CLOSED-END FUND review

THIRD QUARTER 2014

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Third Quarter Overview

After a very strong first half of the year, many closed-end funds (CEFs) were slightly lower during the third quarter, with the average CEF down 2.06% on a share price total return basis, according to Morningstar. Even with the weak quarter, the average CEF remains up, 8.28% year-to-date (YTD) on a share price total return basis. Furthermore, it remains a broad rally YTD with equity CEFs up 6.21% on average, taxable fixed-income CEFs up 6.05% on average and municipal CEFs up 14.01% on average on a share price total return basis.

Despite some early volatility as the fourth quarter commences, the overall environment for many categories of the CEF marketplace remains a positive one. For starters, valuations among the 578 CEFs in the Morningstar database remain compelling as the average CEF is trading at a discount to net asset value (NAV) of 7.80% as of 9/30/2014. This is more than double the average discount of 3.42% from exactly three years ago. Leverage cost for the roughly 70% of CEFs that employ the use of leverage remains very low as the Fed continues to hold the fed funds rate at 0-0.25%, which is where it has been since December of 2008. Furthermore, the overall environment for equity CEFs (particularly U.S. equity CEFs) and credit-sensitive CEFs, remains a positive one. The U.S. economy continues to grow at a moderate pace (our economics team forecasts GDP growth of 2.9% for the third quarter) and corporate earnings for the Standard and Poor's 500 Index are forecasted to increase in the high single digits in 2014. Moderate growth in the U.S. economy, coupled with increases in corporate earnings, not only creates a positive backdrop for equity CEFs but also for credit-sensitive funds. As well, default rates continue to be well below historical averages for both senior loans and below investment-grade corporate bonds. Lastly, the continued decline in long-term interest rates has provided a positive backdrop for long duration fixed-income CEFs such as municipal CEFs.

Fix the Roof While the Sun is Out

Despite the continued positive backdrop for many categories of the CEF marketplace as outlined above, I continue to be an advocate for investors beginning the process of positioning CEF portfolios for the potential for the fed funds rate to move higher in 2015 (based on communications from the Federal Reserve to investors regarding the timing of potential increases). Indeed, I outlined a four part "game plan" in the CEF commentary from 7/24/14 that I believe CEF investors should begin to put in place over the next 1 to 2 quarters (http://www.ftportfolios.com/Commentary/Insights/2014/7/24/second-quarter-2014). I believe if CEF investors take the steps outlined in this "game plan", their CEF portfolios will be in a better position to handle a sustained period of rising fed funds rates. Recall the increases in the fed funds rate in 2004-2006 when rates increased from 1% to 5.25% in a series of 17 increases.

For example, one piece of the "game plan" discussed in the CEF Commentary from July of 2014 was for CEF investors to begin the process of lightening up on long-duration fixed-income CEFs. Levered municipal CEFs are one particular category which tends to have long durations (10 years or more) and could be vulnerable to weakness in a sustained period of rising interest rates. Beginning with the CEF commentary piece from 1/16/2009 (http://www.ftportfolios.com/Commentary/Insights/2009/1/16/fourth_quarter_2008) and through several periods of volatility within the municipal CEF space over the past 5-plus years, I have been a strong advocate for investors maintaining exposure to leveraged municipal CEFs and adding to positions during periods of enhanced volatility. However, as we get closer to the potential for interest rates to move higher in 2015 and given the significant strength in levered municipal CEFs not only over the past year but also over the past 5¾ years, I now believe investors should lighten up on levered municipal CEFs. To be clear, the underlying asset class of municipal bonds is still one that

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provides compelling tax-free yields with historically very low defaults and can provide important balance in a diversified portfolio, but at this juncture I prefer to see investors sell into the recent strength and have the majority of their exposure to the municipal asset class in either non-levered municipal CEFs, non-levered municipal exchange-traded funds (ETFs) or portfolios of individual municipal bonds.

In short, I firmly believe CEF investors should "fix the roof while the sun is out" and make changes to their CEF portfolios while the overall environment remains a good one for many CEF categories. As discussed in the CEF commentary from July of 2014, this means lightening up on long-duration fixed-income CEFs, focusing on short duration CEFs (such as senior loan & limited duration CEFs), focusing on equity income CEFs and, lastly, focusing on non-levered CEFs or funds which have locked in part or all of their leverage cost. I would rather see investors calmly begin the process of making these changes now than panic once the Fed does begin the process of raising the fed funds rate.

Source for all data: Morningstar, 9.30.14

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