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Gabelli Funds, LLC  
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*Update #2*

# **Closed-End Funds**

## **Managed Distribution Policy**

*What Is It?*

*Good For Shareholders?*

### ***Gabelli Closed-End Funds***

Gabelli Funds, LLC is the adviser to seven closed-end funds, five of which trade on the NYSE: Gabelli Equity Trust (GAB), Gabelli Convertible and Income Securities Fund (GCV), Gabelli Global Multimedia Trust (GGT), Gabelli Utility Trust (GUT) and Gabelli Dividend & Income Trust (GDV) and two that trade on the Amex: Gabelli Global Utility & Income Trust (GLU) and Gabelli Global Gold, Natural Resources & Income Trust (GGN). As of December 31, 2005, the seven Gabelli closed-end funds had total assets of over \$5.0 billion.

Our closed-end fund shareholder service team is available at [closedend@gabelli.com](mailto:closedend@gabelli.com) or 914-921-5070.

At Gabelli Funds, LLC, we believe the best fund shareholder is an informed fund shareholder. Accordingly, we periodically share with you our thoughts on topics relating to our investment products. This report provides a background on closed-end funds, explains some of their features and details the managed distribution policy initiative we have taken to add value for our closed-end fund shareholders.

In April of 2002, we prepared a report titled “Closed-End Funds” on the history of closed-end funds. We continued in August of 2002, with a report on the rationale and benefits of rights offerings titled “What’s Right About Rights”. In June of 2004, we authored a report titled “Closed-End Funds, Managed Distribution Policy”. The focus of this report is to update you on managed distribution policies; we describe the pros and cons of distribution policies and their effect on closed-end funds. We prepared this report to provide a better understanding of closed-end funds and, in the process, enhance your ability to make sound investment choices.

### ***The Stock Price Of a Closed-End Fund***

Investment companies are available in one of two structures, either as “open-end” mutual funds or “closed-end” funds. An open-end mutual fund, either load or no-load, bases its offering and redemption share price on the fund’s net asset value per share (NAV) at the end of each trading day. A closed-end fund is a publicly traded investment company that typically raises its initial investment capital through the issuance of a fixed number of shares to investors in a public offering. To facilitate trading, shares of closed-end funds are listed on an exchange, such as the New York Stock Exchange (NYSE), the American Stock Exchange (Amex), and the NASDAQ electronic market (NASDAQ), and trade just like the stocks of other publicly traded companies.

### ***What is Net Asset Value Per Share (NAV) vs. the Market Price?***

The net asset value per share (NAV) of an investment company, either open-end or closed-end, is calculated as the total market value of all the securities and other assets held by a fund minus the total liabilities, divided by the total number of common shares outstanding. The NAV of an investment company will fluctuate with the changes in the market prices of the underlying securities. However, the market price of a closed-end fund is determined in the open market by buyers and sellers. This public market price is the price at which investors may purchase or sell shares of a closed-end fund. The market price of a closed-end fund fluctuates throughout the day and may differ from its underlying NAV, based on the supply and demand for a fund’s shares on the open market. Shares of a closed-end fund may trade at a premium to (higher than) or a discount to (lower than) NAV. The difference between the market price and the NAV is expressed as a percentage that is either a discount or a premium to the NAV, or underlying value. For example, if the NAV of a closed-end fund is \$20 and its market price is \$24, the fund is trading at a premium of 20%. If the NAV is \$20 and its market price is \$16, the fund is trading at a discount of 20%.

### ***Market Value = Shareholder Value***

Theoretically, a closed-end fund’s shares should trade at its NAV, just as with an open-end fund, since the NAV represents a fund’s liquidation value. In practice, closed-end funds usually trade at market prices above or below their underlying per share NAV. Reasons for this may include: the performance of the fund, market sentiment, brand name, investment style, supply or new issuance of other funds, a rights offering, a secondary offering, or the existence of a distribution policy, among other factors.

### ***Closed-End Conundrum***

If nothing else, closed-end funds are a conundrum. They have existed for centuries and have been the subject of many an investment thesis. Despite extensive research, no one can fully explain the inefficiencies of how they trade. (We facetiously propose a study to study the number of studies prepared regarding closed-end funds). The disparity between a closed-end fund’s underlying net asset value and its market price remains largely open to continued academic study.

