

NUVEEN ARIZONA DIVIDEND ADVANTAGE MUNICIPAL FUND 3
Form N-CSRS
November 08, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM N-CSR

CERTIFIED SHAREHOLDER REPORT OF REGISTERED
MANAGEMENT INVESTMENT COMPANIES

Investment Company Act file number 811-21157

Nuveen Arizona Dividend Advantage Municipal Fund 3
(Exact name of registrant as specified in charter)

Nuveen Investments
333 West Wacker Drive
Chicago, IL 60606
(Address of principal executive offices) (Zip code)

Kevin J. McCarthy
Nuveen Investments
333 West Wacker Drive
Chicago, IL 60606
(Name and address of agent for service)

Registrant's telephone number, including area code: (312) 917-7700

Date of fiscal year end: February 28

Date of reporting period: August 31, 2012

Form N-CSR is to be used by management investment companies to file reports with the Commission not later than 10 days after the transmission to stockholders of any report that is required to be transmitted to stockholders under Rule 30e-1 under the Investment Company Act of 1940 (17 CFR 270.30e-1). The Commission may use the information provided on Form N-CSR in its regulatory, disclosure review, inspection, and policymaking roles.

A registrant is required to disclose the information specified by Form N-CSR, and the Commission will make this information public. A registrant is not required to respond to the collection of information contained in Form N-CSR unless the Form displays a currently valid Office of Management and Budget ("OMB") control number. Please direct comments concerning the accuracy of the information collection burden estimate and any suggestions for reducing the burden to Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. The OMB has reviewed this collection of information under the clearance requirements of 44 U.S.C. ss. 3507.

ITEM 1. REPORTS TO STOCKHOLDERS.

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Chairman's
Letter to Shareholders

Dear Shareholders,

Investors have many reasons to remain cautious. The challenges in the Euro area are casting a shadow over global economies and financial markets. The political support for addressing fiscal issues is eroding as the economic and social impacts become more visible. At the same time, member nations appear unwilling to provide adequate financial support or to surrender sufficient sovereignty to strengthen the banks or unify the Euro area financial system. The gains made in reducing deficits, and the hard-won progress on winning popular acceptance of the need for economic austerity, are at risk. To their credit, European political leaders press on to find compromise solutions, but there is increasing concern that time will begin to run out.

In the U.S., strong corporate earnings have enabled the equity markets to withstand much of the downward pressures coming from weakening job creation, slower economic growth and political uncertainty. The Fed remains committed to low interest rates and announced on September 13, 2012 (after the close of this reporting period) another program of quantitative easing (QE3) to continue until mid-2015. Pre-election maneuvering has added to the already highly partisan atmosphere in Congress. The end of the Bush-era tax cuts and implementation of the spending restrictions of the Budget Control Act of 2011, both scheduled to take place at year-end, loom closer.

During the last year, U.S. based investors have experienced a sharp decline and a strong recovery in the equity markets. The experienced investment teams at Nuveen keep their eye on a longer time horizon and use their practiced investment disciplines to negotiate through market peaks and valleys to achieve long-term goals for investors. Experienced professionals pursue investments that will weather short-term volatility and at the same time, seek opportunities that are created by markets that overreact to negative developments. Monitoring this process is an important consideration for the Fund Board as it oversees your Nuveen Fund on your behalf.

As always, I encourage you to contact your financial consultant if you have any questions about your investment in a Nuveen Fund. On behalf of the other members of your Fund Board, we look forward to continuing to earn your trust in the months and years ahead.

Sincerely,

Robert P. Bremner
Chairman of the Board
October 22, 2012

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Portfolio Managers' Comments

Nuveen Arizona Premium Income Municipal Fund, Inc. (NAZ)
Nuveen Arizona Dividend Advantage Municipal Fund (NFZ)
Nuveen Arizona Dividend Advantage Municipal Fund 2 (NKR)
Nuveen Arizona Dividend Advantage Municipal Fund 3 (NXE)
Nuveen Texas Quality Income Municipal Fund (NTX)

Portfolio managers Michael Hamilton and Daniel Close discuss key investment strategies and the six-month performance of the Nuveen Arizona and Texas Funds. Michael assumed portfolio management responsibility for the Arizona Funds in January 2011 and Dan has managed NTX since 2007.

What key strategies were used to manage the Arizona and Texas Funds during the six-month reporting period ended August 31, 2012?

