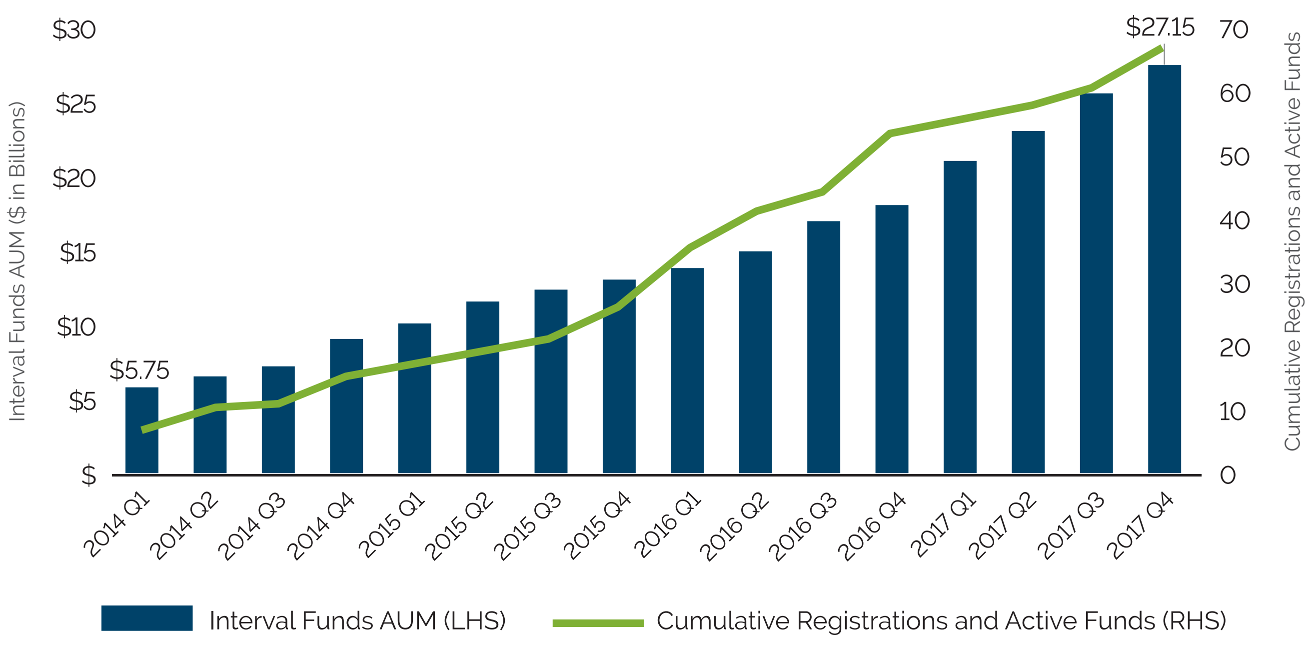
Interval Funds

What Investors Need to Know

The complexities of today's investing environment require investors and their advisors to be increasingly thoughtful about how they construct portfolios. For decades, large institutional investors have been utilizing investment strategies, such as private equity, private real estate, and hedge funds. However, many smaller institutions, advisors, and retail investors have been unable to adopt these investment strategies due to applicable investor qualifications. The interval fund may be part of a solution — allowing broad access to asset classes that may reduce volatility and enhance returns.

The potential benefits of the interval fund structure have been noticed as assets under management and the number of products have seen a large increase in the past five years. Several notable investment managers, such as BlackRock, Blackstone, and PIMCO, have recently launched interval fund products. As of December 31, 2017, there are 43 interval funds with $27 billion in assets under management. Additionally, there are 23 interval funds pending registration with the SEC.

Interval Fund Growth ($ in Billions)



Source: Interval Fund Tracker, Company Filings

There is a lack of succinct information available to investors looking to learn more about this increasingly popular investment product. This paper seeks to inform about the suitability of interval funds for less liquid investments, compare interval funds to open-end and closed-end funds, as well as identify the key features of an interval fund and why these features may appeal to investors.

A better product structure?

The investment marketplace has historically been an uneven playing field. Institutional investors have had access to more and different investment opportunities compared to the limited options available to the broader investing universe. Many investors have viewed the "alternative investments" space as too costly in terms of fees, too illiquid in terms of underlying sub-sectors, and generally inaccessible due to high investment minimums and investor qualifications. Even smaller foundations, endowments, and municipal pension accounts have been precluded from many institutional investments by the applicable investor qualifications. However, the emergence of interval funds may provide entry points these previously precluded investors have been seeking to additional investment strategies, such as debt, energy infrastructure, private equity commercial real estate, and others by addressing the concerns of cost, liquidity, and investment minimums.

What is an Interval Fund?

Interval funds are classified as registered closed-end funds under the Investment Company Act of 1940, although interval funds have characteristics more similar to those of an open-end mutual fund. Interval funds offer their shares continuously and shares are redeemed at Net Asset Value (NAV) — similar to an open-end mutual fund. However, unlike an open-end mutual fund, shares of an interval fund are not available for redemption on a daily basis. Instead, redemptions are only available through the interval fund's repurchase program — a program that is offered at a specified interval (e.g. quarterly, semi-annually, or annually) and for only a percentage of the interval fund's shares. The staggered structure of share repurchases enables interval funds to access sub-sectors of certain asset classes that are too illiquid for open-end funds, which must accommodate daily redemptions.

