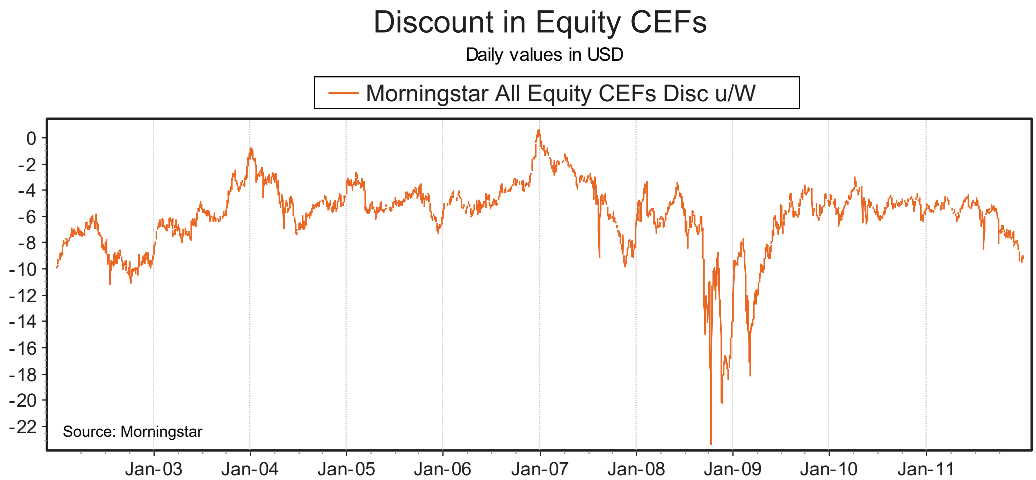
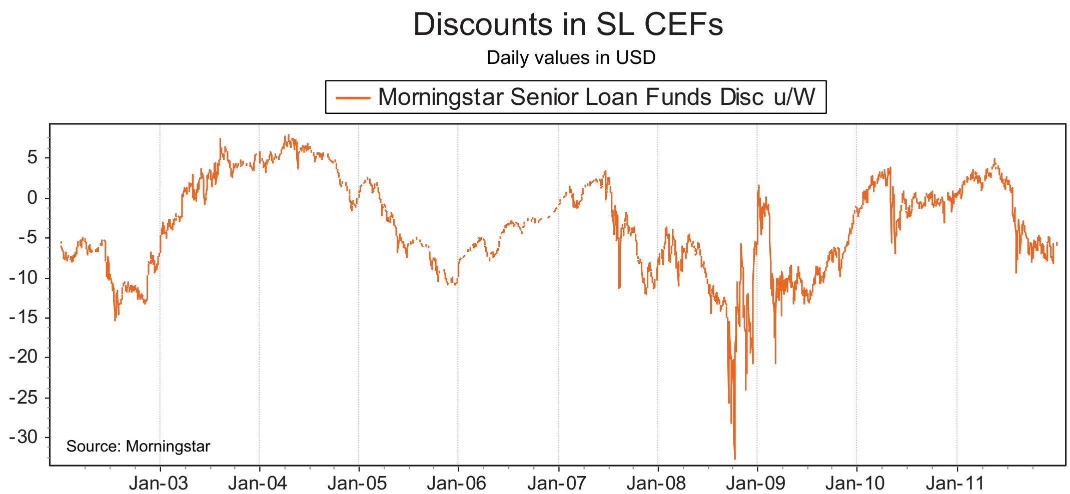
First Trust Advisors L.P.
1-630-915-6784
www.ftportfolios.com



Despite a disappointing 2011 in which the average senior loan fund was lower by 5.37% on a share price total return basis, according to Morningstar, it remains a category I favor based on its compelling fundamentals and valuations. Indeed, in the month of December, there were no defaults among the loans in the S&P/LSTA Index. This represented the third straight month in a row without a default and the default rate is at a miniscule 0.17% by principal amount. This represents a 54-month low. Senior loan defaults are at a 48-month low of 0.62% by number of loans. Despite these very low default rates, senior loans, on average, are still trading well below par and, therefore, I believe represent a compelling value. In fact, as of 12/31/11, the S&P/LSTA U.S. Leveraged Loan Index was trading at 90.75. This is significantly below par and I believe is a result of the panic selling and dramatic flight to quality experienced in the third quarter of 2011. Not only are defaults low for senior loans but according to S&P, since the recession ended in June 2009, publicly filing companies in the S&P/LSTA Index have generated average year-over-year EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization) growth of 16%, with the latest reading from the third quarter of 2011 slightly lower at 15%. Of course, it is important to note that senior loans are subject to significant credit risk and there is no guarantee that defaults on senior loans will remain at low levels.



In addition to the solid fundamentals and compelling valuations of senior loans, the average senior loan closed-end fund is trading at a discount to NAV of 6.1% as of 12/31/11. This is significantly wider than the 5-year average discount to NAV of 1.02%. Lastly, senior loan closed-end funds are yielding an average of 7.3% as of 12/31/11, according to Morningstar, and given the floating-rate nature of the interest on a senior loan, have limited duration risk.

In Summary

I continue to advocate that closed-end fund investors focus on 5 primary categories of the closed-end fund marketplace including municipal funds, domestic equity funds, high-yield funds, senior loan funds and limited duration multi-sector bond funds. By diversifying assets across these 5 compelling areas, investors can attain a blended yield of roughly 7%, take advantage of the compelling fundamentals and valuations of both equities and credit-sensitive securities and take advantage of the attractive 6% tax-free yields that many municipal funds provide. 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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