INTERVAL FUNDS

The cash-back option

Some of private debt's largest players have found a way to offer retail investors limited liquidity through a traditionally illiquid credit platform. **Justin Slaughter** explains how

Interval funds – hybrids between hedge funds and closed-end debt funds which repurchase investor shares at regular intervals – are in vogue in the private credit world.

The US Securities and Exchange Commission has declared effective 38 active interval funds, which have amassed $16.12 billion in net assets between them as of 8 August, according to data collected by Interval Fund Tracker.

The main difference between these hybrid funds and a typical debt fund is that the interval fund manager periodically buys back investors' shares, which cannot be traded on a secondary market. Interval fund managers must allow investors the option to purchase 5-20 percent of the fund's equity at select intervals, usually quarterly or semi-annually, and they are required by law to price these shares at net asset value allowing investors more liquidity than your run-of-the-mill long-term debt fund.

The $16 billion in capital these funds currently have at their disposal may pale in comparison with amounts raised by traditional debt funds, given that the latter have collected $61.6 billion in the first six months of 2017 alone, according to *PDI* data. But nine interval funds launched last year alone, compared with none in 2015, despite the structure being around since the early 1990s. Moreover, 18 interval funds had registrations filed with the SEC waiting approval as of August – including some of private credit's biggest players like Blackstone GSO's Floating Rate Enhanced Income Fund.

Reisner: interval funds have wider scope than BDCs

WHERE'S THE CATCH?

Interval credit funds may be here to stay, but fund managers providing liquidity every quarter with a balance sheet stocked with illiquid investments makes things complicated. In February, a Morningstar analyst warned that "given the potential illiquidity of their underlying holdings, high fees and the complexity associated with the redemption process, interval funds should probably be thought of as niche investments, if they're thought of at all".

38

Active interval funds declared effective by the SEC, according to Interval Fund Tracker

18

Interval funds waiting for SEC approval as of August 2017

9

Interval fund launches in 2016

0

Interval fund launches a year earlier

But several firms that launched interval funds recently tell us that the unique share buy-back structure is popular because some non-institutional investors need such a feature to access alternative credit. These investors may not be able to access traditional, long-term closed-ended funds, either due to the return profiles or the locked-up capital structure.

Brook Taube, chief executive of Medley, which launched an interval credit fund last November, says the firm's Sierra Total Return Fund was designed to provide retail investors with access to private credit, while offering an appropriate amount of liquidity.

"Access to private credit can help satisfy investors' demand for yield," Taube adds. "The fact that the [interval] fund offers liquidity on a quarterly basis makes it an attractive structure for retail investors."

Like all the interval fund managers *PDI* spoke to, Medley has opted to buy back 5 percent liquidity of the Sierra fund on a quarterly basis. The fund invests in debt and equity securities, primarily focused on US and floating rate assets, while it is targeting a $1 billion fundraise and 7-8 percent returns. The fund has raised $2.1 million so far, according to Interval Fund Tracker.

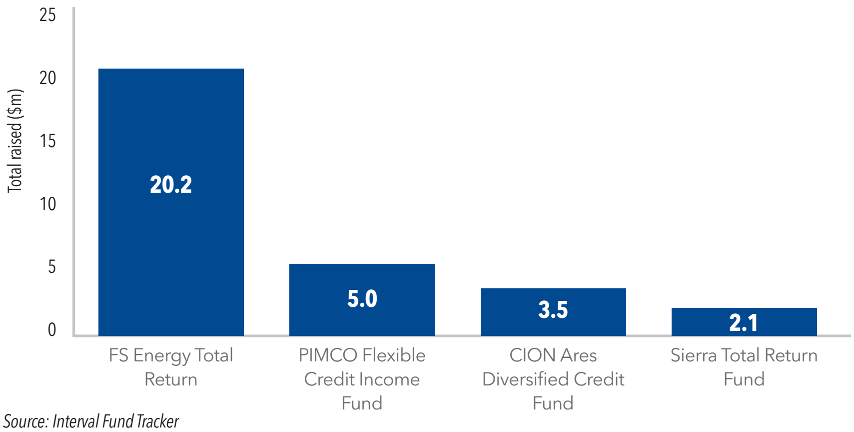
CION Investment Group teamed up with Ares to launch an interval credit fund last year. Michael Reisner, co-chairman and co-chief executive at CION, agrees with Taube that these funds allow retail investors access to new assets traditionally only available to institutional investors.