The discounts at which closed-end funds frequently trade are certainly cause for focus since they represent significant opportunity for shareholders. A revered Wall Street guru once remarked, “. . . *the price discount may be viewed as an expensive monument erected to the inertia and stupidity of stockholders . . . costing owners of these businesses countless millions of dollars*”.

### **Solutions?**

Closed-end funds have tried to narrow their discounts in many ways. Some funds have attempted to narrow discounts by repurchasing their own shares and by executing partial redemptions. Others use leverage to bolster returns. Still others deploy a myriad of additional tactics. These methods have had selected success. Whether these solutions work best alone or in some combination is subject to ongoing analysis.

- Performance
- Share repurchases
- Tender offers
- Interval redemptions
- Managed distribution payments
- Advertising/Public Relations
- Merge with an open-end fund
- Open-ending
- Liquidation

### **The Appeal Of Steady Cash Flow**

A closed-end fund’s ability to provide steady cash payments is one of the most important variables that influences or determines its public price and therefore its premium or discount to NAV. When measured against the competitive backdrop of current interest rates and other potential investments, a consistent cash distribution to shareholders is a valuable attribute for any publicly traded corporation. A closed-end fund’s market price is particularly sensitive to its ability to provide steady cash distributions to its shareholders.

Maintaining and increasing cash payments helps to stabilize and potentially increase a fund’s market price in relation to its NAV. This may serve to narrow the discount or support the premium. A consistent cash distribution policy is invaluable in providing the desired investment cash flow the marketplace demands.

A closed-end fund’s Board of Directors has control over the cash payment of a fund. This ability to affect a closed-end fund’s market price with a managed distribution may be viewed as a useful tool that delivers cash flow to shareholders and adds additional value in narrowing discounts.

### **What is a Managed Distribution Policy?**

An investment company must make distributions of ordinary taxable income (dividends and interest received, net of expenses, and net realized short-term capital gains) and net realized long-term capital gains in order to qualify for favorable tax treatment under the Internal Revenue Service Code. To avoid double taxation (both at the fund level and for shareholders), an investment company will generally distribute substantially all of its ordinary taxable income and net realized long-term capital gains each year. As a regulated investment company, tax benefits associated with the underlying investments, such as qualified dividends subject to favorable tax rates, long-term capital gains or tax exempt interest, can also be passed through to shareholders.

A managed distribution policy is an investment company’s commitment to common shareholders to provide a predictable, but not assured, level of cash flow. This distribution policy typically takes the form of regular fixed cash payments or payments based on a percentage of a fund’s assets, generally on a monthly or quarterly basis. A closed-end fund with a managed distribution policy can offer a consistent, periodic distribution, generally sourced from dividend income, interest income, net realized capital gains (both long and short term), and possibly paid-in capital.

History has shown that in a low interest rate environment, investors may desire a fund that offers both a current income stream and the higher long-term return potential of common stocks. According to Ibbotson Associates, a leading provider of data on long-term investment returns, the average annualized return for stocks from 1926 through 2005 was

10.4%. This 10.4% return consists of a 4.3% average annualized dividend return with the balance coming from a capital appreciation component. Today, the dividend yield on the S&P 500 is only 1.8%.

An additional benefit available to individuals investing in stocks or equity funds comes from the Jobs and Growth Tax Relief Reconciliation Act of 2003 which lowered the maximum Federal income tax rate on qualified dividend income from 38.6% to 15% and on long-term capital gains from 20% to 15%. This makes the after tax return on dividends more attractive relative to other types of income than was the case prior to 2003. Closed-end funds may pass through qualified dividends as a component of their distributions to shareholders, thus allowing shareholders to benefit from the 15% tax rate.

