INVESTMENTS & WEALTH MONITOR

A reprinted article from July/August 2020

INTERVAL FUNDS

Addressing the Needs of High-Net-Worth Investors

By Patrick Newcomb

INVESTMENTS & WEALTH INSTITUTE®

INTERVAL FUNDS

Addressing the Needs of High-Net-Worth Investors

By Patrick Newcomb

Long seen as a niche investment vehicle primarily for institutions and high-net-worth investors, unlisted closed-end funds (CEFs) are gaining attention as a way to offer less-liquid asset classes to retail investors. Interest in unlisted CEFs is likely to expand now that a new wave of products is joining the market. The road to widespread adoption, however, will require overcoming obstacles that have limited their appeal in the past.

Historically, unlisted CEFs have allowed investment providers to offer investment strategies without the daily liquidity requirements of open-end mutual funds or the strict investor requirements of asset classes such as private equity.

Unlisted CEFs differ in several respects from their listed closed-end counterparts, as well as from open-end mutual funds on one side of the liquidity spectrum and alterative asset classes, in this case private equity, on the other (see table 1).

Unlisted CEFs specifically refer to closed-end portfolios that do not trade

Table 1

COMPARISON OF UNLISTED CLOSED-END FUNDS WITH OTHER INVESTMENT VEHICLES

Attributes	Open-end mutual funds	Unlisted Closed-end Funds: Interval funds	Unlisted Closed-end Funds: Tender offer funds	Closed-end funds	Private equity
Offering	Continuous	Continuous	Continuous	Initial public offering or secondary market	Direct investment or through pooled vehicle
Liquidity	Daily liquidity	Fund commits to periodic repurchases as outlined in its prospectus, at three-, six-, or 12-month intervals	Fund conducts periodic repurchases at the discretion of its board	Only on the secondary market	Lock-up period of at least five years, with limited opportunity for resale in the secondary market
Repurchase Range	No range	Not less than 5 percent of assets and not more than 25 percent	Not less than 5 percent of assets and not more than 25 percent	N/A	N/A
Fees & Expenses	Average expense ratios: Active equity – 0.76 percent, Active bond – 0.55 percent*	Average net expense ratio of 2.95 percent; also may charge 2 percent of repurchase proceeds	Average net expense ratio of about 5 percent; also may charge a performance fee if all investors are qualified clients	Net expense ratios typically from 1 percent to 2 percent, as well as commission costs	2 percent of committed capital and 20 percent of profits
Regulation	Investment Company Act of 1940	Investment Company Act of 1940 Rule 25c-3	Securities and Exchange Act of 1934 Rule 13e-4	Investment Company Act of 1940	Dodd-Frank Wall Street Reform and Consumer Protection Act
Investor Availability	All investors	Some funds are available to institutions and accredited investors only	Most funds are available to institutions and accredited investors only	All investors	Institutions and accredited investors only
Investment Minimums	No set minimums	Many available at $1,000 or $2,500	Generally $25,000 or $50,000	No set minimums	Can be as low as $250,000, but usually about $25 million
Net Asset Value Calculation	Daily	Daily/Weekly	Monthly/Quarterly	Daily	N/A

**Investment Company Fact Book 2019*

Source: FUSE Research Network

on an exchange and are continuously offered. They include two types of products: interval funds and tender offer funds. The main distinction between the two is that interval funds must adhere to a defined repurchase schedule, as stated in the fund's prospectus; tender offer funds are allowed more discretion in terms of when to initiate repurchases.

Tender offer funds originated in the late 1980s as a way to offer illiquid debt securities to more investors, and in 1991 they were followed by the first equity tender offer fund.[1] The tender offer structure is advantageous when sponsors want to continuously offer their funds but don't wish to be subjected to liquidity requirements and ongoing asset fluctuations, because they engage in repurchases at net asset value only when the board of directors deems it in the best interests of the fund and its shareholders. In other words, tender offer funds enjoy some of the benefits of both open-end and closed-end funds. Additionally, tender offer funds are permitted to charge a performance fee when they are offered to qualified clients exclusively (i.e., those who will invest $1 million or more with the investment advisor and have a net worth of at least $2.1 million).

