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Opportunities in a Challenging Economy

September 22, 2010

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Opportunities in a Challenging Economy

1. **EIP: the four pillars of our economic perspective**
2. **A challenging time for investors**
3. **One solution: a tactical, event-driven approach using closed end funds**

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Bank leverage is excessive

- Too many pre-2008 loans combined with new capital requirements require banks to reduce lending and/or raise additional capital.
- Large banks have been successful at issuing equity, but small banks and community banks have not.
- The Federal Reserve is likely to maintain a low-rate policy at least into 2012. This helps bank earnings and provides an additional source of capital.
- Until bank capital meets new requirements, loan growth will be very slow.

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Debt continues to weigh on consumers

- **Household debt service as a % of disposable income rose from 11% in 1992 to 14% at the start of 2007. It has since fallen to 12.5%.**
- **Debt reduction, which is proceeding at a good pace, will need to continue for some time, through a combination of repayments and defaults.**
- **While defaults reduce consumer leverage, they impede bank balance sheet recovery.**
- **Personal income growth is vital, but it will be hampered by continuing high unemployment for an extended period.**

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Americans, and particularly baby boomers, have not saved enough

- **Household net worth has fallen from $64.2 trillion at the end of 2007 to $53.5 trillion at the end of the second quarter, 2010.**
- **Consumers need to build their balance sheets by:**
  - ✓ **Increasing savings to a rate of 6% to 9%, up from 0% pre-recession**
  - ✓ **Reducing their debt service via lower debt balances or lower interest rates**
  - ✓ **Extending their working careers**

Sovereigns (nations, states and municipalities) are over-levered

- **Compensation, pension and health care assurances must be re-evaluated.**
- **Budgets, and corresponding services, must be cut to get into balance and reduce the rate of debt growth.**
- **Unfunded federal mandates present a huge challenge to states.**
- **The necessary cutbacks will reduce economic growth in the short run.**

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The solutions all require time

- **Bank and consumer leverage may diminish over 5 – 7 years; we may be two years into this process.**
- **Consumers, who may have lost 20% to 40% of household net worth, will need 5-10 years to rebuild.**
- **The resolution of sovereign debt crises is unclear.**
- **These factors reduce economic consumption and growth rates, suggesting that growth will be 1 – 1.5% lower than historically and economic recovery will be sporadic.**

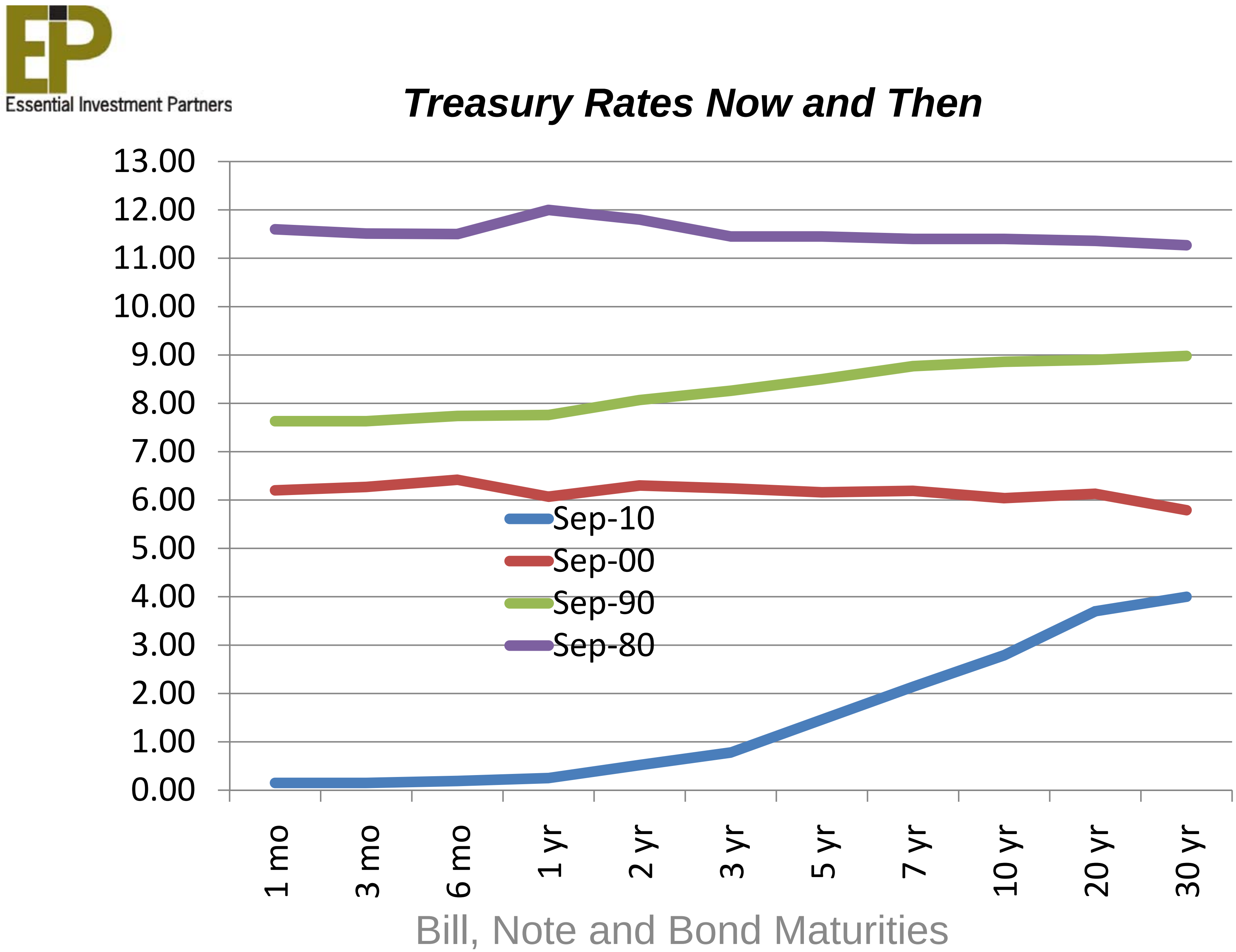
Investment Implications of a Slow Growth Economy