### ***Important Dynamics of a Managed Distribution Policy***

In 1997, our Gabelli closed-end funds requested and received an exemptive order from the Securities and Exchange Commission from Rule 19b-1 of the Investment Company Act of 1940 that prohibits an investment company from distributing realized net long-term capital gains more than once a year. This exemptive order allows Gabelli closed-end funds with a stated distribution policy to distribute realized net long-term capital gains more frequently than once a year. Hence, Gabelli closed-end funds are able to allocate net long-term capital gains realized throughout the year within each distribution, providing a more consistent as well as tax-advantaged level of cash flow to shareholders. Without the exemptive order, a fund would have to either pay some of the capital gains as ordinary income or only pay periodic distributions at a lower rate and make only one distribution of capital gains at the end of the year.

If a fund does not generate a total return from dividends and interest received and net realized capital gains in an amount equal to or in excess of its stated distribution in a given year, and the fund's Board of Directors determines that shareholders favor a stable, consistent distribution policy, then the amount distributed in excess of a fund's investment income and net realized capital gains would be deemed a return of capital. Since this would be considered a return of a portion of a shareholder's original investment, it is not taxable and is treated as a reduction in the shareholder's cost basis. For a closed-end fund with a distribution policy and an exemptive order, a return of capital might be progressively less likely with the passage of time because in later years it is more likely that long-term capital gains can be realized and therefore become available for distribution.

### ***Advantages of a Managed Distribution Policy***

As suggested earlier, the advantages of a managed distribution policy extend beyond an investor's opportunity to participate in equity returns while enjoying a current and consistent stream of cash flow. Managed distribution policies generally serve to reduce the existing discount between a closed-end fund's market price and its NAV per share. Moreover, a number of academic studies and industry reports suggest that funds with managed distribution policies tend to trade at smaller discounts or even premiums to NAV, especially in a low interest rate environment.

Amy Hawkins, an analyst at Raymond James who provides research on closed-end funds, examined managed distributions within the domestic, general equity closed-end fund category. Her study concluded that over the past few years, funds with managed distributions typically sell in the market at smaller discounts to NAV.

Thomas J. Herzfeld, the most noted authority on closed-end fund's has studied discounts for decades. He concludes: *"Although often misunderstood, managed distribution policies have been an effective way to narrow and sometimes eliminate discounts."*

A managed distribution policy may also support a fund's market price during periods when the stock market is in a decline. A managed distribution policy provides a measurable performance target for the investment adviser: to generate portfolio returns in excess of the distribution amount.

### Disadvantages of a Managed Distribution Policy

There are drawbacks to managed distribution policies as well. A regular distribution provides shareholders with dependable cash inflows but conversely results in consistent cash outflows from a fund. These cash outflows from a fund are “lost assets” that would otherwise remain available for investment by a fund’s adviser. Also, a fund may need to hold an above average cash position in anticipation of regular distributions. Each of these factors runs counter to a structural advantage of closed-end funds, which is the retention of assets allowing the fund to remain fully invested.

In addition, closed-end fund listings in newspapers and on websites do not generally identify the sources of a closed-end fund’s cash payments to shareholders, which may provide investors with incomplete information.