Although the introduction of tender offer funds filled a void between open- and closed-end funds for sponsors looking to bring less-liquid investment strategies to market, the structure didn't necessarily address the inaccessibility of these strategies to Main Street investors. Therefore, in 1992, the Securities and Exchange Commission (SEC) undertook a study to explore how the industry could bridge the divide. Following completion of the 500-plus page report, "Protecting Investors: A Half Century of Investment Company Regulation," the SEC adopted Rule 23c-3 of the Investment Company Act of 1940, creating the interval fund structure.[2] Under this structure, sponsors offer periodic liquidity through repurchases at three-, six-, or 12-month intervals. In addition to increased liquidity relative to private investments and tender offer funds, interval funds also are available at lower investment minimums, starting at $1,000 for non-qualified investors.

Although the new interval fund structure seemed like an innovative solution to an important marketplace need, interval funds gained little traction during the first 20 years of their existence. Instead, the investment world grew increasingly bifurcated between retail investors, for whom open-end mutual funds became the primary investment vehicle, and institutions and high-net-worth investors, among whom private equity and other illiquid asset class investments grew exponentially. Simultaneously, the volume of publicly available stocks for investment through open-end mutual funds diminished. According to an SSgA report, "Boom in Private Markets is No Private Matter: Role of PE in a Changing World," the number of public companies declined from 8,090 in 1996 to 4,397 in 2018 as a result of fewer new companies going public and existing public companies delisting. Meanwhile, since 2000, the market capitalization of global listed public equity increased about 2.5 times, and assets under management in private equity grew six times.[3]

This widening opportunity gap between retail investors and institutions and high-net-worth investors has renewed the focus on unlisted closed-end funds, particularly interval funds, as a vehicle that can help broaden investment exposures for retail investors. This, in turn, has led to a surge in interval fund product development and an uptick in asset growth. Interval fund assets grew from $6.6 billion at year-end 2014 to more than $34 billion at year-end 2019 (see figure 1). Some of this growth likely has been at the expense of tender offer funds, which declined from an 80-percent share in 2014 to a 48-percent share in 2019.

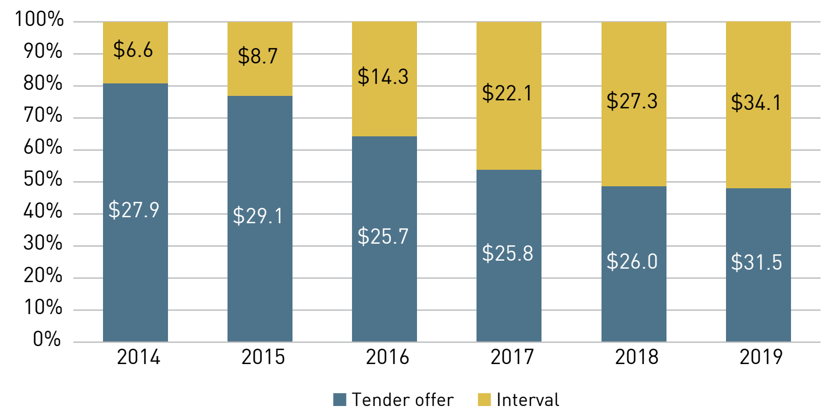
REGULATORY CONVERGENCE

The recent acceleration in interval fund product development and assets can be attributed partly to a convergence in regulatory priorities. First, adoption of SEC Rule 22e-4 (i.e., the liquidity rule) makes open-end mutual funds even less conducive as a vehicle for illiquid securities. The rule maintains the 15-percent limit on the level of illiquid securities a mutual fund may hold, but it requires more robust and systematic risk management processes for ensuring sufficient liquidity.

