Interval Funds: The Future of Alternatives

Alternative investments, such as hedge funds, have faced increasing scrutiny by investors as to whether their 2-and-20 fee structure is justified by the returns. Recent regulatory developments also require a reexamination of the suitability of alternative investments in an open-end fund. Among all vehicles that a fund manager can choose from, the interval fund structure may present unique advantages in offering alternative investment strategies to retail clients.

EVOLVING ALTERNATIVES MARKETPLACE IN RECENT YEARS

Prior to 2008, alternative strategies existed mostly in hedge funds and were primarily available only to institutional investors. Hedge fund managers typically charged a 2% management fee (regardless of the fund's performance) and a 20% performance fee for profits above a certain threshold. The fees were considered by many as overpriced and were famously challenged by Warren Buffett. Even if clients do not mind the high fees, they would still need to deal with K-1 tax forms and various liquidity restrictions such as a lockup period and an advance redemption notice. Furthermore, high-net-worth (HNW) investors might also find diversifying their alternative investment exposure difficult, due to the high minimum investment threshold of individual hedge funds. To resolve this issue, some investment firms created funds of hedge funds, or to pool HNW money into a feeder fund to feed into a hedge fund. Although well-intended, such arrangements lacked transparency and resulted in more fees. From a fund manager perspective, distribution could be a challenge – hedge funds could be sold only to accredited investors or qualified purchasers, and there were many restrictions on how a hedge fund can be marketed.

Although mutual funds have been the preferred investment vehicle for alternative investment managers to expand beyond their usual client base, there are other registered fund structures that may offer their own unique advantages. Among them, the interval fund is particularly appealing.

Following the 2007-2008 financial crisis, the appetite for alternative strategies surged after investors saw the S&P 500 Index's peak-to-trough drawdown of approximately 56%. Recognizing the above-mentioned drawbacks of a hedge fund structure, investment firms responded by creating so-called liquid alternative mutual funds and exchange-traded funds (ETFs) – collectively, "liquid alts" – with the promise to bring hedge fund strategies to all investors. Fueled by the ability of liquid alts to charge higher fees than traditional mutual funds, the development of these products boomed in recent years. The pitch was simple: diversification. Investors could not only add a sleeve of alternative exposure to a traditional portfolio of stocks and bonds, but they could also diversify among liquid alts, given the proliferation of various liquid alt strategies. As a result, liquid alts quickly attracted large amounts of assets. To put things into perspective, in 2008, just $44 billion was invested in liquid alts, while in 2016, assets had exploded to $321 billion[1].

LIQUIDITY RISK AND SEC LIQUIDITY RULE

The Securities and Exchange Commission (SEC) and investment industry veterans have long been cautious of mutual funds' ability to consistently meet client redemptions, especially during bouts of market volatility. The risk mainly stems from common characteristics of alternative investments, such as being more complex, hard to value, and less traded. While these are the same traits that afford the strategy the potential for higher returns, they may make it challenging for a fund to liquidate its holdings in seven days to meet client redemptions, as is required of a mutual fund.

In December 2015, the very public collapse and gating of the Third Avenue Focused Credit Fund, a distressed credit mutual fund, confirmed without doubt that to hold illiquid assets in a daily liquidity vehicle could be a formula for disaster when things deteriorate.

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[1]Source: Morningstar as of September 2016 includes Alternative and Commodity funds and ETFs.

Within weeks of the Third Avenue event, examiners at the SEC sent detailed requests to mutual funds and ETFs seeking information about how they priced less-liquid securities. Subsequently, the SEC finalized a liquidity rule in October 2016[2], which called for rigorous and systematic liquidity tests by open-end funds and ETFs. The rule specifically required funds to evaluate the suitability of investment strategies for the structure they were in, prompting managers to reexamine all fund structure options available for their respective investment strategies. Although mutual funds have been the preferred investment vehicle for alternative investment managers to expand beyond their usual client base, there are other registered fund structures that may offer their own unique advantages. Among them, the interval fund is particularly appealing.

WHAT IS AN INTERVAL FUND?

An interval fund is a continuously offered, closed-end fund registered under the 1940 Act. It offers to buy back shares at net asset value with a repurchase period of three, six or twelve months, while most interval funds do it quarterly. There is considerable variance in terms of the percentage of shares offered to be repurchased at each interval, which must be between 5% and 25% of the fund's NAV.

As its name indicates, an interval fund represents a cross between an open-end fund and a closed-end fund. Figure 1 below outlines a few major fund attributes among open-end funds, interval funds, closed-end funds, and hedge funds.

FIGURE 1: COMPARISON OF FUND STRUCTURES

		Mutual Fund			
	ETF	Open-end Fund	Interval Fund	Closed-end Fund	Hedge Fund
Accredited Investors/ Qualified Purchaser	No	No	No	No	Yes
How Many Investors Can Invest?	No limit	No limit	No limit	No limit	3(c)(1): 100 investors 3(c)(7): Unlimited qualified purchasers
Tax Treatment	1099	1099	1099	1099	K-1
1940 Act-Registered	Yes	Yes	Yes	Yes	No
Continuously Offered	Yes	Yes	Yes	No (one time through IPO)	Yes
Valuation	Intra-day Market	End-of-Day NAV	End-of-Day NAV	Intra-day Market	End-of-Month NAV
Performance Fee	No	No	No	No	Yes
Redemption	Intra-day	Daily	3, 6, or 12 months	No redemption rights but tradable on exchange	Periodic and flexible
Repurchase Cap	None	None	5-25%	None	None
Can Payment of Redemption Proceeds Be Delayed?	No	No	No	Yes	Yes
Illiquid Investments Restriction	15%	15%	75-95%*	No limit	No limit
SEC Liquidity Rule	Applicable	Applicable	Not applicable	Not applicable	Not applicable

*An interval fund is required to hold liquid assets equal to 100% of the amount of its repurchase offer to shareholders.