### Is It A Dividend Or A Distribution? Using The Correct “D” Word:

**Div Yld**

## CLOSED-END FUNDS / EXCHANGE TRADED FUNDS

tick	Low	Stock Exch	Sales	Div Yld	100s	Last	Chg	52-Week	High	Low	Stock Exch	Sales	Div Yld	100s	Last	Chg	52-Week	High	Low	Stock Exch	Sales	Div Yld	100s	Last	Chg	52-Week	High	Low	Stock Exch	Sales	Div Yld	100s	Last	Chg		
858	68.50	NYSE	118	9.08			+0.08	77.28	81.11	86C200	A	8.28	8.9	100	72.5	-0.38	85.4	7.92	85	08	N	8.51	8.2	888	8.22	+0.08	18.40	18.08	NYSE	A	7.8					
722	1.20	NYSE	208	17.40			-0.08	83.88	88.70	86C200	N	1.08	1.8	947	82.0	+0.28	8.47	8.17	88	08	N	8.48	8.7	81	8.42	+0.08	15.96	14.12	NYSE	N	8					
738	78.91	NYSE	288	8.36				82.41	88.88	87C200	A	1.08	0.9	122	82.0	-0.08	8.88	8.48	88	08	N	8.48	8.1	188	8.08	+0.04	18.28	14.28	NYSE	N	8					
738	80.88	NYSE	288	10.88			+0.08	82.88	88.41	87C200	N	1.08	2.4	888	82.0	+0.12	14.08	12.98	88	08	N	7.28	6.4	23	13.08	+0.04	18.14	14.88	NYSE	A	8.51					
938	48	NYSE	227	8.87			-0.08	67.38	68.28	86C200	N	0.18		120	68.28	-0.38	14.18	13.87	88	08	N	8.4	8.2	884	13.81	+0.18	18.77	14.88	NYSE	N	8					
737	1.20	NYSE	88	8.28			-0.08	72.81	81.37	86C200	A	1.08	0.8	184	70.8	+0.18	14.88	13.40	88	08	N	8.18	8.8	288	14.81	+0.08	35.98	14.08	NYSE	N	8					
838	72	NYSE	218	8.38			-0.08	80.80	85.32	87C200	A	1.08	1.3	888	80.78	+0.11	14.78	13.02	88	08	N	8.88	8.1	848	14.88	+0.02	38.87	14.88	NYSE	N	84					
838	1.88	NYSE	188	8.34			-0.08	67.81	81.08	86C200	A	1.08	2.0	771	68.88	+0.18	14.08	12.70	88	08	N	7.2	6.8	87	12.88	+0.01	35.28	13.88	NYSE	N	8					
837	28	NYSE	188	8.77			-0.08	68.87	87.20	86C200	A	1.08	1.8	887	68.88	-0.10	14.08	12.00	88	08	N	8.8	8.2	882	13.88	+0.18	36.84	13.88	NYSE	N	8					
838	38	NYSE	24	14.21			-0.18	78.38	87.84	86C200	A	1.08	3.4	844	87.48	+0.08	12.80	12.27	88	08	N	8.8	7.8	822	12.88	+0.01	35.80	13.00	NYSE	N	8					
637	1.48	NYSE	488	13.21			-0.07	88.78	88.88	86C200	A	1.08	1.2	887	88.38	+0.02	7.47	8.88	88	08	N	8.8	8.8	878	7.82	-0.01	35.45	13.88	NYSE	A	8					
410	318	NYSE	128	4.11			-0.02	88.78	88.88	86C200	A	1.08	1.2	887	88.38	+0.02	11.88	10.81	88	08	N	7.8	8.8	807	11.81	+0.10	17.28	13.00	NYSE	A	8					
478	88	NYSE	188	11.48			-0.08	81.08	82.28	86C200	A	1.08	2.2	188	80.88	+0.08	13.80	12.70	88	08	N	8.8	8.4	438	14.74	+0.88	22.88	13.88	NYSE	A	8					

A managed distribution policy may create confusion regarding the true current return (“yield”) of a closed-end fund. All too often, investors, financial publications, newspapers and websites improperly use a fund’s distribution payment and current market price to calculate the “current yield”. Investors should be wary of these misleading “yield” calculations, particularly when applied to closed-end equity funds.

A “current yield” calculation for a closed-end equity fund with a managed distribution policy may be misleading because the fund’s current market price may not be a factor in determining a fund’s distribution. Generally, a closed-end fund’s distribution policy is in the form of a regular fixed payment or a payment based on a percentage of a fund’s net assets. Investors should be aware that distribution payments may vary during the year, sometimes including a fourth quarter adjusting distribution or a year-end capital gain distribution. Lastly, a fund’s distributions may contain a return of capital, which should not be counted as the “yield”.

If investors receive a return of capital (their own principal), it should never be construed as yield. This confusion may occur when investors, ever eager for income, rely on sources which fail to use the correct “D” word: that is, incorrectly labeling a cash payment to shareholders as a dividend, when it is in fact a distribution.

**Dividend**

A portfolio's dividend and interest income (net of expenses) passed through to shareholders.

**Distribution**

A portfolio's dividend and interest income (net of expenses) plus net capital gains passed through to shareholders. May also include return of capital.

We underscore the point that all dividends are distributions, but not all distributions are dividends.