A prime impetus behind the rule was the collapse of the Third Avenue Focused Credit Fund in 2015. The fund abruptly announced it was closing and that remaining assets would be placed in a liquidating trust and distributed to shareholders as income was received and assets were sold—a process that took

Figure 1

GROWTH OF TENDER OFFER AND INTERVAL FUNDS, 2014–2019 (IN $ BILLIONS)



Source: Fuse Research Network

about a year. Third Avenue Focused Credit was unable to follow the usual protocol of providing advance notice and allowing investors to redeem their investments up to the liquidation date because it had invested heavily in illiquid bonds. When performance deteriorated and shareholders began to redeem, managers had to sell the bonds at deep discounts.[4] Although the circumstances surrounding the fund's collapse (i.e., a highly concentrated fund with a significant portion in illiquid low-quality bonds) were unique among mutual funds, the incident compelled the SEC to undertake an extensive review of how mutual funds manage liquidity risk before it developed the detailed compliance requirements mandated by Rule 22e-4.

The collapse of Third Avenue Focused Credit Fund and the extensive regulatory review that followed underscore the importance of daily liquidity for mutual funds. The SEC worked to shore up the liquidity risk-management procedures of open-end mutual funds and also recognized the need to provide retail investors with greater access to less-liquid investment strategies for the purpose of diversifying market risk. Toward this end, in mid-2019, the SEC issued a concept release and sought comment on "ways to simplify, harmonize, and improve the exempt offering framework to expand investment opportunities while maintaining appropriate investor protections and to promote capital formation."[5] Among the questions posed in the release was whether: "Retail investors should be allowed greater exposure to growth-stage companies through pooled investment funds such as interval funds or other closed-end funds?"

The concept release elicited many comments and several perspectives from across the industry. Regarding interval funds, BlackRock wrote:

> *… easing restrictions on interval funds would promote increased formation of such funds, enabling additional investment in smaller issuers and startup companies. We believe that more flexible provisions, including allowing an interval fund to determine for itself the length of its periodic interval, would provide the flexibility for such funds to invest in those issuers who may be public but have thinly traded shares, or private companies with limited or no liquidity.*[6]

The Investment Company Institute (ICI) responded:

> *[interval funds] are optimal vehicles for retail investors to gain exposure to exempt offerings … therefore, consistent with the Treasury Department's recommendations,*[7] *the SEC should amend its rules to allow interval funds and tender offer funds more flexibility to invest in exempt offerings. Doing so would allow them to tailor products to shareholder preferences and reduce fund shareholder expenses. We recommend that the Commission permit interval funds to:*
>
> - *Use flexible intervals from at least one month to up to one year;*
> - *Eliminate maximum repurchase amounts;*
> - *Conduct more frequent discretionary repurchases;*
> - *Modify the elements of a repurchase policy that must be deemed "fundamental;" and*
> - *Employ a more efficient notification system.*[8]

Taken as a whole, ICI's comments suggest increasing the liquidity of interval funds by allowing for shorter intervals (e.g., one month) and removing the cap on the level of assets that can be repurchased—actions that have the potential to make distributors and advisors more amenable to offering interval funds to their retail clients.

The SEC is now contemplating whether interval funds are an appropriate vehicle to bring less-liquid asset classes to investors en masse, but this is only the latest example of the regulator's attempt to make alternative investments more accessible to the marketplace.

In 2017, the SEC approved a new vehicle known as the auction fund. Although auction funds are technically closed-end funds that, like tender offer and interval funds, are continuously offered, in practice they are more akin to exchange-traded funds. Auction funds are traded on the Nasdaq Private Market platform through auctions that typically are held monthly. To facilitate the process, a group of institutions known as Secondary Liquidity Providers (SLPs), which are obligated to participate, as well as other interested institutions submit bids throughout the month. This allows investors to gain a sense of pricing. At the end of the month, all trades are consolidated and executed at a single clearing price. The required participation of SLPs, along with interest from other types of institutions such as insurance companies and arbitrageurs, helps to ensure that the funds trade near net asset value; however, in instances where that is not the case, investors can instead choose to tender their shares. Unlike interval funds, auction funds are available only to accredited investors, but for financial advisors seeking greater access to less-liquid asset classes for their high-net-worth clients, auction funds offer another option.

