CLOSED-END FUND review

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SECOND QUARTER 2014

Second Quarter Overview

After a very solid first quarter, most closed-end funds (CEFs) continued their winning ways in the second quarter with the average fund up 4.88% on a share price total return basis (according to Morningstar). The average CEF is now up 8.06% year-to-date (YTD) through 6/30/14 on a share price total return basis (Morningstar). The continued rally in the share prices for many CEFs during the second quarter was a broad one as many categories were positive for the quarter. Indeed, Morningstar data showed that on a share price total return basis for the quarter, all equity CEFs were up 6.98% (and are up 7.66% YTD); all taxable fixed-income CEFs were up 3.25% (and are up 6.08% YTD); and all municipal CEFs were up 3.90% (and are up 10.41% YTD).

The first half of 2014 has not disappointed in terms of the expected rebound and better performance for the share prices of many CEFs. Many factors have contributed to the better performance YTD relative to 2013 including (but not limited to):

- Bargain hunters taking advantage of the still wider-than-average discounts to NAV across many categories of the CEF marketplace. As of 6/30/14, the average discount to NAV for all CEFs remains compelling relative to historical averages at 6.07%. Average discount was 3.45% one year ago and 2.04% three years ago.
- Still rock-bottom leverage cost for most leveraged CEFs owing to the Federal Funds rate at 0%-0.25%.
- Continued rally in the U.S. equity markets. The S&P 500 was up 4.49% during the second quarter, according to Bloomberg.
- Significant rally in the U.S. bond markets. The yield on the 10-year U.S. Treasury declined to 2.51% from 2.76% during the quarter according to Bloomberg.
- Very low corporate bond default environment. Moody's reported that the global speculative-grade default rate stood at 2.2% at the close of Q2'14, down from 2.3% at the close of Q1'14. 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 1.9% at the end of Q2'14, up from 1.8% at the end of Q1'14. The default rate on senior loans stood at 0.83% in June (27-month low), down from 0.99% in May, according to Standard & Poor's LCD.
- Limited number of CEF Initial Public Offerings (IPOs) (only 3 through the end of June according to CEFA.com).
- The search for distributions on the part of retail investors and the high distribution rates CEFs provide. As of 6/30/14, the average CEF provided a distribution rates of 6.35%.

  (Source for above stats and data are Morningstar, unless otherwise cited.)

Game Plan for when the Federal Reserve Begins to Increase the Federal Funds Rate

Heading into the second half of 2014, the backdrop for many CEF categories remains a good one with wider-than-average discounts to NAV still prevailing, stable and attractive distribution rates for most CEFs, low leverage cost for the roughly 70% of CEFs which employ leverage and positive macro factors for many CEFs (including a low global inflation environment as well as slow to moderate global economic growth). It is my continued view that this backdrop continues to be a solid one for diversified CEF investors, particularly investors with exposure to favored areas including domestic equity CEFs, limited duration CEFs, senior loan CEFs and municipal CEFs.

While this favorable backdrop will likely continue heading into 2015, based on what the Federal Reserve has communicated to investors, it appears as if the Fed will likely begin to increase the

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Federal Funds rate sometime in the middle of 2015. It has been at 0-0.25% since December of 2008. From my perspective, the good news for CEF investors is that there is plenty of time before the Fed begins to increase the Federal Funds rate. Therefore, investors have time to put together a game plan on how to prepare for higher short-term interest rates (which impacts leverage costs for CEFs which have not locked in their leverage costs) and a likely increase in long-term interest rates, as well as an increase in short-term rates, which will likely increase rates along the entire yield curve.

Below are several investment moves I believe CEF investors should consider as we get closer to the Fed increasing the Federal Funds rate. To be clear, I believe there remains plenty of time to undertake these actions based on the Fed's communications. It appears that higher short-term interest rates are roughly 9 to 12 months away. The current backdrop remains a favorable one for most CEF categories heading into the last half of 2014 and likely into the beginning of 2015. However, it is important to have a game plan for the eventuality of higher interest rates and that is what I have outlined below:

- Lighten up on long-duration fixed-income CEFs: particularly funds that have not locked in some or all of their leverage cost.
- Focus on shorter-duration income CEFs: particularly funds that invest heavily in floating-rate asset classes and therefore have the potential to increase their earnings rate as leverage cost move higher.
- Focus on equity income CEFs that invest in companies or other entities that historically grow their distributions.
- Seek out funds that are either non-leveraged or have locked in some or all of their leverage cost and therefore are less susceptible to the negative impact higher short-term rates could have on leveraged CEFs.

In short, it is important to be prepared for when the backdrop of very low short-term rates (and therefore very low leverage costs) begins to change, and while the current environment remains a good one for many categories of the CEF marketplace and will likely continue to be a good one heading into early 2015, I would suggest having the above game plan in place as we get closer to the middle part of 2015. I believe this will position brokers and investors to be able to take the appropriate actions when short-term interest rates do begin to move higher.

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