



CLAYMORE<sup>SM</sup>

# Claymore Closed-End Fund Market Update

Q1 2009

## ● CLOSED-END FUNDS

### “Normalcy Revisited”

#### HIGHLIGHTS

- “January Effect” succumbs to late first quarter volatility
- Discounts remain over two times wider than the historical average
- Dividend changes persist as some increases begin to appear
- De-levering subsidies and cost of leverage remains low
- IPO market stirs to life, raising more than all of 2008

#### Review

In a market characterized by volatility and uncertainty, it was nice to experience a brief glimpse of normalcy for the closed-end fund market. The “January Effect” arrived right on schedule, the Initial Public Offering (“IPO”) market stirred to life and market price discounts to net asset values (“discounts”) narrowed to approach the longer-term average. There were even a few funds that increased dividends during the first quarter to buck the prevailing trend of dividend reductions. Overall, March was a bright spot for the quarter, with nearly every category of closed-end funds providing positive market price and net asset value (“NAV”) returns. In spite of these positive returns, the average discount for all closed-end funds ended the quarter at -8%, which was nearly twice the ten-year historical average of -4%.

#### Discounts

At one point during the historic volatility witnessed in the fourth quarter of 2008, the closed-end fund market experienced the widest average discount on record of -26% with more than 90% of all funds trading at a discount of -20% or greater. By the end of the first quarter of 2009, however, discounts had narrowed sharply in magnitude and number with the market prices in a couple of closed-end fund categories even advancing to premiums to their respective NAVs (“premiums”). Closed-end funds investing in master limited partnerships (“MLPs”) topped all categories, ending the quarter at an average 14% premium, while closed-end funds investing in real estate investment trusts (“REITs”) ended the quarter last among all categories with an average discount of -20%. Interestingly, MLP and REIT funds also represented the best and worst performers for the quarter, with market price returns of 24% and -27%, respectively.

This disparity reaffirms our view that fund performance represents one factor that may influence closed-end fund premiums and discounts. In addition to performance, one factor often associated with the magnitude of premiums or discounts is dividend yield. Of course, other factors undoubtedly play a role in this premium and discount phenomenon that has perplexed investors and academics alike. Recently, it appears that closed-end fund investors have begun placing more emphasis on dividend sustainability and the risk of NAV volatility, which will be addressed in greater detail in the following sections.

#### Dividends

Following the rapid decline in the fourth quarter of 2008, closed-end funds have continued to reconcile their current dividends with the earnings potential of their investments. On the one hand, levered funds have experienced an overall decrease in the cost of leverage<sup>1</sup>, generally making more income available for common

share dividends. On the other hand, nearly all closed-end funds experienced significant NAV declines over the past year and, for equity funds in particular, corresponding reductions in the earnings potential of their portfolios. Nearly half of all closed-end funds have reduced their dividends since the beginning of last year with an average reduction of just over 30%. It is important to note that a fund's dividend rate is generally set by the fund's board of directors or trustees and may be higher or lower than what a fund is actually realizing in terms of income and gains at any given point in time. In cases where the dividend rates were higher than the income and gains the funds realized during the year, there were returns of capital. Given the investment performance of nearly all asset classes last year paired with a volatile fourth quarter, this was a relatively common occurrence. For equity funds that reduced dividends over the past year, it was not surprising to witness reductions that were somewhat proportional to the NAV performance of the category. For example, equity funds reduced dividends by an average of 40%, which was strikingly similar to the negative total return performance experienced by domestic equities last year. In certain cases, dividend reductions were even more substantial and company press releases often cited a desire to reconcile current dividend rates with the earnings and growth potential of the funds' investments.

As mentioned earlier, the trend has shifted slightly and recent announcements have indicated a mixture of dividend increases and reductions. The majority of dividend increases have come from fixed-income closed-end funds, owing to generally less significant NAV declines versus equity funds and a greater spread between the cost of leverage and income on long-term investments. Another positive development for the quarter was the receding dividend suspension announcements due to the violation of asset coverage requirements and the impact of leverage – which we turn to next.