For equity investors:

* Find sources of growth using a global view
  - ---Asia and emerging middle class markets
  - ---Multinationals, dividend strategies
* Tightly control risk and liquidity

For fixed income investors:

* Beware of spread risk -- in weak economy spreads can change quickly
* Be cautious of duration risk – duration increases as yields fall
* Be creative in seeking special situations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Treasury Rates Now and Then
13.00
12.00
11.00
10.00
9.00
8.00
7.00
6.00
5.00
4.00
3.00
2.00
1.00
0.00
Sep-10
Sep-00
Sep-90
Sep-80
1 mo
3 mo
6 mo
1 yr
2 yr
3 yr
5 yr
7 yr
10 yr
20 yr
30 yr
Bill, Note and Bond Maturities

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Treasury ETF total returns in two recent periods

A declining rate environment

	Yield on June 30, 2008	Yield on Dec. 30, 2008	Total Return
3-7 year ETF	3.4%	1.4%	+10%
7-10 yr. ETF	4.0%	2.1%	+16%
20 + yr. ETF	4.5%	2.6%	+42%

A rising rate environment

	Yield on Dec. 30, 2008	Yield on July 29, 2009	Total Return
3-7 year ETF	1.4%	2.6%	-4%
7-10 yr. ETF	2.1%	3.7%	-8%
20+ yr. ETF	2.6%	4.6%	-23%

This illustration is solely intended to demonstrate that the total return of fixed income instruments can be highly dependent on changes in interest rates. It is not intended to characterize or evaluate any particular investment. The yields indicated on each particular date represent the current yields of corresponding treasury notes and bonds, and the ETF total returns reflect the actual net asset value change of the corresponding IShare Barclay's treasury exchange-traded funds.

