Closed-End Funds and the Age of the Enlightened Investor

× Scott Burns, Director of ETF, CEF and Alts Research



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In the Beginning....Tulips, Ships and Risk

× The closed-end fund traces its roots back to 1774, the heart of the Age of Enlightenment





Post-Financial Crisis Investor is now-Enlightened

× Immanuel Kant:

- × The Enlightenment was "Mankind's final coming of age, the emancipation of the human consciousness from an immature state of ignorance and error."
- × For the investor in 2008, the maturation process was one of awareness especially around **risk** and **liquidity**





Risk is Everywhere!

- × There are no risk-less returns to be found
- × There are return-less risks, however.....



- The point of emphasis is that you need to match the return to the risk and not get caught in the trap of throwing all risk in the same bucket and then throwing that bucket away
- × The best way to avoid return-less risks is through transparency



The Greed and Fear Pendulum

- × Throughout human history financial markets have existed in hyper states vacillating between greed and fear
- × But we have to keep things in context



Risk in Context





Myths and Realities about CEF Investing: Hurtling Towards the Sun or Out of Coffee

- × Leverage
- × Distributions
- × Premium / Discount
- × Initial Public Offerings
- × Performance relative to other investment vehicles



× Myth: Leveraged CEFs are Dangerous: More dangerous than blue chip stocks?





× The five highest leveraged CEF categories heading into 2008





× The five highest leveraged CEF categories heading into 2008





× Taking a longer-term view: we still see the risk





× Taking a longer-term view: same risk, but the return situation has improved





× Risk is only a problem if there is no compensating return

Risk Adjusted Total Return Performance, Both CEF and	OE
Long Duration National Municipal Category	

	3-Year	5-Year	10-Year
# 1 Highest	PMF	MMU	MUH
#2	PML	MVT	MHD
#3	EVN	MUH	MVT
#4	BFK	MHD	MYD
#5	BLE	MVF	BFK
#6	PMX	BPK	NXZ
#7	BBK	NQS	MVF
#8	MVT	FMN	NZF
#9	BKIN	XAA	BPK
# 10	MHD	NZF	NQS
Top CE Fund	# 64	# 39	# 45

Data from Morningstar Direct as of 03/31/2012



Distribution X Closed-end funds, generally speaking, are income producing machines

CEF Average Category Distribution Rates Relative to OE Category Average 12-Month Yields

	CEF Income &	OE Average	Is CEF Yield
Category	Cap Gains Rate (Price)	12-Month Yield	Higher?
Bank Loan	7.5	4.6	Yes
China Region	4.9	0.6	Yes
Commodities Broad Basket	8.6	7.8	Yes
Communications	5.0	1.5	Yes
Conservative Allocation	7.0	2.8	Yes
Convertibles	7.2	2.6	Yes
Diversified Emerging Mkts	3.9	0.8	Yes
Diversified Pacific/Asia	10.0	1.2	Yes
Emerging Markets Bond	7.3	5.6	Yes
Equity Energy	3.0	1.2	Yes
Europe Stock	2.4	1.4	Yes
Financial	3.8	0.9	Yes
Foreign Large Value	11.7	2.1	Yes
Foreign Small/Mid Value	2.4	1.5	Yes
Global Real Estate	8.1	5.0	Yes
Health	6.5	0.1	Yes
High Yield Bond	8.9	7.4	Yes
High Yield Muni	6.6	5.2	Yes
Inflation-Protected Bond	3.2	2.8	Yes
Intermediate Government	4.8	2.8	Yes
Intermediate-Term Bond	6.8	3.5	Yes
Large Blend	2.2	0.9	Yes
Large Growth	3.7	0.2	Yes
Large Value	3.4	1.3	Yes



Distribution – Look Before You Leap

- × Two things for investors to consider, here
 - 1. Is the fund really generating high income?
 - 2. Is the distribution "safe"?
- × Another thing to consider, later
 - × Distribution rates and premiums/discounts are highly correlated.



Distribution – Despite the Headlines, Return of Capital is Not Prevalent





Distribution - RCC is Growing, though, When Present



% of Distribution Rate Derived from Various Sources



Distribution – Is My Distribution Safe?

× Should have asked the question before purchasing.

× Suggests that the investor invested for the wrong reasons.



Distribution - What We Think We Know About Distributions

- × Leveraged portfolios will show greater fluctuations in income generation capability
- × Positive UNII balances can act as cookie jars for distributions
- × Return of Capital can pad under-earned distributions



Distribution – What We Know About Distributions

What Types of Funds Have Been Likely to Cut Their Distributions Over the Past Three Years?				
Fund Characteristics	# of CEFs	Reductions	Increases	Average Net Change in Distribution
Leveraged, Positive UNII balance, no RoC	92	67	173	\$0.0028
Leveraged, Positive UNII balance, RoC	264	169	737	\$0.0103
Leveraged, No UNII balance, no RoC	34	32	10	-\$0.0048
Leveraged, No UNII balance, RoC	79	82	131	-\$0.0026
Not Leveraged, Positive UNII balance, no RoC	29	48	26	-\$0.0233
Not Leveraged, Positive UNII balance, RoC	44	57	43	-\$0.0064
Not Leveraged, No UNII balance, No RoC	30	22	13	-\$0.0017
Not Leveraged, No UNII balance, RoC	58	73	38	-\$0.0190



