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INVESTING IN ALTERNATIVE CREDIT

Finding the Right Unlisted Vehicle

By Alfred Murata, PhD, JD, and Kevin Winters, CIMA®, CFP®

INVESTMENTS & WEALTH INSTITUTE®

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Faced with lower expected returns in the equity and fixed income markets, many investors are turning to alternative credit investments in search of diversification and higher risk-adjusted returns. Investors often allocate capital to private funds in order to gain exposure to the alternative credit universe. Increasingly, they also may invest in alternative credit through various vehicles that are registered under the Investment Company Act of 1940, but unlike some other registered funds, these vehicles do not trade on exchanges. Here, we discuss several types of these vehicles.

THE BASICS OF NON-TRADED REGISTERED VEHICLES

Vehicles that invest in alternatives are typically non-traded closed-end funds that aim to fill the gap between open-end mutual funds and private funds. For closed-end funds not listed on an exchange, investors typically buy and sell shares from the investment manager at the net asset value (NAV). As a result, investors in non-listed closed-end funds are not exposed to the trading premiums and discounts that can arise with some exchange-traded closed-end funds. Although exchange-traded closed-end funds in general can offer investors daily liquidity, they also can have more price volatility due to these premiums and discounts.

Unlisted funds typically have limited, defined redemption terms, and some have net worth or income requirements for investors. By limiting redemptions, unlisted vehicles can invest more easily in less-liquid securities—essentially, the structure of the offering is designed to align with the underlying alternative investments. Over the past several years, the asset managers that structure and manage these funds have become significant participants in less-liquid credit markets, stepping in as many banks and other financial institutions have pulled away due to stricter regulatory requirements.

Tax reporting for non-traded closed-end funds is an attractive feature for many investors. They generally issue a Form 1099 for taxes versus the more onerous Schedule K-1 typical of partnerships, including private equity and hedge funds.

We see a number of different unlisted structures offering exposure to alternatives today (as shown in table 1): interval funds, tender offer funds, non-traded

Table 1

KEY FEATURES OF UNLISTED FUND STRUCTURES

Categories	Interval Funds	Tender Offer Funds	Non-Traded REITs	Non-Traded BDCs
Liquidity	Repurchase offers required at specific intervals (quarterly, semi-annually, annually)	Tender offers at the discretion of the board	Possible discretionary repurchase offers—likely illiquid until fund's expiration	Typically discretionary repurchase offers
Regulatory leverage limits	33.3%	33.3%	Technically unlimited	2:1
Registration	1940 Act	1940 Act	1934 Act, 1933 Act	1940 Act
Who can invest	No limitations	Often limited to qualified clients ($2 million net worth)	$250,000 net worth or $70,000 annual income	Typically accredited investors
NAV frequency	At least weekly	At least monthly	Typically quarterly	At least quarterly
Performance fees	Yes, if limited to qualified clients	Yes, if limited to qualified clients	Yes	Yes
Liquid assets restriction	Must hold liquid assets from beginning of repurchase offer period to pricing date	No	No	No
Tax reporting	1099	1099	1099	1099

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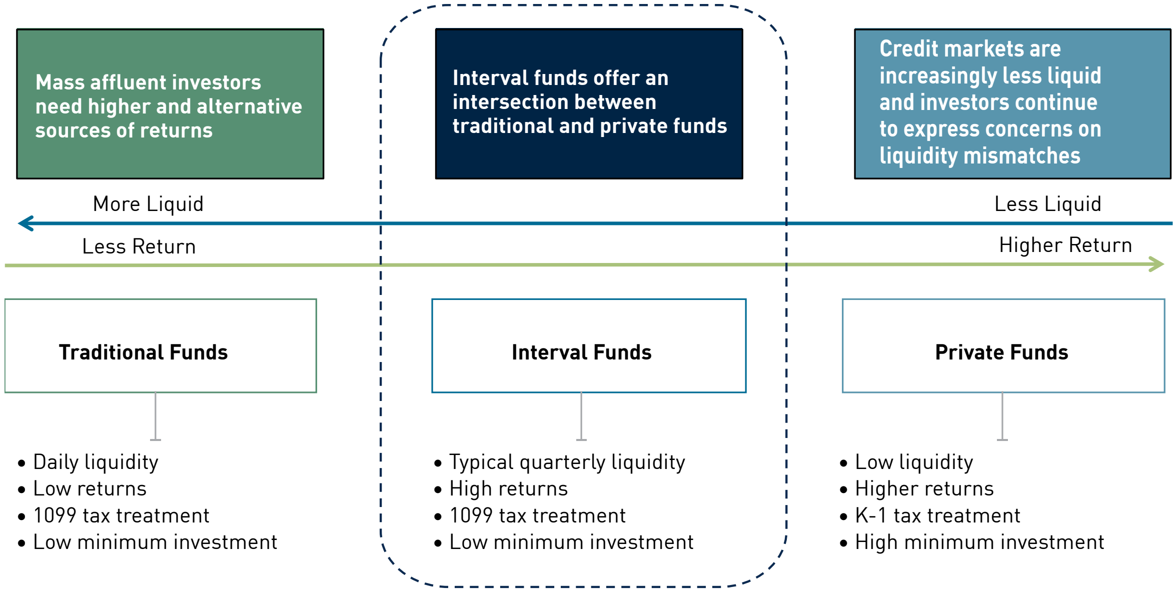
Figure 1