"With the redemption features, the interval funds are perfect for investment managers, which have traditionally focused on illiquid investments, to bring their products out to retail investors in a '40 Act wrapper," Reisner says, referring to the US Investment Company Act of 1940, which all interval funds have to register under, as do business development companies.

He adds that they allow fund managers to capitalise on more investment opportunities than BDCs. While investors "have flocked to BDCs over the years" because these firms provide access to US direct lending, which has realised higher returns than "on-the-run" investments, interval credit funds are also appealing direct-lending access points.

INTERVAL RUNNING

Capital raised by selected recently launched interval funds



Source: Interval Fund Tracker

FLEXIBILITY

However, BDCs are legally required to invest at least 70 percent of their assets in US mid-market companies; not the case with interval credit funds. Accordingly, Ares and CION have more flexibility to invest in direct lending in Europe or elsewhere than BDCs, Reisner says.

"If you look at BDCs as sector-specific products – eg, US mid-market – credit interval funds like ours are more diversified and a core holding, and should be the next evolution in credit products," he adds.

The CION Ares Diversified Credit Fund launched with a fundraising target of $1 billion, though Reisner wants the fund to be "in the market forever with the goal of raising multiple billions". The fund has raised $3.49 million so far, filing data show.

As the Morningstar report notes, interval funds typically charge high fees (or at least higher than mutual funds), most likely because interval fund managers are compensating for the quarterly redemptions.

Jason Mandinach, product strategist for PIMCO Investment Management's Flexible Credit Income Fund, which launched in February, says the fund's management fee is "at the higher end of the range due in part to the portfolio management and operational resources required to handle quarterly repurchases".

But he adds that the fee structure is generally consistent with PIMCO's other closed-end funds.

The PIMCO interval fund's management fee was equal to 1.3 percent of the fund's total assets, payable monthly, an SEC filing shows. The fund targets fixed and floating rate corporate loans, collateralised debt instruments and other forms of debt in the US and globally. The fund has raised $5.09 million to date.

By comparison, the Sierra Total Return Fund has set its management and incentive fees at an annual rate of 1.5 percent and 15 percent respectively, according to its prospectus. The CION Ares Diversified Credit Fund's target yield should be more favorable than liquid credit options because of its "higher yielding assets," Reisner says, which he believes justifies slightly higher fees. All three firms declined to comment on fund performance.

Mandinach also notes that interval funds differ from other closed-end funds in that they are not exchange traded, which means fund managers tend to have less of a focus on distribution yield and can have a greater focus on total return.

Despite the fee, many of these funds have low minimum investment thresholds, some as low as $1,000, according to Marc Yaklofsky, senior vice-president and spokesman at FS Investments. His firm launched its first interval credit fund last February – FS Energy Total Return – and has another one – FS Credit Income Fund – currently in registration with the SEC. The Energy Total Return fund has so far raised a total of $20.28 million.

Even though the interval fund structure has a shorter track record than mutual or closed-end debt funds, investors will continue to be attracted to them in order to access new asset classes with the investor protections of the 1940 Act, branching out from outmoded debt portfolio models.

"In a low growth and low interest rate environment, with equity fully valued or potentially over-valued, the traditional 60 percent equities and 40 percent bonds portfolio allocation is the BlackBerry of portfolio construction," Yaklofsky adds.

"It was once state of the art, but in this environment, it does not provide the returns people had grown accustomed to." ■