CLOSED-END FUND review

FOURTH QUARTER 2014

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2014 Overview

2014 was a solid year for diversified closed-end fund (CEF) investors. I specifically use the term "diversified" because whether I am writing about CEFs or giving a presentation about the CEF structure, I always encourage investors to diversify across several different categories of the CEF structure in order to attain proper diversification and exposure to many different asset classes. According to Morningstar, the average CEF was up 7.88% last year on a share price total return basis. As always, performance varied significantly depending on the category.

For example, two of the categories I advocated investors have exposure to in my commentary a year ago posted solid total returns. The decline in long-term interest rates, coupled with continued very low leverage cost, was particularly beneficial to long-duration municipal CEFs. Municipal CEFs were up on average 17.80% on a share price total return basis in 2014. Many equity-oriented CEF categories also performed well in 2014, particularly equity funds with an emphasis on U.S. equities. Indeed, according to Morningstar, the average domestic equity CEF was positive by 6.10% on a share price total return basis.

On the other side of the ledger, perhaps owing to the fact that long-term rates declined significantly in 2014 (the 10-Year U.S. Treasury began the year at 3.02% and ended the year at 2.17%, according to Bloomberg), and because the Federal Reserve remained "dovish" throughout the year keeping the federal funds rate at 0-0.25%, investors didn't feel the need to shorten durations among their fixed-income CEF positions.

In my view, fundamentals and valuations remain compelling for both the senior loan asset class and senior loan CEFs:

- Defaults on senior loans remain well below 1%, according to S&P;
- Senior loan prices ended the year at a discount to par at 95.34, as measured by the S&P/LSTA US Leveraged Loan Index;
- Inexpensive valuations on senior loan CEFs relative to historical averages, with the average senior loan CEF having ended the year at a discount to net asset value (NAV) of 9.04%. For comparison purposes, one-year ago (12/31/13) there was an average discount to NAV of 4.88%. Five years ago at year-end the average discount to NAV was 1.81%, and ten years ago, during a period the Federal Reserve was raising short-term rates, the year-end figure was a ***premium*** to NAV of 0.07%. (All figures from Morningstar.)

Despite these fundamentals, however, the average senior loan CEF ended the year with a decline of 1.93% (Morningstar, on a share price total return basis). Limited duration CEFs ended the year with only a slight gain of 0.56% on average (Morningstar).

While senior loan CEFs may have been out of favor during 2014, based on the solid fundamentals and compelling valuations as noted above, I continue to advocate they be part of a diversified CEF portfolio. Moreover, based on our Economic Team's forecast for the Federal Reserve to begin raising the Federal Funds rate during the middle part of the year, as well as communications from the Fed itself that it could begin raising rates in 2015, floating-rate senior loan CEFs, as well as limited duration CEFs (which were out of favor in 2014), could become more in favor with investors in 2015 as they begin to shorten durations in their portfolios.

Outlook and Strategy for 2015: Continue to Blend Non-Correlated Categories

As 2015 commences, the backdrop continues to be a good one for many categories of the CEF marketplace, in my opinion. The average discount to NAV was 7.33% as of 12/31/14 (Morningstar) and remains wider than historical averages. Furthermore, leverage costs continue to be very low as the Fed continues to keep the Federal Funds rate at 0-0.25%. This helps the roughly 70% of the CEF universe that employs leverage to earn a generous spread between borrowing cost and the rates they can earn on borrowed proceeds. Indeed, this is part of the reason the average CEF had a very compelling distribution rate of 6.72% based on share price (Morningstar as of 12/31/14). Lastly, continued "plow-horse" (as our Economic's Team has phrased it) economic growth in the United States, coupled with estimates for high single-digit EPS growth for the S&P 500, also provides a solid backdrop for equity-oriented CEFs in 2015 (particularly those focused on U.S. equities), in my opinion.