## De-Levering

Closed-end fund investors learned a difficult lesson about the impact of leverage and the various asset coverage requirements throughout the fourth quarter and into the early part of this year. Without reviewing in greater detail, closed-end funds registered under the Investment Company Act of 1940 are generally required to maintain certain asset coverage levels with respect to leverage in order to declare and, in some cases, pay common share dividends. During the market turmoil over the past few months, several funds were forced to de-lever and, in certain cases, delay dividends until the asset coverage requirements were again met. Fortunately, recent NAV appreciation and proactive efforts to reduce leverage have helped most funds avoid additional dividend delays. Although levered funds generally have a more substantial "cushion" above these asset coverage requirements, a decline in the underlying NAVs may still present a risk to common share dividends.

In addition to reducing leverage, funds have continued to replace auction-rate preferred securities ("ARPS") with alternative forms of leverage. As of March 31, 2009 more than half of all closed-end fund ARPS outstanding had been redeemed or refinanced. The vast majority of ARPS that have yet to be redeemed remain on the municipal side as fewer viable alternatives exist relative to taxable funds.

In spite of the continued challenges associated with leverage, there have been a few positive developments. For one, the cost of leverage remains relatively low at less than 2% for both taxable and tax-exempt funds. The market dislocation sent yields on fixed-income investments to multi-year highs allowing funds the ability to capture significant spreads between the cost of leverage and the yield of their underlying investments. Equity funds, meanwhile also have the potential to benefit from relatively low equity valuations and dividend yields in excess of 3%. Of course, after the historic equity market declines and volatility, dividend reductions remain a very real possibility.

## Outlook

Although discount opportunities remain abundant with nearly 80% of all funds trading at a discount to NAV, the recent rally in certain asset classes should not be ignored. The ideal combination of investment factors would seem to be among funds trading at relatively significant discounts, investing in undervalued asset classes with favorable growth prospects. Of course, there are other factors to consider such as dividend sustainability, leverage and fund management, among other things.

As far as the outlook for the factors reviewed earlier - discounts, dividends and de-levering - here are some thoughts to consider. Although closed-end funds are not an asset class, recently the group has responded negatively to volatility in the equity and credit markets. An increase or spike in volatility could cause discounts to widen out, as could factors specific to the underlying investments. The ten-year average discount was approximately -4%, leaving some room for overall discounts to narrow from the current -8%, if mean reversion is any guide. However, keep in mind, it was just a few months ago that the closed-end fund market recorded a -26% discount to NAV.

On the topic of NAVs, it is also important to consider the underlying investment performance, especially when evaluating total return potential or dividend sustainability. Although dividend increases have started to appear among certain closed-end funds, be aware of a fund's dividend history and strategy. An equity fund experiencing a significant one-year NAV decline, for example, may find it difficult to sustain or increase its previous dividend rate, especially if adjustments weren't made during that time period.

CLAYMORE CLOSED-END FUND RESEARCH DATA POINTS					
	3/31/08	6/30/08	9/30/08	12/31/08	3/31/09
Average CEF Premium/(Discount)	-6.02%	-5.92%	-13.20%	-11.12%	-7.95%
S&P 500 Index <sup>2</sup>	1322.70	1280.00	1166.36	903.256	797.87
CBOE Volatility Index (VIX) <sup>3</sup>	25.61	23.95	39.39	40.00	44.14
10-Yr. Treasury Yield	3.41%	3.97%	3.83%	2.21%	2.67%

*For illustrative purposes only. Past performance is not a guarantee of future results.  
Source: Claymore Data/Fundamental Data Limited, 3/31/09*

However, the cost of leverage has fallen dramatically and yields on certain investments are higher than a year ago, which may help offset the need for more substantial reductions. In addition, some funds implement a managed distribution policy, whereby a dividend rate is established for a period of time that may or may not reflect the actual earnings of the fund for a given time period, which may result in a return of capital. The factors affecting dividends are too numerous and specific to treat adequately here, so it is important to consider fund-specific risks and other information and consult your financial advisor before investing.

