Closed-End Funds

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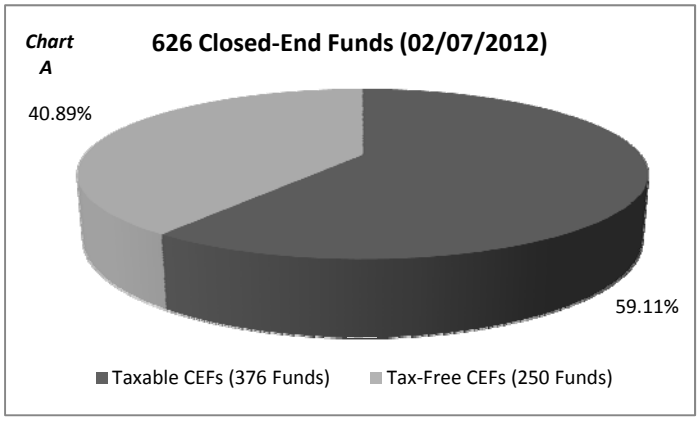
Closed-End Funds 101

Closed-end funds (CEFs) are investment vehicles, actively managed by separate entities known as investment advisors, distinguished by their unique features and benefits. There are currently over 600 CEFs, each with their own unique investment objective, be it capital growth, current income, or a combination of the two. Shares of CEFs are created through an initial public offering (IPO), after which they trade on a major stock exchange, similar to common stocks. As a result of trading on an exchange, CEFs will have both a market price and a net asset value (NAV). Market prices fluctuate based on supply and demand and typically trade above (premium) or below (discount) the fund's NAV. This characteristic, as well as others explained throughout this report, differentiate CEFs from their open-end mutual fund counterparts.

Types of Closed-End Funds

Tax-Free (Municipal) Funds

Municipal funds account for over 40 percent of all CEFs. These funds seek to provide current income exempt from regular federal income tax by investing in municipal securities - bonds issued by state and local governments and agencies. Single-state municipal funds are intended to provide income free from state-related taxes as well. Options available within the municipal fund sector besides the typical investment-grade long-term funds are insured funds, intermediate-term funds, and funds with a substantial amount of low-quality or non-rated funds. A breakdown of these various sub-sectors can be seen in Chart B to the right. The majority of municipal funds utilize a leveraging strategy, which is explained in greater detail later in this report.

