CLOSED-END FUND review

FOURTH QUARTER 2013

Jeff Margolin

Senior Vice President, Closed-End Fund Analyst

First Trust

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

Fourth Quarter Overview

2013 was a mixed year for the closed-end fund (CEF) structure. While the Morningstar universe of 176 equity CEFs were up on average 12.13% on a share price total return basis and clearly benefited from the global rise in equity prices, the Morningstar universe of 387 fixed-income CEFs was lower by an average of 8.56% on a share price total return basis. The over 100 basis points increase in long-term U.S. Treasury rates not only put pressure on the net asset values (NAVs) of fixed-income CEFs that have long durations (such as municipal CEFs) but also caused a palpable shift in investor sentiment in the spring and summer months away from fixed-income and yield-oriented CEFs (even without consideration of how the NAV of the CEF was performing). This magnified share price weakness and caused discounts to NAV to widen to levels which are greater than historical averages. For example, as of 12/31/13, the average CEF was trading at a significant and attractive discount to NAV of 7.33% (according to Morningstar). This is much wider than the 2.77% average discount to NAV that 2013 began with (Morningstar).

Mostly due to the fact CEFs are primarily owned by retail investors, shares are bought and sold on an exchange at a price which is independent from the funds' underlying NAVs and because many CEFs are thinly traded, changes in retail investor sentiment away from the CEF structure can increase volatility in their share prices and cause discounts over short periods of time to widen significantly (even in funds where the underlying NAV is increasing). I believe this phenomenon was on display during the spring and summer months of 2013 as the combination of long-term interest rates trending higher and the continuing steady rise in equity prices, prompted a change in retail investor sentiment away from many categories of the CEF marketplace. The result is that I believe as 2014 commences there are a significant number of very compelling opportunities across many different categories of the CEF marketplace for investors to consider.

Attractive Valuations, Compelling Asset Classes and Low Leverage Costs Characterize Secondary Market of CEFs as 2014 Commences

As 2014 gets underway, it is my belief that the opportunities which exist in the secondary market for CEF investors are as compelling as they have been at any time since early 2009 when the credit crisis was beginning to heal. I base that on three primary factors:

1. **Attractive Valuations:** As mentioned above, average discounts to NAV of 7.33% for the CEF secondary market are much wider than where they were a year ago and I believe they represent very compelling valuations (particularly considering many funds and categories are trading at wider than average historical discounts to NAV). For example, according to Morningstar, the average senior loan CEF as of 12/31/13 was at a discount to NAV of 4.88%. A year ago on 12/31/12, the average senior loan CEF was at a premium to NAV of 0.74%.

2. **Compelling Asset Classes:** As the U.S. economy continues to grow at a modest to moderate pace, it has created a positive backdrop for credit-sensitive asset classes (including high yield bonds and senior loans) as defaults for both of these categories remain well below historical averages and corporate balance sheets continue to improve. For example, Moody's reported that the global speculative-grade default rate stood at 2.6% in December, down from 2.7% in November. Moody's is forecasting a default rate of 2.3% for December 2014. The historical average for the default rate on speculative-grade debt has been approximately 4.7% since 1983. The U.S. speculative-grade default rate stood at 2.2% in December, down from 2.4% in November. The default rate on senior loans stood at 1.61% in December, up from 1.48% in November, according to the Standard & Poor's LCD publication. Leveraged loan portfolio managers expect the default rate to be in the vicinity of 2.0% by the end of 2014 and 2.5% around the close of 2015, remaining below the historical average of 3.2%. Furthermore, the improving U.S. economy has helped propel earnings per share (EPS) growth for the S&P 500 Index. Indeed, according to S&P, earnings per share for the S&P 500

Index are forecasted to grow from $107.19 in 2013 to $121.46 in 2014, which represents a 13.3% increase. I believe this creates a positive environment for domestic equity CEFs, especially in light of the fact that (according to Morningstar) the average domestic equity CEF is at a 7.07% discount to NAV as of December 31, 2013.

3. **Low Leverage Costs:** While the Federal Reserve has begun the process of reducing its bond buying purchases known as quantitative easing (QE), it has also been clear that it does not intend to raise the federal funds rate (which is currently 0-0.25%) until 2015. This is very relevant to the CEFs as approximately 70% of all CEFs employ the use of leverage and of this 70%, roughly 95% are borrowing at an interest rate which is pegged off of short term rates. With the Federal Reserve keeping short-term rates extremely low likely until 2015, it helps leveraged funds earn a positive spread between their borrowing cost and the rates they can earn on the borrowed proceeds. This is part of the reason the average CEF has a distribution rate of 6.89% as of 12/31/13 (Morningstar). This is nearly 45 basis points higher than the average distribution rate of 6.45% from 12/31/12, and with leverage costs likely staying very low through 2014, I would expect most CEFs to be able to maintain distributions at these very compelling levels.

In short, many of the key factors I use to determine whether or not the environment for the categories I favor in the CEF structure are very positive now.

No Changes to My Favored Categories of the CEF Marketplace

While 2013 was a mixed year for the categories of CEFs I favor (with domestic equity CEFs up 14.72%, senior loan CEFs up 2.92%, high yield CEFs up 2.47%, limited duration CEFs down 3.53% and municipal CEFs down 13.42%, according to Morningstar on a share price total return basis), I continue to firmly believe that investors looking to build a CEF portfolio or looking to add to current positions should focus on these primary categories. I base this on the very compelling valuations these categories are trading at, strong fundamentals of the underlying asset classes these categories are invested in and the compelling distributions they are providing. Please see my Blog posts (on the First Trust website) for 1/9/14, 12/10/13 and 9/16/13 for more information on these categories of the CEF marketplace I favor.

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.

First Trust

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