Anyone who owns a home or invests in closed-end funds knows the good and the bad of leverage. Leverage helps you on the upside and hurts you on the downside. Given that the overall market has been involved in a broader de-levering process, it is prudent to carefully evaluate the merits of leverage going forward. Consider a simple comparison example of a closed-end fund with 33% leverage, as a percentage of total assets, versus a closed-end fund without leverage, both with the same amount of total assets invested in the same securities. The return of the levered fund would be approximately 1.5 times that of the non-levered fund. A positive return of 10% on the investments, would translate into a 15% return for the levered fund. Conversely, a negative return of -10% would translate into a negative return of -15% for the levered fund. This simplified example assumes no fees or other expenses. If you adjust the assumptions for the initial leverage amount or return of the underlying investments it is readily apparent as to how leverage can have a significant positive or negative impact on performance.

Generally, it is a mistake to extrapolate the past – whether positive or negative. One place to start to evaluate closed-end fund opportunities may be to consider the best and worst performers along with the most attractive and least attractive premiums and discounts. Then, determine if those premium or discount levels are justified given the outlook for the fund and its investments. Over the past year, for example, REIT funds have been the worst performers by far (down -72% on NAV) and also sit at the widest discounts among all closed-end funds -24%. On the flip side, national municipal closed-end funds have been the best performers over the past year (down -9% on NAV) and sit at discounts of approximately -5%. Are either of these trends sustainable or valuations justified? Only time will tell. These are merely two generic examples of several opportunities to consider among closed-end funds. The combination of discounted funds holding discounted assets along with current distribution rates in excess of three times the ten-year Treasury yield would seem to warrant a closer look.

### Claymore's Closed-End Fund Group - April 2009

All data as of 03/31/2009, unless otherwise noted. Source: Fundamental Data Limited

<sup>1</sup>As a means of attempting to improve the common shareholder's total return, many closed-end funds will utilize leverage to help enhance a fund's yield and overall performance potential. A closed-end fund may benefit from leverage by borrowing and/or issuing preferred shares at a lower interest rate and investing those monies at a higher reinvestment rate to take advantage of any spread that may exist. In general, leverage

may be a positive contributor to performance if the rate earned on the investment strategy exceeds the cost of borrowing or issuing preferred shares. Conversely, leverage can detract from the overall fund performance if the spread narrows; thereby pressuring a fund's cash flows.

Leverage can be structured in a number of different ways. The most typical forms of closed-end fund leverage include the issuance of senior securities in the form of preferred shares, or the utilization of commercial paper, bank loans or debt securities. Leveraging carries certain risks, including higher volatility of NAV, share price and income, which may increase the chance of loss to the common shareholders.

Leverage risk is the risk associated with the borrowing of funds and other investment techniques, including the issuance of the preferred shares by a fund, to leverage the common shares. Leverage is a speculative technique which may expose a fund to greater risk and increase its costs. Increases and decreases in the value of the fund's portfolio will be magnified when a fund utilizes leverage. For example, leverage may cause greater swings in a fund's NAV or cause a fund to lose more than it invested. A fund will also have to pay interest or dividends on its leverage, reducing a fund's return. This expense may be greater than a fund's return on the underlying investment. There is no assurance that a fund's leveraging strategy will be successful.

<sup>2</sup>Standard and Poor's 500 Index is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The index is unmanaged and it is not possible to invest directly in an index. (Source: Standard and Poors)

<sup>3</sup>CBOE Volatility Index ("VIX") - Chicago Board Options Exchange (CBOE) Volatility Index ("VIX"), displays the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. This volatility is meant to be forward looking and is calculated from both calls and puts. The VIX is a widely used measure of market risk. The index is unmanaged and it is not possible to invest directly in an index. (Source: CBOE)

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***There can be no assurance that any closed-end fund will achieve its investment objective(s). The value of any closed-end fund will fluctuate with the value of the underlying securities. Until the original listing of a closed-end fund on an exchange, no closed-end fund's shares will have a history of public trading and, historically closed-end funds often trade at a discount to their net asset value.***

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