During this reporting period, municipal bond prices generally rallied, as strong demand and tight supply combined to create favorable market conditions for municipal bonds. Although the availability of tax-exempt supply improved over that of the same six-month period a year earlier, the pattern of new issuance remained light compared with long-term historical trends. This supply/demand dynamic served as a key driver of performance. Concurrent with rising prices, yields continued to decline across most maturities, especially at the longer end of the municipal yield curve, and the yield curve flattened. During this period, we saw an increasing number of borrowers come to market seeking to take advantage of the low rate environment, with approximately 60% of new municipal paper issued by borrowers that were calling existing debt and refinancing at lower rates.

In this environment, we continued to take a bottom-up approach to discovering sectors that appeared undervalued as well as individual credits that had the potential to perform well over the long term and helped us keep the Funds fully invested. During this period, NTX found value in several areas of the market, including health care, local general obligation (GO) bonds, airports, toll roads, public power and dedicated tax credits. In the Arizona Funds, we focused on managing cashflows from bond calls and maturing bonds and minimizing their impact by anticipating current and future inflows and closely monitoring opportunities for reinvestment. Our buying activity during this period included finding purchase opportunities in the secondary market, adding to the Funds' holdings of existing bonds, and purchasing territorial paper issued by Puerto Rico and the Virgin Islands. These territorial bonds benefited the Funds through higher yields, added diversification, and triple exemption (i.e., exemption from federal, state, and local taxes).

Certain statements in this report are forward-looking statements. Discussions of specific investments are for illustration only and are not intended as recommendations of individual investments. The forward-looking statements and other views expressed herein are those of the portfolio managers as of the date of this report. Actual future results or occurrences may differ significantly from those anticipated in any forward-looking statements, and the views expressed herein are subject to change at any time, due to numerous market and other factors. The Funds disclaim any obligation to update publicly or revise any forward-looking statements or views expressed herein.

Ratings shown are the highest rating given by one of the following national rating agencies: Standard & Poor's Group, Moody's Investors Service, Inc. or Fitch, Inc. Credit ratings are subject to change. AAA, AA, A and BBB are investment grade ratings; BB, B, CCC, CC, C and D are below investment grade ratings. Certain bonds backed by U.S. Government or agency securities are regarded as having an implied rating equal to the rating of such securities. Holdings designated N/R are not rated by these national rating agencies.

In general during this period, we focused on bonds with longer maturities. This enabled us to take advantage of attractive yields at the longer end of the municipal yield curve and also provided some protection for the Funds' duration and yield curve positioning. We also purchased lower rated bonds when we found attractive opportunities, as we believed these bonds continued to offer relative value.

Cash for new purchases during this period was generated primarily by the proceeds from a meaningful number of bond calls resulting from the increase in refinancings. During this period, we worked to redeploy these proceeds to keep the Funds as fully invested as possible. Overall, selling was minimal because the bonds in our portfolios generally offered higher yields than those available in the current marketplace. The Arizona Funds sold a few pre-refunded bonds and credits with short call dates as part of our cashflow management program, while NTX had no sales activity during this period.

As of August 31, 2012, all of these Funds continued to use inverse floating rate securities. We employ inverse floaters for a variety of reasons, including duration management, income enhancement and total return enhancement.

How did the Funds perform?

Individual results for these Nuveen Arizona and Texas Funds, as well as relevant index and peer group information, are presented in the accompanying table.

Average Annual Total Returns on Common Share Net Asset Value*
For periods ended 8/31/12

	6-Month	1-Year	5-Year	10-Year
Arizona Funds				
NAZ	5.29%	14.80%	7.40%	6.03%
NFZ	5.14%	14.72%	7.14%	5.95%
NKR	4.82%	13.89%	7.26%	6.15%
NXE	4.32%	13.02%	7.27%	N/A
S&P Arizona Municipal Bond Index**				
S&P Arizona Municipal Bond Index**	3.39%	9.41%	6.12%	5.29%
S&P Municipal Bond Index**	3.24%	9.35%	6.00%	5.28%
Lipper Other States Municipal Debt Funds Classification Average**				
Lipper Other States Municipal Debt Funds Classification Average**	4.63%	14.84%	7.25%	6.24%
Texas Fund				
NTX	4.90%	12.85%	7.38%	6.28%
S&P Texas Municipal Bond Index**				
S&P Texas Municipal Bond Index**	3.49%	9.06%	6.26%	5.54%
S&P Municipal Bond Index**	3.24%	9.35%	6.00%	5.28%
Lipper Other States Municipal Debt Funds Classification Average**				
Lipper Other States Municipal Debt Funds Classification Average**	4.63%	14.84%	7.25%	6.24%

Past performance is not predictive of future results. Current performance may be higher or lower than the data shown. Returns do not reflect the deduction of taxes that shareholders may have to pay on Fund distributions or upon the sale of Fund shares.

