CLOSED-END FUND review

Jeff Margolin

Senior Vice President, Closed-End Fund Analyst

THIRD QUARTER 2015

Third Quarter Overview

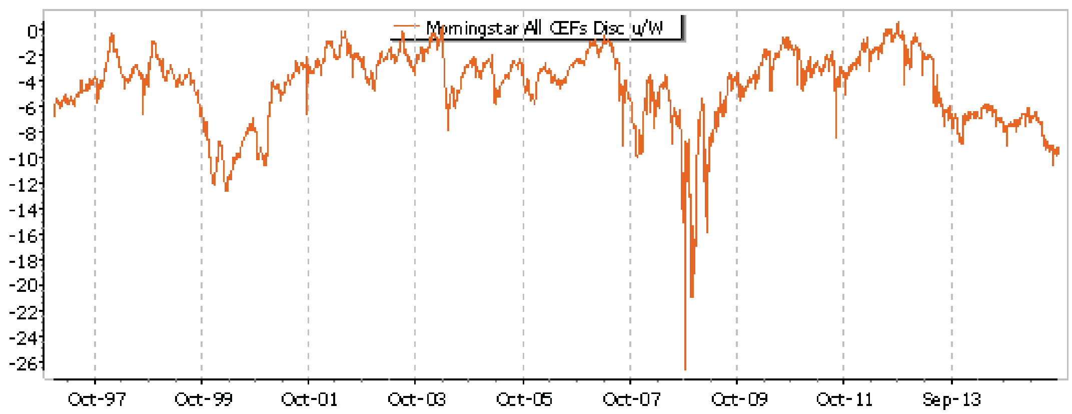
After the second quarter, where the average closed-end fund (CEF) was lower by 3.70% on a share price total return basis, the third quarter was another difficult quarter, with the average CEF lower by 6.28% on a share price total return basis, according to Morningstar. Weakness in the global equity markets impacted equity CEFs with the average equity CEF lower by 15.14% on a share price total return basis. It is clear that an aversion to taking credit risk during the quarter negatively impacted many taxable fixed-income CEFs, with the average taxable fixed-income CEF lower by 4.60% on a share price total return basis. Municipal CEFs were a bright spot during the third quarter, with the average municipal CEF higher by 3.29% on a share price total return basis (Morningstar).

20-Year Look at Discounts/Premiums to Net Asset Values (NAVs)

CEFs trading at discounts to their NAVs is not a new phenomenon. However, it is rare that the broad universe of CEFs trades at an average discount to NAV as wide as 9-10% as it was at the end of the third quarter. As of 9/30/2015, the average CEF was trading at a 9.76% discount to its NAV (Morningstar). As the 20-year chart below illustrates, from 9/29/1995 to 9/30/2015, there have only been a small number of times when average discounts to NAV were as wide as they are today for an extended period of time. Two of those periods include: 1) the credit crisis of 2008-2009 and 2) late 1999 to the first half of 2000 when short- and long-term rates were both simultaneously trending higher.

Average Discounts to NAV

Daily values in USD



Source: Morningstar

Even the horrific terrorist attacks on 9/11/2001 or Russia defaulting on its debt in August of 1998 didn't cause average discounts to widen to levels they were as of 9/30/2015. When S&P downgraded its credit rating of the United States from AAA to AA+ back in August of 2011 (and the stock market had a correction of more than 10% over the next two months), average discounts to NAV widened to levels just shy of where they were on 9/30/2015 but the wide discounts of roughly 8% only lasted approximately a month and quickly narrowed, becoming slight average premiums to NAV by September of the following year.

Despite the fact that credit markets are currently functioning very smoothly; default rates on both high-yield corporate bonds, as well as senior loans, are running at levels well below historical averages; the U.S. economy continues to exhibit "Plow Horse" economic growth (as our Economics Team calls it) and interest rates remain low (although long-term rates have trended slightly higher since February of this year), current average discounts to NAV of 9-10% remain at levels usually reserved for periods of significant stress in the credit and financial markets (or for periods of significantly rising interest rates).

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

As I wrote about in my 2Q CEF commentary in late July, the drumbeat of higher short-term rates, as well as a slight increase in long-term interest rates, are partially responsible for the widening of discounts (and apprehension toward the CEF structure) which began in earnest in the Spring and continued through the Summer (and now into the Fall). Recent volatility in the equity markets and a "risk off" investor mentality have also likely contributed to the discount widening as well. (*http://www.ftportfolios.com/Commentary/Insights/2015/7/22/second-quarter-2015*)

Regardless of the reasons why discounts have widened to such borderline extreme levels (at least when compared to historical averages), I think CEF investors have overdone it on the down side, which has left many categories of the CEF marketplace trading at very compelling and inexpensive valuations. The recent share price weakness and discount widening has also led to a meaningful rise in the distribution rate the average CEF provides. According to Morningstar, as of 9/30/15, the average CEF had a share price distribution rate of 7.70%, which is much higher than the average of 6.71% from 12/31/2014.

Looking at the valuations of many categories within the CEF marketplace, it appears as if investors have already begun to price in not only higher interest rates but also higher default rates among below investment-grade bonds, and this, I believe, has created a very compelling opportunity for investors to dollar-cost average and take advantage of the attractive valuations across many categories within the CEF marketplace. I don't know exactly when discounts will begin to narrow from current levels of 9-10% to levels which are closer to the long-term average of 3-4%. However, historically when average discounts to NAVs are as wide as they are for as long as they have been, and distributions are as high as they currently are, it can create very compelling long-term total return opportunities for CEF investors.

What's Your "Macro View"?

In my view, when average discounts to NAVs widen to levels in the high single-digits or even low double-digits for certain categories and share price distribution rates average in the high single-digits, investors should take a serious look at the CEF structure and focus on categories which are aligned with their macro view. Historically, average discounts in the 9-10% range and average share price distribution rates near 8% do not last that long, as eventually good old-fashioned price discovery takes hold and value investors and bargain hunters begin to take advantage of the compelling valuations and distribution rates.

Given First Trust's macro outlook for continued "Plow Horse" growth in the U.S. economy, potential for mid single-digit growth in S&P 500® Index earnings in 2015 and double-digit earnings in 2016, higher U.S. equity prices and the potential for both short- and long-term interest rates to move higher over the next year, I continue to believe the core parts of an investor's CEF positions should include domestic equity CEFs, senior loan CEFs, limited duration multi-sector CEFs and non-leveraged municipal CEFs. I also continue to believe that convertible CEFs, Master Limited Partnership (MLP) CEFs and preferred securities CEFs that specifically have an emphasis on fixed-to floating[1] rate preferreds are three categories that could be used as satellite positions.

[1] A fixed-to-floating rate security has a coupon rate that is fixed for a certain period of time (typically five, ten or thirty years from the time of issuance), after which the coupon resets at a floating rate based on a spread over the security's benchmark (typically 3-month LIBOR).

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