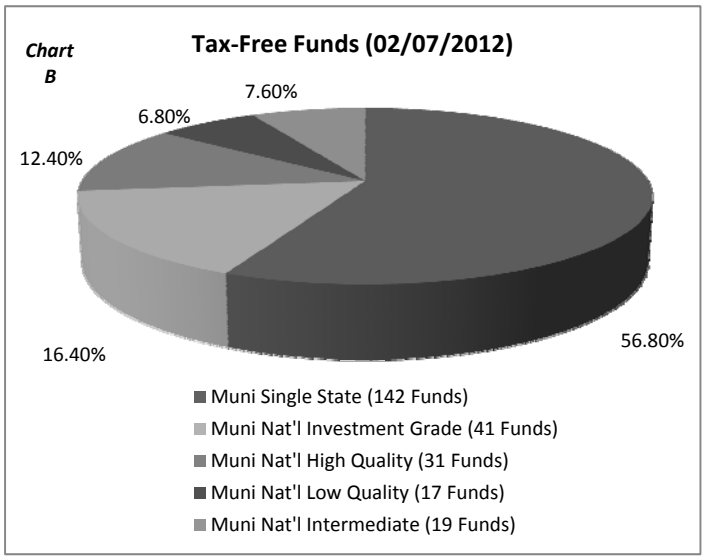


Source: Raymond James

Taxable Funds

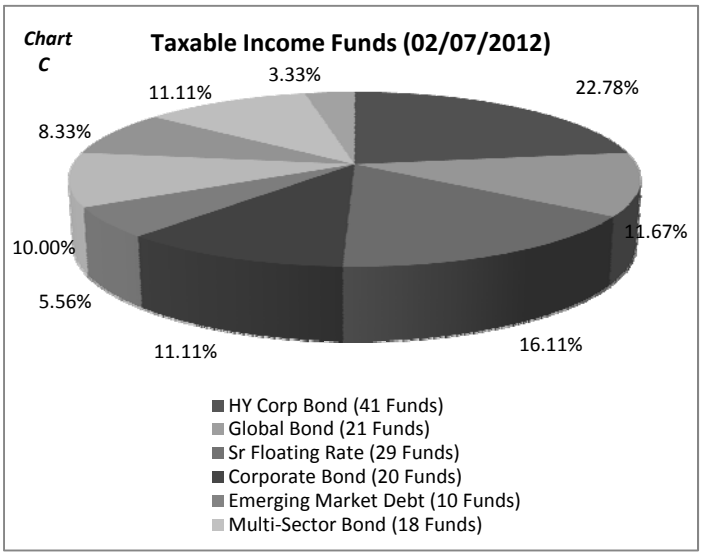
The taxable fund arena can be broken down into two categories - income-oriented funds and equity-oriented funds. Those hybrid funds that combine the two objectives are typically categorized as equity-oriented under the sector equity-income.

Taxable income funds invest in bonds or other debt-related instruments. These include securities such as mortgage-backed securities, U.S. government bonds, corporate bonds, senior bank loans, and preferred stock. Some funds concentrate on one particular type of debt instrument, while others invest in various forms of debt securities (i.e. multi-sector bond funds). There are also a number of funds that invest in international securities, both in developed and emerging market countries. Sector breakdown within the taxable income fund category is available in Chart C.

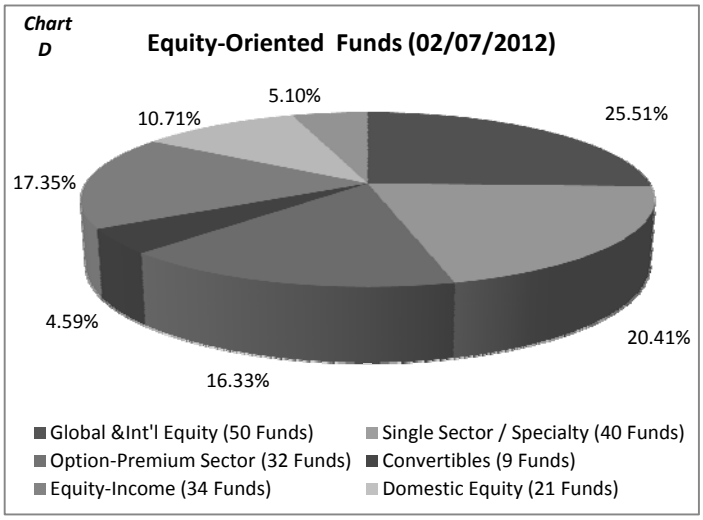


Source: Raymond James

There are a wide array of equity-oriented funds to suit both investors looking for broad-based equity allocations and sector-specific allocations. Chart D represents a breakdown of the various sectors of equity funds. Global/international equity funds invest in both U.S. and foreign equity securities. While some funds are fully diversified throughout various countries, there are also funds available that invest specifically in the equity securities of one country. Domestic equity funds invest primarily in companies whose common stock is both listed and incorporated in the U.S. There are also many sector-specific or specialty funds that invest in specific industries or circumstances, such as master limited partnerships (MLPs), real estate investment trusts (REITs), or venture capital investments. Option-premium funds offer a way to play a sideways equity market and receive income. While each fund's strategy differs, the main objective is to invest in a portfolio of common stocks and write call options on those stocks or comparable indexes. The premium received on the call options then flows through to investors through distributions by the fund on a monthly, quarterly, or semi-annual basis. Lastly, equity-income funds provide exposure to portions of both the equity and debt markets. Many of these funds pass income through to shareholders on a monthly or quarterly basis.



Source: Raymond James



Source: Raymond James

Open-End Funds vs. Closed-End Funds

CEFs differ in many respects from open-end funds, better known simply as mutual funds. Both generally benefit from active professional management, diversification, and stated investment objectives. However, mutual funds typically issue and repurchase shares directly, as needed. Shares are purchased and sold at NAV, calculated at the end of the trading day, rather than at a market price determined by supply and demand. Thus, the price reflects the value of the underlying securities, rather than demand for the fund. Higher liquidity can make mutual funds less volatile investments than CEFs, but the need to hold cash positions to satisfy redemption requests can negatively affect returns in a favorable market. Conversely, CEFs can be fully invested and hold little or no cash position in their portfolios. In addition, CEFs do not incur the ongoing costs associated with creating and redeeming shares and typically have lower expense ratios than standard mutual funds. There are also no minimum investment restrictions or minimum holding periods on purchases of CEF shares.