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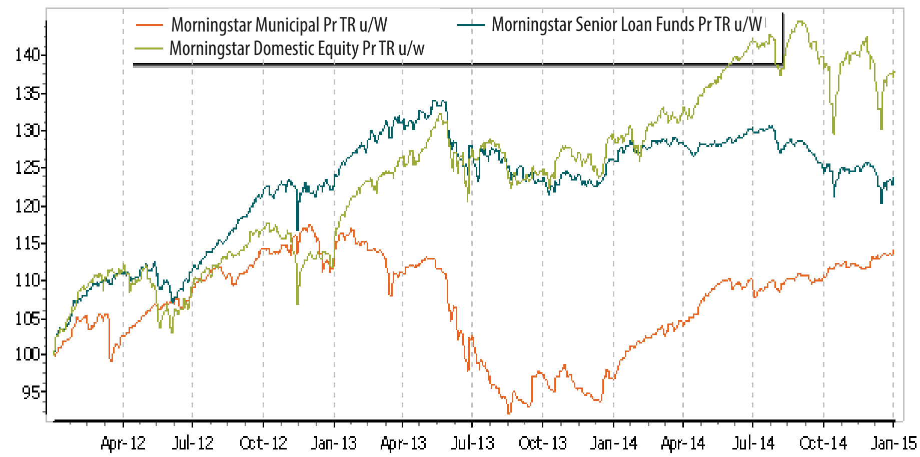
My biggest concern as it relates to investing in CEFs in 2015 is that after six years of the Federal Funds rate at 0-0.25%, and after a continued drop in long-term interest rates, investors have become too complacent as it relates to interest rate risk among their CEF positions. This is part of the reason I advocated investors "Fix the Roof While the Sun is Out" back on October 24th of last year and begin the process of shifting CEF portfolios well in advance of what our Economic's Team is forecasting with a potential rise in both short- and long-term interest rates by the end of the year. (www.ftportfolios.com/Commentary/Insights/2014/10/24/third-quarter-2014)

To that end, I continue to be an advocate for the "balanced, three-pronged approach to investing in CEFs" that I have written about previously, including in this 2012 commentary piece:
www.ftportfolios.com/Commentary/Insights/2012/7/24/second-quarter-2012

However, while I continue to believe this blend should primarily include domestic equity CEFs, senior loan and limited duration multi-sector funds and municipal CEFs, given our viewpoint that both short- and long-term interest rates could be headed higher by the end of 2015, I prefer CEF investors lighten up on their leveraged municipal CEFs in favor of non-levered municipal CEFs which tend to have less duration risk while still providing attractive tax-free income, as well as important balance in a portfolio.

In my view, the three-year chart below clearly illustrates the benefit of having employed this balanced, three-pronged approach to investing in CEFs. As you can see by looking at the chart, all three of these categories: domestic equity CEFs, municipal CEF and senior loan CEFs have produced positive share price total returns (Morningstar) from January 1, 2012 to January 1, 2015. However, while the general trend encompassing the three-year period has been positive on a total return basis for all three categories, these categories have oftentimes not been correlated to one another and, therefore, they have often moved in different directions. In my view, this highlights the benefit of diversifying across different categories of the CEF marketplace, particularly when they are oftentimes non-correlated categories. An investor has not only been able to generate a compelling income stream when blending these three categories to create a more diversified, balanced portfolio of CEFs, but also had less volatility relative than if they only owned one of these categories alone.

Non-Correlated Categories
Daily values in USD



In short, based on three key points including our outlook for continued growth in the U.S. economy and earnings growth for the S&P 500, the potential for short- and long-term rates to move higher by the end of the year (and therefore a concern about duration risk among fixed-income CEFs) and still compelling fundamentals and valuations, I believe the three core parts of an investor's CEF positions in 2015 should be domestic equity CEFs, senior loan and limited duration multi sector CEFs and non-leveraged municipal CEFs. Other categories that I also believe could be used more as satellite CEF positions than core positions (but still offer compelling characteristics) include: preferred CEFs that have an emphasis specifically on fixed- to floating-rate preferreds (as they provide compelling income with less duration risk than preferred CEFs that only focus on perpetual preferreds); convertible CEFs (compelling average distribution rates of 8.05% according to Morningstar as of 12/31/2014 and the potential to participate in some of the upside equities could provide); and MLP CEFs for the distribution growth they historically provide.

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