The redemption process for interval funds differs from both open-end and closed-end funds. It is notable that interval fund redemptions are priced at the NAV on the closing date of the repurchase period. This date may be days or weeks from the date on which an investor submits a redemption request. Closed-end funds trade on the secondary market, which means the price of the fund will typically be at a premium or discount to the fund's NAV. Open-end funds are redeemed in a manner similar to interval funds, but redemptions are processed on a daily basis. When an investor is redeeming shares of an open-end fund, shares will be redeemed at the end-of-day published NAV.

A comparison of key characteristics of open-end mutual funds, closed-end funds, and interval funds are shown in the table below:

	Interval Fund	Open-End Mutual Fund	Closed-End Fund
Access to illiquid investments	✓	Up to 15%	✓
Direct offering of shares by fund at Net Asset Value (NAV)	✓	✓	IPO, then traded on a stock exchange
Ability to continually offer shares	✓	✓	No
Direct redemption (repurchase) at NAV	At specific intervals (e.g. quarterly, semi-annually, annually)	Daily	No. Shares sold at market price in the secondary market (may be a premium or discount to NAV)

What are the key features of an Interval Fund?

Liquidity — Interval funds do not provide daily liquidity. Rather, the interval fund will make repurchase offers at NAV at a specified interval determined by fund (e.g., quarterly, semi-annually, or annually) pursuant to Rule 23c-3 under the 1940 Act and disclosed in its prospectus. The amount of shares that an interval fund commits to repurchase at each periodic interval must be between 5% and 25% of the interval fund's outstanding shares, which establishes a cap on how much of the fund can be redeemed in any given interval.

Transparency — Interval funds publish an NAV on a daily basis after market close, similar to an open-end fund. Interval funds are also required to disclose holdings to investors on a quarterly basis.

Continuous — Interval fund shares are offered on a continuous basis to investors whereas other closed-end funds are offered through a one-time IPO.

Efficiency — Interval funds are generally available to all investors – not just accredited investors or qualified purchasers – at relatively low investment minimums and potentially at a reduced cost compared to hedge funds and private equity funds.

Reporting — Investors receive a 1099, which many taxable investors prefer over K-1 tax reporting. As with all mutual funds, interval funds are subject to the reporting and audit requirements of the 1940 Act.

Governance — Interval funds are managed by a board of trustees, a majority of the members of which are independent from the fund's investment advisor.

Other 1940 Act Requirements — Interval funds are registered as investment companies with the SEC under the 1940 Act, which establishes a host of legal and procedural requirements.

Why is an Interval Fund appealing for investors?

The interval fund structure provides the investment manager flexibility to invest in less liquid segments of certain sectors, such as commercial real estate, private equity, energy, reinsurance, and distressed debt, without the liquidity mismatch that results from having to satisfy daily redemption requests. These less liquid investments have generally provided higher yields and lower volatility compared to their publicly traded counterparts.

Staggered and delayed redemption may provide other benefits to an interval fund investor. One benefit is that it may promote more prudent long-term investor behavior. Investors often react to market turbulence by liquidating positions at inopportune times. An interval fund investor who wants to redeem does so on the repurchase dates established in advance by the interval fund and in accordance with the amounts offered to be repurchased by the interval fund. As a result, interval fund investors may be more likely to ride out the volatility of a turbulent market and possibly achieve a better result over the long-term. Additionally, the staggered and delayed redemption process may protect shareholders that remain invested in an interval fund during times of severe market turbulence. In the case of an open-end fund, heightened investor redemption demands during a time of price depression may require a fund manager to liquidate portfolio investments, which could intensify the price depression of the fund even further and to the disadvantage of remaining shareholders. The interval fund's staggered and delayed redemptions according to an established schedule may protect investors from the "run on the bank" scenario.

Final Thoughts

An interval fund offers a versatile tool for many investor portfolios. However, given the potential illiquidity of their underlying holdings and other operational considerations, understanding the benefits and drawbacks of each investment strategy as well as the product wrapper is key for advisors and potential investors considering interval funds.

Interval funds can be viewed as a hybrid between open-end mutual funds and closed-fund end funds; however, it is the quarterly, semi-annual, or annual redemption periods at NAV that separates an interval fund from its counterparts. Staggered and delayed redemptions may not be suitable for all investors, but the redemption process is also the factor that enables interval funds to access less liquid sub-sectors in a fee-conscious manner. Interval funds are capable of granting more investors access to less liquid investments, which can aid an investment portfolio by potentially reducing volatility and increasing yield.

ABOUT THE AUTHOR

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Mr. Grugeon serves as the Chief Executive Officer of the Adviser, a position he has held since inception of the Adviser. Mr. Grugeon has over forty years of experience in various aspects of the investment management industry including developing and managing investment products, marketing, distribution, trading, relationship management, and overseeing operations. Previously, Mr. Grugeon served as Chief Operating Officer at Nationwide Investment Management Group where he was responsible for the oversight of all management aspects of the Nationwide Funds, a $60 billion mutual fund family. Prior to his fifteen year employment at Nationwide, Mr. Grugeon served as Chief Executive Officer at two other financial services firms, Aris Corporation of America, and Chesapeake Financial Group.

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