CLOSED-END FUND review

THIRD QUARTER 2013

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Third Quarter Overview

The third quarter was a challenging one for many categories of the closed-end fund marketplace. An increase in long-term interest rates during the quarter from 2.47% to 2.62% on the 10-year U.S. Treasury (on September 5th the yield briefly hit 3.00%), hints from the Federal Reserve that it might begin scaling back its bond buying program known as "Quantitative Easing" (which ultimately did not occur) and a palpable shift in investor sentiment away from income and yield-oriented asset classes (for example, open-end municipal bond funds suffered weekly outflows every week during the quarter), helped lead to a 2.37% share price total return decline for all closed-end funds (CEFs) during the quarter (according to Morningstar). Fixed-income CEFs were hit particularly hard during the quarter with the average fixed-income CEF lower by 3.91% on a share price total return basis (Morningstar). Equity CEFs fared better during the quarter with the average fund only lower by 0.06% on a share price total return basis (Morningstar).

Owing to the fact that CEFs are primarily owned by retail investors and because many CEFs are thinly traded, changes in sentiment among investors can have a swift impact on the share prices of CEFs and that is what occurred in the third quarter. Not surprisingly, for most categories share prices were much weaker in the quarter than corresponding net asset values (NAVs). (See Blog from August 16, 2013 entitled "*Senior Loan, Limited Duration and High Yield CEFs*" for more on this topic). While this can be frustrating to CEF investors (particularly those who are new to the CEF structure), it has widened discounts to NAV to very compelling levels, in my view. For example, while the average senior loan CEF was lower by 3.44% on a share price total return basis for the quarter, the average senior loan CEF's NAV was actually positive by 2.10% on a total return basis (Morningstar). I think this is a good example of how even categories of the CEF marketplace where the underlying NAVs were performing well still experienced share price weakness during the third quarter and I think this illustrates how some of the share price weakness during the quarter was overdone and represented a change in investor sentiment (as opposed to underlying weakness in the senior loan asset class).

Challenging Third Quarter but Opportunities and Value Exist in the Secondary Market

As the fourth quarter commences, the average discount to NAV among all 599 CEFs is 6.68% (Morningstar). It was only 1.83% six months ago (Morningstar) and I believe this not only reflects how CEFs became out of favor during the quarter despite compelling yields and fundamentals for many categories, but also indicates that there is real value in many CEFs right now. While a fund's (or a category's) discount to NAV is only 1 metric, I believe CEF investors should focus on it when evaluating a fund or category of CEFs. At present, discounts to NAV which are wider than historical averages present a significant number of opportunities available for long-term CEF investors. Furthermore, not only are discounts to NAV wider than historical averages for many categories of the CEF marketplace, but distribution rates also remain very compelling on both an absolute and relative basis. According to Morningstar, the average share price distribution rate for all CEFs was 6.76% at the end of the quarter, which is higher than the 6.19% average share price distribution rate from a year ago.

More important than just the average share price distribution rate for all CEFs is the fact that most CEFs continue to exhibit stable distributions and this leads me to my next point about why I think a lot of the recent selling pressure in CEFs has been overdone. One of the unique features of the CEF structure is the fact that it is permitted to employ modest amounts of leverage to enhance distributions and potentially enhance total returns. Leverage also enhances volatility and risk. According to Morningstar, roughly 70% of all CEFs employ some form of leverage. Of this 70%, the overwhelming majority have their leverage costs tied to short-term interest rates. This is an important fact and one that I think is often overlooked by CEF investors. With the Federal Reserve again recently saying it does not intend to raise short-term interest rates anytime soon, leverage costs for most CEFs should remain low, and I believe that should help most funds be able to continue to distribute stable, compelling distributions.

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Perhaps even more important than the wider-than-average historical discounts to NAV for many CEF categories, compelling share price distribution rates and low leverage costs (which are contributing to high and stable distributions for many CEFs) is the fact that I believe fundamentals and valuations for the three primary categories of the CEF marketplace I advocate investors have exposure to, namely domestic equity CEFs (please see Blog from September 16, 2013 entitled "*Domestic Equity CEFs Still a Favored Category*"), senior loan and limited duration CEFs and municipal CEFs (please see Blog from September 3, 2013 entitled "*Still out of Favor but with Compelling Yields and Valuations*") continue to be compelling. While it is virtually impossible to know when investor sentiment will shift back in favor of these categories of the CEF marketplace, ultimately I believe at some point investors will look to take advantage of the very compelling opportunities that exist in the secondary market for CEFs. In the meantime, diversified CEF investors can continue to collect the very compelling distributions most CEFs continue to make.

Potential for Tax-Loss Selling

While the recent reiteration from the Federal Reserve that it doesn't intend to raise the Federal Funds rate anytime soon remains a positive for many CEFs as it keeps leverage costs low and distributions, fundamentals and discounts to NAV remain attractive for the categories of the CEF marketplace I continue to favor, there is the potential for enhanced volatility for many CEFs towards the end of the fourth quarter due to the potential for tax-loss selling. (Tax-loss selling is when investors sell securities to realize losses in order to offset gains within their portfolios.) Tax-loss selling tends to be more pronounced in CEFs in years when investors have losses to take and when investors have gains in other parts of their portfolios they wish to offset. Given the fact that the universe of 189 taxable fixed income CEFs is lower on average by 4.41% YTD through September 30th on a share price total return basis (Morningstar) and that the universe of 208 municipal CEFs is lower by 12.82% YTD through September 30th on a share price total return basis (Morningstar), coupled with the fact that it has been a very good year for equities thus far in 2013 (YTD through September 30th the S&P 500 Index is up 20% according to Bloomberg), this year could see more tax-loss selling in CEFs than in recent prior years.

While it is hard to know when it will begin and how long it will last, typically tax-loss selling tends to occur from mid-November through mid to late December. Historically, when tax-loss selling is prevalent, discounts to NAV widen. The share price weakness and discount widening from tax-loss selling tends to be a short-lived, technical phenomenon that historically reverses at the beginning of the following year in January and February when discounts to NAV tend to narrow and share prices tend to bounce back as the tax-loss selling is over and investors look to take advantage of the discounts and opportunities that were created during the prior months' tax-loss selling.

I believe tactical and CEF investors who tend to actively trade their CEF positions should have some cash on hand heading into November and December should we experience weakness and discount widening as a result of tax-loss selling. These investors should be prepared to take advantage of the opportunities which present themselves as a result of tax-loss selling. Longer-term CEF investors who tend not to actively trade their positions but rather usually hold them during periods of short term volatility should be aware that there could be some short-term volatility and weakness as a result of tax loss selling, but should also be aware that it tends to be short-lived and historically the short-term weakness associated with tax-loss selling tends to become short-term strength at the beginning of the following year once the tax-loss selling is over and investors seek to take advantage of the opportunities it creates.

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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