Essential Investment Partners
Closed End Funds – A Unique Opportunity

June, 2014

Essential Investment Partners

About Essential Investment Partners

- EIP is an independent investment counsel and wealth management firm
  - More than $120 million in AUM as of 5/31/14
  - Wealth management: 25 clients and 85% of AUM
  - Separate accounts for third party advisers: 15% of AUM

- Two main disciplines are available as separate accounts
  - Essential Growth Portfolio℠ (launched 12/31/2003)
  - Essential Absolute Return Portfolio℠ (launched 3/31/2009)

- Will be talking about investing in closed end funds today, as used in the Absolute Return Portfolio strategy

Essential Investment Team

Jon Zeschin, CPA/PFS, CFP® is the founder of Essential Investment Partners. He has been the lead portfolio manager for the Essential Growth Portfolio℠ since its inception in 2003 and has been the co-portfolio manager for the Essential Absolute Return Portfolio since March, 2011. Jon is also an independent trustee and audit committee chair for an Asia-focused mutual fund family. Previously, he chaired the board of a NYSE-listed closed end fund. Prior to founding Essential, Jon held senior executive positions with several prominent mutual fund companies. He holds a BBA in Accounting from the Ross School of Business at University of Michigan and a Masters of Management from the Kellogg School of Management at Northwestern University.

Mark Asaro, CFA, is co-Portfolio Manager for the Essential Growth Portfolio℠ and the Essential Absolute Return Portfolio℠. Mark is responsible for all research on stocks, mutual funds, hedge funds and closed end funds. Mark holds an MBA from the University of Colorado, a BS in Finance from Fairfield University and is in the final stages of completing a masters in public policy at the University of Denver.

Closed End Fund (CEF) Market Overview

- Sold to individual investors at launch based on yield or a current investment fad
  - Closed end structure allows leverage which amplifies yield and NAV volatility
  - Fixed pool of assets for the manager — attractive from business perspective and investment perspective (no need to reserve liquidity for redemptions)
  - Attractive to brokers as commission is built into offering price; regular calendar of offerings provides supply of new income ideas
- Highly inefficient market
  - Most funds are relatively small (less than $1 billion) so trading volume is thin and spreads are relatively wide
  - Little or no professional research coverage
  - Very few professional investors in the space. RiverNorth is one of the biggest non-activist investors. Bulldog and Karpus are the biggest activists
- Overall market is small (approximately $225 Bil)
  - Not attractive to large institutions as investments can't be scaled
- The ultimate indicator of retail sentiment
  - Requires contrarian instincts to be successful

Lessons from Sumo

- Tokyo, June 2014

Lessons from Sumo

- The match is quick
  - And may well be over sooner than you think
- The tide can change quickly
  - Be prepared for unanticipated events
- If you want to watch from close up, don't relax
  - It is dangerous to be a passive spectator

Opportunity Set Constantly Shifting

Corporate Actions — generally lower risk, lower return

- Fund mergers — most often consolidations of similar funds offered by same sponsors
- Open ending — relatively rare, usually forced
- Tender offers — usually at a small discount to NAV for a minority of shares. Losing favor lately, replaced by buybacks

Reversion Trades — higher risk, higher potential return

- Out of favor asset class — munis in late 2013, for example
- Interest rate scare — double whammy for levered FI CEFs
- Dividend cut — overreaction
- Anomalies — one fund of a group trades away from the others

Activist Anticipation or Coattailing

Typical activist target

- Smaller sponsor or orphan fund
- Small or medium size asset base
- Consistent, large discount to net asset value
- History of inaction or ineptitude by management and board
- Recent: Bulldog v. Firsthand Technology Value Fund (settlement included buybacks, tender offer and sale of certain holdings)

Activist spends some time accumulating position

- Report holdings on a lagged basis per SEC rules — some early positions are kept confidential
- Usually takes time to accumulate a meaningful position
- Long list of legal actions they might take, usually try to engage board/ management in a discussion about ways to reduce discount

News of activist involvement may spur some price movement

- Not always the case, may be some opportunity left

Essential Process

- Screen constantly for opportunities
  - Quantitative screens on trading ranges
  - Qualitative work on corporate action and activist positions

- Understand the underlying assets and management style
  - Limited ability to hedge NAV exposures

- Check for possible red flags
  - Dividends vs. earnings
  - Pending or recent fund changes

- Pull the trigger on opportunities quickly
  - Trading timeliness is critical as opportunities come and go rapidly

