CLOSED-END FUND review

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SECOND QUARTER 2016

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Second Quarter Overview

Following the solid first quarter performance for closed-end funds (CEFs) when the average CEF was positive by 2.73%, the positive momentum continued during the second quarter, with the average CEF up another 6.33%. Indeed, after grinding through a challenging 2015 (particularly the back half of the year), diversified CEF investors have been rewarded with very strong total returns year-to-date with the average CEF now up over 9% through 6/30/2016 (source: Morningstar. All data is share price total return data).

The positive gains were broad based during the quarter with equity CEFs up an average of 7.94%, taxable fixed-income CEFs up 6.06% and municipal CEFs up 6.12%. While each category of the CEF marketplace has different factors which impact performance, broadly speaking, some of the factors which continue to benefit many CEFs include: higher equity prices (particularly U.S. equities), declining long-term rates and continued "Plow Horse" (as our Economics team phrases it) economic growth in the U.S. economy which helps to create a positive backdrop for many credit sensitive CEFs. Lastly, high distributions and attractive discounts to net asset values (NAVs), particularly for equity and credit sensitive categories (more on that below,) also helped to attract buyers to the secondary market during the quarter.

Average Discounts to NAV Continue to Narrow: Pick Your Spots More Carefully

I have long been a believer that the most successful long-term CEF investors are ones who:

- Maintain diversified CEF portfolios (i.e. blending exposure to equity, credit sensitive and higher credit quality CEFs together);
- Opportunistically take advantage of periods when significant inefficiencies exist in the marketplace (i.e. when average discounts to NAV are meaningfully wider than historical averages) as was the case for much of the second half of 2015;
- Let the compounding of the high distributions many CEFs distribute add-up, which over many years can significantly boost total returns.

I still firmly believe in the above principles. However, as average discounts to NAVs have narrowed this year as share price performance has improved, I do believe when thinking about allocating new money to work in the CEF marketplace, it is important to pick your spots more carefully as valuations for many CEFs are not as inexpensive as they were last year.

According to Morningstar, average discounts to NAVs continued their narrowing process during the quarter, with the average CEF trading at a discount to NAV of 4.65%. They ended the first quarter at an average discount to NAV of 5.83%, which was down from 7.86% to start the year. As average discounts to NAV begin to narrow closer to their long-term average, from my perspective, it is important to focus on categories where valuations (i.e. discounts to NAV) still remain attractive and also where the fundamentals and valuations of the underlying asset class also remain attractive.

Three categories which continue to meet the above criteria include: U.S. equity CEFs, senior loan CEFs and limited-duration CEFs. Indeed, despite improved share price performance so far in 2016, according to Morningstar, all three of these categories continue to trade at high single to low double-digit discounts to NAV. As of 6/30/2016, the average U.S. general equity CEF was at an 11.41% discount to NAV, the average limited duration CEF was at an 8.86% discount to NAV and the average senior loan CEF was at a 7.26% discount to NAV. Furthermore, all three of these categories should continue to benefit from continued slow to moderate growth in the U.S. economy, higher U.S. equity prices and slowly rising interest rates over the next 12-months as our Economics team is forecasting.

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While I continue to favor U.S. equity CEFs, senior loan CEFs and limited-duration CEFs, the most challenging area to find value exists in the higher credit-quality areas of the CEF marketplace. As long-term rates have declined again this year, many long-term bonds are at meaningful premiums to par. Furthermore, the discounts to NAVs of many higher credit-quality CEFs (particularly municipal CEFs) have narrowed completely. For example, according to Morningstar, the average municipal CEF was only at a discount to NAV of 0.10% on 6/30/16. It started the year at an average discount to NAV of 4.84%.

While the tax-free yields remain very attractive for municipal CEFs, in my view, many of the long-term bonds they focus on are not inexpensive and many of the funds are also not inexpensive. If long-term interest rates are steady or trend lower over the next 12-months, municipal CEFs will likely continue to perform well. However, if we finally do see a meaningful rise in long-term rates over the next 12-months, there is the potential for meaningful downside volatility in municipal CEFs as a result of the duration risk many municipal CEFs take and owing to the lofty valuations many long-term municipal bonds are trading at (as well as the lofty valuations relative to historical averages many individual municipal CEFs are currently at).

Given where we are in the interest rate cycle, coupled with the valuations long-term municipal bonds/CEFs are trading at, I think it is important investors are aware of the potential risks. That doesn't mean municipal CEFs should not be included in a diversified CEF portfolio (which should also include equity and credit-sensitive CEFs), but from my perspective it does mean the risks have increased.

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