THE INTERVAL FUND RENAISSANCE: WHY SHOULD INVESTORS CARE?

When people think of traditional investment vehicles, they often think of mutual funds, ETFs, or private funds. But in recent years, a type of non-listed closed-end fund, known as the 'interval fund', has enjoyed a renaissance.

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THE RISE OF INTERVAL FUNDS

Given the difficulties of traditional investing right now—near peak equity market valuations while bond yields remain anchored near record lows—it's no surprise that investors are seeking to diversify their portfolios.

And while the hedge fund and 'liquid alt' industries have struggled in recent years, both in terms of performance and assets flows, interval funds have seen a resurgence of interest. According to Closed-End Fund Advisors, for instance, assets in interval funds nearly quadrupled from $7.8 billion in 2015 to $31.1 billion (as of 9/30/2019).

At the same time, there were more interval funds launched in the last three years (2017-2019) than in the preceding 10 years (2006-2016), as major alternatives managers like Blackstone and Ares seek new ways to reach individual investors. Individual investors, meanwhile, have shifted much of their traditional asset allocations to passive vehicles, freeing up more time and money to invest in these sophisticated alternative strategies.

Moreover, interval funds are becoming particularly appealing as investor demand for private and uncorrelated assets grows. Interval fund portfolio managers invest in a wide range of less liquid assets with higher return potential.

That means the popularity of such vehicles is only expected to continue growing. As Matt Forstenhausler, retired partner at EY, recently remarked: 'Interval funds are experiencing a rightful rebirth, and their popularity is expected to continue to increase.'

NOT YOUR AVERAGE FUND

But what are interval funds, really? While technically classified as a closed-end fund (CEF), the interval fund name is a bit of a misnomer because interval funds share several mutual fund features, including a continuous offering of shares and purchase/ redemption of shares directly with the fund. SEC rules classify any registered fund that does not offer daily redemptions as a CEF, and that's true for interval funds. Interval funds have limited liquidity features, typically quarterly tenders, and their shares do not trade on an exchange. In the past, interval fund sales were often limited to sophisticated institutional and high-net-worth investors. But more recently, investors of all stripes have been waking up to the benefits of these types of funds.

To provide limited liquidity, an interval fund allows

shareholders to sell a portion of their shares back to the fund on a periodic basis at a price based on net asset value. Such opportunities for repurchases take place at certain 'intervals,' which typically occur every three, six or 12 months. Legally, repurchases can range from 5% to a maximum of 25% of the total assets within the fund per repurchase period.

Like other CEFs, these vehicles can house a spectrum of investment strategies, including many that individual investors may find hard to access, such as real estate, structured credit, distressed debt, specialty finance, catastrophe bonds and special situations. Unlike mutual funds, interval funds may invest solely in illiquid assets. Their managers often allocate some fraction of fund assets to more liquid securities, however, due to the periodic liquidity requirements for interval funds.

In addition, interval funds have unique attributes which cannot be replicated by mutual funds, ETFs or limited partnerships. While they combine elements of mutual funds and listed CEFs, they also have a number of distinguishing features.

WHY SHOULD INVESTORS CARE?

Given their distinctive structure, interval funds provide a unique set of benefits for investors. The primary benefit—and the reason for interval funds' growing popularity—is that they offer a way for individuals to invest in a broader set of alternative investment strategies that can provide enhanced returns and historically low correlation to traditional asset classes. For instance, returns on interval funds are often significantly higher than mutual funds, and the illiquid, long-term structure of interval funds helps restrict the 'buy high/sell low' panicked behavior of many investors.

Interval funds are an attractive addition for investors with longer investment horizons, higher risk tolerance and fewer liquidity needs. Savers and more sophisticated investors that are looking to diversify stock and bond portfolios may consider interval funds. And while fees run high in comparison to passive ETFs—gross expense ratios can range from anywhere between 1.5 to 5%—many advisors believe that these actively managed interval funds are definitely worth the cost.

Despite the growth of interval funds in the RIA channel, large broker-dealer firms have been hesitant to add interval funds to their product platforms. Gatekeepers appear bound to outmoded criteria and are evaluating interval funds using mutual fund track record and minimum asset thresholds that may not be applicable to interval funds.

In the mutual fund marketplace, new funds are typically added to a platform only if they have a 3-year Morningstar rating and $100 million or more in assets. In contrast, most interval funds are relatively new, without the requisite 3-year track records, and have less than $100 million in assets. The typical portfolio manager of an interval fund, however, is an experienced alternative investment manager with a long track record managing private funds.

If old standards for mutual funds are applied to interval funds, clients may miss out on high-alpha investment opportunities in the interval fund category.

To learn more about interval funds, please contact XA Investments or your financial advisor.

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