Closed-end funds with managed distribution policies can make regular, predictable payments that may consist of dividend and interest income (net of expenses) as well as capital gains. However, if those two components are insufficient to meet the stated payment, part or all of the distribution may include a return of capital.

***Return of Capital***

If a fund's distribution is not fully covered by investment income and net realized capital gains, the excess portion will be a return of capital. Essentially, a return of capital gives shareholders back their own principal and results in a reduction of capital invested in the fund. In addition, a return of capital makes record keeping more complicated since taxable investors must reduce their cost basis by that amount. A fund's expense ratio may also increase if it distributes capital (or income) thereby lowering the fund's total assets available for the expense ratio calculation. However, despite the challenges of the extra record keeping a distribution that is occasionally supplemented with a return of capital serves as a smoothing mechanism resulting in a more stable and consistent cash flow available to shareholders.

In an ideal world, an investor's return should be earned through income and appreciation in their publicly traded shares. There would never be a need to pay a return of capital. Unfortunately, the stock market does not always cooperate by providing the necessary opportunities to realize capital gains. In this scenario, a closed-end fund with a managed distribution policy is able to continue to make payments to shareholders, but these payments may include a return of capital.

Some commentators describe the return of principal as a "ploy" designed to deceive shareholders into believing they are being paid higher "yields". Some are adamant that the return of capital masks insufficient underlying performance by the investment company's portfolio. However, it may be erroneous to presume that a return of capital is an indication of poor performance.

Sometimes a closed-end may be unwilling to realize capital gains. One of the major benefits of the closed-end fund fixed-capital structure is the absence of uncontrolled redemptions, which gives the portfolio manager the freedom to realize gains at times which are most opportune for the fund. Unrealized capital gains may be embedded in the fund's NAV, while the portfolio's investment performance may be in excess of the fund's distribution rate. If the portfolio manager does not wish to sell a long-term position, realized capital gains will not be generated, and therefore, the fund's distribution may include a return of capital despite positive performance of the underlying portfolio holdings, or NAV.

***Return of Capital Is Not Necessarily An Evil . . .***

Closed-end funds require a more careful analysis to determine if the distribution payments made in advance of future realized gains are in line with the funds' overall portfolio performance. Undoubtedly, if a fund is consistently returning capital and underperforming over the long-term, it will eventually distribute itself into liquidation. However, even this inevitable outcome might be more desirable than keeping a poorly performing fund around at a large discount.

A managed distribution policy may be viewed as a long-term return target for the fund's portfolio manager. If a fund fails to generate portfolio returns in excess of the amount of the distribution, the adviser is penalized with fewer assets on which

to earn an investment advisory fee. A return of capital is always distributed at NAV, so from the shareholder's point of view, even if this represents a slow liquidation of the fund, the shareholder is receiving a cash distribution in the form of principal without suffering a further reduction from a discounted market price. Stated another way, receiving cash at the fund's NAV is not necessarily negative for an owner.

### ***The Gabelli Equity Trust Distribution Policy – A Look Back***

The Gabelli Equity Trust was launched in August of 1986. Raising \$400 million, it was one of the largest equity closed-end fund offerings at that time. The Equity Trust's primary objective is to provide shareholders with long-term growth of capital, with income as a secondary objective. The Equity Trust initiated a distribution policy in 1988 following the stock market collapse in October 1987, when many stocks tumbled over 20% in one month. Although the Equity Trust's NAV held up relatively well during this market crash, the Equity Trust's common stock traded at a significant discount to its NAV. Shareholders and management viewed the discount as unwarranted and unacceptable. In response, our first shareholder initiative was the Board of Directors' authorization to repurchase shares of the fund's common stock immediately after the close of trading on Black Monday, October 19, 1987.

In the summer of 1988, as the prospects for stocks improved, we established an annual distribution policy of 10% of the Equity Trust's average net asset value, consistent with the Equity Trust's objective of generating a 10% real rate of return from the investment portfolio. This distribution policy is intended to provide shareholders with a predictable, but not assured, level of cash flow. Of course, if the portfolio's investment income and net realized long-term capital gains do not equal or exceed 10% of the Equity Trust's average net asset value in any given year, then the excess portion of the distribution would be deemed a non-taxable return of shareholder capital. Our distribution policy was well received by shareholders and, along with other factors, contributed to a lower discount to NAV in the twelve months following its implementation.