For additional information, see the Performance Overview for your Fund in this report.

- * Six-month returns are cumulative; all other returns are annualized.
- ** Refer to Glossary of Terms Used in this Report for definitions. Indexes and Lipper averages are not available for direct investment.

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For the six months ended August 31, 2012, the cumulative returns on common share net asset value (NAV) for all four Arizona Funds exceeded the return for the S&P Arizona Municipal Bond Index and NTX outperformed the S&P Texas Municipal Bond Index. All five of the Funds also outperformed the S&P Municipal Bond Index. For this same period, NAZ, NFZ, NKR and NTX exceeded the average return for the Lipper Other States Municipal Debt Funds Classification Average, while NXE trailed the Lipper average.

Key management factors that influenced the Funds' returns during this period included duration and yield curve positioning, credit exposure and sector allocation. The use of regulatory leverage also was an important positive factor affecting the Funds' performance. Leverage is discussed in more detail later in this report.

In an environment of declining rates and flattening yield curve, municipal bonds with longer maturities generally outperformed those with shorter maturities during this period. Overall, credits at the longest end of the municipal yield curve posted the strongest returns, while bonds at the shortest end produced the weakest results. For the period, duration and yield curve positioning was a positive contributor to the performance of all of these Funds, which had heavier exposures to the outperforming longer segments of the yield curve and correspondingly smaller weightings in the shorter parts of the curve that produced weaker returns. The performance of NXE, which had the shortest duration among the Arizona Funds, was marginally impacted by its shorter positioning. In addition, NTX benefited from its holdings of zero coupon bonds, which generally outperformed the market during this period due to their longer durations.

Credit exposure was another important factor in the Funds' performance during these six months, as lower quality bonds generally outperformed higher quality bonds. This outperformance was due in part to the greater demand for lower-rated bonds as investors looked for investment vehicles offering higher yields. As investors became more comfortable taking on additional investment risk, credit spreads, or the difference in yield spreads between U.S. Treasury securities and comparable investments such as municipal bonds, narrowed through a variety of rating categories. As a result of this spread compression, the Funds benefited from their heavier exposure to lower rated credits and their underweightings in bonds rated AAA and AA.

During this period, revenue bonds as a whole outperformed the general municipal market. Holdings that generally made positive contributions to the Funds' returns included health care (together with hospitals), education, housing and transportation credits. All of the Arizona Funds benefited from good weightings in the health care sector. This was especially true in NAZ, where the Fund's health care holdings had a

better call structure than those of the other Arizona Funds and thus a longer duration, which contributed to performance during this period.

In contrast, pre-refunded bonds, which are typically backed by U.S. Treasury securities, were the poorest performing market segment during this period. The underperformance of these bonds can be attributed primarily to their shorter effective maturities and higher credit quality. Among these five Funds, NKR had the smallest allocation of pre-refunded bonds, while an overweighting in these bonds detracted from the performance of NTX. Although holdings of previously pre-refunded bonds were generally detrimental to performance during this period, NFZ benefited from having bonds pre-refunded during this period, as bonds that had been trading at a discount were called at par. General obligation (GO) bonds and utilities credits also lagged the performance of the general municipal market for this period. While all of the Arizona Funds were overweight in GO and other tax supported bonds, NAZ had the smallest allocation of these bonds, which lessened the impact of these holdings.

APPROVED FUND REORGANIZATIONS

On April 18, 2012, the Funds' Board of Directors/Trustees approved a series of reorganizations for all the Arizona Funds included in this report. The reorganizations are intended to create a single larger state Fund, which would potentially offer shareholders the following benefits:

- Lower Fund expense ratios (excluding the effects of leverage), as fixed costs are spread over a larger asset base;
- Enhanced secondary market trading, as larger Funds potentially make it easier for investors to buy and sell Fund shares;
- Lower per share trading costs through reduced bid/ask spreads due to a larger common share float; and
- Increased Fund flexibility in managing the structure and cost of leverage over time.

The approved reorganizations are as follows:

Acquired Funds	Symbol	Acquiring Fund	Symbol
• Nuveen Arizona Dividend Advantage Municipal Fund	NFZ		
• Nuveen Arizona Dividend Advantage Municipal Fund 2	NKR	Nuveen Arizona Premium Income Municipal Fund, Inc.	NAZ
• Nuveen Arizona Dividend Advantage Municipal Fund 3	NXE		