OVERCOMING OBJECTIONS

Expanding investor use of interval funds will not occur without buy-in from distributor home offices, and on that front, there is still a lot of progress to be made. In late 2017, FUSE Research Network conducted interviews with executives of eight distribution firms, including wirehouses, regionals, and brokerage platforms, on their views toward interval funds as well as the use of alternative strategies in general. It is important to note that at the time of the interviews, the market was continuing its long ascent and several executives described it as a low point for illiquid product demand. In terms of the prevalence of interval funds on distribution platforms, about half of interviewed executives said their firms made interval funds available to any extent and the other half didn't offer them at all. Among those that did include them, the number was minimal. Also, they did not recommend any specific products but rather made them available only through brokerage platforms and to registered investment advisors.

We also wanted to gauge distributor interest in adding interval funds to model portfolios as a way to incorporate less-correlated asset classes. Although executives expressed significant interest in improving diversification through the use of additional asset classes, such as private equity, there was notable concern about the lack of daily liquidity and the ability to rebalance as necessary. That said, some envisioned a future in which interval funds are included in models, suggesting that a sufficient increase in demand would compel firms to overcome the technological and operational challenges that currently make it very difficult to use these funds in models.

This led to the question of how much demand there is among advisors for alternative investment strategies in general. Most described advisor demand as very limited but indicated that, at the firm level, they felt exposure to alternatives was too low and implied that increasing levels would require a top-down push from the home office. However, despite the desire to increase alternatives exposure, distributors were still apprehensive about interval funds, with two chief concerns emerging from their comments. The first, as noted, was the lack of daily liquidity; and the second was the need for advisor education.

A few also mentioned the technological and operational complexities of using interval funds, and others referenced fees, suggesting that the higher fees of interval funds could be an issue given the ongoing pressure to reduce fees in the mutual fund market. These interviews, taken as a whole, didn't suggest a ringing endorsement of interval funds. But perhaps the most succinct comment describing the perspective at the time was the following: "The door into these strategies is larger than the door out."

Though demand for interval funds among distributors can best be described as tepid, product development at asset managers has been robust in recent years. The appeal for asset managers is obvious: Interval funds are higher margin products than mutual funds, which makes them attractive given that passive products continue to encroach upon active mutual fund share. However, the industry seems to understand that overcoming distributor concerns about interval funds will require more than just flooding the market with product. Also, it appears that a coordinated effort is taking place behind the scenes to address the objections of distributors and make interval funds a more viable option for use among advisors and in models.

In 2018, ICI formed the Interval Fund Task Force, comprising fund companies offering interval funds, intermediaries, and service providers as well as the Depository Trust & Clearing Corporation (DTCC), to improve interval fund operational efficiencies and reduce operating risk. To address complexities and inefficiencies in the interval fund market, the task force has undertaken an extensive review of how interval funds are purchased and how repurchase transactions are processed.