The Gabelli Equity Trust has a history of successful investing, providing shareholders with an average annual return of 11.7% from its inception in 1986 through year-end 2005. The returns of the Equity Trust assume the reinvestment of investment income (dividends, interest and net realized short-term capital gains), net realized long-term capital gains, return of capital distributions, the intrinsic value of any rights offerings and spin-offs, and taxes paid on undistributed long-term capital gains. The Equity Trust has distributed over \$1.8 billion in cash to its shareholders since 1986. The majority of the Equity Trust's distributions, 68%, came from net realized long-term capital gains generated from sales of appreciated portfolio securities. An additional 16% of the total distributions were attributable to net investment income and net realized short-term capital gains. The remaining 16% of distributions represented a tax-free return of capital, including the spin-off of two closed-end funds, the Gabelli Global Multimedia Trust in 1994 and the Gabelli Utility Trust in 1999. Since 1997, long-term capital gains comprised over 85% of each year's distributions. The Equity Trust continues its policy of distributing 10% of its average net asset value to shareholders and this policy is now in its nineteenth consecutive year. The Equity Trust's performance of 11.7% from inception in 1986 through year-end 2005 can be compared to the performance of the S&P 500 or the Russell 2000 Value Indices, which returned 11.3% and 12.5% annually, respectively for the period 1986-2005.

### ***Pros and Cons of Closed-End Fund Managed Distribution Policies***

#### ***Pros***

- Consistent cash flow for shareholders
- Initiative designed to reduce discount to NAV
- Creates support for a fund's common stock in declining markets
- Presents the adviser with a measurable performance target
- Provides adviser incentive to earn distribution to avoid a return of capital
- Increases share liquidity

**Cons**

- Return of capital complicates record keeping
- May create confusion regarding true "yield"
- Increased cash positions contrary to purpose of fully invested closed-end structure
- Uses capital for distribution versus investment
- Increases expense ratio if distributions exceeds investment performance

**Closing Thoughts**

A closed-end fund's Board of Directors and its investment adviser have a primary responsibility to enhance shareholder wealth by consistently growing a fund's NAV. In an ideal world, closed-end funds should trade at or above their NAV. Unfortunately, the vicissitudes of the stock market may result in a closed-end fund trading at a discount to its NAV for an extended period of time. Consequently, we believe a fund's adviser and its Board of Directors should institute policies designed to narrow the discount to NAV. Throughout our history, we have taken both of these responsibilities quite seriously. We are justifiably proud of our investment record and the fact that we have initiated policies such as share repurchase programs and managed distribution policies designed to prod our Funds' share price to more closely track the Funds' NAV.

There is no perfect solution to efficiently minimize costly closed-end fund discounts. Properly implemented, managed distribution policies can provide shareholders with regular cash flows and the potential narrowing of market price discounts to NAV. Without managed distribution policies, closed-end funds would have one less tool at their disposal to combat discounts. A distribution policy along with an exemptive order from Rule 19b-1, which allows a fund to distribute long-term capital gains more than once a year, is even better. A managed distribution policy provides an incentive for shareholders to retain their investment in a closed-end fund.

As always, we invite you to share your thoughts with us on any aspect of our stewardship of the assets you have entrusted to us.

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*The average annual returns for the Gabelli Equity Trust on an NAV per share basis through 12/31/05 for the one, five and ten-year periods and the period since inception on 8/21/86 are 5.42%; 6.75%; 10.34%; 11.72%, respectively. The past performance noted does not guarantee future results. Average annual returns reflect changes in NAV, reinvestment of distributions at NAV on the ex-dividend date, adjustments for rights offerings, spin-offs and taxes paid on undistributed long-term capital gains, and are net of expenses. Investment results and the principal value of an investment will fluctuate. When shares are sold, they may be worth more or less than their original cost. Current performance may be lower or higher than the data presented. Visit [www.gabelli.com](http://www.gabelli.com) for more recent month end performance information. Investors should consider the investment objectives, risks and charges and expenses of the Fund carefully before investing.*