Characteristic	Open-End Mutual Funds	Closed-End Funds
Purchase price	End of day NAV	Market price set by supply and demand
Prices change	Daily – close of business	Intra-day
Transaction prices include	Sales, redemption charges	Standard commission
Shares sold to/purchased from	Fund company	Secondary market (NYSE, AMEX)
Shares offered by fund company	Continuously	Primarily at IPO

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Capital Structure

The assets of CEFs are raised during an IPO and the shares outstanding are then generally fixed. Funds that invest within a small universe may choose to impose a cap on the IPO due to liquidity constraints. The closed-end structure allows the manager to be fully invested at all times. CEFs are not subject to daily redemption requests, so managers are not forced to satisfy demand by increasing their investment in potentially over-valued markets or to sell attractive prospects in a declining market. In addition, the yield on CEFs can be higher due to low cash positions, as a larger cash position can lower the overall yield of the portfolio. Furthermore, the fixed asset base facilitates investment in specialized areas such as illiquid markets.

The fund's outstanding shares typically remain relatively constant and additional shares are generally only issued through a rights offering or dividend reinvestment program. A rights offering is an offering of new shares to current investors at a subscription price that is typically lower than the current share price and/or NAV. CEFs typically engage in rights offerings to take advantage of favorable market conditions.

The primary negative effect of the closed-end structure is the possibility of illiquidity. Since shares cannot be purchased or sold directly through the fund company, there are limitations on trading volume. If an order is placed that would materially increase the day's trading volume above the average, the price rises to correct this increase in demand. Likewise, if an investor wishes to sell an unusually large number of shares, the price will drop to a level where there are enough investors willing to purchase this large number of shares. The potential effect of reduced liquidity is that CEFs can experience share price volatility above that of mutual funds.

Discounts and Premiums

CEF shares can trade at discounts or premiums to NAVs. This is advantageous for investors seeking to maximize yield through CEFs. Consider a fund that pays out a 10% dividend on its NAV, currently $10.00. If the fund trades at a 10% discount, a $9.00 investment will produce the same dividend as investing in the individual securities at NAV. The yield will be: 1.00 / 9.00 = 11.11%, by virtue of the discount. This is an improvement over the yield if the fund were trading at NAV: 1.00 / 10.00 = 10.00%. As illustrated, purchasing the fund at a discount improves the yield by 111 basis points. However, the potential for enhanced yield comes at the cost of increased risk. Unfavorable price movements can lead to lower returns than if the fund were trading at NAV. For example, consider the same fund, purchased at a 10% discount for $9.00. Suppose the share price drops further to $8.00, while the NAV remains unchanged. The dividend yield a current shareholder receives will remain the same, but will be offset by the decrease in share price upon trading the share. CEFs can also trade at a premium, or a price higher than NAV. Factors that affect discounts and premiums include relative performance and yield, name recognition of the manager, a large amount of illiquid holdings, size and trading volume of the fund, and a significant amount of unrealized appreciation.

Dividends and Distributions

CEFs pay out earnings to their investors in two ways: income dividends and capital gains distributions. For clarification purposes, dividends for closed-end funds are comprised of one or more of the following: interest income, dividend income, short-term/long-term capital gains, and return of capital. At the end of the fund's fiscal year, the fund will typically reclassify dividends paid into the above categories for tax purposes. Income funds pass through to the shareholders interest and dividends from their investments. Fixed income funds typically have monthly or quarterly dividend payouts. Equity funds generally pay out dividends on a quarterly, semi-annual, or annual basis. Income from dividends is typically taxable, with the exception of that from municipal bond funds, which may be exempt from certain taxes. CEFs pay to shareholders their realized capital gains through capital gains distributions, typically at the end of the year. Income-oriented funds may maintain a balance of undistributed net investment income (UNII), or cushion, to help stabilize dividend payouts. Despite this, CEFs may reduce their dividends in the event of a shortfall in earnings performance, which can negatively affect prices. Investors may also be able to reinvest their distributions in additional shares of a fund to increase invested capital.