Discounts and Premiums – Some Common Myths

Two common myths about CEF discounts and premiums:

× Only buy CEFs trading at a 15% discount or wider

× Never buy a CEF trading at a premium



Discounts and Premiums – Some Common Myths × Myth only buy CEFs Trading at 15% Discount or more

First Opportunity Fund FOFI

as of March 31, 2012	
Last closing price	\$7.05
Last published NAV	\$9.30
Discount	24.2%

Portfolio Summary

12.8%
46.7%
6.3%
0.5%
33.7%

No leverage



Discounts and Premiums - Some Common Myths

- × Myth only buy CEFs Trading at 15% Discount or more
- × First Opportunity Fund
 - \times Of the top 10 holdings:
 - 5 hedge funds, 2 money market funds, Johnson & Johnson, Community Bancorp, Freeport-McMoran
 - NAV total return significantly lagging S&P 500 index over past 1-,
 3-, and 5- year periods as of March 31
 - \times In fiscal 2011, total expense ratio was 1.24%
 - \times Last distribution was made in 2008
 - × The 24% discount is no bargain. The 1-year z-stat of 0.12, reflecting the fund's average 1-year discount and volatility, suggests the discount is ordinary.



Discounts and Premiums - Some Common Myths

× Myth: Never buy CEFs trading at a Premium

× Again, this can strike of market timing.

× However, we've seen what can happen to high-premium CEFs, should their premiums collapse.

		Distribution Rate	3-Year Price	Loss if Price falls
	Premium	at Share Price	Total Return	to NAV overnight
PIMCO High Income Fund PHK	63.15	11.45	50.9	-39.5
PIMCO Global StocksPLUS & Inc PGP	60.4	10.73	50.2	-41.9
Gabelli Utility Trust GUT	46.03	7.66	25.6	-31.8
Babson Capital Corporate Invs MCI	30.89	7.33	36.2	-22.4
Cushing MLP Total Return Fund SRV	28.85	9.22	43.8	-23.0

× But, what about smaller premiums.



Discounts and Premiums – Some Common Myths × Myth: Never buy a closed-fund IPO

Closed-End Fund IPO Launches by Year						
Year of IPO	Number of CEF IPOs	Number of positive since inception NAV total returns	Percentage of positive since inception NAV total returns	Number of positive since inception share price total returns	Percentage of positive since inception share price total returns	
2011	16	10	62.5	4	25.0	
2010	20	19	95.0	18	90.0	
2009	13	13	100.0	13	100.0	
2008	2	1	50.0	1	50.0	
2007	41	21	51.2	18	43.9	
2006	22	15	68.2	13	59.1	
2005	47	36	76.6	34	72.3	
2004	51	43	84.3	44	86.3	
2003	49	42	85.7	41	83.7	
2002	75	73	97.3	73	97.3	
2001	36	36	100.0	36	100.0	

* All Data from Morningstar's Traded Fund Center as of the April 10, 2012 market close

Total returns are cumulative returns that include changes in net asset value or price and the total distributions of the CEF reinvested.

Since inception refers to the total cumulative return from the CEF's initial public offering through April 10, or until the CEF was acquired,

merged, liquidated, or otherwise ceased existence.



The Future for Closed-End Funds: The Obvious Opportunity

- × Closed-End funds are the best vehicle for Income in a fund format
 - \times Only more investors will be looking for income, never less
 - × Demographics require investors to keep "risk" capital in the markets longer as they live longer
 - × Open-end and ETF structures daily liquidity requirements limit available strategies
 - $\times\,$ The ability to add leverage is key for many Alternative strategies to be successful



The Future for Closed-End Funds: The Big Opportunity

- × Closed-End funds are the best vehicle for most Alternative strategies
 - × Open-end and ETF structures daily liquidity requirements limit available strategies
 - × The ability to add leverage is key for many Alternative strategies to be successful

Assets in Liquid Alternative Vehicles USD Bil



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The Future for Closed-End Funds: The Big Opportunity – A Whole New World





The Future for Closed-End Funds: The Big Challenge

× The Fiduciary Standard and the move to fee-based advice

- The elephant in the room is that the distribution model for CEF IPOs doesn't work in a fee-based world
- × That distribution model will need to change radically as more advisors shift to fee-based models
- × Good news, the distribution model in other parts of the world for CEFs seems to work just fine without commissions
- × Fee-based advisors more likely to look at CEFs in the secondary market, enhancing overall liquidity



The Future for Closed-End Funds: The Obvious Challenge

× Active ETFs: growing off all small base

Market: US ETF Currency: USD Eff Date: 2012-03-31 Active/Passive: Actively Managed Exclude Obsolete: Yes





The Future for Closed-End Funds: The Obvious Challenge

- × All of that is irrelevant post the launch of BOND
- × PIMCOtotal return the results:
 - × Launched with \$100 million
 - × Did first creation unit on second day
 - × Average Daily Volume around \$20 million
 - × As of 4/20 had raised \$465 million
 - Has yet to print 30-day SEC yield
 - × Is outperforming the index by 100 bps and the Institutional share class of the mutual fund by **160 bps**
 - First round of investments = conviction list
 - Pro tip: Get in early!



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