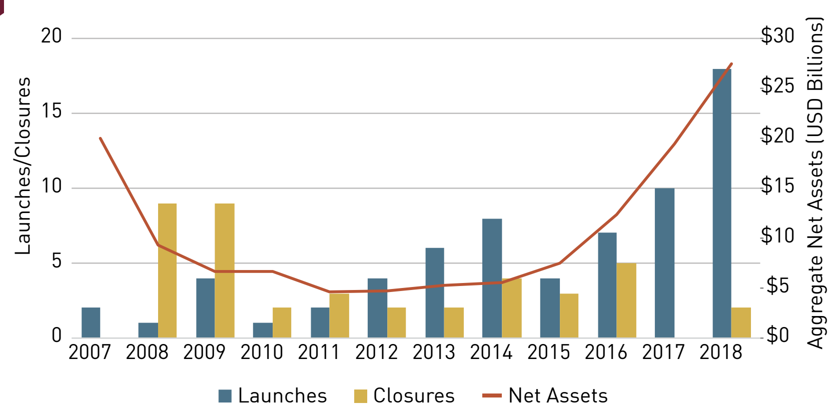
INTERVAL FUNDS: INTERSECTION BETWEEN TRADITIONAL AND PRIVATE FUNDS



Source: PIMCO. For illustrative purposes only.

Figure 2

INTERVAL FUNDS: 2007–2018



Source: Interval Fund Tracker as of December 31, 2018

real estate investment trusts (REITs), and non-traded business development companies (BDCs).

INTERVAL FUNDS

Interval funds are closed-end funds registered under the 1940 Act. They are designed to fill the gap between traditional, public open-end funds and private funds, with some features of each (see figure 1). Interval funds offer less liquidity to investors than open-end vehicles and therefore can invest in less-liquid assets and use leverage. Typically, a percentage of shares in interval funds can be redeemed quarterly, and they price daily at NAV.

Although interval funds and tender offer funds provide limited liquidity to investors by offering to repurchase a limited number of shares on a periodic basis, investors should consider these to be illiquid investments. There is no guarantee that an investor will be able to tender all or any of their requested shares in a periodic repurchase offer.

Among the key benefits of interval funds is that a typical affluent investor can gain exposure to more-complex and less-liquid alternative securities without having to meet specific wealth or income requirements and without having to lock up capital for several years. Interval funds typically repurchase 5 percent to 25 percent of outstanding shares every quarter, although percentages vary by asset manager and fund. Interval funds also offer operational ease: They typically have lower investment minimums than private equity funds and little to no subscription paperwork (depending on the custodian), in addition to 1099 tax reporting treatment.

Over the past several years, high-net-worth investors have flocked to interval funds (see figure 2), because the funds provide some liquidity, have the flexibility to invest across the public and private spheres, and typically pay income quarterly.

TENDER OFFER FUNDS

Tender offer funds, like interval funds, provide more flexibility to invest in illiquid investments than open-end mutual funds. They differ from interval funds in their liquidity profile, redemption process, and fund terms (see table 2).

Table 2

CHARACTERISTICS OF INTERVAL FUNDS, TENDER OFFER FUNDS, AND LISTED CLOSED-END FUNDS

	Unlisted Closed-End Funds		Listed Closed-End Funds
Categories	Interval Fund	Tender Offer Fund	Closed-End Fund
Liquidity	• Not traded on an exchange • Required to repurchase 5%–25% of shares at certain intervals	• Not traded on an exchange • Liquidity at board's discretion, but typically offers periodic liquidity through tender offers	Traded on an exchange—can be difficult to trade in size without moving price
Offering period	Typically continuously offered	Typically offered in initial raise-up	Typically offered in initial raise-up
Investor restrictions	No limitations on who can invest*	Often limited to accredited investors, qualified purchaser, and qualified clients**	No limitations on who can invest
Pricing frequency	NAV priced at least weekly	NAV priced at least monthly	NAV priced daily (shares often will trade at a premium or discount to NAV)
Liquid asset limits	Most hold SEC-defined liquid assets from beginning of repurchase offer period to pricing date	Not required to hold liquid assets	Not required to hold liquid assets
Term	Typically perpetual	Most recent launches have been term funds	Historically perpetual, but recent launches have been 5-, 7-, or 12-year terms

**Many distribution firms may require individuals to be accredited investors in order to access interval funds through their platform.*

***Accredited investor: annual income of $200,000 or net worth of $1 million; qualified purchaser: owns at least $5 million in investments; qualified client: net worth of $2 million*

Source: PIMCO. For illustrative purposes only. These terms are summary in nature and in no way complete. The basic descriptions provided herein are not meant to be all-inclusive.