With liquidity being one of the major concerns among investors, the above comparison highlights some important structural advantages of an interval fund. For investors, it makes hedge fund strategies accessible without severe liquidity restrictions. For fund managers, the predetermined redemptions create discipline without constant liquidity pressure or the burden to comply with the SEC liquidity rule.

CURRENT INTERVAL FUND OFFERING

Although the interval fund structure was adopted by the SEC in 1993, the fund industry was slow in utilizing an interval fund structure, mainly because fund managers, distribution partners, and clients alike were unfamiliar with it. However, the number of interval funds launched in recent years increased significantly, as shown in Figure 2.

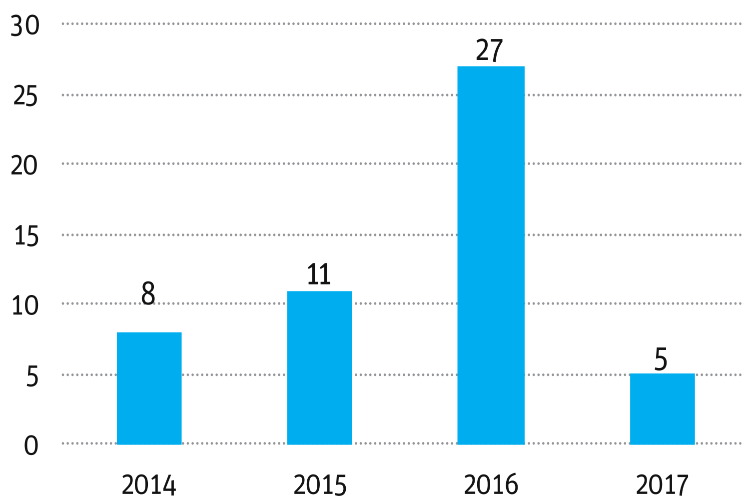
Based on an October report by the U.S. Treasury[3], there were 34 interval funds with about $12.1 billion in assets under management (AUM). Many major fund families – BlackRock, PIMCO, Invesco, Voya – now offer interval funds. While most

[2]https://www.sec.gov/rules/final/2016/33-10233.pdf
[3]U.S. Department of the Treasury: "A Financial System That Creates Economic Opportunities – Capital Markets," October 2017.

interval funds are targeting a fund cap of $1-2 billion, existing interval fund investment strategies vary greatly in size and strategy. Among the most popular strategies utilizing the interval fund structure are those related to credit, real estate, and insurance.

It is worth mentioning that the current low-yield environment has pushed investors to increasingly rely on higher-yielding credit when seeking better returns. Examples of these private credits include loans, esoteric credits, and distressed debts. Access to enhanced yields and quarterly liquidity make the interval fund structure ideal for private credit strategies. As a result, credit has been the fastest-growing segment among all interval fund strategies. The pipeline of funds in registration also indicates the continued rise of credit interval funds.

FIGURE 2: NEW INTERVAL FUND LAUNCHES



Source: Interval Fund Tracker as of September 2017

In the same report, the U.S. Treasury also recommended that the SEC review its interval fund rules 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. This signals to the marketplace that the regulatory environment could be increasingly favorable for interval funds in general, in addition to their immunity from the SEC liquidity rule.

Despite their recent growth, interval funds' AUM is still small, compared with total net assets of $262 billion in closed-end funds, $16.3 trillion in mutual funds, and $2.5 trillion in ETFs.[4] We believe there is still much room for this fund family to grow as both asset managers and investors continue to see the potential structural and regulatory benefits it may offer in managing less-liquid, but higher-yielding alternative strategies.

[4]Source: ICI Fact Book.

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Lu is the Chief Risk Officer at Angel Oak Capital where she oversees all risk management efforts for the firm. She chairs the firm's Risk Management Committee and Valuation Committee, as well as serves as the secretary of the Investment Committee and the secretary of the Angel Oak Funds Trust.

Lu has over 10 years of experience with both buy-side and sell-side firms. Prior to joining Angel Oak, she was a Finance Manager at Wells Fargo focusing on corporate-wide liquidity risk. Previously, she served as a Senior Research Analyst at Evergreen Investments, covering fund of hedge funds, managed futures, real estate, and commodity funds for a $5 billion alternative investment portfolio. Before Evergreen, Lu was a Vice President at Wachovia Securities, where she published white papers to provide Financial Advisors with investment recommendations on alternative investments. At Wachovia, she also worked as a Senior Credit Risk officer supporting the fixed income trading desk.

Lu holds a B.A. degree in Finance from Wuhan University and an M.B.A from the College of William and Mary, where she graduated with distinction, beta gamma sigma. She holds the Chartered Financial Analyst (CFA®), the Financial Risk Manager (FRM), and the Chartered Alternative Investment Analyst (CAIA) designation.

S&P 500 Total Return Index: An American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

Peak-to-Trough Drawdown: A fund's largest cumulative percentage decline in net asset value.

Diversification does not guarantee a profit or protect from loss in a declining market.

The Securities and Exchange Commission (SEC) does not approve or disapprove of any investment.

It is not possible to invest directly in an index.

Must be preceded or accompanied by a prospectus. To obtain an electronic copy of the prospectus, please visit www.angeloakcapital.com.

Mutual fund investing involves risk. Principal loss is possible.

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