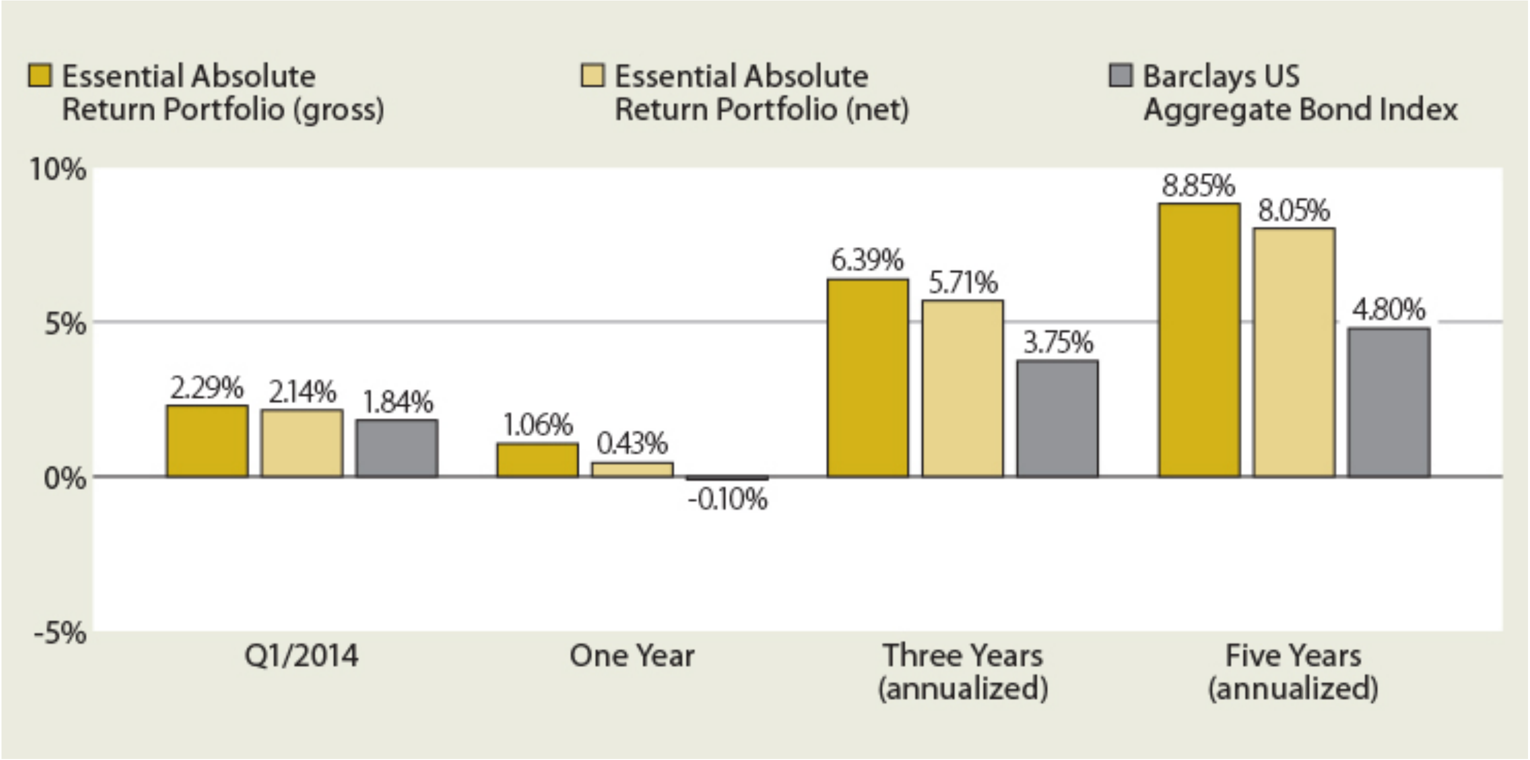
Examples of Opportunities

- Fund mergers
  - Typically large sponsors consolidating similar funds
  - Nuveen state muni funds and Blackrock taxable bond funds on multiple occasions
- Tender offers
  - Can be one time (e.g., in connection with adviser sale) or recurring
  - Retail investor holdings skew participation lower than expected, resulting in greater percentage accepted
  - Low participation: Liberty All Star Equity 7.5% tender, 34.2% tendered, 21.9% accepted
  - High participation: Thai Fund 15% tender, 78.6% tendered, 19.07% accepted
  - Data source: AST Fund Solutions, LLC
- Reversion trades – 2013 opportunities
  - Floating rate loan funds — premiums early in year, discounts later
  - Muni bond funds — NAV losses after May, discounts widen, tax loss selling
- Trading anomalies
  - Western Asset high yield funds – HYI v HIO v HIX
  - Virtually identical portfolios, three different discount levels (9,6,1)

Summary

- Structurally inefficient market
  - While the CEF market has become a bit more efficient over the last few years, it is still structurally inefficient
  - The entity is not well-understood, holdings are still largely retail, little professional research exists and the market isn't big enough to attract large institutions
- Opportunities exist for the knowledgeable and diligent
  - Need a combination of quantitative tools and qualitative skills
  - Must have enough skill to be able to separate good opportunities from value traps
  - Timeliness is critical as opportunities are fleeting
- Look for expertise — bad things can and do happen
  - Need to fundamentally understand how the entity works and what can go wrong
  - Also must understand the motivations of fund management and fund boards
  - There is a very fine line between a big trading opportunity and a justifiable market reaction to adverse events

Total Return Performance for periods ended 03/31/2014



Important Information

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Composite returns are calculated as time-weighted total returns, reflecting the reinvestment of dividends and capital gains, the effects of cash holdings and the deduction of brokerage commissions on transactions.

"EARP gross" means the total return composite for the Essential Absolute Return Portfolio℠ without the effect of management fees, and the "EARP net" reflects the "EARP gross" returns adjusted for the effect of charging fees to each account in the composite. Performance prior to 1/1/2011 reflects a hypothetical fee based on EIP's standard fee schedule of 1% of assets per annum up to $2 million, 0.75% of assets per annum on the next $3 million of assets and 0.50% of assets per annum on assets in excess of $5 million, billed quarterly in arrears, which was the highest fee schedule charged to any client during the period using the Essential Absolute Return Portfolio℠.

Performance from 1/1/2011 reflects actual fees charged to clients. Actual fees may vary depending on, among other things, the applicable fee schedule and portfolio size. The composite contains all accounts which are or were managed as standalone portfolios using this strategy. The portfolio management team changed in March, 2011. Past performance does not guarantee future results.