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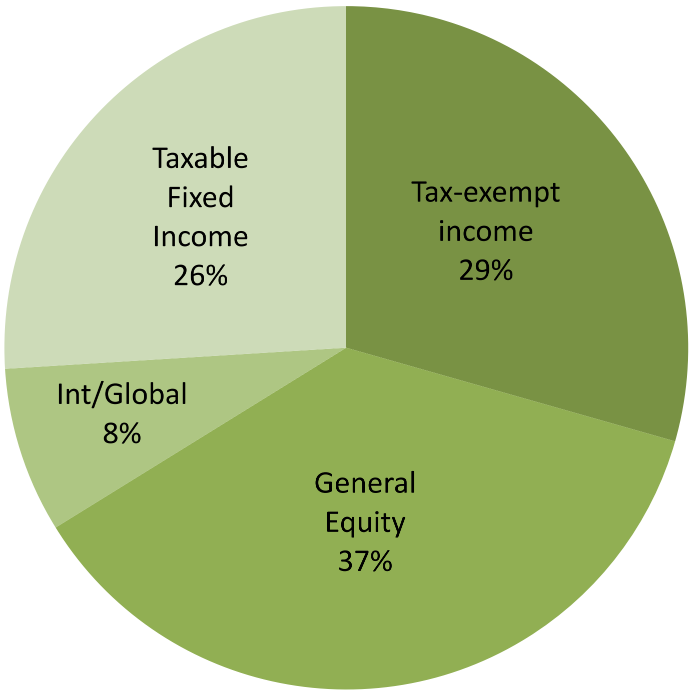
Closed End Funds – A Robust Universe

- 656 Funds (9/2010)
- More than $200 billion in assets
- 38 Lipper Classifications
- National, state specific muni. funds
- Gov't, corp., mortgage, bank loans
- Developed and emerging markets
- All styles of equities

Fund Types (% of assets)



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Essential Absolute Return Portfolio: Unlocking Value in Closed End Funds

Closed end funds (CEF's) have characteristics that enable an investor to unlock value through extensive research and opportunistic trading.

- **Inefficient pricing – an under-researched marketplace**
- **Frequent discounts to value of underlying assets (NAV)**
- **Vulnerability to "activist" investors**

A constituency of "activist" investors has been successful in catalyzing actions that exploit inefficiencies in closed end fund pricing.

- **Liquidation**
- **"Open ending"**
- **Share tenders**

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Example 1: A classic closed end fund special situation

- **February, 2010:** We determine that an activist has a 12% position, and there are a number of favorable factors: 9% discount to NAV, small fund size, floating rate portfolio and 3.5% dividend. We see high probability that the activist will propose open-ending or tender offer at Sept/Oct annual meeting. The fund sponsor has a small portfolio of closed end funds, and may not resist.

- **May, 2010**: We have been systematically purchasing the fund, and during the market sell-off we add to shares at a 12% discount to net asset value. Two positive developments: the activist has built a 16.6% ownership position and the dividend is increased to approximately 3.75%

- **June, July, 2010:** The fund dividend is increased two more times, with the yield now at 4.25%. On July 22 the fund Board of Directors announces that they have voted to liquidate the fund. With the net asset value now at $13.60 to $13.65, we purchase additional shares at $13.30.

- **September, 2010:** Liquidation of the fund is expected to be completed with the next two months. The activist now owns more than 23% of the fund, and we own approximately 5% on behalf of clients. With significant certainty of outcome, we continue to buy shares at @ $13.50 with the net asset value at @ $13.70. We continue to collect the monthly dividend yield of 4.25% and expect to realize an additional 1.5 % to 2.0% as liquidation value is realized.

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Example 2: A developing situation

This fund was identified as we explored opportunities to diversify clients' currency exposure. This is an "interval" fund that has been redeeming 5% to 10% of outstanding shares each year at discounts of @ 1% to NAV. In recent years tendering shareholders have had 15% to 30% of their shares accepted.

April, 2010: The fund trades at 11% to 12% discount to its net asset value. The small fund size (@$95 million) increases its vulnerability to potential activist influence. There is a monthly dividend yield of approximately 5.5% to 6.0% annualized.

We conclude that the yield, currency protection and the likelihood of realizing an 8% to 10% gain on 15% to 30% of our shares each year makes the investment attractive. In addition there is a probability that an activist will become involved.

May, 2010: We establish positions, and continue to add to them throughout the summer at a discount of 9% to 11% to NAV.

September, 2010: SEC filings indicate that an activist established an initial stake in the fund during the second quarter. We expect the annual tender to occur in March, 2011.

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An Alternative to Traditional Fixed Income Investments: Essential Absolute Return Portfolio

***In Summary*:**

Portfolio management seeks to produce returns that are favorable to fixed income options available to investors through a combination of:

- current income
- capital appreciation

At the same time interest rate risk inherent in traditional bond portfolios may be mitigated as:

-investments are relatively short-term
-portfolio duration is limited

Important Information

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