Instead of a set repurchase schedule for investor redemptions, the liquidity in a tender offer fund is more subjective: The board of a tender offer fund decides when to provide liquidity and how much liquidity to provide. A fund can conduct a tender offer at any time to the extent authorized by the board (subject to tender offer fund rules under the 1940 Act). One advantage to this approach is that it negates the need to hold liquid assets to meet frequent redemptions.

Most tender offer funds are limited to accredited investors (those with $200,000 in annual income or $1 million in assets) or qualified purchasers (those with at least $5 million in investments), have set terms or maturities, and target specific assets for investment.

NON-TRADED REITS

Recently, we have seen a resurgence of non-traded REITs, seemingly with better investor alignment and more transparency than the structures utilized a decade ago.

Non-traded REITs have the flexibility to own real estate, originate real estate debt, and securitize real estate assets. They aim to generate attractive and consistent dividends, along with capital appreciation, and therefore may be suited to income-seeking investors looking for a complement to their traditional fixed income holdings. They also have leverage restraints and increasingly are moving toward quarterly versus annual liquidity terms.

Non-traded REITs typically focus on core and core-plus private commercial real estate, generally investing in high-quality assets with stable income profiles, including mortgage and real estate debt; they can be exposed to housing-related risks, including supply-demand pressures, vacancy levels, and cash-flow fluctuations.

Overall, we think the confluence of quality asset managers coming into the sector and the recent better alignment of fees and transparency should make these vehicles increasingly attractive for end investors.

BUSINESS DEVELOPMENT COMPANIES

Lastly, the non-traded BDC structure may be a solution for investors looking to capture opportunities in a growing segment within alternatives—lending to small and mid-sized companies.

The BDC structure was approved by Congress in the 1980s as a way to help U.S. businesses raise capital and create jobs. Following the global financial crisis in 2008–2009, tighter banking regulation has given rise to many BDCs that lend to below-investment-grade middle-market companies by selling equity and debt (senior and junior) instruments. These debt instruments are privately negotiated and are not traded freely, which usually makes the loans less liquid and limits their size. BDCs have gained popularity with investors recently in the overall low-yield environment.

Investors can choose between private and public BDCs. Privately held BDCs are not listed on an exchange and typically are available through broker-dealers and financial advisors, while publicly traded BDCs are permanent capital structures that trade daily on an exchange but can be subject to the higher price volatility often associated with exchange listings. Public BDCs reinvest proceeds on a continual basis and can trade at a discount or premium to book value. Of note, private BDCs typically have the option to convert to permanent capital vehicles through an initial public offering.

BDCs are pass-through structures, distributing 90 percent or more of ordinary income and short-term capital gains annually to shareholders. Investors usually need to be accredited.

FINDING THE BEST SOLUTION

Asset managers are looking continually for optimal solutions for the high-net-worth marketplace, and traditional private credit managers also are moving from institutional-only products to more client-friendly structures, making alternatives more accessible than ever.

With returns in the public markets expected to be lower in the future, we think investors that can give up some liquidity may want to consider unlisted alternative strategies to complement their broader asset allocations. In our view, having flexibility to invest across credit segments and avoiding short-term redemptions can help investors realize the attractive risk-adjusted return potential that alternatives can offer.

As affluent investors consider unlisted alternative strategies, they need to understand each offering's specific characteristics, including the legal structure, use of leverage, redemption process, asset manager history, and the fee structure. They also should be aware of the offering's likely correlation to the public markets. Finally, prudent management of the asset-liability match between the fund structure and its underlying alternative securities is key to making unlisted funds a potentially attractive solution for high-net-worth investors.

Alfred Murata, PhD, JD, is a managing director and portfolio manager in PIMCO's Newport Beach office. He earned a PhD in engineering-economic systems and operations research from Stanford University and a JD from Stanford Law School. Contact him at alfred.murata@pimco.com.

Kevin Winters, CIMA®, CFP®, is executive vice president, alternative credit strategist in PIMCO's Newport Beach office. He earned an undergraduate degree from the University of Colorado at Boulder. Contact him at kevin.winters@pimco.com.

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INVESTMENTS & WEALTH INSTITUTE®

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