Interval funds are offered one of two ways: through a trading network, such as

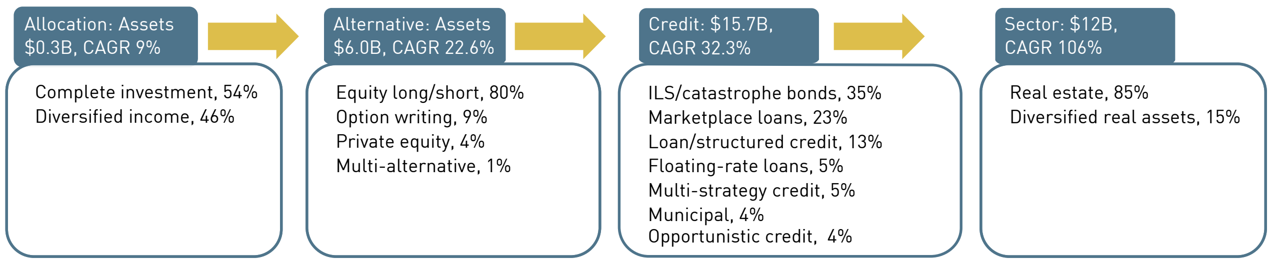
ICI INTERVAL FUND TASK FORCE OBJECTIVES

1. Work toward an appropriate infrastructure to support efficient interval fund shareholder account setup and maintenance as well as trading, clearance, and settlement—and promote development and adoption. Neither AIP nor Fund/SERV completely supports the trading requirements of interval funds, and they are not cross-compatible. Among the recommendations to improve operating efficiency is to further develop the Mutual Fund Profile Service II–Security Issue Database and the Mutual Fund Information Xchange currently used by open-end mutual funds to improve communication and scheduling of interval fund events.
2. Explore developing standard recommended practices regarding common interval fund activities. Areas to consider include how repurchase dates are selected, the frequency and types of communication schedules and methodologies, trade correction policies, approaches to processing dividends, and share class conversions.
3. Improve investor and advisor education about interval funds. Included among the areas in which greater education is needed are the risks of investing in products with illiquid securities and the complexities of interval fund transaction processing.
4. Strive to mitigate current communication pain points. Participants in the interval fund transaction need to evaluate their communication methods and processes around key events, such as when a repurchase requires proration. Discussing these processes and documenting potential operations practices will lead to smoother operational outcomes benefiting all participants.

Source: "Interval Funds: Operational Challenges and the Industry's Way Forward," Investment Company Institute (June 2019), https://www.ici.org/pdf/19_ppr_interval_funds.pdf.

Figure 2

DISTRIBUTION OF INTERVAL FUND ASSETS BY CATEGORY AND SUBCATEGORY



Source: FUSE Research Network

DTCC's Alternative Investments Product (AIP) platform and the Fund/SERV platform used for open-end mutual fund transactions, or through a "check and application" process.

The AIP platform, which debuted in 2008, allows intermediaries to submit and warehouse interval fund repurchase information prior to and throughout the repurchase period, which provides funds with greater transparency to plan for anticipated repurchase activity. A recent ICI survey of intermediaries, fund companies, and service providers indicated that about 40 percent utilize the AIP platform; however, only 10 percent use it exclusively. The task force also found that, over a 90-day period between November 2018 and January 2019, $18.6 million across 383 trades settled through the service. Today, trading and settlement are still manual; however, DTCC is working with broker-dealers, fund companies, administrators, and custodians to automate the process.

Meanwhile, nearly 90 percent use the Fund/SERV platform for interval fund processing, with half using it exclusively. For the 60-day period between December 2018 and January 2019, approximately $1.67 billion across 64,500 interval fund trades settled through Fund/SERV. Although Fund/SERV is an attractive option given the efficiency of its trading and recordkeeping technology, the platform never really developed its interval fund capabilities, meaning the process involves a lot of manual input, which introduces significant risk for all parties involved in the transaction. To compensate for the gaps in platform processing abilities, some participants also use portals or data transmission services, which may require additional technology infrastructures.[9] The Interval Fund Task Force's review of interval fund transaction processing revealed a number of potential pitfalls given the lack of an industry- wide systematic approach, which led the task force to present four objectives in order to improve the accessibility and efficiency of interval funds (see sidebar).

DISSECTING INTERVAL FUND GROWTH

As discussed, interval funds have registered strong growth over the past five years, increasing from $6.6 billion at year-end 2014 to $34 billion at year-end 2019 for a compound annual growth rate (CAGR) of 39 percent. This level of growth is impressive for any vehicle, and further evaluation provides greater insight into the types of strategies and providers into which assets are flowing.