Some CEFs have managed distribution policies - commitments to providing investors with a stable, predictable cash flow, typically on a monthly or quarterly basis. These distributions are typically composed of dividend income, interest income, net realized capital gains, and/or return of capital. They can be either fixed or based on a percentage of assets under management. These distributions are not guaranteed. The majority of managed distribution funds invest in equity securities. The advantage of this policy is that the investor can possibly achieve equity returns while also receiving a regular cash flow. The primary disadvantage is that providing

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investors with cash flow requires removing assets from the fund. This can entail holding a higher cash position, which dilutes returns. Such a policy can also result in misleading yield data, as return of capital should not be counted as yield.

Leverage

The fixed capital structure allows for efficient use of leverage. Income-oriented CEFs, particularly fixed-income funds, employ leverage to enhance yield by capturing the spread between the long and short rates without having to sacrifice credit quality. After an IPO, the fund may choose to raise additional funds by using one of several different forms of leverage. The funds are then used to purchase more securities within the investment objective. The goal is to capture the spread, the difference between the short rate paid to finance the purchase of the additional securities and the interest paid on these securities. The average closed-end municipal bond fund leverages approximately 35% of its assets. Leveraged funds typically benefit the most in decreasing interest rate environments. Equity funds may also utilize a leveraging strategy to increase return performance. Through this strategy, funds may magnify both the gains and losses of the portfolio over that of a non-leveraged fund.

Prior to 2008, the most common form of leverage was Auction-Rate Preferred Shares (ARPS) that were issued from the fund as a dividend-paying senior share class. In early 2008, the auction rate securities market became frozen as the auctions that set the rates lacked buyers — this meant that the funds' preferred shareholders were unable to sell their holdings. To date, this market continues to lack liquidity and this form of leverage is no longer being issued. To circumvent this issue, funds have been employing different types of leverage including Tender Option Bonds (TOBs), Muni-Term Preferred shares (MTPs), bank loans, lines of credit, and notes payable.

Pertaining more to the use of leverage in fixed-income funds, there are two primary situations in which leverage-enhanced yield is negatively affected - a flattening yield curve and an inverted yield curve. During a flattening yield curve, short rates approach long rates and the spread declines. In the case of an inverted yield curve, short rates rise above long rates, resulting in a negative spread. In this environment, the portfolio managers can call the preferred shares, and refinance this leverage with longer term borrowing. Other leveraging methods include reverse repurchase agreements and dollar roll transactions. The investor should be aware that leverage increases share price volatility and market risk. Some funds may over-earn their dividends at times when interest rates are favorable for leverage, thus accruing a cushion of undistributed net investment income (UNII). This UNII cushion can then be used to maintain dividend stability when earnings fall short due to unfavorable moves in interest rates. Additionally, funds may hedge their leveraging costs for periods of time in order to reduce the effects of rising interest rates. This is typically done through interest rate swaps or special fixed dividend periods on their preferred shares.

Conclusion

Closed-end funds offer an opportunity for investors to achieve attractive returns by taking advantage of their unique characteristics. Historically, the majority of CEFs trade at a discount to NAV, making them potentially attractive investments with multiple ways to achieve capital gains and enhanced returns. Because of share price volatility, investors can benefit from the in-depth research offered by Closed-End Fund Research. Closed-End Fund Research seeks to provide Raymond James' Financial Advisors and their clients with the most relevant, comprehensive, and current data and research available on closed-end funds and to provide unbiased opinions.

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Risk Factors

Risk factors vary from fund to fund. Not every risk factor below will pertain to each fund. Based on these risk factors, not every fund may be suitable for all investors.

Market Risk: Closed-end funds are subject to the same risks as their underlying securities. Securities may decline in value due to factors affecting securities markets generally or particular industries. The value of a fund may be worth less than the original investment.

Valuation Risk: Shares may trade above (a premium) or below (a discount) the net asset value (NAV) of the fund's portfolio. At times, discounts could widen or premiums could shrink either diluting positive performance or compounding negative performance. There is no assurance that discounted funds will appreciate to their NAV.

Interest Rate Risk: The risk that securities held by the fund will decline in value due to changes in interest rates. Specific to fixed income securities and some non-fixed rate securities with bond-like characteristics, the value of such a holding may decrease in value as market interest rates increase and vice versa. The prices of longer maturity securities generally fluctuate more than those of shorter-term securities.