Interval funds are divided into four categories: allocation, alternative, credit, and sector, each of which contains subcategories, as shown in figure 2. Credit funds remain the largest category, with $15.7 billion in assets. Both tender offer and interval funds began by making less-liquid fixed-income securities available to more investors. Since then, the selection of strategies has expanded significantly. With about a third of assets, insurance-linked securities (ILS) and catastrophe bonds are the largest credit subcategory. These securities have little to no correlation with the market because they are linked to risks such as natural disasters, thus offering improved portfolio diversification. However, multi-strategy credit funds have been the fastest-growing subcategory over the past few years. These funds can invest across private credit sectors with a goal of delivering alpha regardless of the market cycle.

The second largest and fastest-growing category contains sector interval funds, which have more than doubled in assets over the past few years. The sector category is dominated by real estate interval funds because it has proven to be a happy medium between public real estate investment trusts, which are restricted in the types of securities they can own, and private real estate funds, which offer a wider breadth of real estate investments but are available only to wealthy investors at high minimums.

With $6 billion in assets, the third-largest category is alternatives, which encompasses subcategories including equity long-short and private equity. Within the alternatives category, the majority of assets are still held by institutions and accredited assets. However, given the SEC's goal of making private investments more accessible to everyday investors, product development geared toward the retail market could begin to accelerate in the coming months. Like alternatives funds, allocation interval funds, the smallest of the four categories, also are reserved largely for institutions and accredited investors and frequently apply an endowment investment approach. That said, FUSE believes this category bears watching as the interval fund product structure further permeates the retail market.

Though new firms continue to enter the market, interval fund assets are highly concentrated among the largest providers. This, however, belies the level of opportunity still available in the marketplace for firms seeking to serve retail investors. The largest three firms, which together control more than half of interval fund assets, sell only to institutions and accredited investors (see table 2).

Moving down the list, however, recognizable mutual fund brands begin to appear, many of which make their interval fund products available at investment minimums of $1,000 or $2,500 for nonqualified accounts. For instance, PIMCO, which had no presence in the interval fund market a few years ago, has grown to become the sixth-largest provider. Its most recent launch, Flexible Municipal Income Fund, has accumulated $402 million in assets since debuting in March 2019. Among interval funds, Flexible Municipal Income's A-share is also on the less-expensive side, with an adjusted expense ratio of 1.99 percent and no repurchase fee. The firm has stated that registered investment advisors have been receptive to its interval funds, in part, because the firm sought their input in developing them.

Meanwhile, several other mainstream fund managers, including Lord Abbett, Principal, Franklin, Hartford, Loomis Sayles, and Goldman Sachs, which recently acquired the assets of the Resource Real Estate Diversified Income Fund, have entered the market or have funds in registration. Though most new entrants are coming to market with credit interval funds, Principal's first offering, Principal Diversified Select Real Assets Fund, provides exposure to the sector space through investments in real estate, infrastructure, and natural resources. The entrance of more brand-name fund managers into the interval funds market also bodes well for more-extensive advisor education efforts, because these firms work with their existing distribution partners to deliver programs that address the concerns of advisors and provide guidance about how to effectively incorporate interval funds into client portfolios.