Credit Risk: One or more securities in a fund's portfolio could decline or fail to pay interest or principal when due. Income-related securities of below investment grade quality are predominately speculative with respect to the issuer's capacity to pay interest and repay principal when due and, therefore, involve a greater risk of default. Securities rated below investment grade may not be suitable for all investors.

Concentration/Non-Diversification Risk: A fund which invests a substantial portion of its assets in securities within a specific region, country, or sector may be subject to greater price volatility or adversely affected by the performance of securities in that particular region, country, or sector as caused by a lack of diversification. A fund registered as a "non-diversified" investment company under the Investment Company Act of 1940, may invest greater than 5% of the fund's total assets in the obligations of a single issuer.

Reinvestment Risk: Income from a fund's bond portfolio will decline if and when the fund invests the proceeds from matured, traded, or called bonds at market interest rates that are below the portfolio's current earnings rate. A decline in income could affect the common shares' market price or their overall returns.

Leverage Risk: The use of leverage may lead to increased volatility of a fund's NAV and market price relative to its common shares. Leverage is likely to magnify any losses in the fund's portfolio, which may lead to increased market price declines. Fluctuations in interest rates on borrowings or the dividend rates on preferred shares as a result of changes in short-term interest rates may reduce the return to common shareholders or result in fluctuations in the dividends paid on common shares. There is no assurance that a leveraging strategy will be successful.

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Foreign/Emerging Markets Investment Risk: Investment in foreign securities (both equity and debt) may involve a high degree of risk. Funds invested in foreign securities are subject to additional risks such as, but not limited to, currency risk and exchange rate risk, political and economic instability of the countries the securities originate from, and liquidity of the markets in which securities are purchased and/or traded. In regards to debt securities, such risks may impair the timely payment of principal and/or interest. These international risks are generally greater in emerging markets.

Alternative Minimum Tax (AMT): A fund may invest in securities subject to the alternative minimum tax.

Actively Managed Portfolios Have Fluctuating Dividends: The composition of the funds' portfolios could change, which, all else being equal, could cause a reduction in dividends paid to common shares. Fluctuations in dividend levels over time, up and down, are to be expected.

Small & Mid-Cap Securities Risk: Investing in small and/or mid-capitalization, newer companies generally involves greater risks than investing in larger, more established companies, and may not be appropriate for every investor.

Technology: The companies engaged in the technology industry are subject to fierce competition and their products and services may be subject to rapid obsolescence.

Real Estate: Real estate securities are subject to the many risks associated with the direct ownership of real estate, including but not limited to declines in property values, increases in property taxes, operating expenses, interest rates or competition, overbuilding, changes in zoning laws, and losses from casualty or condemnation.

Options: Certain funds may utilize option strategies. Since option strategies involve unique risk considerations they may not be suitable for all investors.

Illiquid securities: Illiquid securities may trade at a discount when compared to more liquid investments. The fund may be unable to sell illiquid securities in a timely manner or at a fair price due to lack of liquidity. In addition, the sale of such securities may require more time and increased selling expenses. Consequently, the fund's investments in illiquid securities may have an adverse impact on its net asset value.

Insurance: The bonds held in certain closed-end funds may be insured. The insurance relates only to the timely payment of principal and interest by the issuer of the bonds within the fund. The insurance does not remove market risks, since it does not guarantee the market value of the fund's shares. No representation is made as to an insurer's ability to meet its financial commitments.

Margin: Certain funds may borrow on margin and use securities as collateral. This may involve a high degree of risk and is not suitable for all investors.

Aggressive Investment Techniques Risk: Certain funds may use investment techniques and financial instruments that may be considered aggressive. This may include the use of futures contracts, options on futures contracts, forward contracts, swap agreements and similar instruments, and the short sale of securities. These techniques and instruments may expose the fund to substantial risks.

High-Yield Risk: Certain funds may invest in high-yield bonds. These bonds are commonly referred to as "junk bonds" and involve higher risks.

Foreign Currency Risks: Currency fluctuations could materially and adversely affect the value of fund shares. Factors impacting the price of foreign currencies include, but are not limited to, national debt levels and trade deficit, inflation rates, domestic and foreign interest rates, and substantial sales of a currency by a central bank or other government agency.

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