Table 2

TOP-20 INTERVAL FUND MANAGERS

Manager	Category/ Sub-category	AUM ($ in millions)	Investor Restrictions	Minimum Investment Non-Qual/Qual
Stone Ridge Asset Management	Multiple	$8,602,450	Institutions	$10 million
Versus Capital	Real assets	$4,678,225	Institutions	$10 million
Silverbay Capital Management	Equity long/ short	$4,674,019	Accredited	$50,000
Griffin Capital	Multiple	$4,509,116	No	$2,500/$1,000
Bluerock Fund Advisor	Real assets	$2,271,908	No	$2,500/$1,000
PIMCO	Credit	$1,659,261	No	$2,500
Amundi Pioneer	ILS/ Catastrophe bonds	$816,341	Institutions/ Accredited	$1 million
Blackstone	Credit	$786,673	No	$10,000
Resource Real Estate	Real estate	$660,009	No	$2,500/$1,000
CION Ares Management	Credit	$568,802	No	$2,500/$1,000
Invesco	Loans/ Structured credit	$561,979	No	$1,000/$250
Cliffwater	Loans/ Structured credit	$537,072	No	$10,000
Variant Investments	Credit	$324,819	Accredited	$25,000
FS Investments	Multiple	$301,102	No	$2,500/$1,000
Voya	Loans/ Structured credit	$261,397	No	$1,000/$250
Tortoise Capital Advisors	Credit	$246,168	No	$2,500
PREDEX	Real estate	$224,610	No	$2,500
BlackRock	Credit	$211,433	No	$2,500
Destra Capital Advisors	Credit	$198,025	No	$2,500
SharesPost 100	Alternatives	$191,869	No	$2,500

Source: FUSE Research Network

CONCLUSION

Providers of unlisted closed-end funds, particularly interval funds, have been laying the groundwork over the past couple years to make a serious push into the retail market. Although significant progress is still needed to address the concerns of advisors and distributors, including those related to liquidity, operational complexities, and education, the path to broad acceptance could be accelerated by the recent market correction. The market's sharp decline with the onslaught of COVID-19 once again highlights the need for greater diversification in retail investor portfolios—a predicament that may result in interval fund demand meeting supply sooner than expected.

Patrick Newcomb is director of BenchMark Research for FUSE Research Network. He earned a BS in finance and marketing from Boston College. Contact him at pnewcomb@fuse-research.com.

ENDNOTES

1. "Interval and Tender Offer Closed-End Funds: Investment Company Alternatives to Traditional Funds," Chapman and Cutler LLP (March 2019), https://www.chapman.com/media/publication/917_Chapman_Interval_Tender_Offer_Closed-End_Funds_Investment_Companies_0319.pdf.
2. "Protecting Investors: A Half Century of Investment Company Regulation" (May 1992), https://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf.
3. "Boom in Private Markets is No Private Matter: Role of PE in a Changing World," State Street Global Advisors (October 2019), https://www.ssga.com/library-content/pdfs/official-institutions-/boom-in-private-markets-is-no-private-matter.pdf.
4. Jeffrey Ptak and Sarah Bush, "Third Avenue Focused Credit Abruptly Shuttered, " Morningstar (December 11, 2015), https://www.morningstar.com/articles/733021/third-avenue-focused-credit-abruptly-shuttered.
5. "SEC Seeks Public Comment on Ways to Harmonize Private Securities Offering Exemptions," Press Release 2019-97 (June 18, 2019), https://www.sec.gov/news/press-release/2019-97.
6. Comment Letter Re: Concept Release on Harmonization of Securities Offering Exemptions from Barbara Novick, Vice Chairman, and Joanne Medero, Managing Director, BlackRock, Inc. (September 24, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6193326-192493.pdf.
7. In October 2017, the U.S. Department of the Treasury submitted a report that recommended the SEC review its rules regarding interval funds to determine whether more flexible provisions might encourage the creation of registered closed-end funds that invest in offerings of smaller public companies and private companies whose shares have limited or no liquidity. "A Financial System That Creates Economic Opportunities: Capital Markets, https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.
8. Comment Letter Re: Concept Release on Harmonization of Securities Offering Exemptions from Susan M. Olsen, General Counsel, Investment Company Institute (September 24, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6190597-192465.pdf.
9. "Interval Funds: Operational Challenges and the Industry's Way Forward," Investment Company Institute (June 2019), https://www.ici.org/pdf/19_ppr_interval_funds.pdf.

CONTINUING EDUCATION

To take the CE quiz online, go to www.investmentsandwealth.org/IWMquiz

5619 DTC Parkway, Suite 500
Greenwood Village, CO 80111
Phone: +1 303-770-3377
Fax: +1 303-770-1812
www.investmentsandwealth.org